

International **Comparative** Legal Guides



Derivatives **2021**

A practical cross-border insight into derivatives

Second Edition

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1 Documentation and Formalities

1.1 Please provide an overview of the documentation (or framework of documentation) on which derivatives transactions are typically entered into in your jurisdiction. Please note whether there are variances in the documentation for certain types of derivatives transactions or counterparties; for example, differences between over-the-counter (“OTC”) and exchange-traded derivatives (“ETD”) or for particular asset classes.

The 2002 ISDA Master Agreement (Multicurrency – Cross Border) and the 1992 ISDA Master Agreement (Multicurrency – Cross Border) (together, the **ISDA Master Agreements**) are the market standard agreements for documenting over-the-counter (**OTC**) derivatives transactions in Australia. Although there are still some 1992 ISDA Master Agreements in use in the market, the 2002 ISDA Master Agreement is the most commonly used master agreement in Australia.

1.2 Are there any particular documentary or execution requirements in your jurisdiction? For example, requirements as to notaries, number of signatories, or corporate authorisations.

Contracts and deeds can be entered into by individuals, partnerships or corporations, and each type of signatory is subject to different execution requirements.

Corporations in Australia are subject to the *Corporations Act 2001* (Cth) (the **Act**). Under the Act, a company may execute a document in one of five ways. First, a company may execute a document by affixing the company’s common seal. This seal must be affixed in the presence of two directors or a director and the company’s secretary. If a company only has one director, that director alone may witness the affixing of the seal. The Act prescribes certain requirements that must be present in all common seals. Secondly, a company may execute a document pursuant to section 127(1) of the Act if two directors, a director and a company secretary, or the company’s sole director and sole company secretary, sign the document in question.

Individuals may execute contracts by signing, without the need for their signature to be witnessed. However, some state jurisdictions require that execution of deeds by individuals must be witnessed. It is common practice for all execution of agreements and deeds to be witnessed.

Partnerships may execute agreements by signing, provided there are no restrictions expressly set out in the relevant partnership agreement. Only partners appointed by deed may execute a deed on behalf of a general partnership.

Additionally, in practice, deeds are usually expressly stated to be such (i.e. with the words ‘executed as a deed’ or similar) to ensure that courts will construe the document as a deed, rather than a contract.

Some documents, such as statutory declarations and affidavits, may only be witnessed by certain prescribed individuals.

1.3 Which governing law is most often specified in ISDA documentation in your jurisdiction? Will the courts in your jurisdiction give effect to any choice of foreign law in the parties’ derivatives documentation? If the parties do not specify a choice of law in their derivatives contracts, what are the main principles in your jurisdiction that will determine the governing law of the contract?

The governing law specified in ISDA Master Agreements is generally the law of an Australian State. In practice, parties to ISDA Master Agreements generally also replace section 13(b)(i) of the 2002 ISDA Master Agreement so that each party submits to the courts of the chosen Australian State jurisdiction.

Australian courts will generally respect a choice of foreign law provided that the contracting parties have genuinely and validly (expressly or impliedly) selected that foreign law to govern their contract.

Australian courts, in enforcing a choice of law clause, will consider proof of a question of foreign law as a question of fact, which generally requires the use of expert evidence. Generally, a party attempting to plead a question of foreign law in an Australian court will need to plead full particulars of the foreign case law relied upon (rather than merely a conclusion of foreign law). Courts in New South Wales have arrangements for questions of Singapore or New York law to be referred to local judges in those jurisdictions.

If a choice of law clause has not been included in a contract, or if that clause is invalid, Australian courts employ a two-stage test to determine the proper law of the contract. First, the court will ask whether the parties have expressly or impliedly intended that a certain law should apply to govern the contract. Second, if there is no evidence that a choice has been made, the court will undertake an objective assessment to determine which legal system has the closest and most real connection to the contract. In making this assessment, a court may consider the place of residence and business of the parties, the place of contracting, the place of performance, and the nature and subject matter of the contract.

2 Credit Support

2.1 What forms of credit support are typically provided for derivatives transactions in your jurisdiction? How is this typically documented? For example, under an ISDA Credit Support Annex or Credit Support Deed.

Cash in highly liquid currencies and highly liquid debt securities are the most common forms of credit support in Australia.

2.2 Where transactions are collateralised, would this typically be by way of title transfer, by way of security, or a mixture of both methods?

Transactions are predominantly collateralised by way of title transfer.

2.3 What types of assets are acceptable in your jurisdiction as credit support for obligations under derivatives documentation?

All mandatory initial and variation margin must be in the form of (i) cash, (ii) unrated senior debt securities issued by Australian or overseas banks, (iii) highly rated debt securities issued by federal or state governments in Australia and offshore, central banks, local and overseas banks, local governments, corporates, multilateral development banks and international banking agencies, (iv) highly rated covered bonds, (v) highly rated senior securitisation exposures, (vi) equities included in a major stock index, and (vii) gold bullion.

2.4 Are there specific margining requirements in your jurisdiction to collateralise all or certain classes of derivatives transactions? For example, are there requirements as to the posting of initial margin or variation margin between counterparties?

Mandatory margining and risk mitigation requirements for the Australian jurisdiction are set out in *Prudential Standard CPS 226: Margining and risk mitigation for non-centrally cleared derivatives (CPS 226)*. CPS 226 applies to all non-centrally cleared derivatives entered into by Australian Prudential Regulation Authority (APRA) covered entities. It requires all such entities to post and collect variation margin and exchange two-way initial margin. APRA covered entities include banks authorised by APRA as authorised deposit-taking institutions (ADIs), non-operating holding companies (NOHCs), general insurers, life companies, friendly societies and registrable superannuation entities.

2.5 Does your jurisdiction recognise the role of an agent or trustee to enter into relevant agreements or appropriate collateral/enforce security (as applicable)? Does your jurisdiction recognise trusts?

Yes, Australian jurisdictions recognise the role of an agent or trustee to enter into an agreement, to appropriate collateral or enforce security. However, a trustee may only enter into an agreement on behalf of a trust if the trustee has been duly authorised to do so under the relevant trust deed.

Due to Australia's strict protections for trust property and trust beneficiaries, it is important for those entering into an agreement with a trust to ensure that trustee has the power to enter into that type of agreement and thereby bind the trust. As a trust is not a separate legal entity, the trustee is generally

personally liable for its acts and omissions. A third party is unlikely to have any recourse to bind a trust to an agreement if it was entered into by the trustee outside of the scope of their powers under the relevant constituent trust deed.

Similarly, if an agent has not been granted the requisite authority by a principal to enter into an agreement, the agreement may be rendered void. Therefore, it is prudent for parties dealing with potential agents to be satisfied of that agent's authority prior to purporting to enter into an agreement. An agent's authority may be 'express actual authority' established through the passing of a resolution, 'implied actual authority' due to the position or title of the agent at the company, or 'ostensible authority' established by how the agent was represented to the third party by the company.

2.6 What are the required formalities to create and/or perfect a valid security over an asset? Are there any regulatory or similar consents required with respect to the enforcement of security?

Security over personal property in Australia is governed at a Commonwealth level by the *Personal Property Securities Act 2009 (Cth) (PPSA)*. Personal property is defined very broadly to mean almost all property other than land (including fixtures attached to the land). Under the PPSA, a security interest over personal property may be perfected by three methods: registration; possession; or control.

The PPSA introduced the Personal Property Securities Register, a publicly searchable national register that acts as a noticeboard, showing all registered security interests in personal property. Registration defines the priority status the security interest has relative to other security interests in the collateral. A secured party may perfect its interest by being in possession of the property over which it has a security interest. However, this possession cannot be as a result of seizing or repossessing that property. One of the key benefits of perfection is that it protects a security interest from 'vesting' in the person who has granted the security interest in bankruptcy. The PPSA allows perfection by control in relation to certain financial assets such as bank accounts, intermediated securities and investment securities. A secured party can have control of a bank account only if the secured party is the ADI at which the bank account is held.

Security over real estate in Australia may take the form of a legal mortgage or equitable mortgage. A legal mortgage must comply with the statutory requirements of transfers of property in Australia, which can vary by state. An equitable mortgage, in contrast, is created when the legal owner of the property enters into a document or carries out an act that, while not meeting the formal requirements for title to the property to transfer, still demonstrates an intention to create a security interest.

3 Regulatory Issues

3.1 Please provide an overview of the key derivatives regulation(s) applicable in your jurisdiction and the regulatory authorities with principal oversight.

Principal regulatory authorities

The principal regulators of Australia's banking and finance system are the Reserve Bank of Australia (RBA), APRA and the Australian Securities and Investments Commission (ASIC).

The RBA is Australia's central bank and has had a long-standing responsibility for the overall stability of the financial system, monetary policy and the safety and efficiency of Australia's payment systems.

APRA was established for the purpose of regulating bodies in the financial sector including all ADIs, life and general insurance companies and superannuation funds.

ASIC is the peak wholesale market regulator in Australia with responsibility for monitoring and promoting market integrity and consumer protection including through its oversight of the disclosure and market conduct of Australian companies, and for licensing in relation to financial products and services.

Key derivatives regulation

Australia's derivatives markets are regulated by a framework of licensing, disclosure and anti-money laundering laws applicable to all financial products, including derivatives. Derivatives are also subject to specific regulations that impose mandatory reporting, clearing, risk mitigation and margining obligations on participants in Australia's derivatives markets. A summary of these key regulations follows.

Licensing

Derivatives and derivative-like products are financial products that are primarily regulated under the Act.

Any entity who carries on a financial services business in Australia must hold an Australian financial services licence or otherwise be exempt from the requirement to be licensed. Relevantly, financial services include (i) providing advice in relation to, (ii) dealing in (as principal or agent), (iii) making a market for, or (iv) providing custodial or depository services in relation to, derivatives or derivative-like products.

Any entity operating a facility through which offers to buy and sell derivatives are regularly made and accepted (e.g. an exchange), or that clears and settles transactions in derivatives, is generally required to be licensed by ASIC unless exemptions apply.

Reporting and clearing

Part 7.5A of the Act creates a flexible framework for regulating Australia's OTC derivatives markets that empowers the Minister to prescribe a class of derivatives as subject to mandatory trade reporting, central clearing or trade execution obligations. Once a class of derivatives has been prescribed by the Minister, ASIC may, with the Minister's consent, make derivative transaction rules (DTRs) imposing the relevant mandatory obligations.

To date, ASIC has made DTRs imposing mandatory reporting and clearing obligations on participants in Australia's derivatives markets both in and outside Australia.

Margining and risk mitigation

See question 2.5.

Anti-money laundering and counter-terrorism financing

Most entities dealing in derivatives have reporting and other compliance obligations under the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth) and the *Anti-Money Laundering and Counter-Terrorism Financing Rules Instrument 2007* (No. 1). These laws are administered by the Australian Transaction Reports and Analysis Centre and apply to entities that provide 'designated services' with an Australian connection, including issuing derivatives and acquiring or disposing of derivatives as agent of another person.

3.2 Are there any regulatory changes anticipated, or incoming, in your jurisdiction that are likely to have an impact on entry into derivatives transactions and/or counterparties to derivatives transactions? If so, what are these key changes and their timeline for implementation?

In late 2019, ASIC undertook an industry consultation

regarding retail OTC binary options and contracts for difference (CFDs). This arose from ASIC's ongoing concern that retail investors have suffered (or are likely to suffer) significant detriment from binary options and CFDs. Following the consultation, ASIC used its new product intervention powers to issue a range of orders, including:

- from 3 May 2021, a market-wide prohibition on the issue and distribution of OTC binary options to retail clients; and
- from 29 March 2021, conditions on the issue and distribution of OTC CFDs to retail clients (including caps on leverage ratios, conditions affecting close-out arrangements and negative account balances, and prohibitions on CFD-related marketing inducements).

In late 2020, ASIC commenced a consultation process to seek feedback on proposed amendments to simplify DTR requirements relating to OTC derivative transaction reporting. The proposed changes primarily relate to harmonising ASIC's requirements with international standards for transaction, product and party identifiers and transaction data elements. ASIC is now in the review phase of the first consultation and (at the time of writing) is expected to undertake further consultation later in 2021 with a view to implementing varied requirements in late 2022.

3.3 Are there any further practical or regulatory requirements for counterparties wishing to enter into derivatives transactions in your jurisdiction? For example, obtaining and/or maintaining certain licences, consents or authorisations (governmental, regulatory, shareholder or otherwise) or the delegating of certain regulatory responsibilities to an entity with broader regulatory permissions.

Not beyond those set out in question 3.1.

3.4 Does your jurisdiction provide any exemptions from regulatory requirements and/or for special treatment for certain types of counterparties (such as pension funds or public bodies)?

There are various licensing exemptions; however, these are not specifically attributable to counterparties of a certain type.

4 Insolvency / Bankruptcy

4.1 In what circumstances of distress would a default and/or termination right (each as applicable) arise in your jurisdiction?

Common event of default triggers (associated with distress) include the following in relation to a company:

- an application is made to a court for an order that the company be wound up or that a provisional liquidator or receiver or receiver and manager be appointed;
- a liquidator, provisional liquidator, administrator or receiver is appointed;
- a composition or arrangement with creditors is entered into;
- a winding up, dissolution or reorganisation, moratorium, deed of company arrangement or other administration involving one or more of its creditors is proposed;
- the company is insolvent (i.e. is unable to pay its debts as and when they become due and payable) or fails to comply with a statutory demand; or
- a writ of execution is levied against it.

4.2 Are there any automatic stay of creditor action or regulatory intervention regimes in your jurisdiction that may protect the insolvent/bankrupt counterparty or impact the recovery of the close-out amount from an insolvent/bankrupt counterparty? If so, what is the length of such stay of action?

The *Banking Act 1959*, the *Financial Sector (Business Transfer and Group Restructure) Act 1999*, the *Insurance Act 1973* and the *Life Insurance Act 1995* impose temporary or permanent stays on a party's ability to terminate a derivative with an ADI, NOHC, life insurance company, general insurance company or superannuation fund in certain insolvency-related circumstances (such as the appointment of a statutory or judicial manager).

Permanent stays are imposed to permanently prohibit termination rights as a result of the relevant regulated body becoming the subject of an APRA direction, a recapitalisation direction, or the conversion or write-off of a capital instrument issued by the regulated body (or a determination to do so). Generally, a temporary stay will end at midnight 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) unless APRA makes a declaration to extend the stay permanently if it is satisfied in relation to certain solvency and licensing-related matters in respect of the regulated body.

In the case of both a temporary or permanent stay, the non-defaulting party will continue to have the right to close-out on the occurrence of another event of default (such as a payment default) with no adverse impact on the enforceability of close-out netting as a consequence of doing so.

4.3 In what circumstances (if any) could an insolvency/bankruptcy official render derivatives transactions void or voidable in your jurisdiction?

A liquidator may render derivatives transactions entered into by an Australian company void or voidable under the Act to the extent they constitute:

- an unfair preference;
- an uncommercial transaction;
- a transaction with the purpose of obstructing creditors' rights;
- an unfair loan; or
- an unreasonable director-related transaction.

In the case of the first three types of transactions mentioned above:

- the transaction will only be voidable if the company was insolvent at the time of the transaction or became insolvent as a result of that transaction;
- in the case of an unfair preference, the transaction was entered into during the six-month period ending on the relation-back day;
- in the case of an uncommercial transaction, the transaction was entered into during the two-year period ending on the relation-back day; and
- in the case of a transaction entered into for the purpose of obstructing creditors' rights, the transaction was entered into during the 10 years ending on the relation-back day.

The 'relation-back day' is usually:

- the winding-up application date;
- the liquidator appointment date; or
- if the company was in administration prior to the appointment of the liquidator, the date of the appointment of the administrator.

The impact of the above voidable transaction regime on derivatives is subject to the *Payment Systems and Netting Act*

1998 (Cth) (the **Netting Act**), which provides that none of the following transactions will be void or voidable on the external administration of a party under a 'close-out netting contract' (where Australian law governs the contract or the external administration):

- the netting or termination of obligations under the contract;
- a payment by the party to discharge a net obligation under the contract; and
- the giving of certain security.

A party may not rely on these protections if it has not acted in good faith or there are reasonable grounds for suspecting the party was insolvent at the relevant time.

A 2002 ISDA Master Agreement (and 1992 ISDA Master Agreement under which the parties have elected the Second Method) will generally be a close-out netting contract for the purposes of the Netting Act.

4.4 Are there clawback provisions specified in the legislation of your jurisdiction that could apply to derivatives transactions? If so, in what circumstances could such clawback provisions apply?

Please see question 4.3 above.

4.5 In your jurisdiction, could an insolvency/bankruptcy-related close-out of derivatives transactions be deemed to take effect prior to an insolvency/bankruptcy taking effect?

A provision in a derivatives contract that deems a termination of a derivatives transaction to occur immediately prior to the external administration of a party should be enforceable under Australian law subject to the application of any stay on the exercise of termination rights discussed in question 4.2 above.

4.6 Would a court in your jurisdiction give effect to contractual provisions in a contract (even if such contract is governed by the laws of another country) that have the effect of distributing payments to parties in the order specified in the contract?

On the winding up of a party that is an Australian company, any assets available to the company to pay its creditors must be applied in a statutory order of priority set out in section 556 of the Act. The Australian courts will not give effect to contractual provisions in a contract that have the effect of distributing payments to parties other than in a manner consistent with this statutory order of priority (even if such contract is governed by the laws of another country).

5 Close-out Netting

5.1 Has an industry-standard legal opinion been produced in your jurisdiction in respect of the enforceability of close-out netting and/or set-off provisions in derivatives documentation? What are the key legal considerations for parties wishing to net their exposures when closing out derivatives transactions in your jurisdiction?

An industry-standard legal opinion has been obtained in relation to the enforceability of close-out netting on the external administration of an Australian company.

Subject to the application of any stays on the exercise of termination rights discussed in question 4.2 above, Australia is generally a favourable jurisdiction for netting.

5.2 Are there any restrictions in your jurisdiction on close-out netting in respect of all derivatives transactions under a single master agreement, including in the event of an early termination of transactions?

Please see question 5.1 above.

5.3 Is Automatic Early Termination (“AET”) typically applied/disapplied in your jurisdiction and/or in respect of entities established in your jurisdiction?

Automatic Early Termination is not required to apply in order for close-out netting under an ISDA Master Agreement to be enforceable under Australian law. Automatic Early Termination is therefore typically disapplied in relation to parties that are subject to Australian law on their insolvency.

5.4 Is it possible for the termination currency to be denominated in a currency other than your domestic currency? Can judgment debts be applied in a currency other than your domestic currency?

The calculation of a termination amount under an ISDA Master Agreement in a currency other than Australian dollars will be enforceable (subject to the discretion of an Australian court to award judgments in Australian dollars *in lieu* of a foreign currency). However, to avoid the application of section 554C of the Act, parties usually elect Australian dollars as the termination currency where one of the parties is an Australian company. Section 554C requires debts to be proved in a liquidation in Australian dollars at the ‘relevant date’ (which is generally the day the winding-up order is made but can be earlier) at either an agreed rate or, in the absence of agreement, a rate set out in the section.

6 Taxation

6.1 Are derivatives transactions taxed as income or capital in your jurisdiction? Does your answer depend on the asset class?

Gains from derivatives transactions should ordinarily be taxed as income under general principles if entered into as an ordinary incident of carrying on a business, or where the gain was obtained as part of a business operation or commercial transaction for profit-making purposes.

Australia also has a special regime (referred to as the ‘taxation of financial arrangements’ or ‘TOFA’ regime) that taxes gains and losses from certain financial arrangements (which may include derivatives transactions) in a manner that more closely aligns the tax and commercial/accounting recognition of gains and losses. The TOFA regime automatically applies to certain large taxpayers and taxpayers who elect for the regime to apply to their financial arrangements. The TOFA regime may impact the timing of when gains and losses are recognised for income tax purposes, among other consequences.

If the TOFA regime does not apply and a derivatives transaction was not entered into for a profit-making purpose (for example, where a futures contract is used to hedge a capital transaction), the transaction may be taxed on capital account.

6.2 Would part of any payment in respect of derivatives transactions be subject to withholding taxes in your jurisdiction? Does your answer depend on the asset class? If so, what are the typical methods for reducing or limiting exposure to withholding taxes?

Payments of Australian interest, dividends and royalties (as well as payments from certain Australian managed funds) to non-residents are *prima facie* subject to Australian withholding tax.

Generally speaking, payments in respect of derivatives transactions should not ordinarily be subject to withholding taxes in Australia, even where the payment is calculated by reference to interest, dividend or royalty payment obligations.

For example, while interest rate swaps may have payments calculated by reference to interest obligations, because the obligations do not ordinarily depend upon the existence of an underlying loan, the swap payments themselves should not be regarded as interest (or in the nature of interest).

6.3 Are there any relevant taxation exclusions or exceptions for certain classes of derivatives?

There are no specific tax exceptions for certain classes of derivatives in Australia.

Note that where foreign residents invest in Australian derivatives via a widely held foreign fund or through an Australian independent fund manager, income tax exemptions may be available under Australia’s investment manager regime.

7 Bespoke Jurisdictional Matters

7.1 Are there any material considerations that should be considered by market participants wishing to enter into derivatives transactions in your jurisdiction? Please include any cross-border issues that apply when posting or receiving collateral with foreign counterparties (e.g. restrictions on foreign currencies) or restrictions on transferability (e.g. assignment and novation, including notice mechanics, timings, etc.).

At common law in Australia, unless explicitly stated in a contract, a party to a contract has a general right to assign its contractual rights without any consent or approval from the other contracting party. It is common in practice for commercial contracts to prohibit assignment without consent of the other parties to a contract.

In contrast, at common law in Australia, a contract may only be novated with the consent of all contracting parties, including the new contracting party, as novation extinguishes the old contract through the creation of a new contract. In practice, novation usually takes the form of a deed.

8 Market Trends

8.1 What has been the most significant change(s), if any, to the way in which derivatives are transacted and/or documented in recent years?

Consistent with derivatives markets worldwide, Australia has experienced an increase in the volume of derivatives that are cleared through exchanges, in order to comply with mandatory clearing obligations. When coupled with the mandatory margining requirements, the amount of required collateral that must be exchanged with central clearing counterparties or bilaterally, and the associated costs, has increased significantly.

The introduction of mandatory reporting in relation to OTC derivatives has also led to a significant uplift in compliance costs for reporting entities.

8.2 What, if any, ongoing or upcoming legal, commercial or technological developments do you see as having the greatest impact on the market for derivatives transactions in your jurisdiction? For example, developments that might have an impact on commercial terms, the volume of trades and/or the main types of products traded, smart contracts or other technological solutions.

The end of LIBOR will be the key disrupter for the Australian derivatives market in the near- to medium-term future. The

ICE Benchmark Administration has confirmed that it will cease to publish most LIBOR rates from 31 December 2021. New derivatives contracts will therefore need to reference robust alternative reference rates, which in most cases is the risk-free rate. Liquidity continues to increase for products already referencing a risk-free rate. While Australia is taking a multiple-rate approach, which means that the Bank Bill Swap Rate (**BBSW**) continues to remain robust and appropriate in certain transactions, overseas market practice will have a bearing on the reference rates used in Australia. Even though BBSW can still be referenced after 31 December 2021, there will be a major increase in references to the risk-free rate, AONIA, once this becomes market practice overseas.



Louise McCoach is a leading banking and finance lawyer with over 25 years of in-house counsel and private practice experience and the recipient of a number of awards relating to her work in derivatives. Louise has a Master of Laws from the University of Sydney and has held a number of non-executive board positions.

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