Credit derivatives, Netting and ISDA Documentation: Recent Developments in Australia

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1 Introduction

Derivatives are not new. However, the ways in which they are used is constantly changing and developing. The evolution of the credit derivatives market in relatively recent years is a classic case in point. The range of legal issues that arise in this context is dynamic and with each product nuance other issues arise. In time, many of these issues lead to changes in the standard industry documentation. However, because of the constantly evolving nature of the credit derivatives market, such documentation cannot always deal with each and every situation that may arise.

In a similar vein, although this is the fifth year anniversary of the Payment Systems and Netting Act (C'wth), the legislation that revolutionised the law on netting in Australia continues to raise new and interesting issues.

The theme of continual change is again evident in the registration requirements with respect to credit support given in relation to derivatives. There has been a recent amendment to the relevant provision in the Corporations Act and changes in the European Union may lead to further changes in Australia in the future.

New documentation

2002 ISDA Master Agreement

The changes and impact of the 2002 ISDA Master Agreement, which was released on 8 January 2003, have been discussed in other forums. The Australian Financial Markets Association has published updated commentary on the 2002 ISDA Master Agreement. As yet, the 2002 ISDA Master Agreement has not been widely adopted in the Australian market. However, it is likely to be a matter of time before it is widely adopted and used in both Australia and internationally.

2003 Credit Derivatives Definitions

The Definitions were published on 11 February 2003. It is interesting to note that the Definitions were supplemented in May this year, which was before their "official" commencement date of 30 June 2003. This illustrates how dynamic this market has been in recent times.

The Definitions can be used in confirmations of individual credit derivatives transactions under an ISDA Master Agreement. The Definitions expand and revise the 1999 Credit Derivatives Definitions (and the supplements to them).

2 Credit derivatives

2.1 What are credit derivatives?

A credit derivative is a product that isolates the credit risk of an asset or pool of assets, and transfers it from the "protection buyer" to the "protection seller".

Credit default swaps are the most common form of credit derivative product used in Australia today[44]. Under such a swap, protection against a credit event occurring is swapped for a series of regular payments until the credit event does occur or the expiry date is reached.

The credit events in a credit default swap are referenced to either an entity or a portfolio of entities. Such events usually include failure to pay by the reference entity, bankruptcy of the reference entity and adverse restructuring of the reference entity's debts. The protection buyer could (but need not) have a credit exposure to such entity or entities.

Credit default swaps may be physically settled or cash settled. If they are settled by physical delivery, then the protection seller buys specified obligations of the referenced entity from the protection buyer at full par price (even though, at that time, they may be worth less)[45]. Alternatively, if the

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[43] I am grateful for the comments of my partner, Scott Farrell, on an earlier draft of this paper.
[44] Other forms of credit derivatives are credit linked notes (discussed below), credit spread products and total return swaps.
[45] That is, there may be an assignment of the underlying loan contract, if that is the reference obligation

swap is to be cash settled, then when the credit event occurs, the protection seller will pay to the protection buyer an amount which is equal to the difference between the par price of the relevant obligations and the market price of those obligations (assessed after the credit event has occurred).

Credit linked notes represent the commoditisation (or securitisation) of credit default swaps. They are notes issued to investors by an issuer (usually a special purpose vehicle) where the return to investors reflects the terms of a credit default swap entered into by the special purpose vehicle. In this way, the protection seller is able to spread the credit risk associated with the credit default swap to a range of investors.

2.2 Use in Australia

The 2002 Australian Financial Market Report (published by the Australian Financial Markets Association) shows that the annual turnover of credit derivatives in Australian in 2001-2002 was A$22 billion.

Currently in Australia, credit derivatives are primarily used in:

- large financing transactions, as a means of distributing credit risk; and
- structured products, as a means of meeting investor-driven demand for the returns associated with risks that would not otherwise be available to such investors.

In the retail market, credit derivative products take the form of credit linked notes. Example of such issues are the unlisted Prise Notes and the ASX listed 10.25% Nexus Yield Bonds.

Nexus Yield Bonds pay a fixed rate of interest (at an enhanced rate) over their term and (subject to credit related events not occurring) the principal is repaid at the end of the term. Nexus is able to pay the enhanced return to investors because, in addition to the interest it receives on the funds received from investors (which are deposited into an interest bearing account), it receives payments pursuant to a credit derivative, under which Nexus Bonds Limited is the protection seller in respect of a portfolio of obligations.

The holders of Nexus Yield Bonds assume part of the credit exposure on the underlying portfolio. This is because if a specified credit event occurs then (in some circumstances) the noteholders will bear this loss. This is through a reduction in the aggregate outstanding principal amount which would also reduce future interest payments, since they would be calculated on the reduced principal amount.

To date in Australia, there has not been a retail issue of credit linked notes that has been rated by rating agencies. However, Generator Bonds, which are rated credit linked notes, are currently being offered to the retail market in New Zealand. This may represent a trend that is adopted in the Australian market in the future.

In the wholesale market, the majority of transactions are credit default swaps based on single names or single portfolios. However, there are also many credit linked notes issues. Unlike the retail market, it is common for such wholesale credit linked notes to be rated by rating agencies. In general in the wholesale markets, single name credit default swaps are usually physically delivered.

2.3 Are credit derivatives insurance contracts?

(a) Issue

It is important that credit derivatives are structured so that they do not unintentionally constitute insurance contracts. This is because the consequences of a contract being an insurance contract are onerous and extensive[46].

(b) How may it be addressed?

For a contract to constitute an insurance contract at common law, there must be an intention to indemnify another for its loss[47]. That is,

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[46] For example, the protection seller may be required to be authorised under the Insurance Act 1973; both the protection seller and buyer may require licences under Chapter 7 of the Corporations Act; an obligation of utmost good faith may be incorporated into the contract and there are various tax and stamp duty laws that apply to insurance contracts.

[47] Prudential Insurance Co v Inland Revenue Commissioners [1904] 2 KB 658

the obligation of protection seller must be dependent on the protection buyer's loss.

If a credit event under a credit derivative triggers an obligation to pay an amount then it should not constitute such an indemnity, so long as:

- the obligation exists irrespective of any loss suffered by the protection buyer; and
- the amount is not quantified by reference to the amount that the protection buyer does not receive following the credit event.

The fact that the result of a credit derivative may, in any particular circumstance, be economically equivalent to insurance does not alter the fundamental requirement that for there to be a contract of insurance there must be an intention to indemnify. In the absence of such an intention to indemnify, a credit derivative transaction should not constitute a contract of insurance.

It is interesting to note that the Credit Derivatives Definitions contain a deemed agreement (in Section 9.1(b)(i)) that:

> "the parties will be obligated to perform, subject to Section 3.1, in accordance with the Settlement Method applicable to such Credit Derivative Transaction, irrespective of the existence or amount of the parties' credit exposure to a Reference Entity, and Buyer need not suffer any loss nor provide evidence of any loss as a result of the occurrence of a Credit Event"

For the reasons discussed above, provided the terms of the transaction and the parties intention is consistent with this deemed agreement, then a credit derivative documented using the Credit Derivatives Definitions and including this deemed agreement should not constitute an insurance contract.

2.4 Impact of a duty of confidentiality on credit derivatives

(a) Issue

If there is a relationship between the reference entity and the counterparties to the credit derivative, then there may also be a duty of confidentiality owed by that counterparty to the reference entity. In this case, that duty could be breached if that counterparty provides the other party to the credit derivative with information that is confidential. The very nature and operation of a credit derivative may conflict with the duty of confidentiality.

(b) How may it be addressed?

Section 9.1(b)(iv) of the Credit Derivatives Definitions contains a representation in relation to confidentiality. The representation is essentially that either party may have confidential information and the existence of the credit derivative does not create an obligation to disclose such information. This representation will be deemed to be incorporated in any credit derivative documented under the definitions, unless it is expressly excluded. However, in some circumstances it will be important for such information to be disclosed. This issue is avoided if the underlying reference obligation contains a consent given by the Reference Entity for the disclosure of the relevant information in these circumstances.

It may be possible to mitigate this confidentiality issue by amending the definition of "Credit Event" such that it will only occur when there exists publicly available information about the relevant event. However, there is a risk that the effectiveness of the credit derivative may be reduced by reliance on publicly available information, since there may be a time lag between the occurrence of the event and its entry into the public domain.

2.5 Insider trading risk

Issue

The insider trading prohibition in section 1043A of the Corporations Act should be considered in the context of credit derivatives. For example, it would operate to prohibit the entry into such a transaction by a person who is in possession of information which is not generally available and if it were generally available would be expected by a reasonable person to have a material effect on the price or value of the credit derivative. For example, if a protection buyer has credit information because of its banking relationship with the reference entity, then the impact of the insider trading prohibition should be carefully considered.

(a) How may it be addressed?

In this context, it is important to note that section 1043F of the Corporations Act provides that a body corporate does not contravene the insider trading prohibition if there are appropriate Chinese walls arrangements in place.

2.6 Consent issues

(a) Issue

As mentioned, credit default swaps in the wholesale market are generally physically deliverable. Therefore, on the occurrence of the credit event, the specified obligations are sold by the protection buyer to the protection seller. It is important that the underlying loan agreement permits such assignment to occur in accordance with the requirements for delivery under the particular credit derivative.

(b) How may it be addressed?

It is important to carefully consider the nature of the underlying loan agreement. The standard confirmation for credit derivatives contain the ability to specify whether the deliverable obligation characteristics are "Assignable Loan" or "Consent Required Loan". If the underlying loan does not contain a requirement to obtain consent (and there are no other restrictions on assignment) then it would be appropriate to specify "Assignable Loan". Naturally, you would specify "Consent Required Loan" if consent to the assignment was required. If this is specified and consent is not obtained at the relevant time, then pursuant to the operation of the Credit Derivatives Definitions there would be a partial cash settlement of the credit derivative.

3 Netting

3.1 Payment Systems and Netting Act 1998 ("Netting Act")

The Netting Act, in conjunction with section 553C of the Corporations Act, constitute the legislative protection for set off and netting in Australia. Contractual set off, of course, sourced in the common law.

The table below summarises the basic position in Australia[48]:

Netting regime	When does it apply?	Example	Mutuality	Written agreement	Designation	Protected from "claw back"?
Contractual set off	Before winding up[49]	Section 6(f) of an ISDA	No	Yes (evidentiary issues if sought to establish on the basis of oral contract)	Not applicable	No
Insolvency set off (section 553C)	When a company is being wound up	Amounts owing under a loan and amounts owing pursuant	Yes	No	No	Yes, unless section 553C(2) applies

48 for completeness, I note that the equitable right of set off and the right to set off pursuant to the Statutes of Set-off are also relevant in Australia (with the exception of the non-applicability of the Statutes of Set-off in New South Wales and Queensland) .

49 Can be exercised against a company in voluntary administration: Cinema Plus Ltd (Administrators Appointed) & Anor v ANZ Banking Group Limited (2000) 49 NSWLR 513. However, the exercise of this right is subject to the administrator's right of indemnity from the company's assets for liabilities incurred by the administrator and the remuneration then owing to the administrator. This could reduce the amount that is available for set off.

		to a deposit				
Close out netting contract	Before and on external admin.	ISDA, GMRA	No	Yes (evidentiary issues if sought to establish elements on the basis of an oral contract)	No	Yes, unless section 14(3) or 15(5) applies
Approved multilateral netting	Before and on external admin.	CS1 (cheques), CS2 (direct debit), but not yet approved	No	Yes, need rules	Yes	Yes, unless section 10(4) applies
Approved RTGS system	Before and on external admin.	RITS, Austraclear and CHESS	No	Yes, need rules	Yes	Protection from the Zero Hour Rule
Market netting	Before and on external admin.	CLS; CHESS	No	Yes, need a market netting contract	Yes	Yes

3.2 Who can obtain the benefit of the close out netting contract provisions?

Pre-external administration protection under section 14(1) of the Netting Act is given to close out netting contracts that:

- are governed by Australian law; **and**
- are entered into in circumstances that are within Commonwealth constitutional reach.

The phrase "Commonwealth constitutional reach" is defined to include a contract entered into by a "constitutional corporation", which means a foreign corporation[50] or a trading or financial corporation formed within the limits of the Commonwealth[51]. So long as one of the parties to the contract is a "constitutional corporation" the requirements of the definition are satisfied. Even if one of the parties is a "constitutional corporation", if the contract is governed by a law other than Australian law then pre-external administration protection will not be available.

On external administration, protection under section 14(2) of the Netting Act is given to close out netting contracts in circumstances where:

- the contract is governed by Australian law; **or**
- the external administration is governed by Australian law.

Therefore, so long as there is an external administration that is governed by Australian law, the section will validate the netting even if the contract is not governed by Australian law (and vice versa).

The Netting Act defines "external administration" broadly to mean if a person:

- becomes a body corporate that is an externally administered body corporate within the meaning in the Corporations Act[52];

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[50] This phrase is not defined in the Netting Act, but has been held to mean an entity incorporated in a country other than Australia: New South Wales v Commonwealth (1990) 169 CLR 482
[51] This could include a statutory corporation
[52] That is: a body corporate that is being wound up; in respect of property which a receiver or a receiver and manager has been appointed; that is under administration; that has executed a deed of company

- becomes an individual who is an insolvent under administration within the meaning of the Corporations Act; or

- has their property taken control of by someone for the benefit of the person's creditors because the person is, or is likely to become insolvent.

In respect of an Australian incorporated company, the following insolvency proceedings would fall within the meaning of "external administration": winding up; compromise or arrangement with creditors; administration; receivership; statutory management under the Banking Act; judicial management under the Life Insurance Act; and the appointment of an acting trustee of a superannuation fund.

In terms of a foreign company carrying on business in Australia, the following Australian proceedings would constitute "external administration": letter of request; ancillary liquidation; winding up under Part 5.7 or order recognising the foreign liquidation order.

However, it is clear from the definition of "external administration" that the Netting Act has a much broader scope that just companies. For example, it is possible that the statutory corporations will be subject to external administration as defined in the Netting Act. However, statutes that establish statutory corporations do not usually contain provisions dealing with their winding up. Such legislation is normally enacted at the time of the winding up of the relevant entity. It would be then that one would determine whether there was an "external administration" for the purposes of the Netting Act. If Australian law governed the contract, but the "winding down" was not "external administration" then section 14(2) would not apply, but, section 14(1) should operate to validate the contracts, provided they are entered into in circumstances that are within Commonwealth constitutional reach.

arrangement that has not yet terminated; or that has entered into a compromise or arrangement with other person the administration of which has not been concluded.

3.3 Close out netting contracts - section 14(5) of the Netting Act

If section 14(2) of the Netting Act applies, it validates the:

- termination of obligations;
- calculation of the termination values and the determination of a net amount; and
- the payment of the net amount,

in that none of those things is void or voidable in the external administration.

However, pursuant to section 14(5) of the Netting Act, the protection afforded by sections 14(2) is lost if:

- the party not in external administration did not act in good faith in entering into the transaction that created the terminated obligation; **or**
- when the transaction that created the terminated obligation was entered into, the party not in external administration had reasonable grounds for suspecting that the other party was insolvent at that time or would become insolvent because of, or because of matters including:

  (i) **entering into the transaction; or**

  (ii) **a person doing an act, or making an omission, for the purposes of giving effect to the transaction;** or

- **the other person neither provided valuable consideration under, nor changed their position in reliance on, the transaction.**

In this context, consider the following chain of events:

- counterparty A and counterparty B enter into transactions under an ISDA Master Agreement ("**non-tainted transactions**");
- counterparty B receives reason to suspect counterparty A's insolvency;

- counterparty A and counterparty B then enter into further transaction, because for example an existing transaction is varied (such that it becomes a "new" transaction or because existing transactions are simply "rolled over to form new transactions") ("**tainted transactions**");

- insolvency of counterparty A and close-out of all transactions (including the tainted transactions). Under the terms of the ISDA Master Agreement (which does not distinguish between tainted and other transactions) this would result in a close-out amount being payable between the parties; and

- counterparty B would pay the close-out amount to counterparty A's liquidator if it were owing by counterparty B and would prove for the close-out amount if it were payable to counterparty B.

(a) **The first question is: does section 14(5) of the Netting Act apply *only* to the tainted transactions or does it apply to the *entire* net amount?**

Section 14(5) of the Netting Act provides that section 14(2) of the Netting Act does not apply to:

> "an *obligation* owed by a party to a close-out netting contract to another person" (italics added),

if the conditions of section 14(5) are met.

On its face, this could include the Section 6(e) amount under an ISDA Master Agreement if a tainted transaction were included in the netting. On this view, no transaction (whether or not tainted) included in that section 6(e) amount would have the protection of section 14(2) of the Netting Act.

However, section 14(5)(b) refers to the relevant obligation under that section having being:

> "terminated under the contract".

The Section 6(e) amount is never terminated, rather, it constitutes the close out amount that is payable as a result of terminating transaction. In addition, section 14(2)(e) of the Netting Act provides that:

> "obligations that are, or have been, terminated under the contract are to be disregarded in the external administration *(but see subsection (5))*" (italics added).

These two references could be read to mean that section 14(5) is only intended to apply to the obligations which are terminated under the close-out netting contract rather than the net amount payable itself. That is, it applies to the tainted transaction and not the overall net amount.

Some support for this view may be taken from the explanatory memorandum to the Netting Act which explained the intention of section 14(5) of the Netting Act to be:

> "Obligations will also not have the benefit of clauses 14(1) or (2) if they would amount to a voidable preference"

Some guidance as to what is meant by "obligations" in this context may also be taken from the commentary in the explanatory memorandum on section 14(3) of the Netting Act:

> "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 was insolvent"

This indicates that an "obligation" is intended to be something which arises from a single transaction and is not the net amount.

As a result, I think that the better view is that section 14(5) is intended to result in section 14(2) not applying to only the tainted transactions not to the entire net amount.

(b) The second question is: what is the means by which the tainted transactions *can* be excluded from the netting calculation?

The definition of "close-out netting contract" in section 5 of the Netting Act requires that there is not a disaggregation of the Section 6(e) amount under the ISDA Master Agreement. However, if Section 14(5) is to apply *only* to the terminated transactions and not the other transactions, then some disaggregation must (by necessity) take place.

This inconsistency is emphasised by the fact that:

- **the ISDA Master Agreement provides no means by which the tainted transactions can be excluded from the Section 6(e) calculation; and**
- **section 14(2)(a) of the Netting Act states that the netting must take place "in accordance with the contract" and provides no means by which the contract can be "rewritten" in order to exclude the tainted transactions.**

As a result, because there is no means under the Netting Act by which a court could withdraw the protection of the Netting Act from only the tainted transactions, there is a risk that in order to give effect to section 14(5) a court would find that the protection of the Netting Act is to be withdrawn from the netting of all of the transactions under the ISDA Master Agreement.

However, there is a means of resolving this inconsistency if the counterparty is being wound up under the Corporations Act.

If the netting of the tainted transactions were to be challenged by counterparty A's liquidator, it is likely that the challenge would be made on the basis that the entry into the tainted transactions resulted in a voidable preference. The order would be sought under section 588FF of the Corporations Act (which empowers a court to grant a range of orders with respect to a voidable transaction).

Subject to the court's discretion, it is likely that a court would grant an order for the payment of money by counterparty B to the liquidator redressing the loss suffered by the liquidator as a result of the incorporation of the tainted transactions in the netting under the ISDA Master Agreement. Such an order:

- would be permitted under section 588FF, because the netting of the tainted transaction would be a voidable preference; and
- **would be consistent with section 14(2)(d) of the Netting Act as it specifically provides that obligations to which section 14(5) applies are not to be disregarded in the external administration of the counterparty (unlike the other netted transactions). They are therefore available to be the subject of a proceeding under the Corporations Act in the winding up of the counterparty. If the tainted transactions were a voidable preference, then section 14(5) of the Netting Act would be applicable to then.**

This should lead to the same result as if the tainted transaction were separated from the netting under the ISDA Master Agreement. However, no actual separation takes place as this would be inconsistent with the precise words of the ISDA Master Agreement and the Netting Act.

3.4 Market netting - are delivery obligations protected?

Part 5 of the Netting Act is intended to protect netting in the licensed markets or licensed CS facilities under the Corporations Act. CHESS is a netting market under the Netting Act. The operation of Part 5 on CHESS is considered below.

(a) Is there a "market netting contract"?

A precondition to the protective provisions of section 16 of the Netting Act is the existence of a "market netting contract".

The Netting Act defines a "market netting contract" to mean:

"(a) a contract:

(i) entered into in accordance with the rules that govern the operation of a netting market; and

(ii) under which obligations between parties to the contract are netted; or

(b) a contract declared by the regulations to be a market netting contract for the purposes of this Act;

but does not include..."

In the context of CHESS what is the relevant "market netting contract"?

The SCH Business Rules could themselves be sought to be characterised as the relevant "market netting contract". These rules do operate as a contract under seal between the participants and ASTC. However, it is questionable whether this contract is entered into in accordance within the rules that govern the operation of a netting market (to satisfy paragraph (a)(i) of the definition), since it is itself the contract (being the SCH Business Rules) that governs the operation of the netting market.

Alternatively, the individual contracts relating to particular trades between the participants in CHESS may be characterised as the relevant "market netting contracts". The difficulty with this interpretation is that it is not these contracts that provide for netting (as required to satisfy paragraph (a)(ii) of the definition), rather, the netting arises from the SCH Business Rules.

In this context, I think that the better view is that the "market netting contract" comprises the SCH Business Rules together with the individual transactions entered into between the parties in the netting market pursuant to those rules. The two are so inextricably linked that I think they should be characterised as together constituting the "market netting contract" for the purposes of the Netting Act.

This is supported by the fact that the approval of the system by the Treasurer as a "netting market" was given to ASTC, rather than being given in relation to a particular aspect of the system that ASTC operates.

There is further support for this view in the explanatory memorandum to the Netting Act. It relevantly states that:

"17. Market netting is intended to extend to markets in which the rules novate market contracts to a clearing entity, to which deposits and margins are paid and security is provided. The Bill will extend to rules requiring the netting of deposits and margins and the realisation and **netting of securities"** (emphasis added)

"79. The Bill will put the following matters beyond doubt:

(a) The novation of market-netting contracts where they seek to achieve this.

(b) The efficacy of netting to produce a single settlement amount (either positive or negative) for settlement.

(c) The ability of the netting market to use cash margins and security for margins in accordance with the rules of the netting market to meet the obligations of a broker, without interference by the brokers clients."

(b) What is protected?

Section 16(2) of the Netting Act provides that if a party to a market netting contract goes into external administration and Australian law governs either the external administration or the contract, then:

- obligations under the market netting contract may be terminated, termination values may be calculated and a net amount become payable in accordance with the market netting contract;

- obligations that are, or have been, netted or terminated under the market netting contract are to be disregarded in the external administration;

- any net obligation owed by the party under the market netting contract that has not been discharged is provable in the external administration;

- any net obligation owed to the party under the market netting contract that has not been discharged may be recovered by the external administrator for the benefit of creditors;

- none of the following is void or voidable in the external administration:

the netting or termination of obligations under the market netting contract;

a payment by the party to discharge a net obligation under the market netting contract;

a payment or transfer of property (whether absolutely or by way of security) by a party to meet an obligation under the market netting contract to pay a deposit or margin call.

The netting of payment obligations is clearly protected under this section. If you read "obligation" as intending to cover both payment and delivery obligations, then the netting of delivery obligations is also protected. However, there are arguments that may suggest that the term "obligation" in Part 5 of the Netting Act covers only payment obligations (and not delivery obligations). This is because, section 16(2)(e) (for example) refers to a net obligation being "provable in the external administration". Delivery obligations will not be provable in a technical sense because it is not a debt or a monetary claim. However, in light of the legislative intention behind Part 5, I think that the phrase "obligations" in this context should be read broadly so that it encompasses both payment *and* delivery obligations in CHESS. This interpretation would then lead to the protection of netting in relation to delivery obligations.

I understand that the Netting Act is to be reviewed this year. I am hopeful that this seemingly unintended drafting oversight in the Netting Act will be corrected in the context of this review.

3.5 Payment systems - insolvency inside and outside the system

Can the insolvency of an ultimate payer on whose behalf a participant in a payment system enters an instruction result in that instruction being set aside as a void or voidable disposition of property?

Provided the participants in the system operate as principals with respect to each other, then, the answer to that question is no. On the basis of the decision in **Re Loteka Pty Limited (in liq)**[53], the disposition by the participant's (insolvent) third party customer would not be void or voidable as against the other participants in the system, but rather would be voidable as against the ultimate beneficiary of the payment. Such voidability arises outside the system itself. This concept is very important in the context of many systemic payment systems that utilise multilateral netting.

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4 Credit support - registration issues

4.1 Types of credit support

In Australia, credit support for derivatives (documented under the ISDA Master Agreement) usually take the form of the 1995 ISDA Credit Support Annex, which is governed by English law ("**ECSA**") or the 1994 Credit Support Annex, which is governed by New York law ("**NYCSA**").

4.2 Registration requirements

In Australia, certain kinds of "charges" on the property of a company are registrable in accordance with Chapter 2K of the Corporations Act.[54] Chapter 2K operates with respect to charged assets (wherever located) of Australian companies and to charged assets of registered foreign companies, in so far as the charged assets are (or may be in the future) located in Australia. Thus, Chapter 2K may apply even where a document is governed by a foreign law.

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[53] (1990) 1 QdR 322

[54] "Charge" is defined in s 9; the term is defined broadly, and encompasses most forms of security interest.

If Chapter 2K is applicable, the relevant question is whether the security interest that is created is of a kind that is required to be registered. A charge will be registrable under Australian law if it falls within one of the categories of registrable charge (in section 262 of the Corporations Act).

4.3 Absolute transfer

The ECSA operates to transfer absolutely the cash or securities to the collateral taker. It does not give rise to any registration issues under the Corporations Act. As a matter of practice, most credit support agreements relating to Australian entities or assets located in Australia will take this form of agreement.

4.4 Security interest

In some situations, the collateral taker will require that the NYCSA be used. Use of the NYCSA does give rise to the question of whether a registrable charge is created under Australian law, since it operates to create a security interest in the cash or securities.

The charges which are most likely to be created are a floating charge, a charge over marketable securities or a charge over book debts.

In determining whether the NYCSA creates any of these charges, it is important to remember it is not sufficient simply to look to the characterisation of the security interest created by the NYCSA ("**NYCSA security interest**") under New York law. Rather, the correct approach is to identify the rights arising under the NYCSA security interest and then characterise that collection of rights under Australian law.

(a) Floating charge

In determining whether a NYCSA security interest amounts to a floating charge under Australian law, it is necessary to consider the indicia of floating charges under Australian law, namely whether the charge is over a class of present and future assets, whether the class of assets would, in the ordinary course of the business, be changing from time to time, and whether the chargor is able to continue dealing with the charged assets as its own until the chargee takes some further step to exercise control.[55]

[55] *Re Yorkshire Woolcombers Association Ltd* [1903] 2 Ch D 284 per Romer LJ

These indicia may be present in a NYCSA context. For example, paragraph 4(d)(i) of the NYCSA allows the collateral provider to substitute collateral by notice to the collateral taker. This, arguably, is consistent with the idea of "changing assets" and circulating property. Similarly, paragraph 6(c)(i) gives the collateral taker the right to deal with the secured property prior to enforcement; for example, to pledge, sell or otherwise dispose of the property. Notwithstanding that to deal with secured property in this way is not contemplated by Australian law, it may be that Australian courts hold that the right to such a disposition creates a floating charge, at least for the purposes of registration.[56]

(b) Book debts

A more specific problem arises in circumstances where cash collateral is deposited with a third party or where security is obtained over cash deposited with the counterparty. In these situations, a question arises as to whether cash deposits constitute "book debts", such that charges on those cash deposits are required to be registered under s 262(1)(f) of the Corporations Act.

There is no statutory definition of "book debts" in Australia and relevant case law seems to adopt the same position as is held in New Zealand.[57] That is that "book debts" encompass only "commercial receivables", which generally do not cover bank deposits.

However, the situation may be different in relation to cash collateral where the collateral giver is itself a financial institution, in which case it is arguable that an interest-bearing deposit is analogous to a commercial receivable. This argument has indirect judicial support in Australia in so far as it can be said that the question of whether a charge over book debts can ever encompass cash deposits is not *completely* closed.[58] Thus, in Australia at the moment it cannot be said definitively that charges over cash deposits of a financial institution do not need to be registered as book debts.

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[56] Note that under the NYCSA it is possible to elect that both paragraphs 4(d)(i) and 6(c)(i) are not applicable.

[57] see *Watson v Parapara Coal Co Ltd (In liquidation) and another* [1915] 17 GLR 791

[58] See *Perrins v State Bank of Victoria* [1991] 1 VR 749 per Gobbo J at 755; *Re Permanent Houses (Holdings) Ltd* [1988] BCLC 563 per Hoffman J.

(c) Marketable securities

The Corporations Act defines "marketable security" to mean debentures, stock, shares or bonds of any government, local authority, body corporate, association or society including any right or option in respect of shares in any body corporate and any interest in a managed investment scheme. Because of this broad definition, collateral under a NYCSA could be a "marketable security".

Charges on marketable securities are required to be registered under the Corporations Act. However, there are some exceptions to this registration requirement.

(i) Pledge of a marketable security

The term "pledge" in this context is to be given its Australian law meaning, which is that it is a possessory security under which the pledgee has no more than a right of possession and a right of sale on default by the pledgor. As the NYCSA creates a broader set of rights, it would probably not be characterised as a pledge under Australian law. Accordingly, this exception is unlikely to be available.

(ii) Registration in the name of the mortgagee

There is an exception to registration where there is a mortgage under which the marketable security is registered in the name of the mortgagee (or nominee). Provided the collateral that comprises marketable securities are actually registered in the name of the secured party (or its nominee) and are no longer in the security provider's name, then this exception should be capable of being applied to the NYCSA in an appropriate case.

(iii) Deposit of documents

There is another exception to registration where a charge is created in whole or in part by the deposit of a document of title to the marketable security. This requires that the actual act of delivering the documents creates the security interest. Under Australian law, it is likely that the charge in the NYCSA would be created by the documents themselves, not by the deposit of the securities. However, the relevant law to consider in this case is the law governing the document. Accordingly, if as a matter of New York law the deposit of the securities creates the security interest, then this exception may apply.

(iv) Electronic book entry systems

There is a new exception to the registration requirements for marketable securities in section 262(1)(g)(iii) of the Corporations Act.

In April 2003 the Corporations Act was amended to add the following exception to registrability in respect of marketable securities:

> "a charge where there is an agreement in force under which the chargee (or a person who has agreed to act on instructions of the chargee) controls the sending of some or all electronic messages or other electronic messages or other electronic communications by which the marketable security could be transferred".

The amendment is intended to create an equivalent treatment for dematerialised securities as currently exists for certificated securities (see (iii) above).

The obvious application of the section is to charges in respect of CHESS securities. In the context of credit support for derivatives, the more relevant enquiry is whether it can be applied to charges over securities in Austraclear?

A charge

For the exception to apply there need to be a "charge". The Austraclear Regulations provide that the terms of the security interest will be as agreed between the parties (outside the Austraclear system)[59]. It is only if the only evidence of the security interest is created by

[59] Regulation 9.5, Austraclear Regulations

the Austraclear system itself that the nature of the security interest will be specified by the Austraclear Regulations as a pledge or an equitable mortgage. As the NYCSA does provide the terms of the security interest and that security interest would be characterised as a charge under Australian law, this element of the exception would be satisfied in the ordinary course.

An agreement under which gives the chargee control

The second element of the exception is that there must be an agreement under which the chargee (or someone who acts on their instructions) controls the electronic communications by which the marketable securities could be transferred.

The Austraclear Regulations operate as a contract between each member, participating bank and Austraclear Limited[60]. As such, the Austraclear Regulations could be characterised as a relevant agreement.

The Austraclear Regulations provide that once an "encumbrance" is entered in the Austraclear system, Austraclear will recognise the "encumbrancee" as the only member who will be entitled to enter a transaction to transfer the security or to uplift the security from the system.[61] Therefore, both the collateral taker and Austraclear (who has agreed to act only on the instructions of the collateral taker in these circumstances) would exercise control over the transfer of the relevant securities.

In this respect, it is interesting to note that the explanatory memorandum to this amendment says that:

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[60] Regulation 23.3, Austraclear Regulations
[61] Regulation 9.3, Austraclear Regulations

> "The requisite control may be found in whole or in part in the charge instrument itself or in the tripartite sponsorship agreement that is typically a feature of transactions involving charges over CHESS registered securities or in the rules of an exchange of clearing house that are deemed to constitute an agreement between a member and the exchange or clearing house".

The instructions to transfer would take the form of "electronic messages" in the Austraclear system.

Accordingly, pursuant to the contract that is the Austraclear Regulations, the chargee controls the electronic messages that operate to transfer of "encumbered" securities in Austraclear.

4.5 EU Collateral Directive

The European Parliament and Council signed Directive 2022/47/EC ("**Collateral Directive**") on 6 June 2002. Member States[62] are required to have implemented the directive by 27 December 2003.

It appears that implementation of the Collateral Directive will facilitate the use of collateral arrangements such as the NYCSA by British and European institutions by bringing greater certainty to those transactions and by removing legal impedients to conducting those transactions in a particular fashion. This may leave Australia out of step with world practice.
The Collateral Directive was designed to provide uniform minimum requirements for the provision of cash and securities as collateral (under both pledge and transfer structures). In particular, the Collateral Directive seeks to:

(a) simplify collateral creation requirements;

[62] Currently Belgium, Germany, France, Italy, Luxembourg, the Netherlands, Denmark, Ireland, the United Kingdom, Greece, Spain, Portugal, Austria, Finland and Sweden.

(b) provide some limited protection from insolvency law for collateral arrangements (including those rules which may inhibit the realisation of collateral or the effectiveness of close-out netting);

(c) create legal certainty in relation to the conflict of laws treatment of certain securities used as collateral (including the application of the law of the place where the account is located for book entry securities collateral);

(d) limit the administrative burdens affecting the use of collateral; and

(e) recognise agreements which permit the collateral taker to reuse (or rehypothecate) collateral under pledge structures.

Of particular relevance to the use of the NYCSA, Article 3 of the Collateral Directive precludes a Member State from requiring that the creation, validity, perfection, enforceability or admissibility of a financial collateral arrangement is dependent on any formal act. Recital 10 provides that precluded formal acts include "the making of any filing with an official or public body or registration in a public register." In contrast, as noted above, there is still some uncertainty surrounding the registrability of these types of arrangements under Australian law.