

UPDATE 2
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[U2.01] Introduction

This update updates the Guide in a number of areas as follows:

- it incorporates a 14 December 2001 recommendation from AFMA’s Documentation Committee in relation to Australian Dollar Overnight Index Agreements
- it incorporates a 14 December 2001 recommendation from AFMA’s Documentation Committee in relation to using ISDA’s basic set-off clause
- it incorporates a 9 March 2001 recommendation from AFMA’s Documentation Committee which suggested a change to the standard Novation Agreement
- references to the “Corporations Law” throughout the Guide have been changed to “Corporations Act”
- it incorporates some additional wording that can be used in a confirmation if parties want to deem an ISDA Master Agreement to be in place before they have actually executed it
- it incorporates commentary in relation to the Financial Services Reform Act 2001 in relation to the regulation of derivatives
- references to articles of the 1991 Definitions have been updated to be references to the equivalent articles in the 2000 Definitions
- a number of other minor miscellaneous amendments have been made.

To see the exact changes that have been made to each part, you can view the history version for that part dated 31 May 2002.

[U2.02] Australian dollar overnight index agreements (AONIA)

On 14 December 2001 AFMA’s Documentation Committee published the following recommendation on the AFMA website. The recommendation is now incorporated as part of the On-line Guide. The recommendation remains unchanged. It was prepared without the involvement of Mallesons Stephen Jaques.

AFMA suggests that the following definitions be used in confirmations for Australian dollar overnight index swaps:

“**AUD-AONIA-OIS-COMPOUND**” means that the rate for a Reset Date, calculated in accordance with the formula set forth below in this subparagraph, will be the rate of return of a daily compound interest investment.

“**AUD-AONIA-OIS-COMPOUND**” will be calculated as follows, and the resulting percentage will be rounded, if necessary, in accordance with the method set forth in Section 8.1(a) but to the nearest one ten-thousandth of a percentage point (0.0001%):

$$\left[\prod_{i=1}^{d_O} \left(1 + \frac{AONIA_i \times n_i}{365} \right) - 1 \right] \times \frac{365}{d}$$

where:

“ d_o ”, for any Calculation Period, is the number of Sydney Banking Days in the relevant Calculation Period;

“ i ”, is a series of whole numbers from one to d_o , each representing the relevant Sydney Banking Days in chronological order from, and including, the first Sydney Banking Day in the relevant Calculation Period;

“ $AONIA_i$ ”, for any day “ i ” in the relevant Calculation Period, is a reference rate equal to the interbank overnight cash rate for that day calculated by the Reserve Bank of Australia which appears on Reuters Monitor System Page RBA30 by 9:00am Sydney time on the following Sydney Banking Day. If in respect of any day such rate does not appear on Reuters Monitor System page RBA30 by that time, the rate for that day will be the target cash rate for that day published on Reuters Monitor System page RBA30 by 9:00am Sydney time on the following Sydney Banking Day. If in respect of any day such rate does not appear on Reuters Monitor System page RBA30 by that time, the rate for that day will be as agreed between the parties acting in good faith and in a commercially reasonable manner. If the parties cannot agree then the rate for that day will be determined by the Calculation Agent acting in good faith having regard to comparable rates then available;

“ n_i ”, is 1, except where the Sydney Banking Day is the day immediately preceding a day which is not a Sydney Banking Day, in which case n_i is the number of calendar days from, and including, that Sydney Banking Day to, but excluding, the next Sydney Banking Day;

“ d ”, is the number of calendar days in the relevant Calculation Period.”

Background:

ISDA’s Annex to the 2000 ISDA Definitions (June 2000 version) contains various definitions (with their associated formula) intended for documenting overnight index swaps. These include overnight index swaps based on EONIA_i and EURONIA_i (for Euro), SONIA_i (for Sterling) and TOIS_i (for Swiss francs). The ISDA annex does not currently contain definitions or a formula for Australian dollar overnight index swaps.

Australian dollar overnight index swaps have now become increasingly common in the Australian market. The committee identified a lack of standardisation in the approach taken to documenting these trades in the Australian market, and decided it was worthwhile suggesting a standard approach. The committee sought to generally model its drafting on the principles used in the current overnight index swap definitions adopted by ISDA. The committee proposes to ask ISDA to incorporate the AONIA definitions on the next occasion the Annex to the 2000 ISDA Definitions are updated.

Before using the suggested AONIA definitions and formula, you should satisfy yourself that they operate in an appropriate way. Also, you will need to take care to appropriately incorporate them in your confirmation.

[U2.03] Set-off clause

On 14 December 2001 AFMA’s Documentation Committee published on the AFMA website a recommendation concerning the suggested form of set-off clause. The recommendation is now incorporated as part of the On-line Guide. The commentary on the recommendation has been enlarged for the purpose of incorporating the recommendation in the On-line Guide.

The User’s Guide to the 1992 ISDA Master Agreement at page 56 contains a suggested form of set-off clause (“ISDA’s basic set-off clause”). Up to 31 May 2002 AFMA’s Guide to OTC Documents contained two suggested set-off clauses being the version in Part 5 (which did not provide for set-off in respect of amounts contingently owing) and the alternative version in [18.07] (which did allow for set-off in respect of amounts contingently owing). The wording of each of those clauses can be found in the history files for Parts 5 and 18 dated 31 May 2002.

AFMA no longer recommends the use of these set-off clauses. Instead, AFMA recommends that market participants consider using ISDA's basic set-off clause which is as follows:

“(f) *Set-off*. Any amount (the ‘Early Termination Amount’) payable to one party (the Payee) by the other party (the Payer) under Section 6(e), in circumstances where there is a Defaulting Party or one Affected Party in the case where a Termination Event under Section 5(b)(iv) has occurred, will, at the option of the party (“X”) other than the Defaulting Party or the Affected Party (and without prior notice to the Defaulting Party or the Affected Party), be reduced by its set-off against any amount(s) (the ‘Other Agreement Amount’) payable (whether at such time or in the future or upon the occurrence of a contingency) by the Payee to the Payer (irrespective of the currency, place of payment or booking office of the obligation) under any other agreement(s) between the Payee and the Payer or instrument(s) or undertaking(s) issued or executed by one party to, or in favour of, the other party (and the Other Agreement Amount will be discharged promptly and in all respects to the extent it is so set-off). X will give notice to the other party of any set-off effected under this Section 6(f).

For this purpose, either the Early Termination Amount or the Other Agreement Amount (or the relevant portion of such amounts) may be converted by X into the currency in which the other is denominated at the rate of exchange at which such party would be able, acting in a reasonable manner and in good faith, to purchase the relevant amount of such currency.

If an obligation is unascertained, X may in good faith estimate that obligation and set-off in respect of the estimate, subject to the relevant party accounting to the other when the obligation is ascertained.

Nothing in this Section 6(f) shall be effective to create a charge or other security interest. This Section 6(f) shall be without prejudice and in addition to any right of set-off, combination of accounts, lien or other right to which any party is at any time otherwise entitled (whether by operation of law, contract or otherwise).”

Background:

The User's Guide to the 1992 ISDA Master Agreement contains example drafting and commentary for various types of set-off clause (see pages 54 to 58 of the User's Guide). ISDA's basic set-off clause is one of these.

The history version for Part 5 of AFMA's Guide to OTC Documents dated 31 May 2002 contains a commentary on the differences between ISDA's basic set-off clause and the AFMA clause.

The reasons AFMA no longer recommends the AFMA clause include:

- Where a form of document is widely accepted globally, AFMA's Documentation Committee believes it has become increasingly desirable to match the document used in Australia with the document used globally. An exception to this is where there is a specific Australian legal, regulatory or market reason that justifies a difference. The committee does not believe there is a specific Australian difference that justifies the separate clause in this case.
- The AFMA clause only gives the option about whether or not to set-off to the party obliged to make the payment under the ISDA master agreement. This could be the Defaulting Party or the Affected Party (in which case the non-Defaulting Party or non-Affected Party would not have the right to set-off under the clause). The ISDA basic set-off clause only allows a set off at the election of the non-Defaulting Party or non-Affected Party.

The AFMA clause was drafted to allow the payer to elect the set-off as this reflects Australian insolvency law. On insolvency of a party, the mandatory insolvency set-off provision

contained in the Corporations Act (section 553C) will operate to set-off amounts owing mutually between the parties. A clause which purports to limit set-off to when it is conducted at the option of the non-Defaulting Party will not be enforceable in restricting set-off following insolvency.

While this issue still remains, it is recognised that the ISDA basic set-off clause will be effective before insolvency (this was acknowledged in the commentary to the AFMA clause). Accordingly, in the interest of achieving global consistency AFMA has concluded that there is no legal reason why the ISDA basic set-off clause cannot be used under Australian law. However, participants must appreciate that it will not operate to prevent the mandatory set-off law from operating following insolvency.

- The reason why the payee was not given the option to elect to set off was because of a view that the question of whether a payer should be able to set-off should be covered in the agreement under which the obligation to pay arises. If the payee under an ISDA Master Agreement wants to require the other party to set off, it means that the payee must be a “payer” under another agreement between it and the payer under the ISDA Master Agreement. When the original AFMA clause was prepared it was considered at that time appropriate that a payee under an ISDA Master Agreement should cover its ability to set off payments due under other agreements under the terms of those other agreements. For example, the parties may enter into an agreement where they agree that payments under it must be made “without set-off or counterclaim”.

The ISDA basic set-off clause could operate to override other agreements that prohibit set-off and participants who decide to adopt the ISDA basic set-off clause should consider whether they are agreeable to this possibility. That said, AFMA has again concluded that, despite this issue, it is preferable to achieve global consistency with the set-off clause.

Some points market participants should consider when deciding whether ISDA’s basic set-off clause is acceptable to them include:

- ISDA’s basic set-off clause contemplates the set-off of contingent amounts whereas the AFMA clause previously contained in Part 5 of the AFMA Guide does not. AFMA’s alternative set-off clause (previously contained in [18.07] and now in the history version of Part 18 dated 31 May 2002) gives more detail about the mechanism for setting off contingencies than does ISDA’s basic set-off clause. While some market participants may prefer this approach, the committee takes the view that the level of detail in this context is not an issue driven by Australian law, regulation or market practice.
- ISDA’s basic set-off clause contemplates set-off of amounts under “any other agreement(s) between the Payee and Payer or instrument(s) or undertaking(s) issued or executed by one party to, or in favour of, the other party”. Participants using this clause need to be satisfied with the scope of the other amounts that can be set-off. For example, the AFMA clause also allows set off against amounts arising under Section 8 or 11 of the ISDA Master Agreement. If participants wanted to continue to be able to include those amounts in the set-off calculation, they could replace “or” after “Payer” in the fourth last line of the first paragraph of the ISDA basic set-off clause with:

“, under Section 8 or 11 or under”

- Under the ISDA clause, conversions from one currency to another are done at the rate of exchange at which the non-Defaulting Party or non-Affected Party "would be able, acting in a reasonable manner and in good faith, to purchase the relevant amount of such currency". This differs from the formulation used in AFMA’s set-off clause.
- ISDA’s basic set-off clause does not permit set-off by either party if there are two Affected Parties or for Termination Events other than Credit Events Upon Merger. This is presumably

on the view adopted by the drafters that set-off should only be claimed by a non-Defaulting Party or a non-Affected Party in the limited circumstance of a credit event upon merger and that, otherwise, contractual set-off should not be permitted and payments be made as they fall. Participants should be satisfied with this approach.

[U2.04] Novation Agreement

On 9 March 2001 AFMA's Documentation Committee published a recommendation on the AFMA website concerning clause 5 of the AFMA recommended Novation Agreement appearing at Part 24 of the AFMA Guide to OTC Documents. The recommendation is now incorporated as part of the On-line Guide. The recommendation remains unchanged.

AFMA recommends that Clause 5 of AFMA's suggested form of novation agreement be amended to read as follows:

“Each party is to pay its own costs, charges and expenses (including, without limitation, legal expenses) in entering into this agreement.”

Background:

Part 24.02 of AFMA's Guide to OTC Documents (Volume 3) contains a suggested form of novation agreement. Clause 5 reads as follows:

“Each party is to pay its own costs, charges and expenses (including, without limitation, legal expenses) in entering into this agreement except that the Substitute Party agrees to pay or reimburse the other parties for all stamp duties, fees, taxes and charges which are payable in connection with the novation of any Transaction.”

The Documentation Committee believes that there is no reason in principle why the Substitute Party should necessarily be the one to pay stamp duties, fees, taxes and charges. For example, if the novation has been instigated at the request of the Retiring Party, it might be appropriate for the Retiring Party to pay such amounts (if in fact there are any). As a result, the committee believes that the reference to a particular party paying any stamp duties, fees, taxes or charges should be omitted. If parties to the novation agreement believe that this amount should be borne by one particular party, then this can be a matter of negotiation in each case.

[U2.05] Corporations Act

Throughout the Guide, references to the “Corporations Law” have been changed to “Corporations Act”.

[U2.06] Regulation

In [6.04A] some commentary has been included summarising the implications of the Financial Services Reform Act 2001 in relation to derivatives. In each of the other product specific parts of the Guide, a cross reference has been included to [6.04A]. Also in [3.16] a reference has been made to Corporations Act section 1101I which provides that contracts for financial products are not gaming contracts.

[U2.07] 2000 Definitions

The Guide has been updated so that references to articles of the 1991 Definitions are now references to equivalent articles in the 2000 Definitions.

[U2.08] Update opinions for 1997 IFEMA and GMRA

In [25.13] the opinion issued by Mallesons on the 1997 IFEMA following the enactment of the Payment Systems and Netting Act has replaced the earlier opinion (the earlier opinion can be found in the history file).

In [26.15A] the opinion issued by Mallesons on the GMRA following the enactment of the Payment Systems and Netting Act has been inserted.

[U2.09] Miscellaneous amendments

Numerous other minor miscellaneous amendments have been made such as deleting references to Volume 2 as copies of ISDA documents are no longer included in the Guide.