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FINANCIAL SYSTEM LEGISLATION AMENDMENT (RESILIENCE AND
COLLATERAL PROTECTION) BILL 2016

EXPLANATORY MEMORANDUM

(Circulated by the authority of the
Assistant Treasurer, the Hon Kelly O'Dwyer MP)

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

<i>Abbreviation</i>	<i>Definition</i>
ADI	Authorised Deposit-taking Institutions
AFS licensee	Australian financial services licensee
AMSLA	Australian Master Securities Lending Agreement
APCA	Australian Payments Clearing Association
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASX 24 MIRs	ASIC's Market Integrity Rules (ASX 24 Market)
Banking Act	<i>Banking Act 1959</i>
BCBS	The Basel Committee on Banking Supervision
BCBS-IOSCO Margin Requirements	margin requirements for non-centrally cleared derivatives published by BCBS and IOSCO in September 2013 as revised in March 2015
the Bill	Financial System Legislation Amendment (Resilience and Collateral Protection) Bill 2016
Business Transfer Act	<i>Financial Sector (Business Transfer and Group Restructure) Act 1999</i>
CCP	central counterparty
CHES	Clearing House Electronic Sub-register System
CFR	Council of Financial Regulators
Corporations Act	<i>Corporations Act 2001</i>
Corporations Regulations	<i>Corporations Regulations 2001</i>
Cross-Border Insolvency Act	<i>Cross-Border Insolvency Act 2008</i>
EU Financial Collateral Directive	Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements
G20	The Group of Twenty
GMSLA	Global Master Securities Lending Agreement
GMRA	Global Master Repurchase Agreement

<i>Abbreviation</i>	<i>Definition</i>
FMI	financial market infrastructure
FSB	Financial Stability Board
Industry Acts	Banking Act, Business Transfer Act, Insurance Act and Life Insurance Act
the Inquiry	The Financial System Inquiry
Insurance Act	<i>Insurance Act 1973</i>
IOSCO	The International Organization of Securities Commissions
ISDA	International Swaps and Derivatives Association Inc.
Key Attributes	<i>Key Attributes for Effective Resolution of Financial Institutions</i>
Life Insurance Act	<i>Life Insurance Act 1995</i>
OTC	Over-the-counter
PHI Act	<i>Private Health Insurance (Prudential Supervision) Act 2015</i>
PPSA	<i>Personal Property Securities Act 2009</i>
PSN Act	<i>Payment Systems and Netting Act 1998</i>
Regulated Entity	ADIs, life insurers and general insurers regulated by APRA
RBA	Reserve Bank of Australia
Reserve Bank Act	<i>Reserve Bank Act 1959</i>
Resolution Events	Any of the following occurrences: the appointment of a statutory manager or judicial manager, the statutory manager or judicial manager taking action to facilitate recapitalisation or certain events occurring in relation to a compulsory transfer of business which are described in subsection 36AA(2) of the <i>Business Transfer Act</i> .
RITS	Reserve Bank of Australia Information and Transfer System
RTGS	Real Time Gross Settlement
Stay Protocol	ISDA 2015 Universal Resolution Stay Protocol

Overview

The Financial System Legislation Amendment (Resilience and Collateral Protection) Bill 2016 (the Bill) amends the *Payment System and Netting Act 1998* (PSN Act) and associated provisions in other Acts to:

- enable entities subject to Australian law to give, and enforce rights in respect of, margin provided by way of security in connection with certain financial market transactions in a manner consistent with international requirements;
- clarify domestic legislation to support globally coordinated policy efforts and provide certainty about the operation of Australian law in relation to the exercise of termination rights (also known as close-out rights) under certain financial market transactions; and
- enhance financial system stability by ensuring legal certainty for the operation of approved Real Time Gross Settlement (RTGS) systems, approved netting arrangements and netting markets (more specifically, market netting contracts) in all market conditions.

The Bill also makes consequential amendments to the *Banking Act 1959* (Banking Act), *Financial Sector (Business Transfer and Group Restructure) Act 1999* (Business Transfer Act), *Insurance Act 1973* (Insurance Act); *Life Insurance Act 1995* (Life Insurance Act); and *Private Health Insurance (Prudential Supervision) Act 2015* (PHI Act).

Date of effect: The amendments will commence on the 28th day after the Bill receives Royal Assent.

Proposal announced: The Government announced, in its response to the Financial System Inquiry (the Inquiry), on 20 October 2015 its intention to amend legislation to support globally coordinated policy efforts and facilitate the ongoing participation of Australian entities in international capital markets.

Financial impact: The measures have no financial impact on Commonwealth expenditure or revenue.

Human rights implications: This Bill does not raise any human rights issue. See *Statement of Compatibility with Human Rights* — Chapter 3.

Compliance cost impact: There is no regulatory compliance cost associated with this Bill.

A regulatory impact statement for the Bill is being finalised, and will be informed by consultation.

Chapter 1

Enforcing security, close-out netting, stays on close-out rights, approved RTGS systems, approved netting arrangements and market netting contracts

Outline of chapter

1.1 The Bill amends the PSN Act and associated provisions in other Acts to:

- enable entities subject to Australian law to give, and enforce rights in respect of, margin provided by way of security in connection with certain financial market transactions in the manner required by international requirements;
- 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 certain financial market transactions; and
- enhance financial system stability by ensuring legal certainty for the operation of approved RTGS systems, approved netting arrangements and netting markets (more specifically, market netting contracts) in all market conditions.

1.2 The Bill also makes consequential amendments to the Banking Act, Business Transfer Act, Insurance Act, Life Insurance Act and PHI Act.

1.3 This Chapter explains the context and case for these changes.

Context of amendments

Part 1 — Enforcing security in certain financial market transactions

G20 derivatives reform

1.4 In the aftermath of the recent financial crisis, the Group of Twenty (G20) initiated a reform agenda to improve transparency in derivatives markets, mitigate systemic risk and protect against market abuse.¹ In 2011, the G20 agreed to add margin requirements on non-centrally cleared derivatives to the over-the-counter (OTC) derivative reform agenda. Margin requirements are intended to reduce systemic risk and promote central clearing. It is anticipated that margin requirements would reduce the contagion and spill over effects experienced in the global financial crisis by ensuring that ‘collateral is available to offset losses caused by the default of a derivatives counterparty’.²

1.5 The margin requirements for non-centrally cleared derivatives published by Basel Committee on Banking Supervision (BCBS) and Board of the International Organization of Securities Commissions (IOSCO) (BCBS-IOSCO Margin Requirements) set out an internationally consistent framework, to be implemented by national regulators. In their *Report on the Australian Derivatives Market — November 2015*, the Council of Financial Regulators (CFR) stated that Australia intends to implement the BCBS-IOSCO Margin Requirements framework and the associated risk mitigation standards in its regulatory regime. It is understood that this will initially be done through APRA’s prudential standards (as a prudential standard on margining).

1.6 Under the BCBS-IOSCO Margin Requirements, covered entities are required to ensure that margin collected is ‘immediately available to the collecting party in the event of the counterparty’s default’, but also that the collected margin is subject to arrangements that ‘fully protect the posting party to the extent possible under applicable law in the event that the collecting party enters bankruptcy’.³ The BCBS-IOSCO Margin

1 Financial Stability Board (FSB), *Implementing OTC Derivatives Market Reforms* (Financial Stability Board, 25 October 2010) (available at www.financialstabilityboard.org/wp-content/uploads/r_101025.pdf), iii.

2 BCBS-IOSCO Margin Requirements, 3.

3 Key Principle 5 of the BCBS-IOSCO Margin Requirements provides that: ‘Because the exchange of initial margin on a net basis may be insufficient to protect two market participants with large gross derivatives exposures to each other in the case of one firm’s failure, the gross initial margin between such firms should be exchanged. Initial margin collected should be held in such a way as to ensure that (i) the margin collected is immediately available to the collecting party in the event of the counterparty’s default, and (ii) 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

Requirements provide that counterparty risk exposures should be ‘fully covered with a high degree of confidence’ and that assets collected as collateral for initial and variation margin purposes need to be able to ‘be liquidated in a reasonable amount of time to generate proceeds that could sufficiently protect collecting entities covered by the requirements from losses on non-centrally cleared derivatives in the event of a counterparty default’.⁴

Current and future market practice for transferring margin

1.7 Participants in non-cleared derivatives markets (outside of the US markets) have traditionally transferred margin (otherwise described as collateral or secured property) by way of absolute transfer⁵ rather than by way of security.

1.8 One of the reasons why non-US market participants, including Australian market participants, have preferred to use collateral arrangements under which collateral is absolutely transferred is that the granting of security interests generally involves a number of additional enforceability, validity and perfection requirements (including, for example, registration, filing and stamping requirements). The Australian position has been further complicated by the existence of priority regimes which apply in respect of the assets of certain types of entities, stays on the enforcement of security on the commencement of certain insolvency proceedings and the introduction of the *Personal Property Securities Act 2009* (PPSA) — which sets out new rules for the creation, priority and enforcement of security interests in personal property.

1.9 The requirement under the BCBS-IOSCO Margin Requirements for *gross* initial margin to be exchanged is likely to result in initial margin (at least) being transferred by way of security rather than by way of absolute transfer and there may be compelling reasons why market participants choose to provide both initial margin and variation margin by way of security rather than by way of absolute transfer (for example, because of benefits to the collateral provider on the secured party’s insolvency).

bankruptcy. Jurisdictions are encouraged to review the relevant local laws to ensure that collateral can be sufficiently protected in the event of bankruptcy’.

4 BCBS-IOSCO Margin Requirements, 5 (Key Principles 3 and 4).

5 For example, market participants may use the ISDA English law Credit Support Annex.

International comparison

1.10 Many other industrialised countries (including, for example, the United Kingdom and other members of the European Union) have enacted similar legislation to clarify their securities laws to provide for ‘rapid and non-formalistic enforcement procedures in order to safeguard financial stability and limit contagion effects in case of a default of a party’ to certain financial markets contracts.⁶ In doing so, they both reduce possible risks for parties to certain contracts in respect of which margin is provided and remove impediment to the international competitiveness of their local financial institutions. For example, it is expected that these reforms will reduce the risk that a secured party (which had based its evaluations of its counterparty credit risk on the expectation that its exposures were appropriately secured) actually loses priority to other parties on the counterparty’s default.

1.11 The fact that legislation protecting the enforcement of security in similar financial markets contracts has been thought appropriate elsewhere (including in the European Union), coupled with a concern that the absence of appropriate protections in Australia could affect the international competitiveness of Australian financial institutions, reinforces the need for this reform.

1.12 This legislation will allow Australia to maintain its position as a regional financial centre with a strong regulatory and legislative framework.

Existing Australian law (close-out netting contracts)

1.13 The objective underlying the framing of the PSN Act was to provide the utmost legal clarity and certainty that the netting arrangements established in relation to payment systems, transactions and facilities were legally valid and protected, including in situations where one of the participants or parties entered external administration.

1.14 The PSN Act provides a range of protections and carve-outs for certain retail payment systems, the RTGS system used in Australia to settle a number of important types of wholesale transactions, certain types of OTC transactions (called ‘close-out netting contracts’ in the PSN Act), and the contracts entered into by a central counterparty (CCP) in clearing bilateral trades or trades conducted on a financial market (called ‘market netting contracts’ in the PSN Act).

6 See e.g. the Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (‘EU Financial Collateral Directive’) and the *Financial Collateral Arrangements (No 2) Regulations 2003* (amended by the *Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements)(Amendment) Regulations 2010*) (‘UK Financial Collateral Regulations’).

1.15 The PSN Act sets out a number of powerful provisions which may override other laws (e.g. insolvency laws) and contractual arrangements. Some sections of the PSN Act expressly provide that certain provisions have effect despite any other law. The paramountcy of the provisions in the PSN Act, even where a participant is subject to external administration is critical in protecting systemic stability and ensuring the legal validity of the systems, activities and arrangements which are at the core of the financial system.

1.16 Part 4 of the PSN Act applies to financial market transactions covered by close-out netting contracts. Contracts which fall within the definition of a 'close-out netting contract' under the PSN Act are widely used in financial markets transactions such as currency (foreign exchange) derivatives, interest rate swaps and other interest rate derivatives, credit derivatives, equity derivatives, securities lending arrangements, repurchase agreements and other types of derivatives. These contracts contain terms which permit a party to the contract to terminate the contract if the counterparty becomes insolvent (or if some other condition is satisfied), to calculate the termination values of the obligations of the parties, and to net the termination values so calculated to arrive at a net amount payable by one party to the other.

1.17 The 'close-out netting contract' concept used in Part 4 of the PSN Act applies to a range of master agreements which govern the terms of derivatives transactions in respect of which margin requirements will be imposed.⁷

1.18 With respect to close-out netting contracts, Part 4 of the PSN Act already provides that, despite any other law, obligations may be terminated, termination values may be calculated and a net amount become payable in accordance with the contract. The current provisions in the PSN Act therefore facilitate the termination of obligations to make payments and deliveries of margin under the close-out netting contract and the inclusion of the value of margin provided by way of title transfer in the calculation of the net amount payable under the relevant close-out netting contract.

⁷ The legislative protections provided to financial market documentation such as the 1992 and 2002 ISDA Master Agreement, Global Master Securities Lending Agreement and Global Master Repurchase Agreement as close-out netting contracts are vitally important in allowing market participants to effectively manage their risks. Since the PSN Act was introduced in 1998, the legislative definition of 'close-out netting contract' has proved to be an adaptable definition that has remained relevant and helpful to market participants despite the evolution of financial markets which has occurred since this time.

Providing margin by way of security

1.19 Another way to provide margin is for margin to be provided by way of security rather than by way of absolute transfer. It is expected that at least initial margin will be provided by way of security under the margin requirements to be imposed on market participants in order to ensure that the key principles set out in the BCBS-IOSCO Margin Requirements are complied with. The transfer mechanism used in many of the documents under which margin is provided by way of security, such as the New York law governed Credit Support Annex and the English law governed Credit Support Deed, both published by ISDA, is economically similar to the way in which margin is transferred to title transfer arrangements (although it is noted that differences may arise with initial margin provided by way of security interest under forthcoming margin requirements).

1.20 However, the current protections provided under the PSN Act in respect of close-out netting contracts do not protect actions taken to enforce security (hence the preference for absolute transfer). The amendments proposed in the Bill are designed to ensure that the security-based margin arrangements entered into to comply with margin requirements may be enforced in accordance with their terms, notwithstanding other contradictory laws (such as insolvency law and inconsistent priority regimes). This will provide the same legal certainty to security-based margin arrangements as is currently provided for the netting and discharge of net obligations mechanisms inherent in close-out netting contracts supported by title transfer margin arrangements, making the legal effect consistent with the economic effect of these two mechanisms.

1.21 It is vitally important to reduce risks of systemic instability and contagion effects. This means ensuring that the margin collected be immediately available to the collecting party (i.e. secured party, collateral taker) in the event of a counterparty's default and that the assets collected as collateral can be liquidated in a reasonable amount of time. It is particularly important that the collecting party can act without having to obtain consents from external administrators that may otherwise be required, and that the collecting party's rights in the collateral are not subordinated to the interests of other creditors due to the operation of other priority regimes. It is therefore necessary to amend the PSN Act to ensure that the enforcement of security (including in the case of a default or insolvency of the counterparty) is allowed, regardless of provisions in other legislation including the Corporations Act, Banking Act, Insurance Act and PPSA. Otherwise, there is a range of existing Australian law issues which could prevent the collecting party exercising its rights under security-based margin arrangements.

- 1.22 Some of the issues which arise in the context of creating and enforcing rights as a secured party under Australian law include:⁸
- a) the assets of an Australian ADI in Australia are subject to a priority regime which would prefer other creditors (e.g. holders of protected accounts) ahead of a secured party;⁹
 - b) the assets of a foreign ADI in Australia are subject to a priority regime which would prefer liabilities of the foreign ADI in Australia ahead of a secured party;¹⁰
 - c) the assets of a general insurer regulated under the Insurance Act in Australia are subject to a priority regime which would prefer other creditors ahead of a secured party;¹¹
 - d) a secured party is restricted from enforcing its security interest over an Australian company's property during the company's administration¹² and an administrator is given certain rights in respect of dealing with property subject to circulating security interests;¹³
 - e) certain stays may apply in respect of an entity due to the recognition of a foreign insolvency proceeding under the *Cross-Border Insolvency Act 2008* (Cross-Border Insolvency Act);
 - f) client money and client property rules may affect the way in which a secured party must hold, and enforce rights against, collateral provided to it;
 - g) the PPSA imposes additional requirements governing the enforceability, validity and perfection of security interests;

8 Please also refer to the discussion in other parts of this paper in respect of the restrictions on granting security imposed on the trustees of Superannuation Funds and life companies.

9 For example, sections 13A(3) and 16 of the Banking Act and section 86 of the *Reserve Bank Act 1959*.

10 Section 11F of the Banking Act.

11 Section 116(3) of the Insurance Act. Section 116A of the Insurance Act deals with assets and liabilities in Australia.

12 Section 440B of the Corporations Act. A restriction on the exercise of third party property rights even applies in respect of possessory security interests. The exemption available in respect of possessory security interests (section 440JA) may not be applicable in all possible circumstances regarding dealings in OTC derivatives.

13 Sections 442B, 442C, 442CA of the Corporations Act.

- h) the PPSA and Corporations Act set out priority rules which may result in a secured party losing priority in respect of secured assets¹⁴ and those Acts set out circumstances in which property secured by a security interest may vest in the grantor;¹⁵
- i) other security interests may arise in respect of the property of a grantor by operation of law;¹⁶
- j) security agreements may need to be stamped to be admissible in court proceedings; and
- k) the PPSA sets out rules governing the enforcement of security interests (including procedural requirements and duties).

1.23 These legacy Australian law issues could prevent entities subject to Australian law from being able to grant, or enforce rights in, margin provided by way of security in the manner contemplated by the BCBS-IOSCO Margin Requirements.

1.24 The PSN Act is amended by this Bill to ensure that a party to a close-out netting contract can enforce security in respect of certain financial property, subject to safeguards to protect against abuse and limit the unintended consequences of such a powerful protection. The PSN Act is the preferred vehicle to make the proposed amendment because it covers the widest possible range of external administration proceedings conducted under Australian or foreign law and has the required authority to override provisions in any other legislation. The application of the PSN Act's protective framework 'despite any other law' (subject to clarifying the matters described in part 2 below and the existing carve-outs in subsections 14(3) and (5) of the PSN Act) provides a strong foundation for the protections to be provided in this Bill.

14 For example, certain claims mandatorily preferred at law (e.g. employee entitlements) may take priority over certain secured parties' rights. Partial priority regimes are also set out in various sections of the Corporations Act, including section 433 (property subject to circulating security interest — payment of certain debts to have priority), section 443E (Right of indemnity has priority over other debts). The PPSA also sets out a priority regime which applies in respect of security interests (see e.g. Part 2.6 of the PPSA).

15 For example, section 267 or 267A of the PPSA and section 588FL of the Corporations Act.

16 See, for example, section 443F of the Corporations Act (lien to secure indemnity). To secure a right of indemnity granted to an administrator under section 443D, the administrator has a lien on the company's property, subject to the priority regime set out in section 443F(2).

1.25 Additionally, the protection provided under Part 4 in order for the termination of obligations, the netting of obligations and any payment made by a party under the contract to discharge a net obligation not to be void or voidable in the external administration will be extended to acts taken in respect of the provision of collateral, including creation and enforcement of security (including the application of proceeds).

Subsection 14(3)

1.26 One related issue which has arisen during previous consultation processes in 2011 and 2014 relates to a drafting oversight in the PSN Act regarding subsection 14(3) which prevents a party to a close-out netting contract misusing the protections granted under the PSN Act. The current wording of subsection 14(3) of the PSN Act may not adequately prevent a party from abusing the PSN Act protections. This Bill prevents such an outcome.

Expanded definition of ‘external administration’

1.27 The existing definition of ‘external administration’ in section 5 of the PSN Act does not explicitly refer to certain types of resolution procedures that do not neatly fall into the traditional conception of an insolvency proceeding conducted for the benefit of creditors.

1.28 This Bill will expand the definition to explicitly cover resolution measures for bank and non-bank financial institutions, such as the statutory management regime for Australian ADIs under the Banking Act and the judicial management regime for life companies and general insurers under the Life Insurance Act and Insurance Act respectively.

1.29 Accordingly, the definition of ‘external administration’ will be amended to include all types of traditional insolvency proceedings and more recent processes in the nature of ‘resolution’ (the statutory management to which an ADI may be subject and the judicial management to which an insurer or life company may be subject).

Part 2 — Certainty for application of stays on close-out rights

Introduction

1.30 Currently, the stays imposed under the Industry Acts are potentially inconsistent with the crucial protections provided to close-out rights under derivatives arrangements under the PSN Act. Similarly, the operation of Australian resolution stays is not consistent with the approach adopted in other important jurisdictions (such as the European Union).

1.31 This Bill sets out amendments to ensure, to the extent possible, that Australian law more closely reflects international best practice which has developed in recent years following the financial crisis.

1.32 The reforms in this Bill will clarify the ability of market participants to exercise certain termination rights (also known as close-out rights) in resolution proceedings and are intended to ensure that the Australian resolution stay regime applies in accordance with international best practice for resolution regimes. These reforms will ensure that an appropriate balance is struck between ensuring that counterparties can effectively manage their risks whilst also giving the Australian Prudential Regulation Authority (APRA) the best chance to resolve an important financial institution, such as an Australian bank, which is in distress.

1.33 The concept of netting is internationally recognised as an effective way to minimise risk in high value financial transactions. Netting allows a party to a netting contract to replace a number of gross obligations with a single net position, substantially reducing the value at risk should one party default. The PSN Act was enacted in part to provide a certain legal basis for the effectiveness of defined categories of netting contracts in Australia. The ability of a party to net obligations has become increasingly important not only for managing credit risk but also for determining capital requirements.

Potential inconsistency in law

1.34 Stakeholders have raised a concern that the PSN Act and the Industry Acts are inconsistent as to whether the appointment of a statutory manager or judicial manager (as applicable) to an ADI, life insurer and general insurer regulated by APRA (each, a Regulated Entity) allows a counterparty to a netting contract to legally terminate the contract, calculate the values of outstanding obligations, and aggregate these values so that only that net cash amount is payable / receivable (that is, ‘close-out’ of the netting contract).

1.35 Currently, section 15C of the Banking Act provides that the fact that a statutory manager is in control of an ADI’s business does not allow the contract, or a party to the contract, to do any of the following:

- deny any obligations under that contract;
- accelerate any debt under that contract; or
- close-out any transaction relating to that contract.

1.36 Corresponding provisions exist in the Insurance Act and Life Insurance Act when a judicial manager is in control of an insurer; and in the Business Transfer Act when a compulsory transfer of business has been effected under that Act. Other provisions which have a similar effect are set out in the Industry Acts in respect of certain other resolution-related activities such as the giving of directions, the giving of recapitalisation directions and the taking of certain actions in respect of a recapitalisation. These other provisions are discussed in further detail in the ‘Detailed explanation of new law’ part of this memorandum.

1.37 Without such provisions, the regulatory actions described in the relevant sections of the Industry Acts could potentially constitute an ‘event of default’ or other ‘specific event’ under many commercial contracts. Such ‘events’ have the potential to trigger a number of contractual consequences, which may ultimately have an adverse effect on the financial position of the regulated entity and cause systemic disruption. The provisions in the Industry Acts are therefore designed to ensure that specified actions taken by APRA do not constitute such ‘events’ or trigger such consequences.

1.38 In contrast to the Industry Acts, sections 14(2) and 16(2) of the PSN Act provide certain netting protections may apply if, respectively:

- a person who is, or has been, a party to a close-out netting contract goes into external administration and Australian law governs either the external administration or the contract; or
- a party to a market netting contract goes into external administration and Australian law governs either the external administration or the contract.

1.39 In general terms, sections 14(2) and 16(2) of the PSN Act provide that, in certain circumstances, transactions under the close-out netting contract or market netting contract may be ‘closed-out’ if a party to a close-out netting contract or market netting contract goes into external administration.

1.40 The inconsistency between the protection given to close-out netting under the PSN Act and stay on closing out transactions under the Industry Acts creates uncertainty as to the capacity of a party to a netting contract to exercise a contractual right to close-out of a contract with a Regulated Entity that is under statutory or judicial management. This uncertainty has the potential to impede the efficiency of the financial markets in Australia by making it more difficult for Australian entities to enter into hedging arrangements, as well as impeding the ability of the APRA to effectively manage distress in financial institutions and also impacting on the amount of capital required to be held by Regulated Entities.

1.41 Certainty of close-out netting rights is fundamental to domestic and foreign market participant's assessment of the risks associated with transacting with Australian Regulated Entities, and any uncertainty could inhibit Australian Regulated Entities' abilities to fully participate in global financial markets. However, this needs to be balanced with the need for a stay to apply in respect of certain termination rights which may be granted under contracts to which a regulated entity is party, to enable the resolution authority (e.g. APRA) to adequately resolve the Regulated Entity so that obligations continue to be met (whether in the existing Regulated Entity or through a transfer of business).

1.42 To address this inconsistency, this Bill sets out amendments to clearly define the extent to which a counterparty may exercise existing rights to close-out transactions under a close-out netting contract or market netting contract due to the appointment of a statutory or judicial manager (or occurrence of other regulatory action or circumstances described in the relevant section of the Industry Act) (if at all). The amendments are to provide certainty:

- as to the circumstances in which a counterparty to a close-out netting contract is stayed from exercising close-out rights triggered solely by the appointment of a statutory or judicial manager or compulsory transfer of business, and the duration of any such stay; and
- that the stays described in the Industry Acts do not apply to market netting contracts.

International developments

1.43 Since the global financial crisis, prudential regulators and legislatures have sought to develop resolution regimes for regulated financial institutions to improve the relevant regulator's ability to manage a financial institution which becomes distressed and limit any possible contagion effects of that distress.

1.44 One aspect of the resolution regimes which have been adopted, or are being developed, internationally is the ability of the resolution authority (e.g. the prudential regulator) of a regulated entity to suspend the termination rights (also called close-out rights) of counterparties under contracts, including derivatives contracts.

1.45 In October 2011 the Financial Stability Board (FSB) released its *Key Attributes of Resolutions Regimes for Financial Institutions* (the Key Attributes), which outlined the core elements that would allow authorities to resolve financial institutions in an orderly manner without taxpayer exposure. In particular, the FSB stated that the legal framework governing

netting contracts should be clear, transparent and enforceable during a crisis, and should not hamper the effective implementation of resolution measures.

1.46 The FSB Key Attributes recommended:¹⁷

The legal framework governing set-off rights, contractual netting and collateralisation agreements and the segregation of client assets should be clear, transparent and enforceable during a crisis or resolution of firms, and should not hamper the effective implementation of resolution measures.

Subject to adequate safeguards, entry into resolution and the exercise of any resolution powers should not trigger statutory or contractual set-off rights, or constitute an event that entitles any counterparty of the firm in resolution to exercise contractual acceleration or early termination rights provided the substantive obligations under the contract continue to be performed.

Should contractual acceleration or early termination rights nevertheless be exercisable, the resolution authority should have the power to stay temporarily such rights where they arise by reason only of entry into resolution or in connection with the exercise of any resolution powers'.¹⁸

1.47 Another key development in the international approach to financial institution resolution has been that, in 2014, the International Swaps and Derivatives Association Inc. (ISDA) published the 2014 Resolution Stay Protocol (relaunched as the ISDA 2015 Universal Resolution Stay Protocol in November 2015) (Stay Protocol). It enables parties to amend the terms of certain agreements to contractually recognise the cross-border application of special resolution regimes applicable to certain financial companies and support the resolution of certain financial companies under the United States Bankruptcy Code. This is achieved by the parties to the Stay Protocol contractually recognising temporary stays of cross-default and early termination rights when a party to the contract is subject to a resolution action. The Stay

17 Financial Stability Board, 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (15 October 2014), paragraphs 4.1 to 4.3.

18 Reference is also made to article 71(1) of Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014, which provides that, 'Member States shall ensure that resolution authorities have the power to suspend the termination rights of any party to a contract with an institution under resolution from the publication of the notice pursuant to Article 83(4) until midnight in the Member State of the resolution authority of the institution under resolution at the end of the business day following that publication, provided that the payment and delivery obligations and the provision of collateral continue to be performed'.

Protocol sets out certain requirements which must be satisfied in order for the limitations on the exercise of particular default rights of parties to be applicable, including that the exercise of authority under the 'Protocol-eligible Regime' (as defined in the Stay Protocol) complies fully with each element of the 'Creditor Safeguards' (as defined in the Stay Protocol). One Creditor Safeguard is that, whilst resolution-based 'Default Rights' are, or at the discretion of the administrative authority may be, temporarily or permanently stayed, nullified, invalidated or otherwise overridden in the relevant context, the duration of a temporary stay on close-out rights must not exceed two business days.

1.48 Due to the increasing importance of cross-border resolution proceedings for large international financial institutions, it will be important that the stays imposed under Australian statutes, including the stay imposed under the Business Transfer Act, operate in accordance with international best practice, as described in the FSB Key Attributes of Effective Resolution Regimes and the Stay Protocol.

Stay on enforcing security

1.49 The stays set out in the Industry Act do not expressly prevent a regulated entity's counterparties from accessing any security or collateral that has been lodged as part of a contractual arrangement on the grounds described in the relevant section of the Industry Act.

1.50 Accordingly, a risk arises that, if a Regulated Entity has lodged security or collateral with a counterparty as part of a contractual arrangement, the terms of the contractual arrangement may provide for a right on the part of the counterparty to take action in realising or otherwise obtaining benefit from the security or collateral due to the appointment of the statutory manager or judicial manager or compulsory transfer of business. The enforcement of security (e.g. by liquidating a Regulated Entity's assets subject to the security) could exacerbate what would be the already fragile financial position of Regulated Entities in distress and frustrate measures taken by the Government to stabilise them and resolve the distress they are in.

1.51 In order to ensure that the enforcement of security is stayed under the Industry Acts in the same way as close-out netting rights are stayed, this Bill will amend section 15C of the Banking Act and the equivalent provisions in other Industry Acts to ensure that the mere appointment of a statutory manager or judicial manager to, or compulsory transfer of business from, the regulated entity does not trigger these terms.

Business Transfer Act amendments

1.52 The Financial Stability Board's (FSB) *Key Attributes for Effective Resolution of Financial Institutions* (Key Attributes) outlines international best practice in the area of financial crisis resolution. One of the key attributes was that a resolution authority (such as APRA) should only be permitted to 'transfer *all* of the eligible contracts with a particular counterparty to a new entity and would not be permitted to select for transfer individual contracts with the same counterparty and subject to the same netting agreement' ('no cherry-picking' rule) (paragraph 2.1(iii) of Key Attributes).

1.53 Effectively, cherry picking could allow APRA to select only those transactions with a positive value to the new entity, and leave behind all those transactions with a negative value, leaving the counterparty without netting protection. Such an outcome would place counterparties at a substantial disadvantage during a transfer of business process. This risk would be taken into account as part of the credit risk process when a party considers whether to enter into a netting contract. The result could be to inhibit contracting and consequently reduce the benefits which can flow from netting contracts.

1.54 This Bill amends the Business Transfer Act to clarify that particular transactions under a particular close-out netting contract, market netting contract or approved netting arrangement cannot be transferred without the other transactions under that close-out netting contract, market netting contract or approved netting arrangement (i.e. 'cherry picking' is not to occur within a close-out netting contract, market netting contract or approved netting arrangement). Any such transfer will be void in respect of the relevant contract or arrangement. However, this amendment will not otherwise constrain or fetter the regulators' ability to pick and choose which assets and liabilities to transfer or otherwise affect the validity of the transfer generally. This reflects the FSB recommendation and applies regardless of whether a statutory manager or judicial manager is appointed.

Part 3 — Impact of non-terminal administrations on participation in approved RTGS systems and approved netting arrangements

Approved RTGS systems

1.55 In RTGS systems, individual payments are processed and settled continuously in real time. For example, under the Reserve Bank of Australia's RTGS system, known as the Reserve Bank Information and Transfer System (RITS), the processing of payments only occurs if the paying institution has funds available in its settlement account with the central bank. Settlement through an RTGS system prevents unintended

credit risk arising from the settlement process, as the release of funds to the payee's account occurs at the time — or shortly after — the corresponding entries are passed to their institutions' accounts with the central bank. In this way the transaction is completed in all its elements — including settlement — immediately and irrevocably.

1.56 Part 2 of the PSN Act applies in respect of approved RTGS systems. An approved RTGS system is a payment or settlement system approved by the Reserve Bank of Australia (RBA), by legislative instrument, under section 9 of the PSN Act. Part 2 of the PSN Act was intended to overcome the effects of the Zero Hour Rule¹⁹ in relation to approved RTGS systems and ensure that transactions executed through an approved RTGS system are not declared to be void by a court or some other competent authority by virtue of section 468 of the Corporations Act (and other similar existing legislative provisions).

Modern resolution regimes and need for reform

1.57 In the years since the introduction of the PSN Act, external administration proceedings which are intended to be rehabilitative, rather than distributive, in nature have become more important, particularly in the context of systemically important financial institutions, such as banks, insurers and financial market infrastructure (FMI). These regimes, often described as 'resolution regimes', focus on resolution and reorganisation of the institution and aim to facilitate the institution continuing as a going concern. Examples of such regimes include the statutory management regime for ADIs set out in the Banking Act and the judicial management regimes for general insurers and life companies set out in the Insurance Act and Life Insurance Act respectively. More traditional external administration proceedings, such as administration under Part 5.3A of the Corporations Act, also have a rehabilitative aim and such proceedings do not necessarily end with the 'death' of the company which is subject to the proceeding. It has also been recognised that there is a possibility that an administrator may be appointed by the board of a Regulated Entity which is an Australian company before a statutory manager was appointed.

19 The effect of the Zero Hour Rule, if it applies, is to provide that when an event is specified to have occurred on a particular day then that event takes place at the earliest point in time after midnight on the commencement of that day. The alternative to this rule is that the event occurs at the moment in the day that it actually took place. For example, if a court orders the winding up of a company at 3:30 pm on a particular day, there is doubt about whether the winding-up commences immediately after midnight on the day that the order is deemed by the Corporations Act to take place (as would be the case if the Zero Hour Rule applies); or whether the winding-up commences at the time the order is made (i.e. 3:30 pm) — see *re Red Robin Milk Bar Limited* [1968] NZLR 28 at 29 per McGregor J; *re Seaford (deceased) Seaford v Seifert* [1967] 2 All ER 458, and on appeal at [1969] 1 All ER 482 at 486; *John Serafino ex parte: Classic Manufacturing Pty Limited*, No P1358 of 1988 (unreported); *Bankruptcy Act 1966* section 57A; *re Pollard; ex parte Pollard* [1903] 2 KB 41.

1.58 In order for these resolution measures to be effective in ‘resolving’ the Regulated Entity, the external administrator (e.g. the statutory manager, judicial manager or administrator) needs to be able to continue to operate the Regulated Entity’s business. It may be beneficial to the Regulated Entity, other participants and financial system stability generally, if the Regulated Entity was able to continue to participate in the approved RTGS system. However, this can only occur if other participants can continue to transact with the participant that is subject to the resolution measure without risk that the payments or transfers that they receive from the Regulated Entity may be unwound.

1.59 Any inability of a Regulated Entity to access an approved RTGS system, such as RITS, could accelerate the failure of the Regulated Entity, which is the very outcome the resolution measure is trying to avoid. Accordingly, it is important that the protections provided to approved RTGS systems, and approved netting arrangements (described below), under the PSN Act allow a financial institution which is under the control of a statutory manager or judicial manager to continue to transact in key systems (e.g. RITS and certain other systemically important payment systems).

Approved netting arrangements

1.60 In addition to approved RTGS systems, some systemically important payment systems and multilateral netting arrangements crucial for the operation of the Australian financial systems are protected under the PSN Act as approved netting arrangements.²⁰ Under approved netting arrangements, a series of gross payment obligations between parties are replaced by a single net position as between the parties.

1.61 Part 2 of the PSN Act applies to approved netting arrangements. An approved netting arrangement is a netting arrangement approved by the RBA under section 12 of the PSN Act. Under section 11 a person may apply to the RBA for approval of an arrangement that has more than two parties and under which the obligations owed by the parties to each other are netted and the RBA may approve the arrangement if it is satisfied of certain criteria.

20 For example, the following payment systems, each operated by Australian Payments Clearing Association Limited (APCA) have been approved as approved netting arrangements: Australian Paper Clearing System (APCS), Bulk Electronic Clearing System (BECS), Consumer Electronic Clearing System (CECS), High-value Clearing System (HVCS) and Issuers and Acquirers Community Framework (IAC). Austraclear (in Fallback mode) and ASX Settlement have also been approved under section 12.

1.62 Under section 10 of the PSN Act, if a party to an approved netting arrangement goes into external administration, the party may do anything permitted or required by the arrangement in order to net:

- obligations incurred before or on the day on which the party goes into external administration; and
- net obligations if the obligations that are directly or indirectly netted are incurred before or on the day on which the party goes into external administration.

1.63 As is the case in respect of approved RTGS systems, any inability of a Regulated Entity to access an approved netting arrangement such as the payment systems operated by Australian Payments Clearing Association (APCA) could accelerate the failure of the Regulated Entity. The reform set out in this Bill to Part 3 of the PSN Act in respect of non-terminal administrations is intended to ensure that a participant that is subject to a non-terminal administration may continue to participate in the approved netting arrangement, notwithstanding the non-terminal administration. For example, it is important that the operator of the approved netting arrangement may net obligations incurred by the resolution authority, on behalf of the participant, during the time at which the participant is subject to the non-terminal administration.

1.64 Accordingly, it is important that the protections provided to approved netting arrangements under the PSN Act allow a financial institution which is under the control of a statutory manager or judicial manager to continue to transact in these arrangements.

Part 4 — Cash market settlement activities in approved netting arrangements

1.65 Australia's cash equity settlement system is currently operated through a licensed clearing and settlement facility (i.e. the holder of an Australian Clearing and Settlement (CS) facility licence under the Corporations Act). The multilateral netting arrangement documented by the operating rules of the cash equity settlement system is approved by the RBA under section 12 of the PSN Act. The netting arrangement is therefore an 'approved netting arrangement' in terms of Part 3 of the PSN Act. Settlement occurs in the system through the simultaneous exchange of title to securities for payment (commonly known as 'delivery versus payment' or 'DvP') in the settlement facility on a deferred multilateral net basis (commonly referred to as 'daily batch' settlement).

1.66 If a participant in the system enters external administration, there may be a risk that transactions settled by the participant on or after the day on which it enters external administration (for example, because the transactions are settled on a deferred basis (e.g. t+2, t+3), settlement occurs after external administration) may be unwound under general Australian insolvency law. It may not be practicable to mitigate this risk by either obtaining the external administrator's prior consent, or suspending the participant from the settlement system immediately, without risking delays to settlement or liquidity problems for non-defaulting participants.

1.67 This Bill amends the PSN Act to clarify that the settlement by way of a payment or a transfer of property by a party under the arrangement to discharge a net obligation which arises under the arrangement by a participant is explicitly validated, where such settlements occur under an approved netting arrangement contained in the rules of, or contracts which relate to, a licensed CS facility (as defined in section 761A of the Corporations Act). Please also refer to impact of the amendments discussed in respect of the impact of non-terminal administrations on participation in approved RTGS systems and approved netting arrangements on the netting of certain obligations incurred during non-terminal administrations.

Part 5 — Market netting contracts and recovery regimes for netting markets

1.68 One part of the PSN Act deals with netting arrangements covered by market netting contracts. These include contracts used by certain stock exchanges, derivatives exchanges and clearing facilities, including CCPs. CCPs are highly important financial market infrastructure, particularly in modern markets as domestic and international regulation is mandating that certain transactions which were previously entered into on a bilateral basis be cleared through a CCP.

1.69 The PSN Act currently provides a range of powerful protections in respect of market netting contracts. These protections reflect the importance of these netting markets to financial system stability and encompass the protection of netting, the enforcement of security, and the transfer of property, rights and obligations (e.g. porting). To ensure that the insolvency of one member of the market does not have a systemic impact on all members of the market, it is extremely important that these arrangements are effective and legally certain.

1.70 CCPs across the world are implementing a comprehensive suite of ‘recovery powers’ that will enhance their ability to withstand extreme financial shocks. International regulatory guidance applicable to systemically important financial market infrastructures such as certain CCPs requires them to develop comprehensive and effective recovery plans (because the ‘disorderly failure of such a CCP could lead to severe systemic disruptions’) and ensure their recovery powers are ‘reliable, timely, and have a sound legal basis’.²¹ It is important to ensure that a CCP’s recovery rules are robustly protected, including in respect of contributions by a participant to a CCP’s mutualised financial resources (default fund); and that such contributions will not be void or voidable in the event that the participant subsequently enters external administration.

1.71 This Bill will amend the legislative protections currently provided to netting markets such as CCPs to protect the CCP’s exercise of its recovery powers, including the receipt of default fund contributions (and other obligations), by providing robust protection of the contractual rules governing the netting market.

1.72 These amendments will also provide robust protections to payments, and transfers of and dealings with, rights, obligations or property, in accordance with the rules that govern the operation of a netting market. This will protect default fund contributions and other payments or transfers of property by the party to meet an obligation under a market netting contract from being void under Australian insolvency law.

21 Committee on Payments and Market Infrastructures (CPMI) and IOSCO, *Recovery of financial market infrastructures* (October 2014), 1 and 14.

Summary of new law

Part 1 — Enforcing security in certain financial markets transactions

1.73 The expansion of the protections of Part 4 of the PSN Act to protect the enforcement of security in the context of margin requirements is required to ensure that, in circumstances where Australian law applies, entities are able to comply with the 2015 BCBS Margin Requirements (and the way in which those requirements are imposed by regulators domestically and internationally) and that such enforcement of security is not impeded by existing Australian law.

1.74 However, this extension of the protections is subject to the safeguards set out in the Bill and security may only be enforced if it complies with the criteria set out in the new provisions.

1.75 If subsections 14(1) or 14(2) of the PSN Act apply, then security given in writing over financial property, in respect of obligations of a party to the contract, may be enforced in accordance with the terms of the security, subject to the safeguards set out in the Bill. However, in order for the enforcement of security to prevail despite any other law in the manner set out in the Bill, a number of criteria must be satisfied, including that:

- the obligations secured by the financial property, and discharged through the enforcement must be:
 - eligible obligations (such term defined in the Bill) in relation to the close-out netting contract; or
 - obligations under the contract of a party to the contract to pay interest on an eligible obligation; or
 - obligations of a party to the contract to pay costs and expenses incurred in connection with enforcing security given in respect of an eligible obligation;
- before enforcement, the financial property must be transferred or otherwise dealt with so as to be in the possession or under the control of the secured party or another person (other than the grantor), who acknowledges in writing that he, she or it has that possession or control of the financial property on behalf of the secured party. The requirement that the other person (other than the grantor) acknowledge in writing that he, she or it has the possession or control of the financial property on behalf of the secured property is not intended to cover a scenario commonly seen in project finance or syndicated facility transactions whereby a security trustee holds security over assets (and potentially

holds the assets provided under that security) for the benefit of other interested parties in addition to a counterparty to the close-out netting contract. The Bill then goes on to provide that financial property is taken not to be in the possession of a person, or is taken to be in the possession or under the control of a person in certain specified circumstances; and

- the enforcement is carried out in a manner that complies with section 420A of the Corporations Act (if it applies) and any applicable general law duties that are not inconsistent with the terms of the security.

1.76 The Bill ensures that a party does not have the protections provided by the PSN Act if they knowingly purchased obligations under a close-out netting contract of an insolvent party from a third party.

Part 2 — Certainty for application of stays on close-out rights

1.77 The Bill promotes the capacity to effectively resolve distress of regulated bodies in the financial sector, and the stability of Australia's financial system, by addressing the inconsistency between the PSN Act and the Industry Acts in ways that broadly align Australian law to international standards, taking into account recent international developments.

1.78 The amendments in the Bill strike a balance between the dual objectives of protecting the legitimate interests of parties to netting contracts, while at the same time ensuring the Commonwealth can effectively address prudential concerns with a financial institution. The amendments will clarify that:

- the protections given to approved RTGS systems, approved netting arrangements and market netting contracts under the PSN Act prevail over stays on close-out rights;
- stays on close-out rights set out in the Industry Acts prevail over the protections given in respect of close-out netting contracts under the PSN Act in the circumstances and for the duration set out in the Bill. However, the stays in the Industry Acts only relate to the particular action described in the relevant stay provision and do not prohibit a party closing out for any other reason (e.g. a counterparty may still terminate because the regulated body, e.g. an ADI, fails to make a payment or perform an obligation, irrespective of whether that failure to pay or perform was in compliance of a direction by the resolution authority);

- in respect of certain derivatives-related arrangements, certain stays (e.g. the stay which arises on the appointment of a statutory manager or judicial manager) apply to restrict a party from exercising its close-out rights for a temporary period (generally, that time period ends at midnight by legal time in the Australian Capital Territory at the end of the first business day after the day on which the trigger event happens e.g. the appointment of the statutory manager which is a close-out right). This time period is described as the ‘resolution period’; and
- a stay may continue to apply permanently if APRA declares it is satisfied of certain solvency-related matters in respect of the regulated body in respect of which the stay applies. However, during the resolution period, APRA may declare instead that the stay ceases if it is satisfied that it will not make a declaration that the relevant stay continues.

1.79 Generally, the amendments are intended to:

- reduce the risk of foreign counterparties declining to enter into such contracts with Regulated Entities in Australia, thereby reducing the risk that such Entities are unable to hedge their risks and maintain business dependent on those risks being hedged; and
- reduce the risk of contagion in periods of financial distress by providing confidence to foreign counterparties that the Australian law is broadly consistent with accepted international benchmarks.

Close-out netting contracts

1.80 Close-out netting is a contractual mechanism that permits one party to the contract to terminate the contract if the other party becomes insolvent, to calculate the termination values of the obligations of the parties, and to net the termination values so calculated to arrive at a net amount payable by one party to the other. This mechanism reduces financial risk and provides legal certainty to parties to a bilateral contract in the case of insolvency of one party to the contract.

1.81 The Bill establishes a framework in respect to close-out netting contracts and the appointment of a statutory or judicial manager to one of the parties to the contract (the Regulated Entity). The specific mechanisms are described in the ‘Detailed explanation of new law’ below.

Approved RTGS systems, approved netting arrangements and market netting contracts

1.82 Due to the importance of approved RTGS systems, approved netting arrangements and netting markets to systemic stability and in light of recent international developments, the Bill clarifies that the protections provided in respect of approved RTGS systems, approved netting arrangements and netting markets have effect despite any other law (including the specified provisions and the specified stay provisions).

Voidable preferences

1.83 The Bill also extends the existing protection provided in section 14 of the PSN Act that the termination of obligations, the netting of obligations and any payment under the close-out netting contract to discharge a net obligation are not considered void or voidable in the external administration to certain things done by a party to a close-out netting contract while the party is in external administration and a specified stay provision applies to the contract. Such things are provided with legal certainty, and are unable to be ‘clawed-back’ under the operation of insolvency law, to facilitate an external administrator such as a statutory manager achieving the objectives of the external administration.

Business Transfer Act amendments

1.84 The Bill also provides that, if there is a partial transfer of the business under the Business Transfer Act of a transferring body which is a party to a close-out netting contract, market netting contract or approved netting arrangement — and the partial transfer covers some (but not all) of the assets and liabilities the body has; under the contract or arrangement, with respect to another party to the contract or arrangement, that partial transfer is void to the extent of the assets or liabilities the transferring body has, just before the partial transfer, under the contract or arrangement, with respect to the counterparty.

Part 3 — Impact of non-terminal administrations on participation in approved RTGS systems and approved netting arrangements

1.85 The amendment to Part 2 of the PSN Act protects payments and transfers executed through an approved RTGS system throughout the course of an external administration other than winding up under the Corporations Act (or the equivalent under foreign laws) (i.e. a non-terminal administration, as defined in the Bill).

1.86 The protection provided under section 6 of the PSN Act is extended by the Bill to provide that, if a participant in an approved RTGS system becomes subject to a non-terminal administration, any payment or settlement transaction executed through the system at any time before the participant goes into, or while the participant is in the non-terminal administration has the same effect it would have had if the participant had not gone into that non-terminal administration.

1.87 However, this amendment does not affect the operation of section 6, as currently drafted, with respect to a winding up under the Corporations Act (irrespective of whether the winding up is a winding up in insolvency, a winding up by the court on other grounds, a winding up by ASIC or a voluntary winding up) or an equivalent insolvency proceeding under foreign laws.

1.88 The key objectives of the reforms to the protection provided under the PSN Act to approved RTGS systems²² and approved netting arrangements²³ are:

- that transactions completed by a member of an approved RTGS system who is subject to a non-terminal administration are not void by virtue of the zero hour rule, section 468 of the Corporations Act or any similar approach that would automatically make void all payments completed by the RTGS system member who is under external administration. This is particularly important in respect of statutory management and judicial management; and
- ensure that a Regulated Entity which is subject to a resolution measure such as statutory management can effectively participate in an approved RTGS system and that counterparties to transactions through approved RTGS systems can transact through such a system with confidence.

1.89 The system administrator continues to have discretion over whether they suspend a participant in external administration.

1.90 In order for a Regulated Entity to be able to continue to access an approved netting arrangement during a resolution measure such as statutory management, the protections provided to approved netting arrangements under section 10 must extend to:

²² Please refer to paragraphs 1.56 and 1.224 for further detail regarding approved RTGS arrangements.

²³ Please refer to paragraphs 1.60 and 1.224 for further detail regarding approved netting arrangements.

- obligations incurred before the participant such as a Regulated Entity goes into, and while the participant is in, such a non-terminal external administration (such as a resolution measure like statutory management); and
- net obligations if the obligations that are directly or indirectly netted are incurred before the participant such as a Regulated Entity, and while the participant is in, such a non-terminal external administration.

1.91 This is expected to facilitate the continued participation of the Regulated Entity in the approved netting arrangement where such participation may be fundamental to the entity's ongoing viability (e.g. due to the necessity of making payments through such an arrangement).

Part 4 — Cash market settlement activities in approved netting arrangements

1.92 Amendments are made to Part 3 of the PSN Act to provide that, for an approved netting arrangement that is governed by the rules of a licensed CS facility (as defined in section 761A of the Corporations Act), a payment, or a transfer of property, by a party under the arrangement to discharge a net obligation (such net obligation being a net obligation which arises under the approved netting arrangement) is not to be void or voidable in the event that a party to the arrangement is, or comes under, external administration.

Part 5 — Market netting contracts and payments and transfers under netting markets

1.93 The definition of market netting contract in the PSN Act is amended to include the rules governing the operation of a netting market if those rules have effect as a contract between a participant in the netting market and one or more other persons.

1.94 Part 5 of the PSN Act is amended to provide that any payment or a transfer of property (whether absolutely or by way of security) by the party to meet an obligation under the market netting contract is not to be void or voidable in the external administration of the party to the market netting contract.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
<i>Enforcing security in certain financial markets transactions</i>	
<p>Security given in writing over financial property, in respect of obligations of a party to the contract, may be enforced in accordance with the terms of the security but subject to the criteria set out in section 15A of the PSN Act.</p> <p>This has effect in relation to a close-out netting contract subject to a specified stay provision that applies to the contract (see discussion regarding stays below) and despite any other law (including the specified provisions).</p>	<p>The existing protections provided under the PSN Act in respect of close-out netting contracts do not protect actions taken to enforce security.</p> <p>A range of legacy Australian law issues could prevent entities subject to Australian law from being able to provide, or enforce rights in, margin provided by way of security in the manner contemplated by the BCBS-IOSCO Margin Requirements, including for example the existence of priority regimes which apply in respect of the assets of certain types of entities, stays on the enforcement of security on the commencement of certain insolvency proceedings and rules for the creation, priority and enforcement of security interests in personal property.</p>
<p>A party may not rely on the protections granted by the PSN Act if the person acquired the right or obligation from another person with notice that that other person, <i>or the other party to the contract</i>, was at that time unable to pay their debts as and when they became due and payable (and the person acquired the right or obligation otherwise than as a result of the operation of section 22, 35 or 36R of the Business Transfer Act).</p>	<p>A party may not rely on the protections granted by the PSN Act 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.</p>
<p>A person goes into external administration if:</p> <ul style="list-style-type: none"> (a) they become a body corporate that is an externally administered body corporate within the meaning of the Corporations Act; or (b) they become an individual who is an insolvent under administration; or (c) someone takes control of the person's property for the benefit of the person's creditors because the person is, or is likely to become, insolvent; or 	<p>A person goes into external administration if:</p> <ul style="list-style-type: none"> (a) they become a body corporate that is an externally administered body corporate within the meaning of the Corporations Act; or (b) they become an individual who is an insolvent under administration; or (c) someone takes control of the person's property for the benefit of the person's creditors because the person is, or is likely to become, insolvent.

<i>New law</i>	<i>Current law</i>
<p>(d) an ADI statutory manager takes control of the person’s business under the Banking Act; or</p> <p>(e) the person comes under judicial management under the Insurance Act; or</p> <p>(f) the person, or a part of the person’s business, comes under judicial management under the Life Insurance Act.</p>	
<p>The external administrator for a person who goes into external administration is the person who takes control of the property, business, or the part of the business, of the person under the administration.</p>	<p>The external administrator for a person who goes into external administration is the person who takes control of the person’s property under the administration.</p>
<i>Certainty for application of stays on close-out rights</i>	
<p>A party to a close-out netting contract cannot close-out transactions under the contract on the grounds of the appointment of a statutory manager or judicial manager or the action taken in respect of a recapitalisation of a Regulated Entity (such grounds being the Relevant Event and this potentially being the trigger event) unless the relevant stay has ceased to apply to the contract.</p> <p>If an obligation under the contract of a party to the contract is an eligible obligation in relation to the contract and a specified stay provision (other than a direction stay provision) applies to a trigger event that happens in relation to the contract, then the stay ceases to apply at the end of the resolution period and a party to the contract may close-out the transactions under the contract in accordance with the contract on the grounds of the Relevant Event at that time.²⁴</p>	<p>The Industry Acts provide that a party to a contract cannot close-out transactions under the contract on the grounds that a statutory or judicial manager has been appointed to a party to that contract or on the grounds of the action taken in respect of a recapitalisation of a Regulated Entity.</p> <p>The PSN Act provides that, where subsection 14(1) or 14(2) applies, a party to a netting contract can close-out transactions under the contract in accordance with the contract, including, if applicable, on the grounds that an external administrator such as a statutory manager or judicial manager has been appointed to a party to that contract or a recapitalisation action has been taken.</p>

24 In this comparison table, the references to a party being able to close-out transactions under a contract or arrangement, when used in respect of the PSN Act, mean that obligations may be terminated, termination values may be calculated and a net amount may become payable in accordance with the contract or arrangement.

<i>New law</i>	<i>Current law</i>
<p>The resolution period is the period starting when the trigger event happens (e.g. when the Relevant Event happens) and ending at midnight (by legal time in the Australian Capital Territory) at the end of the first business day after the day on which the trigger event happens.</p> <p>APRA may shorten this period if it is satisfied that it will not make a declaration that the stay will continue before the end of the resolution period.</p> <p>APRA may extend this period should specified objective circumstances exist that protect the legitimate interests of counterparties, including by making it permanent.</p>	
<p>A party to a close-out netting contract <i>cannot</i> close-out transactions under the contract on the grounds that an act is done for the purposes of Division 2 of 3 of Part 4 of the Business Transfer Act or that a certificate of transfer comes into force under Division 3 of Part 4 of the Business Transfer Act (such grounds being the Relevant Transfer Event and this potentially being a trigger event) unless the relevant stay has ceased to apply to the contract.</p> <p>If an obligation under the contract of a party to the contract is an eligible obligation in relation to the contract and a specified stay provision (other than a direction stay provision) applies to a trigger event that happens in relation to the contract, then the stay ceases to apply at the end of the resolution period and a party to the contract may close-out the transactions under the contract in accordance with the contract on the grounds of the Relevant Transfer Event at that time.</p> <p>The resolution period is the period starting when the trigger event happens (i.e. when the Relevant Transfer Event happens) and</p>	<p>The Business Transfer Act provide that a party to a contract cannot close-out transactions under the contract on the grounds that an act is done for the purposes of Division 2 of 3 of Part 4 of the Business Transfer Act or that a certificate of transfer comes into force under Division 3 of Part 4 of the Business Transfer Act.</p> <p>The PSN Act provides that, where subsection 14(1) or 14(2) applies, a party to a netting contract can close-out transactions under the contract in accordance with the contract, including, if applicable, on the grounds that actions have been taken in respect of a compulsory transfer of business.</p>

<i>New law</i>	<i>Current law</i>
<p>ending at the time APRA declares the resolution period ends for the Relevant Transfer Event or, if a certificate of transfer comes into force, just after that certificate comes into force.</p> <p>APRA may <i>shorten</i> this period if it is satisfied that it will not make a declaration that the stay will continue before the end of the resolution period.</p> <p>APRA may <i>extend</i> this period should specified objective circumstances exist that protect the legitimate interests of counterparties.</p>	
<p>If subsection 10(1) or 10(2) applies, a party to the approved netting arrangement may close-out transactions under the arrangement in accordance with the arrangement.</p>	<p>The Industry Acts provide that a party to a contract cannot close-out transactions under the contract on the grounds that a statutory or judicial manager has been appointed to a party to that contract or on the grounds of the action taken in respect of a recapitalisation of a Regulated Entity or on the grounds of certain actions done in connection with a compulsory transfer of business.</p> <p>The PSN Act provides that, where subsection 10(1) or 10(2) applies, a party to an approved netting arrangement can close-out transactions under the arrangement in accordance with the arrangement.</p>
<p>If subsection 16(1) or 16(2) applies, a party to the market netting contract may close-out transactions under the contract in accordance with the contract.</p>	<p>The Industry Acts provide that a party to a contract cannot close-out transactions under the contract on the grounds that a statutory or judicial manager has been appointed to a party to that contract or on the grounds of the action taken in respect of a recapitalisation of a Regulated Entity or on the grounds of certain actions done in connection with a compulsory transfer of business.</p> <p>The PSN Act provides that, where subsection 16(1) or 16(2) applies, a party to a market netting contract can close-out transactions under the contract in accordance with the contract.</p>

<i>New law</i>	<i>Current law</i>
<p>The specified stay provisions of the Industry Acts generally provide that the fact that the event described in the specified stay provision occurs does not allow the contract, or a party to the contract, to do any of the following:</p> <ul style="list-style-type: none"> • deny any obligations under that contract; • accelerate any debt under that contract; • close out any transaction relating to that contract; or • enforce any security under that contract. 	<p>The specified stay provisions of the Industry Acts generally provide that the fact that the event described in the specified stay provision occurs does not allow the contract, or a party to the contract, to do any of the following:</p> <ul style="list-style-type: none"> • deny any obligations under that contract; • accelerate any debt under that contract; or • close out any transaction relating to that contract.
<p>The following things done by a party to a close-out netting contract while it is in external administration and while a specified stay provision under an Industry Act applies to the contract, are not liable to be set aside as void or voidable under the application of the Corporations Act in an external administration:</p> <ol style="list-style-type: none"> (a) making a payment, or transferring property, to another person to meet an obligation under the contract; (b) creating rights or obligations in another person under the contract; (c) giving any security to another person in relation to the contract; or (d) entering into one or more close-out netting contracts with another person. 	
<p>A partial transfer that covers some (but not all) of the assets and liabilities the body has, under a close out netting contract, market netting contract or approved netting arrangement, with respect to another party to the contract or arrangement is void to the extent of the assets or liabilities the transferring body has, just before the partial transfer, under the contract or arrangement, with respect to the counterparty</p>	<p>The Business Transfer Act provides that a party to a contract cannot close-out transactions under the contract on the grounds that an act is done for the purposes of Division 2 of 3 of Part 4 of the Business Transfer Act or that a certificate of transfer comes into force under Division 3 of Part 4 of the Business Transfer Act.</p>

<i>New law</i>	<i>Current law</i>
<p>While the stay in section 36AA of the Business Transfer Act applies (as set out in the PSN Act), a party to a close out netting contract cannot close-out transactions under the contract on the basis of the acts described in section 36AA, unless the transfer purports to relate to some (but not all) of the assets and liabilities under that contract.</p>	
<p><i>Impact of non-terminal administrations on participation in approved RTGS systems and approved netting arrangements</i></p>	
<p>The current law continues to apply if a participant in an approved RTGS system goes into external administration (other than non-terminal administration).</p> <p>If:</p> <ul style="list-style-type: none"> (a) a participant in an approved RTGS system goes into non-terminal administration; (b) there is a transaction involving the payment of money, or the transfer of an asset, by the participant; and (c) the transaction is executed through the approved RTGS system at any time before the participant goes into, or while the participant is in, non-terminal administration; <p>the payment or transfer has the same effect it would have had if the participant had not gone into non-terminal administration.</p>	<p>If:</p> <ul style="list-style-type: none"> (a) a participant in an approved RTGS system goes into external administration; (b) there is a transaction involving the payment of money, or the transfer of an asset, by the participant; and (c) the transaction is executed through the approved RTGS system at any time on the day on which the external administrator is appointed, <p>the payment or transfer has the same effect it would have had if the participant had gone into external administration on the next day.</p>
<p>The current law continues to apply if a party to an approved netting arrangement goes into external administration if the external administration is not a non-terminal administration.</p> <p>If a party to an approved netting arrangement goes into external administration and the external administration is a non-terminal administration, the party may do anything permitted or required by the arrangement in order to net:</p>	<p>If a party to an approved netting arrangement goes into external administration, the party may do anything permitted or required by the arrangement in order to net:</p> <ul style="list-style-type: none"> (a) obligations incurred before or on the day on which the party goes into external administration; and (b) net obligations if the obligations that are directly or indirectly netted are incurred before or on the day on which the party goes into external administration.

<i>New law</i>	<i>Current law</i>
<p>(a) obligations incurred before the participant goes into, or while the participant is in, non-terminal administration; and</p> <p>(b) net obligations if the obligations that are directly or indirectly netted are incurred before the participant goes into, or while the participant is in, non-terminal administration.</p>	
<i>Cash market settlement activities in approved netting arrangements</i>	
<p>If a party to an approved netting arrangement goes into external administration, then for an arrangement that is governed by the rules of a licensed CS facility (as defined in section 761A of the Corporations Act), a payment, or a transfer of property, by a party under the arrangement to discharge a net obligation (which arises under the arrangement) is not to be void or voidable in the external administration.</p>	<p>If a party to an approved netting arrangement goes into external administration, the netting and any payment made by the party under the arrangement to discharge a net obligation is not to be voidable in the external administration.</p>
<i>Market netting contracts and recovery regimes for netting markets</i>	
<p>In addition to the existing definition of market netting contract, a market netting contract also means the rules governing the operation of a netting market, if those rules have effect as a contract between a participant in the netting market and one or more other persons.</p>	<p>A market netting contract means:</p> <p>(a) a contract:</p> <p style="padding-left: 20px;">(i) entered into in accordance with the rules that govern the operation of a netting market; and</p> <p style="padding-left: 20px;">(ii) under which obligations between parties to the contract are netted; or</p> <p>(b) a contract declared by the regulations to be a market netting contract for the purposes of the PSN Act;</p> <p>but does not include:</p> <p>(c) a contract that constitutes, or is part of, an approved netting arrangement; or</p> <p>(d) a contract declared by the regulations not to be a market netting contract for the purposes of the PSN Act.</p>

<i>New law</i>	<i>Current law</i>
If a party to a market netting contract goes into external administration and Australian law governs either the external administration or the contract, a payment, or a transfer of property (whether absolutely or by way of security), by the party to meet an obligation under the contract is not to be void or voidable in the external administration.	If a party to a market netting contract goes into external administration and Australian law governs either the external administration or the contract, a payment, or a transfer of property (whether absolutely or by way of security), by the party to meet an obligation under the contract to pay a deposit or margin call is not to be void or voidable in the external administration.

Detailed explanation of new law

Part 1 — Enforcing security in certain financial markets transactions

Existing provisions of the PSN Act

1.95 Section 14 of the PSN Act sets out certain actions that may be done under the terms of close-out netting contracts. Close-out netting contracts are defined in section 5 of the PSN Act as a contract under which, if a particular event happens, particular obligations of the parties terminate or may be terminated, the termination values of the obligations are calculated or may be calculated and the termination values are netted, or may be netted, so that only a net cash amount (whether in Australian currency or some other currency) is payable (or a contract declared by the regulations to be a close-out netting contract for the purposes of the PSN Act subject to certain exclusions in paragraphs (c) to (e) of the definition).

1.96 The PSN Act in this manner provides certain protections to the contracts widely used in financial markets transactions such as currency (foreign exchange) derivatives, interest rate swaps and other interest rate derivatives, credit derivatives, equity derivatives, securities lending agreements, master repurchase agreements and other types of derivatives.

1.97 Existing subsection 14(1) allows obligations under a close-out netting contract to be terminated, termination values to be calculated and a net amount to become payable in accordance with the contract if Australian law governs the close-out netting contract and the contract is entered into in circumstances that are within Commonwealth constitutional reach. Subsection 14(2) allows the same thing to be done where a person who is, or has been, a party to a close-out netting contract goes into external administration and Australian law governs either the external administration or the contract, and makes it explicit that termination and netting can occur despite the external administration. These two subsections are not mutually exclusive. The existing subsections 14(3) and 14(5) provide that a person may not rely on the application of subsections 14(1) and 14(2) (subsection 14(1) only in the case of subsection 14(3)) if certain conditions set out in subsections 14(3) or 14(5) are present. Subsection 14(4) provides that subsections 14(1) and 14(2) have effect despite any other law (including the specified provisions, which are defined in section 5).

1.98 The ability to override other legislation makes these provisions in the PSN Act particularly powerful. The main policy rationale for the special powers provided under the PSN Act is that the entities and transactions that benefit from them are at the heart of the financial system and are important in protecting financial systemic stability.

1.99 While the protection provided by section 14 of the PSN Act is powerful, it is limited in all cases to actions that are allowed under the terms of the close-out netting contract. In the case of two parties transacting under a close-out netting contract, each transaction entered into between the parties occurs under the close-out netting contract. Accordingly, the scope of the actions permissible under section 14 of the PSN Act is significantly determined by the terms of the close-out netting contract.

Amendments to subsection 14(1) of the PSN Act

1.100 Amendments are made to subsection 14(1) of the PSN Act that allow a party to a close-out netting contract to whom security has been granted (this party is called the secured party or collateral taker interchangeably in this explanatory memorandum) to enforce security in certain situations in accordance with the terms of the security where the counterparty (the counterparty is also described as the grantor or collateral provider in this explanatory memorandum) defaults on its obligations but has not entered external administration.

1.101 Such defaults would be likely to occur in situations where the counterparty is experiencing financial difficulties, and it is important for the secured party to be able to take immediate action without having to wait for a formal external administration to commence and without needing to comply with, or be affected by, other existing requirements under Australian law (e.g. perfection and priority rules under the PPSA). Due to the impending margin requirements and importance of being able to enforce security for certain Regulated Entity's capital requirements, it is important that entities subject to Australian law can provide, and enforce rights in, margin provided by way of security in the manner contemplated by the BCBS-IOSCO Margin Requirements.

1.102 However, it is also important to ensure that these powerful protections provided to secured parties under close-out netting contracts are not abused and accordingly the protection of the enforcement of security is subject to a range of safeguards.

Enforcing security

1.103 This Bill reforms the PSN to ensure that entities subject to Australian law can grant, and enforce rights in, margin provided by way of security in the manner contemplated by the BCBS-IOSCO Margin Requirements. The PSN Act is amended to provide that any security which has been given in writing over financial property, in respect of obligations of a party to the contract, may be enforced in accordance with the terms of the security (subject to the conditions set out in the new section 14A of the PSN Act). The reference to security contemplates the

traditional forms of security, being the charge, mortgage, pledge and lien rather than non-traditional forms of ‘security interest’ (as contemplated by the PPSA) such as a conditional sale agreement (including an agreement to sell subject to retention of title). The obligations referred to in the new paragraph (ca) are intended to apply broadly to encompass monetary and non-monetary obligations, including obligations to deliver commodities under commodity derivatives, securities under securities lending arrangements and securities, bonds or other instruments under repurchase agreements, and contingent obligations. [**Schedule 1, Part 1, item 21, after paragraph 14(1)(c), paragraph (ca)**]

1.104 Clarification is also made by establishing Divisions within Part 4, the first in respect of the effectiveness of close-out netting contracts (which should not be read to mean that, if the relevant parts of Division 1 of Part 4 of the PSN Act do not apply, the contract or security is not otherwise effective in accordance with other laws) and the second in respect of the circumstances in which non direction stays may cease. [**Schedule 1, Part 1, item 20, Before section 14, Division 1—Effectiveness of close out netting contracts**]

References to ‘enforce’ and ‘enforcement’

1.105 The references to ‘enforced’, and ‘enforcement’ of, security in the PSN Act should be broadly interpreted to include the exercise by the secured party of a right, power or remedy existing because of the security arising under an agreement or instrument relating to the security (including the close-out netting contract), under a written or unwritten law or in any other way.

1.106 Similarly, the references to ‘enforced’, ‘enforcement’ and ‘discharged through enforcement’ include:

- the satisfaction (through payment of an amount, or through realisation of the secured financial property by way of sale or liquidation) of; or
- setting off the value of the secured financial property (or the proceeds of the secured financial property obtained through selling or liquidating that property) against; or
- applying that value in discharge of any of the following:
 - eligible obligations in relation to the contract; or
 - obligations under the contract of a party to the contract to pay interest on an eligible obligation; or

- obligations of a party to the contract to pay costs and expenses incurred in connection with enforcing security given in respect of an eligible obligation.

1.107 However, the secured party is subject to any conditions or restrictions on enforcement to which the secured party agrees in the terms of the security.

No protection of creating security if not otherwise able to

1.108 The protection given to the enforcement of security under the PSN Act does not of itself allow for the creation of security by an entity where that entity does not otherwise have the power to create the security or the security could not otherwise have been created, or otherwise do away with any fundamental legal requirement regarding the creation of security (e.g. that there be a valid contract and that there be no fraud or other vitiating factors).

Interaction with the PPSA and other laws

1.109 This Bill intentionally overrides, rather than adopting, the PPSA. It was not considered necessary to refer to ‘security interest’ or otherwise incorporate concepts of the PPSA (including the PPSA concepts of ‘control’ or ‘possession’), as these are not entirely appropriate for use in this context. The approach taken in this Bill is broadly consistent with the approach which has previously been taken on this issue in other parts of the PSN Act (e.g. section 16). Similarly, it is not considered appropriate to refer to the specific types of personal property described in the PPSA, as this could lead to uncertainty and unnecessary complexity, which is inconsistent with the intention of this reform facilitating enforcement of security in practical circumstances without unnecessary legal complexity.

1.110 The PPSA requirements for perfection do not apply in order for an enforcement of security to be protected under the PSN Act. The amendments have the effect that, unless the PPSA is applicable in the context of ‘excess’ collateral or proceeds of collateral, the PPSA (including the provisions which relate to the perfection, priority and enforcement of security interests) do not apply to restrict the enforcement of security which is otherwise protected under the PSN Act. For example, the secured party is not required to register any security interest that secured party has under the security on the Personal Property Securities Register (PPS Register), comply with any of the requirements in the PPSA regarding perfection and priority in order to obtain the benefits of the protection provided under the PSN Act in respect of enforcing security. In consideration of any potential mischief which could be caused to other creditors, it is noted that, under the PPSA, as the PPSA currently applies, security interests under the PPSA may be perfected by means other than

registration (e.g. perfection by possession or control)²⁵ and such security interests may not be registered on the PPS Register. Therefore, searches of the PPS Register conducted by interested parties in respect of an entity may not show up all security interests granted by an entity in any case.

1.111 Similarly, unless it is applicable in the context of collateral or proceeds of collateral which are in excess of the amount used to discharge the eligible obligations (discussed below in the context of the reference to ‘to the extent that’ in subsection 14A(1)), the application of the secured property or proceeds of the secured property to discharge the obligations described in paragraph 14(1)(a) will not be subject to the preference regimes set out in the Industry Acts²⁶ and priority regime in the Corporations Act and PPSA.

Financial property

1.112 In order for the enforcement of security to be protected under the amendments, only security over financial property may be enforced. The term financial property is defined in section 5 of the PSN Act to include a range of different property provided as collateral in financial markets transactions and uses existing concepts familiar to Australian law such as:

- ‘security’ (within the meaning of section 92 of the Corporations Act but disregarding subsections 92(3) and (4) which alter the meaning of the term in relation to specific Chapters of the Corporations Act), which includes debentures, stocks or bonds issued or proposed to be issued by a government, shares in, and debentures of, a body, interests in a managed investment scheme, units of such shares but does not include certain derivatives or excluded securities);
- a derivative. The amendments provide that term derivative, when used in the PSN Act, has the same meaning as in Chapter 7 of the Corporations Act; [***Schedule 1, Part 1, item 1, Section 5, ‘derivative’ and item 4, Section 5, ‘financial property’***]

25 Section 26 of the PPSA provides for the conditions which must be satisfied in order for a person to have control of an intermediated security that is credited to or recorded in a securities account. Also, it is noted that section 57(1) provides that a security interest in collateral that is currently perfected by control has priority over a security interest in the same collateral that is currently perfected by another means.

26 For example, sections 11F and 13A(3) of the Banking Act and section 116(3) of the Insurance Act.

- a financial product (within the meaning of the Corporations Act) that is traded on a financial market (within the meaning of that Act) that is:
 - operated in accordance with an Australian market licence (within the meaning of that Act); or
 - exempt from the operation of Part 7.2 of that Act. This definition is intended to capture any other financial products which may be traded on financial markets which do not otherwise fall into another category of ‘financial property’;
- a negotiable instrument (within the meaning of the PPSA), which is defined in section 10 of the PPSA to include a range of debt instruments such as bills of exchange, cheques, promissory notes, certain letters of credit and certain other writings evidencing a right to payment of currency (subject to certain exclusions);
- currency (whether of Australia or of any other country);
- gold;
- property declared by regulations to be financial property for the purposes of the PSN Act. As financial markets, and market conventions, change rapidly, it is important that the definition of property in respect of which security may be enforced can be adapted and updated to evolve with the markets. Accordingly, a regulation power is provided to allow for regulations to declare property to be financial property for the purposes of the PSN Act;
- if a person (an intermediary) maintains an account to which interests in property or rights to payment or delivery of property described above may be credited or debited — the rights of a person in whose name the intermediary maintains the account. This is intended to capture a range of property, including:
 - accounts where a bank holds currency as banker for a customer in an account such as a savings account, cheque account or other accounts in which the customer has a right to payment of the equivalent amount of currency;
 - securities accounts and other intermediated debt and equity securities, being an interest in debt or equity securities recorded in fungible book-entry form in an account maintained by an intermediary where such interest has been credited to the account. It is noted

that the interest of the holder of the account is generally considered to be a right to a beneficial interest in whatever is held by the intermediary for the account holder; and

- proceeds (including rights and property) of property that is financial property.

1.113 This is intended to provide a list of property which, generally, includes cash (including cash accounts), securities accounts, government and central bank securities, corporate bonds, covered bonds, equities and gold (including accounts of gold) and cover debt and equity securities irrespective of whether they are directly held bearer securities, directly held registered securities, directly held dematerialised securities or indirectly held securities (using the term securities in its generic sense). The location of the property, intermediary or account is not relevant to the definition. [*Schedule 1, Part 1, item 4, Section 5, 'financial property'*]

1.114 To ensure that the definition can be adapted if the Government becomes aware of certain types of property against which security should not be able to be enforced, the Government may declare by regulations that certain property is not to be financial property for the purposes of the PSN Act.

Amendments to paragraph 14(1)(d)

1.115 Amendments to paragraph 14(1)(d) are made which are intended to ensure that certain actions by a defaulting counterparty in violation of the terms of the close-out netting contract or security such as disposals of rights or assets cannot stop the secured party from enforcing security it holds. The purpose of extending paragraph 14(1)(d) to the enforcement of security is to ensure that the security can be enforced even if one of the parties to the contract has breached it, including by improperly assigning the rights that may be netted under the contract of financial property or improperly creating, or allowing to exist, an encumbrance or other rights in relation to those rights or financial property. The protection provided to the enforcement of security is intended to ensure that the secured party's rights to the financial property subject to the security are not subject to any other third party's interest (whether that third party be a secured party or a creditor which would otherwise be mandatorily preferred by operation of laws)²⁷ or any priority regime (i.e. the security in respect of that amount should be first ranking despite any other law).

27 For example, sections 555 and 556 of the Corporations Act set out a priority regime which would otherwise apply on the insolvency of a grantor of security under a close-out netting contract which is a company registered, or taken to be registered, under the Corporations Act. Similarly, Part 2.6 of the PPSA (and other provisions of the PPSA) sets out a priority regime which could result in a secured party losing priority.

1.116 The effect of these provisions is that an acquisition of title to rights or property by a third person in breach of a close-out netting contract may potentially be voidable in the event of enforcement occurring.

1.117 It is clarified that paragraph 14(1)(d) applies to the matters contained in new paragraph 14(1)(ca). That is to say, it applies to the enforcement of the security given in writing over financial property in respect of obligations of a party to the contract. [**Schedule 1, Part 1, item 22, paragraph 14(1)(d)**]

1.118 Amendments to subparagraphs 14(1)(d)(ii) and (iii) clarify that the enforcement of security remains valid despite any encumbrance or other interest granted over the rights that may be netted under the contract or financial property by the defaulting counterparty to a third party in violation of the terms of the close-out netting contract. It is noted that this provision may give rise to a possible breach of paragraph 51(xxxi) of the Constitution which prohibits the acquisition of property other than on just terms. This issue arises because the property may have been transferred to an innocent third party prior to the commencement of this amendment, whose interests may subsequently suffer because of the operation of this amendment. The issue is being addressed through an application provision confining the effect of this amendment to cases where the interest is granted after the commencement of the amendment so that no acquisition on unjust terms occurs (see paragraph 1.272 in respect of Part 3 — Application, sub item (5)). [**Schedule 1, Part 1, item 23, subparagraphs 16(1)(d)(ii) and (iii)**]

Amendments to subsection 14(2) of the PSN Act

1.119 The following amendments address issues arising when a party who is, or has been, a party to a close-out netting contract goes into external administration. The key issues relate to the enforcement of security given in writing over financial property in respect of obligations of a party to the contract without obtaining the consent of the external administrator or the court, and ensuring that the external administrator cannot unwind that enforcement of security (including the discharge of any obligations of the party to the contract).

1.120 It is clarified that in a situation where such a party enters external administration the secured party can enforce security given in writing over financial property in respect of obligations of a party to the contract in accordance with the terms of the security (but subject to the criteria in section 14A, discussed below). As noted in paragraph 1.22 there are currently a range of issues which arise in the context of creating and enforcing rights as a secured party under Australian law which could prevent entities subject to Australian law from being able to provide, or

enforce rights in, margin provided by way of security in the manner contemplated by the BCBS-IOSCO Margin Requirements. This amendment and the amendment to subsection 14(1) are designed to remove this ambiguity. It is noted that this amendment is worded in a flexible manner intended to encompass more complex types of security arrangements, for example in cases where the financial property is held by a person who is not the secured party or the grantor (e.g. a third party custodian). The same interpretation of terms described above in respect of the amendment to paragraph 14(1) applies in the context of this amendment. [***Schedule 1, Part 1, item 24, after paragraph 14(2)(f), paragraph (fa)***]

1.121 Division 2 of Part 5.7B of the Corporations Act provides that certain transactions entered into before the commencement of an external administration may be unwound. This includes unreasonable payments to directors, transactions that are of an uncommercial nature, payments to a creditor that provide an unfair preference to that creditor and others. There may be some ambiguity as to whether the enforcement of security may not fall under one of these headings, and could therefore be subject to being unwound or voided. Existing paragraph 14(2)(g) provides that the termination of obligations, the netting of obligations and any payment made by the party under the contract to discharge a net obligation are not to be void or voidable in the external administration of a party to a close-out netting contract. Any enforcement of security under paragraph (fa) is added to this list of transactions, thereby removing the ambiguity referred to above. It is noted that there is a definition in section 5 of the PSN Act which clarifies the scope of the term ‘voidable’ and states that, among others, it includes transactions to which Division 2 of Part 5.7B of the Corporations Act applies. [***Schedule 1, Part 1, item 25, Paragraph 14(2)(g)***]

Criteria which must be satisfied for the enforcement of security to be protected under the PSN Act

1.122 The protections provided under paragraphs 14(1)(ca) and 14(2) of the PSN apply to the enforcement of security over financial property only to the extent that certain safeguards are satisfied. These safeguards are described in the paragraphs below. The reference to ‘to the extent that’ in subsection 14A(1) should be interpreted to mean that the application of proceeds of an enforcement which go beyond the discharge of the obligations described in paragraph 14(1)(a) is subject to the general Australian law regarding priority, securities, insolvency and creditors’ rights (including the priority regimes set out in the PPSA and the Corporations Act). [***Schedule 1, Part 1, item 27, after section 14, subsection 14A(1)***]

Eligible obligations

1.123 Paragraph 14A(1)(a) requires that the obligations secured by the financial property, and discharged through the enforcement, are:

- eligible obligations in relation to the contract; or
- obligations under the contract of a party to the contract to pay interest on an eligible obligation; or
- obligations of a party to the contract to pay costs and expenses incurred in connection with enforcing security given in respect of an eligible obligation. [***Schedule 1, Part 1, item 27, after section 14, paragraph 14A(1)(a)***]

1.124 The ‘eligible obligation’ term has the meaning given in section 14A, specifically subsection 14A(7). [***Schedule 1, Part 1, item 1, Section 5***] An obligation is an eligible obligation in relation to a close out netting contract if the obligation is any of the following:

- an obligation under the contract of a party to the contract that relates to a derivative or foreign exchange contract;
- a net obligation that results from the netting of 2 or more obligations that:
 - must include at least one obligation which is an obligation under the contract of a party to the contract that relates to a derivative or foreign exchange contract; and
 - may include one or more incidental obligations that, taken together, do not form a material part of the net obligation. [***Schedule 1, Part 1, item 27, after section 14, subsection 14A(7)***]

1.125 The regulations may declare that an obligation is an eligible obligation in relation to a close out netting contract. The regulations may also declare that an obligation is not an eligible obligation in relation to a close-out netting contract if circumstances arise in respect of which it is considered that it would be inappropriate to extend the coverage of the PSN Act protections. While the ‘eligible obligation’ term should address the range of obligations it is designed to address, given the rapidly evolving nature of the financial markets and the need to both ensure the protections provided under the PSN Act are sufficiently broad and robust and ensure that any potential abuse or mischief is quickly dealt with, it will be possible to make regulations expanding or narrowing the coverage of the term eligible obligation should the definition prove to have inappropriate coverage. [***Schedule 1, Part 1, item 27, after section 14, paragraph 14A(7)(c) and subsection 14A(8)***]

1.126 The key consideration inherent in the term eligible obligation is whether an obligation under the contract of a party to the contract relates to a derivative or foreign exchange contract. The definition of derivative from Chapter 7 of the Corporations Act has been used here due to its flexibility and breadth. As margin requirements are expected to be imposed in respect of all derivatives transactions that are not cleared by CCPs, it was considered important to use a definition which encompasses, in a facilitative manner, a wide range of derivatives transactions, including credit derivatives, equity derivatives, foreign exchange derivatives, interest rate derivatives, weather derivatives, commodity derivatives (including physically settled commodity derivatives which are documents under a derivatives master agreement such as an ISDA Master Agreement which provides for obligations to be closed-out on default of a party), securities lending arrangements (including those documented under a Global Master Securities Lending Agreement (GMSLA) or Australian Master Securities Lending Agreement (AMSLA)), repurchase agreements (including those documents under a Global Master Repurchase Agreement (GMRA)) and other types of derivative transactions. Foreign exchange contract has the same meaning as in Chapter 7 of the Corporations Act. **[Schedule 1, Part 1, item 1, Section 5, 'derivative' and item 4, Section 5, 'foreign exchange contract' and item 27, after section 14, paragraph 14A(7)(a)]**

1.127 To fall within the eligible obligation term, an obligation may also relate to a foreign exchange contract. This is to deal with the issues which arise in relation to short-term foreign exchange derivatives under Corporations Regulation 7.1.04. **[Schedule 1, Part 1, item 27, after section 14, paragraph 14A(7)(a)]**

1.128 Paragraph 14A(7)(b) provides for a net obligation (that results from the netting of 2 or more obligations) which complies with certain criteria to constitute an eligible obligation. The criteria are described in paragraph 1.124 above. This paragraph 14A(7)(b) contemplates a situation where a derivatives master agreement, such as an ISDA Master Agreement, GMSLA, GMRA or AMSLA, provides that, if particular events happen (e.g. an event of default), the obligations in relation to the transactions entered into under the master agreement are terminated and a net amount becomes payable. In addition to payment and delivery obligations in relation to specific transactions which are terminated, the obligations which are terminated under a master agreement may also include a range of obligations which are not directly related to any particular transaction, such as obligations to make certain representations and undertakings (including to comply with laws), provide certain information including taxation documents, pay expenses and provide notices. The mere fact that these obligations are terminated under a master agreement does not result in a net obligation which results from the netting of two or more obligations under the contract ceasing to constitute

an eligible obligation. Similarly, the mere fact that one or more incidental payment or delivery obligations which do not relate to a derivative or foreign exchange contract are included in the net obligation does not necessarily result in the resulting net obligation ceasing to constitute an eligible obligation if those incidental obligations, taken together, do not form a material part of the net obligation. [**Schedule 1, Part 1, item 27, after section 14, paragraph 14A(7)(b)**]

Possession or control

1.129 Another safeguard set out in subsection 14A(1) is that the protections provided under paragraphs 14(1)(ca) and 14(2) of the PSN Act apply to the enforcement of security over financial property only to the extent that, before the enforcement, the financial property is transferred or otherwise dealt with so as to be in the possession or under the control of:

- the secured party; or
- another person (who is not the grantor), who acknowledges in writing that he, she or it has that possession or control of the financial property on behalf of the secured party.
[**Schedule 1, Part 1, item 27, after section 14, paragraph 14A(1)(b)**]

1.130 The broad phrase ‘transferred or otherwise dealt with’ provides flexibility to accommodate different types of transfer mechanisms and transfer arrangements that exist in the market and the difficulties in applying traditional transfer-based analysis to modern financial markets, in which property may be held through chains of intermediaries as records in book-entry accounts. [**Schedule 1, Part 1, item 27, after section 14, paragraph 14A(1)(b)**]

1.131 Before enforcement, the financial property must be transferred or otherwise dealt with *so as to be in the possession or under the control* of the secured party or other third party who acknowledges that he, she or it has that possession or control of the financial property on behalf of the secured party. The reference to another person who gives the required acknowledgement is intended to cover situations where a third party such as a custodian has possession or control of the relevant financial property and acknowledges, including in an agreement such as an account control agreement, that it has that possession or control of the financial property on behalf of the secured party. It is understood that these third party custody arrangements are already common in the market and that these types of arrangements may be used by parties in complying with margin requirements (particularly for initial margin). [**Schedule 1, Part 1, item 27, after section 14, paragraph 14A(1)(b)**]

1.132 In using concepts of possession or control, the approach taken in The Financial Collateral Arrangements (No.2) Regulations 2003 in the United Kingdom and the EU Financial Collateral Directive, and associated interpretation of English courts and commentary from the Financial Markets Law Committee noting issues in respect of that interpretation, has been informative. For example, in these amendments, the concept of ‘possession’ is intended to have a more general application beyond its technical legal meaning (which could confine the concept to financial property such as bearer securities in certificated form only). As contemplated in the EU Financial Collateral Directive, an underlying policy consideration for these amendments is to ‘provide a balance between market efficiency and the safety of the parties to the arrangement and third parties, thereby avoiding inter alia the risk of fraud’ (Recital 10 of the EU Financial Collateral Directive). These amendments address some of the issues identified in other jurisdictions in subsection 14A(5) (as described below).

1.133 The general concepts of possession or control are supplemented by deeming provisions in subsections 14A(2), (3), (4) and (5) to provide certainty as to the application of these concepts to specific examples of market practice. Subsection 14A(2) provides that, even if a person has actual possession of collateral, if it appears to be in the possession of the grantor, the person would not have possession of the collateral (subsection 14A(2)). However, this does not prevent the control element of paragraph 14A(1)(b) applying to a particular structure such that paragraph 14A(1)(b) may still be satisfied. [**Schedule 1, Part 1, item 27, after section 14, subsection 14A(2)**]

1.134 Subsections 14A(3), (4) and (5) are intended to address the way in which the possession and control analysis of paragraph 14A(1)(b) applies in respect of specific financial market structures. It is acknowledged that historical legal concepts of possession and control may need to, but do not currently (or adequately), deal with control structures used in modern financial market²⁸ and therefore the Bill provides certainty as to specific circumstances in which the control test in paragraph 14A(1)(b) will, and will not, be satisfied. These deeming provisions are intended to be inclusive and are not intended to restrict in any way the general application of the concepts of possession or control to financial market structures. These deeming provisions are described below.

28 One such market structure in which there may be uncertainty as to the application of the existing legal definition of control is tri-party custodian arrangements in which the grantor retains certain rights, including the right to receive and withdraw income from secured financial property such as shares and the right to withdraw excess financial property.

1.135 Without limiting the general application of paragraph 14A(1)(b) (for example, if the financial property is in the possession of the person under principles of general law), financial property is taken to be in the possession of a person for the purposes of paragraph 14A(1)(b) if:

- in a case where there is an issuer of the financial property—the person is registered by, or on behalf of, the issuer as the registered owner of the financial property; or
- in a case where the financial property is an intermediated security—the person is the person in whose name the intermediary maintains the account. [***Schedule 1, Part 1, item 27, after section 14, subsection 14A(3)***]

1.136 The first limb of paragraph 14A(1)(b) is intended to cover the situations where the secured party or third party is registered by, or on behalf of, the issuer as the registered owner of the financial property, including where such registration happens on the Clearing House Electronic Sub register System (CHESS) sub register, maintained by ASX Settlement, or the issuer sponsored sub register, maintained by the issuer or a share registry on the issuer's behalf. The second limb of this paragraph is intended to apply in respect of an intermediated security (which is defined in the section 5 of the PSN Act to mean the rights mentioned in paragraph (h) of the definition of financial property) where the secured party or third party acting on the secured party's behalf is the person in whose name the intermediary maintains the account. [***Schedule 1, Part 1, item 27, after section 14, subsection 14A(3) and item 4, Section 5***]

1.137 Subsection 14A(4) is intended to address the developing market practice whereby financial collateral is held in an account maintained by a third party custodian in the name of the grantor (i.e. the counterparty, rather than the secured party) and security over the account is granted to the secured party. For the purposes of this amendment, the relevant financial property would be the rights of the grantor in the account (i.e. an intermediated security for the purposes of the PSN Act). In these (and other similar) circumstances, financial property is taken to be under the control of a person for the purposes of paragraph 14A(1)(b) if:

- the financial property is an intermediated security (as defined in section 5 of the PSN Act); and
- there is an agreement in force between the intermediary and one or more other persons, one of which is the secured party or the grantor (such as an account control agreement or tripartite agreement between the grantor, secured party and custodian); and

- the agreement has one or more of the following effects:
 - the person in whose name the intermediary maintains the account is not able to transfer or otherwise deal with the financial property;
 - the intermediary must not comply with instructions given by the grantor in relation to the financial property without seeking the consent of the secured party (or a person who has agreed to act on the instructions of the secured party);
 - the intermediary must comply, or must comply in one or more specified circumstances, with instructions (including instructions to debit the account) given by the secured party in relation to the intermediated security without seeking the consent of the grantor (or any person who has agreed to act on the instructions of the grantor).
[Schedule 1, Part 1, item 27, after section 14, subsection 14A(4)]

1.138 The agreement described in paragraphs 14A(4)(b) and (c) is described broadly in contemplation of a situation where the intermediary may be the same entity as the secured party.

1.139 Subsection 14A(5) provides for clarification as to the impact of certain rights that a grantor may have in respect of a security arrangement on the analysis regarding possession and control. This paragraph is intended to address some of the uncertainties which have been discussed in respect of The Financial Collateral Arrangements (No.2) Regulations 2003 in the United Kingdom. For example, the fact that a grantor has the right to receive and withdraw income in relation to the financial property, to receive notices in relation to the financial property, to vote in relation to the financial property or to determine the value of the financial property does not stop paragraph 14A(1)(b) from being satisfied. It is important to note that subsection 14A(5) does not exhaustively list the rights which a grantor may retain and, depending on the circumstances, paragraph 14A(1)(b) may still be satisfied if the grantor has other rights. If the grantor retains the right to substitute financial property, to withdraw excess financial property or to require the release of financial property if the secured party becomes insolvent, paragraph 14A(1)(b) will only be satisfied if the secured party (or a person who has agreed to act on the instructions of the secured party) has the right (however described) to consent to the exercise of that right by the grantor. The reference to ‘excess’ in the reference to the right to withdraw excess financial property in subsection 14A(5) is intended to refer to a circumstances where the value, or estimated value, of the financial property exceeds the amount of

financial property required to be posted from time to time under the security arrangement between the grantor and secured party.²⁹

[Schedule 1, Part 1, item 27, after section 14, subsection 14A(5)]

1.140 However, for the purposes of paragraph (1)(b), financial property is taken not to be in the possession of a person if the financial property is in the actual or apparent possession of the grantor.

[Schedule 1, Part 1, item 27, after section 14, subsection 14A(2)]

1.141 Regulations may prescribe circumstances in which financial property is, or is not, transferred or dealt with so as to be in the possession or under the control of the secured party for the purposes of paragraph 14A(1)(b). Whilst paragraph 14A(1)(b) and the associated deeming provisions should provide a robust and flexible mechanism which strikes the balance described above, it may be appropriate to use regulations to specify additional situations which do, or do not, satisfy the requirements set out in paragraph 14A(1)(b). This is particularly important because the possession and control analysis is complex, and the protective regime set out in the PSN Act must respond efficiently to changes in collateral holding arrangements that may evolve in the ever-changing financial markets. **[Schedule 1, Part 1, item 27, after section 14, subsection 14A(6)]**

Compliance with other duties

1.142 The final safeguard set out in subsection 14A(1) is that the enforcement must be carried out in a manner that complies with section 420A of the Corporations Act 2001 (if it applies) and any applicable general law duties that are not inconsistent with the terms of the security. **[Schedule 1, Part 1, item 27, after section 14, paragraph 14A(1)(c)]**

1.143 In order for the enforcement of security to prevail over other laws in accordance with the protections set out in the PSN Act, the secured party must comply with the duties that are not inconsistent with the terms of the security to which it is otherwise subject. For example, the duties to which controllers³⁰ are subject under Part 5.2 of the Corporations Act (e.g. section 420A regarding the controller's duty of care in exercising power of sale) may still apply.

29 In this regard, reference is made to the Financial Markets Law Committee paper entitled *Issue 1: Collateral Directive — Analysis of uncertainty regarding the meaning of 'possession or ... control' and 'excess financial collateral' under the Financial Collateral Arrangements (No. 2) Regulations 2003*, dated December 2012.

30 It is anticipated that a secured party may be a controller which is not a receiver, receiver and manager or managing controller for the purposes of the Corporations Act.

1.144 Whilst the security may be enforced in accordance with the terms of the security, the protections provided to the enforcement of security under subsections 14(1) and 14(2) would not apply to the extent the terms of the security purported to allow a secured party to appropriate or sell financial property at zero value as the enforcement would not reflect any attempt to calculate, or value, the financial property in good faith or in a commercially reasonable manner.

Interaction with other laws

1.145 Clarification has been made in subsection 14(4) to provide that subsections 14(1) and 14(2) have effect in relation to a close-out netting contract:

- subject to a specified stay provision (defined in section 5 of the PSN Act) that applies to the contract; and
- despite any other law (including the specified provisions).
[Schedule 1, Part 1, item 26, Subsections 14(3), (4) and (5), subsection 14(4)]

1.146 Division 2 of the PSN Act sets out the circumstances in which non direction stays may cease. The impact of the specified stay provisions, and circumstances in which non direction stays may cease, is described in Part 2 — Certainty for application of stays on close-out rights below.

1.147 In addition to the provisions already specified, the definition of specified provisions set out in section 5 of the PSN Act has been expanded to include:

- subsections 11CD(2) and (3), section 11F and subsection 13A(3) of the Banking Act; and ***[Schedule 1, Part 1, item 7, Section 5 (paragraphs (a) and (b) of the definition of specified provisions)]***
- subsections 105(2) and (3) of the Insurance Act; and ***[Schedule 1, Part 1, item 7, Section 5 (paragraphs (a) and (b) of the definition of specified provisions)]***
- section 187 and subsections 230C(2) and (3) of the Life Insurance Act; and ***[Schedule 1, Part 1, item 7, Section 5 (paragraphs (a) and (b) of the definition of specified provisions)]***
- sections 440B, 468 and 556 of the Corporations Act; and ***[Schedule 1, Part 1, item 8, Section 5 (paragraph (d) of the definition of specified provisions)]***

- subsections 101(3) and (4) of the PHI Act. [***Schedule 1, Part 1, item 9, Section 5 (after paragraph (f) of the definition of specified provisions)***]

1.148 The specified provisions definition is an inclusive list of the provisions of other laws over which the PSN Act prevails and is inserted for transparency and ease of reference.

1.149 The references to subsections 11CD(2) and (3) of the Banking Act, subsections 105(2) and (3) of the Insurance Act, subsections 230C(2) and (3) of the Life Insurance Act and subsections 101(3) and (4) of the PHIA Act are included to clarify that the protections provided under the PSN Act to close-out netting and other matters prevail over the regime set out in those Acts for a party or parties to be relieved from obligations owed to the relevant entity. In any circumstances where an entity such as a Regulated Entity or a private health insurer registered under Division 3 of Part 2 of the PHI Act is prevented from fulfilling its obligations under the contract (e.g. because of a direction under Subdivision A of Part II of the Banking Act), the counterparty would be able to close-out transactions under the contract and enforce security in the manner protected by the PSN Act. This is described using an example in paragraph 1.185 below.

1.150 The references to sections 440B and 556 of the Corporations Act are included to clarify that the PSN Act would prevail over these provisions, which may otherwise impose a stay on enforcement of security in certain circumstances (section 440B) and which set out certain priority payments (section 556). This accords with the general policy intention of these amendments, which is to ensure that security may be enforced in the manner contemplated in the PSN Act notwithstanding existing impediments under Australian law, such as perfection and registration requirements and priority regimes. There are thus strong policy reasons associated with the preservation of financial system stability and the need to ensure that entities subject to Australian law can provide, and enforce rights in respect of, margin by way of security in connection with certain derivatives in the manner required by international standards in protecting the enforcement of security in the manner set out in the Bill.

1.151 As the protections provided under subsections 14(1) and (2) have effect despite any other law (subject to the reforms in respect of specified stay provisions discussed below), if another law purported to prevent enforcement of the security in accordance with its terms, it would be inconsistent and must yield. Similarly, if any other law purported to impose conditions that must be satisfied before the security can be enforced, that other law would also be inconsistent and must yield (subject to the reforms in respect of specified stay provisions discussed below).

1.152 However, another law which purported to regulate the manner in which the security is enforced (for example, section 420A of the Corporations Act, if it applied, as described above) would continue to apply provided that it only impacted the way in which the secured party need to enforce its security and did not in any way inhibit the actual enforcement of security.

Circumstances in which subsections 14(1) and 14(2) do not apply

1.153 The PSN Act enhances the legal certainty of close-out netting contracts. In particular, subsection 14(2) preserves the validity of close-out netting contracts on the external administration (see paragraph 1.1600 below for a description of this definition) of a party to that contract.

1.154 Subsection 14(3) of the PSN Act previously provided that a person may not rely on the application of subsection 14(2) of the PSN Act 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.

1.155 The subsection is designed to prevent a party to a close-out netting contract from knowingly buying up the debts (rights or obligations) of an insolvent person with a view to netting them against that party's own obligations under the contract.³¹

1.156 However, the unamended wording of subsection 14(3) of the PSN Act may not cover all situations of potential misuse by counterparties. For example, party A acquires from party B a right or obligation under a close-out netting contract with party C. In this case, if party C was unable to pay their debts as and when they became due and payable (that is, was insolvent), the wording of subsection 14(3) may not prevent party A acquiring those rights and obligations from party B, and obtaining the benefit of subsection 14(2), even if they had notice that party C was insolvent.

1.157 The amended subsection 14(3) provides that a party to a close-out netting contract is prevented from netting rights and obligations of an insolvent counterparty acquired from a third party. The Bill also clarifies that this subsection does not apply if the acquisition of rights and obligations was part of a transfer under the Business Transfer Act.
[Schedule 1, Part 1, item 26, Subsections 14(3), (4) and (5), subsection 14(3)]

31 See Explanatory Memorandum to the Payment Systems and Netting Bill 1998, paragraph 73 of the notes to clauses.

1.158 The existing subsection 14(5) of the PSN Act is replaced by subsection 14(6), which expands the scope of that subsection to contemplate the giving of the security. Under subsection 14(6), the protection otherwise provided under subsection 14(1) or 14(2) does not apply to an obligation owed by a party to a close-out netting contract, or to security given by a party to another person in respect of such an obligation, if the party goes into external administration, the person acquired the obligation or the security otherwise than as a result of a compulsory transfer of business and subsection (8) applies in relation to the transaction that created the terminated obligation or the security. The Bill clarifies that subsection 14(6) does not apply (i.e. rights and obligations may still be netted and security may be enforced in these circumstances) if the acquisition of rights and obligations was part of a transfer under the Business Transfer Act. Please refer to paragraphs 1.229 to 1.236 for an explanation of subsection 14(5). [***Schedule 1, Part 1, item 26, Subsections 14(3), (4) and (5), subsection 14(6)***]

1.159 Subsection 14(8) is substantively similar to the existing subsection 14(5)(c), however has been updated to reflect that subsection 14(6) now covers both obligations owed by a party to a close-out netting contract *and* the giving of security by a party to another person in respect of such an obligation. Accordingly, subsection 14(6) will have the effect set out in that clause if any of the following are satisfied in relation to the transaction that created the terminated obligation or the security:

- the other person did not act in good faith in entering into the transaction;
- when the transaction was entered into, the other person had reasonable grounds for suspecting that the party was insolvent at that time or would become insolvent because of, or because of matters including:
 - entering into the transaction; or
 - a person doing an act, or making an omission, for the purposes of giving effect to the transaction;
- the other person neither provided valuable consideration under, nor changed their position in reliance on, the transaction. [***Schedule 1, Part 1, item 26, Subsections 14(3), (4) and (5), subsection 14(8)***]

Expanded definition of external administration

1.160 The PSN Act provides a range of fundamentally important protections to financial market transactions, payment and settlement systems and financial market infrastructure in circumstances where a

party to a close-out netting contract, market netting contract or approved netting arrangement or a participant in an approved RTGS system goes into external administration.³²

1.161 In some circumstances (particularly where the relevant close-out netting contract or market netting contract is not governed by Australian law), a party or participant going into external administration is a prerequisite to the application of several of these vitally important protections. Without such an external administration, as the term is defined in the PSN Act, those protections may not be able to apply.

1.162 Despite the importance of the external administration to the term, it is unclear whether resolution measures such as statutory management and judicial management fall within the definition in all circumstances.

1.163 Accordingly, the definition of external administration in section 5 of the PSN Act will be expanded to provide that a person goes into external administration if, in addition to the existing circumstances:

- an ADI statutory manager takes control of the person's business under the Banking Act; or
- the person comes under judicial management under the Insurance Act; or
- the person, or a part of the person's business, comes under judicial management under the Life Insurance Act.
[Schedule 1, Part 1, item 2, Section 5 (at the end of the definition of external administration)]

1.164 Consequential amendments are also made to the definition of external administrator in section 5 to clarify that the external administrator for a person who goes into external administration is the person who takes control of the property, business or the part of the business, of the person under the administration. This change is necessary as an external administration may relate to the person's business or part of the business as well as the person's property. For example, under the Life Insurance Act, a life company, or part of the business of a life company, may be placed under judicial management. **[Schedule 1, Part 1, item 3, Section 5 (definition of external administrator)]**

32 Under section 5 of the PSN Act, 'a person goes into external administration if:

- (a) they become a body corporate that is an externally administered body corporate within the meaning of the *Corporations Act 2001*; or
- (b) they become an individual who is an insolvent under administration; or
- (c) someone takes control of the person's property for the benefit of the person's creditors because the person is, or is likely to become, insolvent.'

Part 2 — Certainty for application of stays on close-out rights

1.165 The PSN Act was enacted to reinforce the effectiveness of netting contracts in Australia. Broadly, it provides that the action of netting in certain contracts is legally certain, and cannot later be unwound, as may be the case should insolvency law prevail. Further, it allows close-out and market netting to proceed upon the appointment of an external administrator, such as a liquidator, receiver or administrator.

Netting contracts

1.166 Close-out netting is a contractual mechanism that enables the termination of obligations (e.g. obligations under transactions), calculation of the termination values of the obligations and the netting of the termination values so that only a net cash amount is payable in the case of insolvency (or other defined event of default, such as the appointment of a liquidator, receiver or administrator).

1.167 If one party to a netting contract becomes insolvent or otherwise defaults on its obligations, or another event of default (as defined in the applicable contract) occurs, close-out netting provisions in the contract allow the non-defaulting party to terminate all outstanding transactions within the contract, and aggregate these transactions values so that a single net sum will be owed by, or owed to, the non-defaulting party (that is, ‘close-out’ of the contract).

1.168 Close-out netting is a common feature of derivative transactions, including currency (foreign exchange), interest rate swaps, securities lending transactions and repurchase agreements, and the master agreements frequently used to govern such transactions (such as the ISDA Master Agreement, GMSLA, GMRA and AMSLA). In such cases, close-out netting mitigates credit risks associated with these derivatives.

Payment Systems and Netting Act

1.169 Section 5 of the PSN Act defines a close-out netting contract as a contract under which, if a particular event happens, particular obligations of the parties terminate or may be terminated, and the termination values of the obligations are calculated or may be calculated and the termination values are netted, or may be netted, so that only a net cash amount (whether in Australian currency or some other currency) is payable.

1.170 The PSN Act enhances the legal certainty of close-out netting contracts. In particular, subsection 14(2) preserves the validity of close-out netting contracts on the external administration of a party to that contract. To support subsection 14(2), subsection 14(4) provides that subsection 14(2) has effect despite any other law, including insolvency law.³³

1.171 The provisions of the PSN Act reflect the importance of the legal certainty of close-out netting arrangements. In the absence of certainty, domestic and foreign counterparties may be reluctant to enter into financial market transactions that are generally regarded as an essential part of sound financial management, such as interest rate and currency swaps and other arrangements which hedge exposures. Similarly, without this certainty, counterparties may face increased capital requirements in respect of exposures under such transactions which make such transactions commercially unviable.

Industry Acts

1.172 The Industry Acts empower APRA to appoint a statutory manager (in the case of an ADI) and the Federal Court to appoint a judicial manager (in the case of a general insurer or life company) in certain circumstances.³⁴ In such cases, the statutory manager or judicial manager is charged with managing the Regulated Entity in the interests of depositors or policy holders and promoting financial system stability in Australia.

1.173 However, the appointment of a statutory manager or judicial manager may constitute an act of default under close-out netting contracts (such as the ISDA Master Agreement). As such, the appointment of a statutory manager or judicial manager would provide counterparties with a right to close-out of a close-out netting contract on the basis that a statutory or judicial manager has been appointed to the other party.

33 Under insolvency law, liquidators may ‘claw-back’ payments made to particular creditors in certain circumstances. For example, sections 588FE and 588FF of the Corporations Act.

34 For example, section 13A of the Banking Act empowers APRA to appoint a statutory manager to an ADI if:

- 1) the ADI informs APRA that the ADI considers that it is likely to become unable to meet its obligations or that it is about to suspend payment; or
- 2) APRA considers that, in the absence of external support:
 - (i) the ADI may become unable to meet its obligations; or
 - (ii) the ADI may suspend payment; or
 - (iii) it is likely that the ADI will be unable to carry on banking business in Australia consistently with the interests of its depositors; or
 - (iv) it is likely that the ADI will be unable to carry on banking business in Australia consistently with the stability of the financial system in Australia; or
- 3) the ADI becomes unable to meet its obligations or suspends payment.

1.174 To provide statutory managers and judicial managers with flexibility to meet their objectives, the Industry Acts restrict certain contractual rights triggered on the appointment of a statutory or judicial manager and certain other resolution activities (described below). In particular, subsection 15C(2) of the Banking Act provides that the fact that an ADI statutory manager is in control of the ADI's business does not allow the contract, or a party to the contract, to do any of the following:

- deny any obligations under that contract;
- accelerate any debt under that contract;
- close-out any transaction relating to that contract.

1.175 This Bill amends subsection 15C(2) to provide that the fact that an ADI statutory manager is in control of the ADI's business does not allow the contract, or a party to the contract, to, in addition to the matters described above, enforce any security under that contract.

1.176 Similar provisions are set out in subsection 62V(2) of the Insurance Act, and subsection 165B(2) of the Life Insurance Act in respect of the appointment of a judicial manager.

1.177 These provisions can assist a statutory or judicial manager in preserving currency and interest rate hedges if they are in the interests of depositors or policy holders or promote financial system stability. The automatic termination of large volumes of financial contracts upon the appointment of a statutory or judicial manager could result in market instability and frustrate the implementation of resolution measures.

1.178 In addition to the provisions which do not allow for the close-out of transactions under a contract due to the appointment of a statutory manager or judicial manager, certain other stays exist under the Industry Acts and PHI Act. For example, in addition to the stays on close-out rights which apply in respect of the appointment of a statutory manager or judicial manager, the following do not allow the contract, or a party to the contract, to close out transactions relating to that contract:

- the fact that the relevant Regulated Entity, private health insurer or certain other body (e.g. an authorised NOHC as defined in the Banking Act) is subject to a direction by APRA under the relevant provisions of the Industry Acts (see subsection 11CD(1A) of the Banking Act, subsection 105(1A) of the Insurance Act, subsection 230C(1A) of the Life Insurance Act and subsection 101(2) of the PHI Act);

- the fact that the relevant Regulated Entity is subject to a recapitalisation direction (see subsection 13N(2) of the Banking Act, subsection 103K(2) of the Insurance Act and subsection 230AJ(2) of the Life Insurance Act);
- the fact that the statutory manager or judicial manager of a Regulated Entity does certain acts to facilitate recapitalisation (see subsection 14AC(2) of the Banking Act, subsection 62ZB(2) of the Insurance Act and subsection 168C(2) of the Life Insurance Act); and
- the fact that an act is done for the purposes of Division 2 or 3 of Part 4 of the Business Transfer Act, or that a certificate of transfer comes into force under Division 3 of Part 4 of the Business Transfer Act, in connection with the relevant body (see subsection 36AA(2) of the Business Transfer Act).

1.179 The PSN Act is clarified to describe each of these provisions of the Industry Acts and PHI Act which stay close-out rights (along with subsection 15C(2) of the Banking Act, subsection 62V(2) of the Insurance Act, and subsection 165B(2) of the Life Insurance Act in relation to statutory management and judicial management) as a specified stay provision. [***Schedule 1, Part 1, item 10, Section 5, ‘specified stay provision’ definition***]

1.180 The provisions of the Industry Acts and PHI Act which do not allow the contract, or a party to the contract, to close-out transactions relating to that contract due to the fact of the relevant entity being subject to a direction by APRA or a recapitalisation direction are defined in the PSN Act as each being a direction stay provision. These provisions are defined in both the definition specified stay provision and direction stay provision because the framework set out in the Bill provides for these stays to interact with the PSN Act in a different manner to non-direction related specified stay provisions (as described below). [***Schedule 1, Part 1, item 1, Section 5, ‘direction stay provision’ definition***]

1.181 Generally speaking, as a matter of Australian law, the stays in the Industry Acts and PHI Act apply where the relevant regulated entity is party to a contract, whether the proper law of the contract is:

- Australian law, including the law of a state or territory; or
- law of a foreign country, including the law of part of a foreign country.

1.182 However, this does not necessarily mean that a foreign court would recognise Australian law as applying in these circumstances and may not give effect to the stays set out under the Industry Acts. This also necessitates the need for international cooperation regarding resolution regimes, and the Stay Protocol is one approach which has been adopted by a number of foreign regulators and international systemically important financial institutions to achieve this objective.

Close-out for any other reason

1.183 However, these stays should not be read to cover any other event of default or ground for termination beyond the specific circumstances described in the provision (even if it occurs simultaneously with the event described in the relevant stay provision). No specified stay provision, including a direction stay provision, has any effect in respect of any other close-out event happening in relation to the contract (e.g. a failure to comply with an obligation under the contract). The stays in the Industry Acts do not prevent a counterparty from closing-out transactions relating to a close-out netting contract on the basis of an action other than the appointment of a statutory or judicial manager or relevant fact referred to in the other specified stay provisions.³⁵ For example, counterparties may close-out transactions relating to such an arrangement or contract because the Regulated Entity or private health insurer is insolvent, or if a Regulated Entity or private health insurer under statutory or judicial management or subject to a direction from APRA (as applicable) fails to satisfy any substantive obligations under a close-out netting contract or market netting contract (including any payment and delivery obligations). These other events generally constitute separate events of default which could trigger the close-out rights under the contract or arrangement which would be protected under the PSN Act notwithstanding the specified stay provisions.

1.184 Even if APRA specifically gives a direction that a Regulated Entity or private health insurer is not to make payments or deliveries or otherwise perform obligations under a close-out netting contract (or for the regulated entity not to make payments generally) or a direction has this effect (even inadvertently), the counterparty may rely on the protections of the PSN Act and exercise a close-out right it has to close-out transactions on the basis of such non-performance when the relevant obligation is not performed (i.e. PSN Act prevails over the direction stay provision in those circumstances).

35 It is noted that the protections under the PSN Act provided in respect of approved RTGS systems, approved netting arrangements and market netting contracts have effect despite any other law (including the specified provisions and the specified stay provisions), such that a party to such a contract or arrangement may close-out for the matters described in the specified stay provisions.

1.185 This is explained in the following example. APRA gives a direction on a Monday to an ADI under Subdivision A or B of Division 1BA of Part II of the Banking Act (e.g. section 11CA) or section 29 of the Banking Act which prevents the ADI from fulfilling an obligation under a close-out netting contract with another party (this party is the Terminating Party for this example) which it was otherwise required to perform on Thursday. Due to the operation of section 11CD(1A), the Terminating Party (or the contract itself):

- is *not* able to terminate transactions relating to the close-out netting contract on Monday in reliance on an event of default which arises because APRA has given the direction;
- may terminate transactions relating to the close-out netting contract in reliance on an event of default which arises because the ADI has not fulfilled an obligation under a close-out netting contract on Thursday.

Framework for the interaction between PSN Act protections and stays

1.186 A potential inconsistency exists between the PSN Act and the specified stay provisions. The specified stay provisions provide that a party cannot close-out transactions relating to a contract due to happening of the event described in the specified stay provision, while the PSN Act provides that parties to close-out netting contracts and market netting contracts can close-out transactions on the appointment of an external administrator in the manner contemplated in the PSN Act.

1.187 This Bill resolves this potential inconsistency by amending the PSN Act to introduce a new framework to deal with the occurrence of the events described in the specified stay provisions.

1.188 The general principle of the reforms to the operation of the stays on close-out rights in close-out netting contracts and market netting contracts is that:

- the protections given to important approved RTGS systems, approved netting arrangements and market netting contracts under the PSN Act prevail over stays on close-out rights set out in the specified stay provisions; and
- a specified stay provision of an Industry Act which applies to a close-out netting contract will prevail over the protections given to close-out netting contracts under the PSN Act broadly in the manner set out in the Bill.

Close-out netting contracts

1.189 For close-out netting contracts, the new framework involves the following features:

- **close-out generally prevented on grounds of a direction or recapitalisation direction for all types of close-out netting contracts.** Counterparties generally cannot close-out transactions under a close-out netting contract on the grounds that a Regulated Entity or private health insurer is subject to a direction or recapitalisation direction (regardless of the nature of obligations under the close-out netting contract);
- **for close-out netting contracts which do *not* contain an obligation related to a derivative or foreign exchange contract, close-out generally prevented on grounds of the appointment of a statutory manager or judicial manager, the taking of recapitalisation act or certain transfer-related events (Resolution Events).** Counterparties generally cannot close-out transactions under a close-out netting contract under which there are *no* eligible obligations (e.g. obligations that relate to a derivative or foreign exchange contract) on the grounds of the appointment of a statutory manager or judicial manager, the statutory manager or judicial manager taking action to facilitate recapitalisation or certain events occurring in relation to a compulsory transfer of business (these grounds are described in this explanatory memorandum as Resolution Events);
- **for close-out netting contracts which contain an obligation related to a derivative or foreign exchange contract, close-out prevented on grounds of Resolution Events for the resolution period.** For close-out netting contracts under which there is an eligible obligation, counterparties are restricted from closing out transactions under the contract on the grounds of a Resolution Event for a *temporary* period (the ‘resolution period’, which has the meaning given by section 15A). [*Schedule 1, Part 1, item 6, Section 5, ‘resolution period’ definition*]

The resolution period starts when the trigger event occurs (e.g. when the Resolution Event which is grounds for closing out transactions related to the contract occurs) and ends:

- for the transfer stay under subsection 36AA(2) of the Business Transfer Act, just after the certificate of transfer comes into force or when APRA declares that the resolution period for the relevant event ends; and

- for other stays, at midnight at the end of the business day after the trigger event (e.g. the Resolution Event which is a close-out right under the contract) unless a declaration by APRA that the stay ceases to apply takes effect at an earlier time;
- However, **close-out is permitted during the resolution period** if APRA makes a declaration determining the stay ceases to apply.
- At the end of the relevant resolution period, counterparties are generally permitted to close-out transactions under close-out netting contracts on the grounds of the Resolution Event.
- **Close-out prevented permanently beyond resolution period if resolution action is successful.** A stay may continue to apply permanently if APRA declares it is satisfied of certain solvency- and licensing-related matters in respect of the Regulated Entity.

1.190 However, as described above, the stays only relate to the particular action described in the specified stay provisions and the framework does not prohibit a party closing out for any other reason (e.g. a counterparty may still close-out transactions because the Regulated Entity fails to make a payment or perform an obligation).

Close-out generally prevented on grounds of a direction or recapitalisation direction

1.191 As a general matter, the protections provided in respect of close-out netting contracts under subsections 14(1) and (2) have effect in relation to a close-out netting contract subject to a specified stay provision that applies to the contract. [*Schedule 1, Part 1, item 26, paragraph 14(4)(a)*]

1.192 Division 2 of Part 4 of the PSN Act, entitled ‘Ceasing non direction stays for derivatives contracts’ clarifies the circumstances in which non-direction stays³⁶ may cease. However, the PSN Act (including Division 2 of Part 4) does not provide that direction stay provisions cease to have effect. Accordingly, counterparties generally cannot close-out

36 The reference to a ‘non-direction stay’ is used interchangeably with the term ‘a specified stay provision (other than direction stay provision)’ and, generally, means the provisions of the Industry Acts which restrict the close-out of transactions on the grounds of the appointment of a statutory manager or judicial manager, the taking of actions to facilitate recapitalisation and events related to compulsory transfers of business.

transactions under a close-out netting contract on the grounds that a Regulated Entity or private health insurer is subject to a direction or recapitalisation direction (regardless of the nature of obligations under the close-out netting contract). [*Schedule 1, Part 1, item 26, Note 2 at the end of subsection 14(4) and item 28, at the end of Part 4, Division 2*]

Close-out netting contracts with no obligations related to derivatives or foreign exchange contracts

1.193 Counterparties generally cannot close-out transactions under a close-out netting contract under which there are no eligible obligations (e.g. obligations that relate to a derivative or foreign exchange contract) on the grounds of a Resolution Event.³⁷

1.194 As described above, Division 2 of Part 4 of the PSN Act clarifies the circumstances in which non-direction stays may cease. However, these stays will only cease to apply in accordance with that Division if, among other things, an obligation under the contract of a party to the contract is an eligible obligation in relation to the contract. Accordingly, the stays which apply for Resolution Events will not cease to apply for close-out netting contracts under which there are no eligible obligations (as that term is defined in subsection 14A). [*Schedule 1, Part 1, item 28, at the end of Part 4, subsection 15A(1)*]

Close-out netting contracts with obligations related to derivatives or foreign exchange contracts

1.195 The framework in the Bill ensures that, in the event of a Resolution Event occurring in respect of a Regulated Entity, the appropriate balance is struck between ensuring that counterparties to contracts with the Regulated Entity can manage their risks but also giving APRA the best chance to determine the appropriate course of action to take in resolving the distressed Regulated Entity. A particular focus on international developments have been to ensure that any stay which is imposed on a counterparty's exercise of close-out rights in respect of financial market transactions such as arrangements governing derivatives and foreign exchange contracts is temporary.

37 As discussed in the Glossary, a Resolution Event, in this explanatory memorandum, is any of the following occurrences: the appointment of a statutory manager or judicial manager, the statutory manager or judicial manager taking action to facilitate recapitalisation or certain events occurring in relation to a compulsory transfer of business. I.e. the events contemplated in the non-direction stay stays.

1.196 Division 2 of Part 4 of the PSN Act is intended to clarify that the specified stay provisions of the Industry Acts apply in respect of financial market transactions such as derivatives-related arrangements in a manner broadly consistent with international best practice, as set out in the FSB's Key Attributes and the Stay Protocol.

1.197 Generally, for a close-out netting contract under which an obligation of a party to the contract is an eligible obligation in relation to the contract (such that paragraph 15A(1)(a) is satisfied), the counterparty to the contract is restricted from closing out transactions under the contract on the grounds of a Resolution Event for a temporary period in the manner set out in Division 2 of Part 4 of the PSN Act.

1.198 In order for a specified stay provision (other than a direction stay provision) to cease to apply to a close-out netting contract under section 15A, subsection 15A(1) requires, in relation to a close-out netting contract to which a regulated body is a party, that the following are satisfied:

- an obligation under the contract of a party to the contract is an eligible obligation in relation to the contract; and
- a specified stay provision (other than a direction stay provision) applies to a trigger event that happens in relation to the contract. [***Schedule 1, Part 1, item 28, at the end of Part 4, subsection 15A(1)***]

1.199 The term 'trigger event' for a close-out netting contract is defined in section 5 of the PSN Act to mean a particular event, such as a Resolution Event, which, if it happens, gives rise to close-out rights under the contract. In other words, a 'trigger event' happens in respect of a close-out netting contract if, on the happening of the event:

- particular obligations of the parties terminate or may be terminated; and
- the termination values of the obligations are calculated or may be calculated; and
- the termination values are netted, or may be netted, so that only a net cash amount (whether in Australian currency or some other currency) is payable. [***Schedule 1, Part 1, item 10, Section 5, 'trigger event' definition***]

1.200 The term 'regulated body' is defined in section 5 of the PSN Act to mean:

- a body corporate that is an ADI for the purposes of the Banking Act; or

- a general insurer within the meaning of the Insurance Act; or
- a body corporate that is registered under section 21 of the Life Insurance Act; or
- a private health insurer within the meaning of the PHI Act. **[Schedule 1, Part 1, item 6, Section 5, ‘regulated body’ definition]**

1.201 Under subsection 15A(2), in Division 2 of Part 4 of the PSN Act, a specified stay provision (other than a direction stay provision)³⁸ ceases to apply to a close-out netting contract:

- at the time when a declaration by APRA that the non-direction stay ceases under section 15B in relation to the contract takes effect; or
- at the end of the resolution period for the trigger event, if no declaration has been made by APRA during that period that the non-direction stay continues under section 15C. **[Schedule 1, Part 1, item 28, at the end of Part 4, subsection 15A(2)]**

1.202 In other words, once one of these things occurs, a counterparty may close-out transactions relating to a close-out netting contract on the grounds of a Resolution Event.

1.203 Under subsection 15A(3), for a trigger event, the resolution period starts when the Resolution Event which gives rise to a close-out right under the contract happens (i.e. when the trigger event happens) and ends:

- for a transfer-related stay (i.e. subsection 36AA(2) of the Business Transfer Act):
 - if APRA declares, in writing, that the resolution period ends under subsection 15A(4); or
 - if a certificate of transfer under the Business Transfer Act comes into force, just after the certificate of transfer comes into force.
- for other non-direction stays, at midnight (by legal time in the Australian Capital Territory) at the end of the first business day after the day on which the trigger event happens. This is intended to be consistent with international

³⁸ These types of provisions of an Industry Act are referred to in the PSN Act as a specified stay provision (other than a direction stay provision) (see, for example, subsection 15A(2)).

requirements³⁹ and the approach taken in other jurisdictions, and is considered to provide certainty as to the time at which counterparties to contracts with the Regulated Entity subject to the Resolution Event may close-out transactions relating to the contracts.⁴⁰ This resolution period cannot be amended by regulations. [**Schedule 1, Part 1, item 28, at the end of Part 4, subsection 15A(3)**]

1.204 The note to subsection 15A(3) clarifies that the transfer-related stay applies indefinitely if a certificate of transfer does not come into force and APRA does not declare that the resolution period ends. This is because there does not appear to be any compelling policy reason why a party should be able to close-out transactions solely because of preparatory actions taken in respect of a transfer when no transfer occurs (noting that a counterparty would be able to terminate if there were any other substantive events of default such as insolvency or a failure to pay). [**Schedule 1, Part 1, item 28, at the end of Part 4, note at the end of subsection 15A(3)**]

End of transfer-related resolution period on APRA's declaration

1.205 APRA has a power to allow counterparties to close-out transactions under a close-out netting contract on the basis of the occurrence of an act done in relation to a compulsory transfer of business for the purposes of Division 2 or 3 of Part 4 of the Business Transfer Act which triggers close-out rights under the contract if APRA is satisfied that it will not issue a certificate of transfer under that Act. This would protect counterparties from their close-out rights being stayed, potentially indefinitely for certain preparatory actions related to an aborted transfer, if APRA considers that it will not issue the certificate of transfer. If the conditions set out in subsection 15A(4) are satisfied, APRA may declare, in writing that the resolution period for that trigger event ends. [**Schedule 1, Part 1, item 28, at the end of Part 4, subsection 15A(4)**]

1.206 The Bill provides that a declaration to shorten the default period is not a legislative instrument. The provision is included to assist readers and is merely declaratory of the law, as the instrument is not a legislative instrument within the meaning of section 5 of the *Legislative Instruments Act 2003*. [**Schedule 1, Part 1, item 28, at the end of Part 4, subsection 15A(5)**]

39 I-Annex 5 — Temporary stay on early termination rights of the FSB Key Attributes provides that a temporary stay of the exercise of early termination rights should be subject to a number of conditions, including that the 'stay be strictly limited in time (for example, for a period not exceeding two business days)'.
40 See, for example, section 70C of *The Bank Recovery and Resolution Order 2014* (UK).

APRA may declare that non direction stays cease before the end of the resolution period

1.207 APRA also has the power to allow counterparties to close-out transactions before the end of the resolution period for a trigger event where it is clear that this will protect counterparties from the operation of a full resolution period. APRA has this declaratory power where APRA is satisfied that it will not make a declaration under section 15C in relation to a party before the end of the resolution period for the trigger event. It is expected that this will be particularly relevant where APRA does not expect that the Regulated Entity subject to the Resolution Event will satisfy the solvency- and licensing-related conditions set out in section 15C (e.g. if APRA does not expect the Regulated Entity will be solvent or the Regulated Entity's level of capital will comply with the minimum capital requirements that apply to it by the end of the resolution period).

1.208 APRA may, before the end of the resolution period for the trigger event, declare that the specified stay provision is to cease to apply to all close out netting contracts of the party if:

- a trigger event to which a specified stay provision (other than a direction stay provision) applies happens in relation to a close out netting contract to which a regulated body is a party; and
- APRA is satisfied that APRA will not make a declaration under section 15C in relation to a party before the end of the resolution period for the trigger event. [***Schedule 1, Part 1, item 28, at the end of Part 4, section 15B***]

1.209 A declaration that the relevant non-direction stay ceases must be made before the end of the resolution period for the trigger event, and takes effect either at the time when the declaration is made or, if the declaration specifies a time before the end of the resolution period for when the specified stay provision is to cease to apply, at the specified time. Once the declaration takes effect, counterparties will not be prevented from closing out transactions relating to the close-out netting contracts to which the Regulated Entity is a party. The declaration cannot be varied or revoked once made. [***Schedule 1, Part 1, item 28, at the end of Part 4, subsections 15B(2), (3) and (4)***]

1.210 The Bill provides that such a declaration, if made in writing, is not a legislative instrument. The provision is included to assist readers and is merely declaratory of the law, as the instrument is not a legislative instrument within the meaning of section 5 of the *Legislative Instruments Act 2003*. [***Schedule 1, Part 1, item 28, at the end of Part 4, subsection 15B(5)***]

Extending the prevention of close-out

1.211 The final feature of the framework is the capacity to prevent the close-out of transactions relating to close-out netting contracts on the grounds of a Resolution Event beyond the resolution period where certain conditions have been met. This features provides APRA with the ability, should it wish, to continue to prevent close-out should this course of action be considered to be in the interests of depositors or policy holders, or beneficial for the protection of financial stability.

1.212 To protect the legitimate interests of counterparties to close-out netting contracts, the Bill provides that a specified stay provision may only continue (and be declared to continue) if the following specified circumstances exist:

- a trigger event to which a specified stay provision (other than a direction stay provision) applies happens in relation to a close out netting contract to which a regulated body is a party;
- APRA is satisfied that all the matters set out in subsection 15C(3) will be satisfied in relation to the regulated body in respect of which the declaration may be made:
 - if a certificate of transfer will come into force under the Business Transfer Act, just after that coming into force; or
 - in all other cases, at the time the declaration will be made;
- the regulated body in respect of which the declaration may be made is not in external administration (as defined in the PSN Act) (other than statutory management or judicial management); and
- APRA has not already made a declaration under section 15B that the specified stay provision ceases to apply. This is to provide certainty, so that APRA cannot make a declaration extending the application of the relevant stay if it has previously made a declaration that the stay ceases to apply.
[Schedule 1, Part 1, item 28, at the end of Part 4, subsections 15C(1) and (2)]

1.213 If these conditions are satisfied, APRA may declare that the specified stay provision is to continue to apply to:

- if a certificate of transfer for a total transfer will come into force under the Business Transfer Act, all close out netting contracts to which the receiving body (within the meaning of the Business Transfer Act) will become a party;

- if a certificate of transfer for a partial transfer will come into force under the Business Transfer Act, either or both of the following:
 - all close out netting contracts to which the transferring body (within the meaning of the Business Transfer Act) is a party;
 - all close out netting contracts to which the receiving body (within the meaning of the Business Transfer Act) will become a party; or
- in all other cases, all close out netting contracts to which the regulated body is a party. [*Schedule 1, Part 1, item 28, at the end of Part 4, subsection 15C(2)*]

Solvency- and licensing-related conditions

1.214 One of the specified circumstances which must be satisfied in order for a specified stay provision to continue to apply is that APRA must be satisfied that all the matters set out in subsection 15C(3) will be satisfied in relation to the regulated body in respect of which the declaration may be made at the time the declaration will be made (or just after the coming into force of a certificate of transfer, if applicable).

1.215 The conditions of which APRA must be satisfied are as follows:

- that the regulated body is able to meet all its liabilities under close out netting contracts to which it is a party as and when they become due and payable (including all payment and delivery obligations); and
- that the regulated body is solvent (within the meaning of the Corporations Act); and
- that the regulated body has each material authorisation (however described) necessary for its regulated business. The term authorisations should be interpreted to include any licenses (e.g. an Australian financial services licence) and other authorisations upon which the regulated body relies to carry out its regulated business. The term ‘regulated business’ of a regulated body is defined in section 5 of the PSN Act to mean:
 - if the regulated body is an ADI, the body’s banking business (within the meaning of the Banking Act); or

- if the regulated body is a general insurer, the body’s insurance business (within the meaning of the Insurance Act); or
- if the regulated body is a life insurance company—the body’s life insurance business (within the meaning of the Life Insurance Act); and [*Schedule 1, Part 1, item 6, Section 5, ‘regulated business’ definition*]
- that either of the following is satisfied:
 - the party’s level of capital complies with the minimum capital requirements that apply to it under the Banking Act, the Insurance Act or the Life Insurance Act (as the case requires) and the applicable prudential standards made under the relevant Act; or
 - arrangements are in place to ensure that the regulated body performs all its obligations under close out netting contracts to which it is a party as and when they are due to be performed. Those arrangements must remain in place until at least the earliest day on which the party’s level of capital complies with the applicable minimum capital requirements or the statutory management or judicial management comes to an end. [*Schedule 1, Part 1, item 28, at the end of Part 4, subsections 15C(3), (4) and (5)*]

1.216 These requirements are intended to reflect international developments such as the Stay Protocol as closely as possible, particularly the requirements set out in the elements of paragraph (e) of the definition of ‘Protocol-eligible Regime’ in the Stay Protocol which relates to any ‘Close-out Stay’ (as that term is defined in the Stay Protocol), whilst also reflecting concepts recognised in Australian law.

1.217 Subsection 15C(5) of the PSN Act is focussed on the outcome of the arrangements, not the mere fact that assurances or arrangements are in place. In relation to the ‘arrangements’ described in subsection 15A(5), in order to any arrangements to satisfy subsection 15A(5), there must be a high degree of certainty that those arrangements will ensure performance. The focus on subsection 15A(5) is on the outcome of the arrangements rather than the mere fact that a guarantee has been given or other arrangement has been put in place. This requirement may be satisfied, for example, if the Commonwealth were to provide a guarantee which covered all the regulated body’s obligations (including payment and delivery obligations) under close out netting contracts to which it is a party as and when they are due to be performed and which remained in place until at least the earliest day on which the circumstances set out in

paragraph 15A(5)(b) occurred. However, this Bill does not provide the Government with the power to provide any guarantee. Nor does the Bill commit the Government to provide such a guarantee in any situations in which a Resolution Event occurs. The Bill merely provides that one criterion would be satisfied if a guarantee given by the Commonwealth was in place which satisfied the description of the arrangements in subsection 15A(5).⁴¹

1.218 A declaration made under section 15C cannot be varied or revoked. [*Schedule 1, Part 1, item 28, at the end of Part 4, subsection 15C(6)*]

1.219 The Bill provides that such a declaration, if made in writing, is not a legislative instrument. The provision is included to assist readers and is merely declaratory of the law, as the instrument is not a legislative instrument within the meaning of section 5 of the *Legislative Instruments Act 2003*. [*Schedule 1, Part 1, item 28, at the end of Part 4, subsection 15C(7)*]

Regulation making powers regarding declarations

1.220 As outlined above, the Bill empowers APRA to make declarations in certain circumstances. A regulation making power is included with respect to the declarations in sections 15B and 15C. Then regulation making power is in substantially the same form for each of these declarations.

1.221 The Bill provides that the regulations may do any of the following:

- prescribe requirements relating to how declarations made by APRA are to be made (including requirements relating to the content or form of declarations);
- prescribe requirements relating to the notification or publication of declarations;
- include provisions that apply to determining, either generally or for a particular purpose, the time when declarations are taken to be made. [*Schedule 1, Part 1, item 28, at the end of Part 4, subsections 15B(6) and 15C(8)*]

41 For example, section 70C of the Banking Act provides that the Treasurer (with the Finance Minister's approval) may authorise the making of contracts or arrangements for the purpose of protecting the interests of depositors of ADI's and protecting financial system stability in Australia up to \$20 billion. Similar authorisations are present in the Insurance Act (section 131A) and the Life Insurance Act (section 251A).

1.222 By providing for the use of regulations, it will be possible, if required, to specify factors that increase certainty as to the declaration regime.

Approved RTGS systems, approved netting arrangements and market netting contracts

1.223 The Bill also addresses the potential inconsistency between the Industry Acts and the PSN Act concerning market netting contracts. The Bill also clarifies that the protections providing to approved netting arrangements apply despite any other law (including the specified provisions and the specified stay provisions).

1.224 Approved RTGS systems are payment or settlement systems approved by the RBA under section 9 of the PSN Act. Approved netting arrangements typically arise in respect of multilateral netting in certain approved payment systems and securities settlement systems. Market netting typically arises under the rules of a stock exchange, futures exchange or CCP. The payment systems, settlement systems, exchanges and CCPs protected as approved RTGS systems, approved netting arrangements and netting markets under the PSN Act are fundamental to systemic stability in Australia. There are strong financial system stability reasons for ensuring that the operator of such a system, arrangement or market can enforce the arrangement or rules governing the operation of the market in accordance with their terms. Legal certainty is of the utmost importance in relation to these systems, arrangements and markets, and any uncertainty could cause significant systemic disruption. Accordingly, it has been considered that the protections provided to approved RTGS systems, approved netting arrangements and market netting contracts under the PSN Act should generally prevail over the specified stay provisions.

1.225 Accordingly, a new subsection 6(2) of the PSN Act is inserted by the Bill to provide that the protections which apply in respect of approved RTGS systems in section 6 have effect despite any other law (including the specified provisions and the specified stay provisions). A similar provision is inserted by the Bill in section 6A(2) in respect of the new protections which apply in respect of approved RTGS systems in respect of non-terminal administrations to ensure that those protections have effect despite any other law (including the specified provisions and the specified stay provisions). [***Schedule 1, Part 1, item 13, Subsection 6(2) and item 14, After section 6, subsection 6A(2)***]

1.226 Similarly, a new subsection 10(3) of the PSN Act is inserted by the Bill to provide that the protections which apply in respect of approved netting arrangements in subsections 10(1) and 10(2) have effect despite any other law (including the specified provisions and the specified stay provisions). [***Schedule 1, Part 1, item 19, Subsection 10(3)***]

1.227 Similarly, a new subsection 16(3) is inserted by the Bill to provide that the protections which apply in respect of netting markets and market netting contracts in subsections 16(1) and 16(2) have effect despite any other law (including the specified provisions and the specified stay provisions). [*Schedule 1, Part 1, item 30, Subsection 16(3)*]

1.228 Reference is made in the note to each of subsections 6(2), 6A(2), 10(3) and 16(3) that section 5 of the PSN Act defines specified provisions and specified stay provision. [*Schedule 1, Part 1, item 19, Subsection 10(3) and item 30, Subsection 16(3)*]

Additional protections from things being void or voidable

1.229 Under insolvency law, liquidators may ‘claw-back’ payments made to particular creditors in certain circumstances. For example, sections 588FE and 588FF of the Corporations Act allow a court to make orders setting aside voidable transactions, including unfair preference in certain circumstances.

1.230 Section 588FG of the Corporations Act provides a defence to a person who becomes a party to a transaction if that person became a party in good faith and at the time when the person became such a party the person had no reasonable grounds for suspecting that the company was insolvent at that time or would become insolvent because of, or because of matters including, entering into the transaction or a person doing an act, or making an omission, for the purpose of giving effect to the transaction.

1.231 In certain circumstances, the framework created by this Bill could give rise to transactions that may be voidable under insolvency law. For example:

- if a counterparty to a close-out netting contract was prevented from closing-out transactions under the contract with a Regulated Entity because of the application of a specified stay provision; and
- the Regulated Entity later becomes insolvent; and
- a court considers that the counterparty had reasonable grounds for suspecting that the Regulated Entity was insolvent or would become insolvent because of the matters described above; and
- payments received from the Regulated Entity under the transactions under the close-out netting contract that were prevented from being closed-out due to the operation of a specified stay provision may be liable to be set aside as an unfair preference (and as such become voidable).

1.232 Such an interpretation would require counterparties to meet their gross obligations outlined in this Bill, but merely hold a right to prove in the liquidation for the gross debts owed to them by the failed Regulated Entity.

1.233 The Bill prevents such a situation arising by providing, under subsection 14(5) of the PSN Act, that none of the following things done by a party to a close out netting contract, while it is in external administration and a specified stay provision applies to the contract, is to be void or voidable in an external administration (including under section 588FE of the Corporations Act):

- making a payment, or transferring property, to another person to meet an obligation under the contract;
- creating rights or obligations in another person under the contract;
- giving any security to another person in relation to the contract;
- entering into one or more close out netting contracts with another person. [*Schedule 1, Part 1, item 26, Subsections 14(3), (4) and (5), subsection 14(5)*]

1.234 Subsection 14(5) is intended to extend the existing protection provided in section 14 of the PSN Act that the termination of obligations, the netting of obligations and any payment under the close-out netting contract to discharge a net obligation are not considered void or voidable in the external administration (e.g. in existing subsection 14(2)(g)) to certain things done by a party to a close-out netting contract while the party is in external administration and a specified stay provision applies to the contract.

1.235 Reflecting subsection 14(6) of the PSN Act, subsection 14(5) does not protect counterparties in respect of a thing mentioned in subsection 14(5) which is done by a party to a close-out netting contract in relation to another person if the transaction did not result from the operation of section 22, 35 or 36R of the Business Transfer Act and, in relation to the transaction under which that thing was done:

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

- entering into the transaction; or
- a person doing an act, or making an omission, for the purposes of giving effect to the transaction;
- the counterparty neither provided valuable consideration under, nor changed their position in reliance on, the transaction. [*Schedule 1, Part 1, item 26, Subsections 14(3), (4) and (5), subsections 14(7) and 14(8)*]

1.236 If the transaction results from the operation of section 22, 35 or 36R of the Business Transfer Act (i.e. as a result of a compulsory transfer of business under that Act), the relevant protections of the PSN Act which otherwise applied would continue.

Enforcing security

1.237 In order to ensure that the enforcement of security is stayed under the Industry Acts in the same way as close-out netting rights are stayed, certain provisions of the Industry Acts which impose stays on close-out rights have been amended to provide that the fact or happening of the event described in the relevant legislative provision does not allow the contract, or a party to the contract, to enforce any security under that contract. The reference to ‘security’ in these amendments is a reference to traditional forms of security. [*Schedule 1, Part 2, item 31, after paragraph 11CD(1A)(c), paragraph 11CD(1A)(d) of the Banking Act, item 33, at the end of subsections 13N(2) and 14AC(2) of the Banking Act, item 36, at the end of subsection 36AA(2) of the Business Transfer Act, item 38, at the end of subsections 62V(2), 62ZB(2) and 103K(2) of the Insurance Act, item 39, after paragraph 105(1A)(c) of the Insurance Act, item 40, at the end of subsections 165B(2), 168C(2) and 230AJ(2) of the Life Insurance Act, item 41, after paragraph 230C(1A)(c) of the Life Insurance Act and item 42, at the end of subsection 101(2) of the PHI Act*]

1.238 Certain supplemental changes have been made to the provisions of the Banking Act to explicitly recognise that the existing protection of certain contractual rights given under the Banking Act in relation to an asset that secures liabilities to holders of covered bonds, or their representatives, in circumstances where payments under the covered bonds to the holders or representatives are not made. Clarification is provided that subsections 11CD(1A) and 15C(2) have effect subject to section 31B of the Banking Act (which provides for the existing protections in relation to covered bonds). [*Schedule 1, Part 2, item 32, Subsection 11CD(1A) of the Banking Act and item 34, at the end of subsection 15C(2) of the Banking Act*]

Business Transfer Act amendments

1.239 Transferring the business of an entity in financial distress to a healthy institution can be a less disruptive and costly means of resolving problems in financial institutions than wind-up.

1.240 Currently, Part 4 of the Business Transfer Act contains compulsory transfer of business powers. These powers may be used to transfer business from a distressed financial institution to a healthy one that is willing to receive (purchase) the business. The transfer may be of all the assets and liabilities of the institution (a total transfer) or of only some of the assets and liabilities of the institution (a partial transfer).

1.241 To support Part 4 of the Business Transfer Act, section 36AA of that Act currently limits the effect that certain acts taken in respect of a compulsory transfer has on contracts to which a body corporate that is, or is proposed to become, a transferring body is or was party. In particular, subsection 36AA(2) provides that the fact that an act is done for the purposes of Division 2 or 3, or that a certificate of transfer comes into force under Division 3, in connection with the body does not allow the contract, or any other party to the contract, to do any of the following:

- deny any obligations under that contract;
- accelerate any debt under that contract;
- close-out any transaction relating to that contract.

1.242 There is some concern that the Business Transfer Act does not currently include provisions ensuring that APRA would not engage in ‘cherry picking’ when undertaking a compulsory transfer of business.

1.243 As such, the Bill provides that if:

- a certificate of transfer comes into force in respect of a partial transfer; and
- just before the partial transfer, the transferring body is a party to a close out netting contract, market netting contract or approved netting arrangement; and
- the partial transfer covers some (but not all) of the assets and liabilities the body has, under the contract or arrangement, with respect to another party to the contract or arrangement (the counterparty),

then the partial transfer is void to the extent of the assets or liabilities the transferring body has, just before the partial transfer, under the contract or arrangement, with respect to the

counterparty. Accordingly, those assets and liabilities are not transferred to the transferee and instead remain with the transferring body. [*Schedule 1, Part 2, item 37, after section 36AA, section 36AB*]

1.244 The Bill also clarifies that the PSN Act affects what the assets and liabilities of a party to a close out netting contract, market netting contract or approved netting arrangement are taken to include. For example, paragraphs 10(1)(c), 14(1)(e) and 16(1)(e), in relation to approved netting arrangements, close-out netting contracts and market netting contracts respectively, generally provide that, for the purposes of any law, the assets of a party to the arrangement or contract are taken to include any net obligation owed to the party under the arrangement or contract and not to include obligations terminated under the arrangement or contract. [*Schedule 1, Part 2, item 37, after section 36AA, note after subsection 36AB(1)*]

1.245 The Bill also provides that if APRA makes a compulsory transfer determination (or issues a certificate of transfer) that covers some (but not all) of the assets and liabilities under a close-out netting contract, the counterparty is not prevented from closing out transactions under that contract. The equivalent amendments are not made in respect of market netting contracts as the protections provided in respect of market netting contracts under the PSN Act generally have effect despite any other law (including the specified provisions and the specified stay provisions).

1.246 These amendments are consistent with the FSB's recommendation that the resolution authority (APRA) would only be permitted to transfer all transactions under a particular close-out netting contracts, market netting contract or approved netting arrangement with a particular counterparty to a new entity, and would not be permitted to differentiate between individual rights, obligations or transactions with the same counterparty and subject to the same contract.⁴²

1.247 To support these amendments, the definitions of 'approved netting arrangement', 'close-out netting contract' and 'market netting contract' are inserted into subsection 4(1) of the Business Transfer Act. The terms are defined in each case as having the same meaning as in the PSN Act. The amendment ensures that the terms have consistent meaning between the PSN Act and the Business Transfer Act. [*Schedule 1, Part 2, item 35, subsection 4(1) of the Business Transfer Act*]

42 FSB, Key Attributes (15 October 2014), I-Annex 5 — Temporary stay on early termination rights.

1.248 To support these amendments, the Bill also amends the way in which sections 6, 10, 14 and 16 of the PSN Act interact with the Business Transfer Act (specifically subsection 36AA(2)) as described above.

1.249 None of the powers granted to APRA under this Bill allow it to engage in ‘cherry picking’ within the same contract⁴³ with the same counterparty. APRA does not have the ability to force counterparties to continue to honour certain obligations under a close-out netting contract, whilst at the same time disclaiming other obligations under that same close-out netting contract or otherwise alter, modify or vary the obligations.

Part 3 — Impact of non-terminal administrations on participation in approved RTGS systems and approved netting arrangements

1.250 It is fundamentally important to the stability of the Australian financial system that the payment and settlement systems approved by the RBA as approved RTGS systems have robust protection in all market conditions. Cash transfers and securities settlements made in approved RTGS systems, and made prior to the exclusion of the failed institution from the approved RTGS system, should not be rendered void by the zero hour rule as a disposition made after the commencement of the winding up.⁴⁴

1.251 As a consequence of the development of rehabilitative regimes, particularly for systemically important financial institutions, there is now a contemplation that a financial institution which is a participant in an approved RTGS system or approved netting arrangement may become subject to the control of an external administrator (in the form of a statutory manager or judicial manager) but that it would be in the interests of Australian (and potentially international) systemic stability and in the interests of depositors and policy holders that the institution subject to the non-terminal administration (e.g. the institution subject to statutory management or judicial management) continue to transact in the key payment and settlement systems, exchanges and clearing houses. For this to occur, the system must benefit from robust protections throughout the duration of that non-terminal administration (as the protections need to extend beyond the first day of the external administration, which was previously the day on which the operator of the system, administrator of market would have expected to exclude the institution). If there were to be any uncertainty as to the protections during the course of the non-terminal

43 A standard master agreement (together with each transaction entered into under that master agreement) is considered a single close-out netting contract.

44 As noted in the Objectives section of the Explanatory Memorandum to the Payment Systems and Netting Bill 1998.

administration, this uncertainty could, among other things, result in the systemic failure of other participants in the system and a loss of confidence in the financial system generally.⁴⁵

1.252 Accordingly, a new concept of ‘non-terminal administration’ has been included in section 5 of the PSN Act. A person goes into non terminal administration if they go into external administration and the external administration is not a winding up under the Corporations Act (whether that winding up is a winding up by the court, a voluntary winding up or a winding up by ASIC) or a corresponding law of a foreign country. [***Schedule 1, Part 1, item 6, Section 5, ‘non-terminal administration’ definition***]

Approved RTGS systems

1.253 A new section 6A of the PSN Act is inserted by the Bill to clarify that, if the 3 conditions described below are satisfied, section 6A will deem a payment or transfer made by a participant through an approved RTGS system to have had the same effect it would have had if the participant had not gone into non terminal administration. The three conditions are as follows and are similar to those which apply under the existing section 6. [***Schedule 1, Part 1, item 14, After section 6, section 6A Non terminal administration not to affect transactions***]

1.254 First, it will apply where a participant in an approved RTGS system goes into non-terminal administration (paragraph 6A(1)(a)).

1.255 Second, there is a transaction involving the payment of money, or the transfer of an asset, by the participant (paragraph 6A(1)(c)). As is the case in respect of section 6 (as explained in paragraphs 18 to 26 of the Explanatory Memorandum to the Payment Systems and Netting Bill 1998), the protection will therefore apply to both cash transfers and the transfer of ownership of an asset. It will apply to both linked cash transfers and to both legs of security settlements (i.e. the cash transfer and the exchange of ownership).

1.256 Third, the payment or settlement transaction is executed through the system at any time before the participant goes into, or while the participant is in, non-terminal administration (paragraph 6A(1)(b)).

1.257 Clarification is made that the existing protection given in respect of approved RTGS systems under section 6 of the PSN Act apply in accordance with the existing terms of that section in circumstances where

45 See the Status quo section of the Explanatory Memorandum to the Payment Systems and Netting Bill 1998.

a participant in an approved RTGS system goes into external administration (other than non-terminal administration). [**Schedule 1, Part 1, item 12, Paragraph 6(1)(a)**]

1.258 Supplemental changes have been made to clarify the heading of the existing section 6 of the PSN Act. [**Schedule 1, Part 1, item 11, Section 6 (heading)**]

Approved netting arrangements

1.259 The protections provided in the Bill in respect of approved netting arrangements apply in circumstances where a party to an approved netting arrangement goes into non-terminal administration and allow a party (including the operator of the approved netting arrangement) to do anything permitted or required by the arrangement in order to net:

- obligations incurred before the participant goes into, or while the participant is in, non-terminal administration; and
- net obligations if the obligations that are directly or indirectly netted are incurred before the participant goes into, or while the participant is in, non-terminal administration.
[**Schedule 1, Part 1, item 16, After paragraph 10(2)(a), paragraph 10(2)(aa)**]

1.260 This change applies in respect of all approved netting arrangements.

1.261 Clarification is made that the existing protection given under paragraph 10(2)(a) applies where the party to an approved netting arrangement goes into external administration and that external administration is *not* a non-terminal administration. [**Schedule 1, Part 1, item 15, Paragraph 10(2)(a)**]

1.262 The mechanism for claiming that transactions which are netted through an approved netting arrangement are voidable under section 10(4) would still enable obligations netted under the arrangement during an external administration (which is not a winding up) which are unfair preferences to be unwound.⁴⁶

⁴⁶ See paragraph 59 of the Explanatory Memorandum to the Payment Systems and Netting Bill 1998.

Part 4 — Cash market settlement activities in approved netting arrangements

1.263 In order to validate the settlement of net obligations by a participant on or after the date on which it enters external administration which occur under an approved netting arrangement contained in the rules of, or contracts which relate to, a licensed CS facility (as defined in section 761A of the Corporations Act), it is important for section 10(2) of the PSN Act to expressly cover any transfer of assets as well as any payment made to discharge a net obligation. This is because settlement occurs on a delivery (i.e. of assets) versus payment basis, and both the delivery and the payment need to be protected. The intention is to provide a more comprehensive protection from insolvency laws in respect of these settlements. This intention is evinced by specifying in subsection 10(2)(f) of the PSN that, for an arrangement that is governed by the rules of a licensed CS facility as defined in section 761A of the Corporations Act, a payment, or a transfer of property, by a party under the arrangement to discharge a net obligation is not to be void or voidable in the external administration. [*Schedule 1, Part 1, item 17, After paragraph 10(2)(e), paragraph 10(2)(f)*]

1.264 This protection will only apply in respect of an approved netting arrangement contained in the rules of, or contracts which relate to, a licensed CS facility (as defined in section 761A of the Corporations Act), rather than in respect of any approved netting arrangement. This is because systems (e.g. payment systems) other than securities settlement systems have been approved as approved netting arrangements and the protection of settlements which involve the transfer of assets is not considered necessary or appropriate for those other types of arrangements.

1.265 Clarification is made to note 1 to subsection 10(2) of the PSN Act that paragraph (a) only authorises the party to take any action to arrive at a net obligation; it does not authorise the party to settle the net obligation by payment *or transfer of property*. This should not be read in any way as impacting on the protection provided in other paragraphs of subsection 10(2). [*Schedule 1, Part 1, item 18, Subsection 10(2) (note 1)*]

Part 5 — Market netting contracts

1.266 Recent international developments such as CPMI and IOSCO's *Recovery of financial market infrastructures* paper have demonstrated the importance of systemically important FMIs having comprehensive and effective recovery plans and 'a set of recovery tools that is comprehensive and effective in allowing the FMI to, where relevant, allocate any

uncovered losses and cover liquidity shortfalls'.⁴⁷ Importantly, in order to be effective, the recovery tools must be 'reliable, timely and have a sound legal basis' and there 'should be a high degree of certainty that the FMI will be able to implement each tool in all relevant circumstances, including in times of stress'.⁴⁸ Some of the recovery tools, such as replenishment, may be implemented in circumstances where there are no transactions on foot between the CCP and any participants.

1.267 As it is important to systemic stability and imperative to minimise any possible contagion effects, the protections set out in Part 5 of the PSN Act to market netting contracts and netting markets must robustly apply in all circumstances including where the only arrangement as between the operator of the netting market (i.e. the CCP) and a participant is the rules governing the operation of the netting market where those rules have effect as a contract between a participant in the netting market and one or more other persons (e.g. each other participant). One example of this is that section 822B of the Corporations Act sets out that the operating rules of a licensed CS facility have effect as a contract under seal between certain persons. The specific agreements made under the contract are not relevant for these purposes.

1.268 To achieve this robust protection, the definition of 'market netting contract' in section 5 of the PSN Act is clarified to provide that, in addition to the existing limbs of the definition, the definition also includes the rules governing the operation of a netting market, if those rules have effect as a contract between a participant in the netting market and one or more other persons. [*Schedule 1, Part 1, item 5, Section 5 (after paragraph (a) of the definition of market netting contract), 'market netting contract' definition*]

1.269 The recovery tools in a comprehensive recovery plan include tools to replenish any financial resources that may be employed in a stress event. This tool includes collecting resources from participants by means of cash calls or other mechanisms by which the CCP calls for contributions to replenish or otherwise supplement its default fund. The default fund represents pre-funded mutualised financial resources used to meet losses incurred by the CCP on default of a participant.

1.270 In order for the rules which govern the operation of the netting market such as a CCP, including the recovery rules, to be implemented in an expedient, robust and legally certain manner in all market conditions, including in times of financial distress, subparagraph 16(2)(g)(iii) of the PSN Act has been amended to ensure that any payment, or transfer of

⁴⁷ CPMI and IOSCO, *Recovery of financial market infrastructures* (October 2014), page 1.

⁴⁸ CPMI and IOSCO, *Recovery of financial market infrastructures* (October 2014), section 3.3.5.

property (whether absolutely or by way of security), by a party to meet an obligation under the contract is not void or voidable in an external administration. Such an obligation may, but does not have to be, an obligation to contribute to, or otherwise replenish, the netting market's default fund. An external administrator may not bring legal proceedings to recover amounts, or property, received by the operator of a netting market as a payment, or a transfer of property, by the party in external administration to meet an obligation under the contract. [**Schedule 1, Part 1, item 29, Subparagraph 16(2)(g)(iii)**]

1.271 Generally, the protection set out in section 16(2)(g) which prevents certain things being void or voidable in an external administration applies irrespective of whether the participant was in external administration or not at the time that the thing happened (e.g. at the time the payment, or transfer of property, was done).

Application

Approved netting arrangements, close-out netting contracts and market netting contracts

1.272 Clarification is provided that in general the amendments in the Bill apply to existing and future market netting contracts and external administrations, enforcements of security regardless of when the security was given. An exception is made for the amendments to subparagraph 16(1)(d) in items 3 and 4 of the Bill, which only affect disposals of rights or property, or the creation or operation of encumbrances or interests occurring after the amendments take effect. This amendment is intended to avoid possible breaches of paragraph 51(xxxi) of the Constitution with respect to the acquisition of property on other than just terms (see paragraphs 1.68 and 1.69 for further explanation). [**Schedule 1, item 43, application of amendments**]

1.273 The amendments made by Part 1 of Schedule 1 of this Bill apply in relation to approved netting arrangements, market netting contracts and close out netting contracts entered into after the start time, or that are in existence immediately before the commencement of this Schedule.

1.274 Except in relation to the amendments made by item 26 of this Bill (in respect of the repeal of subsections 14(3), (4) and (5) and substitution of new subsections 14(3), (4), (5), (6), (7) and (8)), the amendments made by Part 1 of Schedule 1 of this Bill do not apply in relation to an external administration that commenced before the commencement of this Schedule.

1.275 The amendments made by Part 1 of Schedule 1 of this Bill apply in relation to trigger events that occur for a close out netting contract after the commencement of this Schedule.

1.276 The amendments which are made by items 22 and 23 of the Bill to paragraph 14(1)(d) and subparagraphs 14(1)(d)(ii) and (iii) do not apply to disposals of rights or property, or the creation or operation of encumbrances or interests, before the commencement of this Schedule. The reason for this is discussed above.

1.277 The amendments made by item 26 of the Bill in respect of the repeal of subsections 14(3), (4) and (5) and substitution of new subsections 14(3), (4), (5), (6), (7) and (8) deal with a range of issues including an additional protection from certain things being void or voidable in an external administration, the interaction between the PSN Act and other laws and the circumstances in which the protections in section 14 will not apply. These amendments apply in relation to a person being in external administration, whether the external administration commences before or after the commencement of this Schedule.

1.278 The amendment made by item 37 involves the insertion of section 36AB which provides, generally, that, if certain circumstances exist, a partial transfer is void to the extent of the assets or liabilities the transferring body has, just before the partial transfer, under the contract or arrangement, with respect to the counterparty. This amendment applies to a partial transfer if the certificate of transfer comes into force after the commencement of this Schedule.

1.279 The amendments made by Parts 1 and 2 of this Bill apply in relation to the enforcement of a security after the commencement of this Schedule, even if the security was given before the commencement of this Schedule. This is to ensure that these important reforms apply to as broad a range of security arrangements as possible to facilitate the compliance by entities subject to Australian law with international and commercial requirements.

Chapter 2

Statement of Compatibility with Human Rights

Prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011

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

2.1 This Bill is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Overview of the Bill

2.2 The Financial System Legislation Amendment (Resilience and Collateral Protection) Bill 2016 (the Bill) amends the *Payment System and Netting Act 1998* (PSN Act) to:

- enable Australian entities to collect, post, hold, and enforce rights in respect of, collateral provided by way of security in connection with certain financial market transactions in the manner required by international requirements;
- 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 certain financial market transactions; and
- enhance financial system stability by protecting the operation of approved RTGS systems, approved netting arrangements and netting markets (more specifically, market netting contracts) in all market conditions.

2.3 The Bill also makes consequential amendments to the Banking Act; Business Transfer Act; Insurance Act; Life Insurance Act; and PHI Act.

Human rights implications

2.4 This Bill does not engage any of the applicable rights or freedoms.

Conclusion

2.5 This Bill is compatible with human rights as it does not raise any human rights issues.