

# UPDATE 12

## September 2005

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#### **[U12.01] Payments by way of exchange**

A change has been made to Part 3 which involves deleting the commentary relevant to the recommendation to amend Section 2(a)(i) of the ISDA Master Agreement. The inclusion of a sentence which provides that payments will be by way of exchange originally was intended to strengthen the argument that various types of transactions are 'bona fide swaps', and payments under them will not be interest liable to the deduction of Australian withholding tax. The additional sentence was relevant in the context of currency swaps, interest rate swaps and any other type of swap that hedges genuine underlying exposure. It was not relevant to any other type of transaction.

It is a question of fact whether or not a swap is a bona fide swap for the purpose of the Australian withholding tax provisions. Therefore, if it can be concluded that a swap is bona fide, then it follows that payments under it should not be subject to Australian withholding tax. However, if the swap is not bona fide, then Australian withholding tax issues may arise. In other words, the additional sentence is more in the nature of a representation which, if proven incorrect, will not assist a counterparty to overcome the Australian withholding tax problem.

Ultimately, it is a matter for each counterparty to ensure that it is entering into a transaction that does not trigger Australian withholding tax consequences. Accordingly, AFMA has decided that a preferable approach is to remove the additional sentence as a recommended amendment to the Schedule. Parties, as has always been the case, should continue to analyse the Australian withholding tax implications of their intended transactions.

See the amendments to [3.14], [3.35]-[3.42] and paragraph (1) of the recommended Part 5 of the Schedule (see [5.33]).

#### **[U12.02] ISDA Protocol language**

An additional provision has been included in [5.33] on incorporating the ISDA Protocol into the 2002 Master Agreement.

The 2002 Master Agreement contains a number of significant changes to the 1992 Master Agreement, including the introduction of the "Close-out Amount" as a new damages measure. However, existing ISDA ancillary documents (for example, definition booklets and credit support annexes) drafted prior to 2002 do not contemplate these changes. As a result, there are a number of references in various ISDA Definitions booklets to terminology used in the 1992 Master Agreement that is

not used in the 2002 Master Agreement (for example, a number of the Definitions refer to either “Market Quotation” or “Loss”). Accordingly, using the 2002 Master Agreement in conjunction with the existing ISDA suite of documents could lead to some degree of “mismatch” between the relevant documents.

The ISDA Protocol (found on the ISDA website by clicking on the “Protocol” bar in the left menu on the home page) is designed to confirm the parties’ intentions as to how the existing documentation is to interact with the 2002 Master Agreement. In particular, the ISDA Protocol includes 18 separate Annexes of amendments. These amendments, when elected by the parties as applicable, are deemed to be made to the pre-2002 ancillary documents when used in connection with a 2002 Master Agreement.

In light of the inconsistencies which would arise when ancillary ISDA documentation is used with a 2002 Master Agreement, AFMA recommends including in the Schedule to each 2002 Master Agreement a provision incorporating the ISDA Protocol amendments in a way that amends the relevant documents ancillary to that 2002 Master Agreement as if the two parties were adhering parties. This would give each party the benefit of the ISDA Protocol, whilst ensuring that the required amendments are made when each party enters into a 2002 Master Agreement.

The suggested wording is as follows:

*“The parties agree that the terms of each Annex to the 2002 Master Agreement Protocol published by the International Swaps and Derivatives Association, Inc. (“Protocol”) apply to this Agreement as if the parties had adhered to the Protocol without amendment.”*

Parties also could elect to adopt less than all of the Annexes using this option if commercially preferred. If so, the recommended clause would need to be changed.

See the amendment to paragraph (3) of [5.33].