Australian Government

Attorney-General's Department

Industry consultation on financial products and the Personal Property Securities Act 2009 (Cth)

Public consultation paper

September 2020

Consultation process

Request for feedback and comments

This paper seeks information from industry to inform policy considerations relating to security interests in financial products contained in the *Personal Property Securities Act 2009* (Cth) (PPS Act).

The 2015 Review of the *Personal Property Securities Act 2009* (Cth) (the Review) recommended government undertake further consultation with industry experts on provisions related to financial products in the PPS Act. The Attorney-General's Department is keen to ensure that policies achieve the right settings for the treatment of financial services in the PPS Act, from both a legal and commercial perspective.

This paper provides information on the current operation of the PPS Act and how it impacts on certain financial products. The paper seeks input from the financial services industry (preferably by way of written submissions) about the practical operation of the PPS Act on the trading of financial products, including whether the current provisions in the legislation are fit for purpose or require clarification or amendment.

Interested parties are invited to comment on some or all of the questions raised in this paper.

Electronic lodgement is preferred. For accessibility reasons, please submit responses sent via email in a Word or RTF format. An additional PDF version may also be submitted.

If you would like all or part of your submission to remain in confidence, you should provide this information marked as such in a separate attachment.

Closing date for submissions: 16 October 2020

Email: PPSAReform@ag.gov.au

Submissions to be emailed to the above email address.

Any queries concerning the consultation process may also be directed to this email address.

Contents

1. Background

1.1 The Review of the PPS Act (the Review)

The *Personal Property Securities Act 2009* (Cth) (the PPS Act) established an entirely new regime for the creation, legal effect and enforcement of security interests in personal property. The PPS Act replaced a number of complex and fragmented rules that were scattered across more than 70 Commonwealth, state and territory statutes and common law rules.

In April 2014, the Attorney-General announced a review of the PPS Act in accordance with s 343 of the Act. Mr Bruce Whittaker, a leading expert in personal property securities law, conducted the review. Mr Whittaker's *Final Report of the Review of the Personal Property Securities Act 2009* (the Review) was tabled in Parliament in March 2015.

The Review makes 394 recommendations to improve the PPS Act, enhance the usability of the Personal Property Securities Register (the Register) and increase public awareness of the personal property securities framework. Government is currently considering its response to these recommendations.

The Review found that although the PPS Act had improved the consistency of Australia's secured transactions laws, it could be complex and at times unclear. The Review broadly recommended simplifying both the PPS Act and the Register. Clearer and simpler rules can lead to more predictable outcomes, which would give financiers greater confidence in the PPS Act and in their ability to take effective security interest under it. This, in turn, would assist borrowers to use their assets as collateral, and enhance their ability to raise cost-effective finance. It is also imperative that the PPS Act is fit for purpose as Australia works to recover economically from the downturn caused by the global pandemic.

The Review made a number of recommendations about how financial assets should be dealt with in the PPS Act. As many of the laws and practices associated with dealings in financial assets are complex and specialised, the Attorney-General's Department (the department) is seeking the views of experts in the financial services industry and other stakeholders to inform policy considerations and to ensure that the PPS Act is appropriately tailored to the Australian legal and commercial environment.

1.2 The *Personal Property Securities Act 2009* (Cth)

Key concepts

The PPS Act is a single national law governing almost all security interests in personal property (generally, property other than land) that have a connection with Australia. The PPS Act also established the Register, a single national register of security interests in personal property. The Register is an online noticeboard showing searchers whether someone is claiming a security interest against a good or asset.

One of the important objectives of the PPS Act is to provide businesses and individuals with a method of risk protection when selling and/or acquiring assets. By enabling secured parties to register their security interest (or provide notice by other methods – discussed below under **perfection**), they can protect their interests in the event that the grantor of the security interest becomes bankrupt or insolvent.

For example, when selling goods on a retention of title basis, properly registering an interest will protect the seller should a customer become bankrupt or insolvent. The seller with an interest registered properly on the Register will be the first in line to get their goods or money back. If a lender takes security for its debt, it will generally rank ahead of unsecured creditors to the value of the property that it has security over. For a purchaser buying a good such as a used car, searching the Register can help identify whether the good is free from existing financed debt and therefore safe from possible repossession.

The PPS Act only applies to personal property. How personal property is categorised has an impact on how it is dealt with under the PPS Act in terms of how it can be 'perfected' and how effective that method of perfection is to secure priority for a secured party.

Personal property is all forms of property other than real estate. Under the PPS Act, there are four main categories of personal property:

1. goods
2. financial property
3. intermediated securities, and
4. intangible property.

A **security interest** is an interest in personal property that **in substance** secures payment of a debt or other obligation regardless of the form of the transaction.

For a security interest to be enforceable, it must have **attached** to the collateral (the secured property). Attachment gives the secured party an interest in the collateral that is effective against the person who has granted the security interest (the grantor). A security interest attaches to collateral if the grantor has rights in the collateral and accepts money or does some other act by which the security interest arises.

Perfection is a technical concept particular to the PPS Act. Perfection is about providing notice of the existence of a security interest in the collateral to other parties. A perfected security interest has **priority** over unperfected interests, and will generally remain effective in an insolvency of the grantor.

Under the PPS Act, a secured party can perfect its security interest in a number of ways:

- **Registration:** by filing an online form called a financing statement on the Register. This statement contains information about the security interest, including information about the grantor, the secured party and the collateral.

- **Possession:** by taking possession of the collateral. This method is only available for tangible property. If the secured party is in possession of the collateral, this provides notice to other parties that they may have a security interest in the collateral.

- **Control:** by taking control of the collateral. This perfection method is only available for certain types of property, generally financial property. It is the most powerful method of perfection, as a security interest that is perfected by control has priority over all other security interests, including those that are perfected by registration. Reasons for this are discussed in part 3 of this paper.

- **Temporary perfection:** in limited situations, by being automatically perfected for a period of time. When it applies, temporary perfection gives a secured party an opportunity to permanently perfect its security interest before the period of time expires and the interest becomes unperfected. Only certain types of security interests are able to be temporarily perfected.

Perfection of a security interest, in addition to the timing and method of perfection, will affect the **priority** this security interest has relative to other security interests in the same collateral and its status in the event of the insolvency or bankruptcy of the grantor. Perfection gives a security interest the best priority and effectiveness, enabling it to be enforced against liquidators and third parties if needed. This is why effectively perfecting a security interest is important.

Financial property as security in Australia

Using financial property as security has become increasingly common. While many businesses continue to grant security over their physical assets such as their equipment and other goods, an increasing number also grant security over their intangible assets, financial property and intermediated securities.

Examples of the types of activities in financial services that could be affected by the PPS Act includes buying or selling shares and other investment products or dealing in or lending on debts (book debts or account receivables).

Financial property is defined in s 10 of the PPS Act as any of the following types of personal property:

a) chattel paper[1]
b) currency
c) a document of title
d) an investment instrument, or
e) a negotiable instrument.

[1] The Review recommended that references to chattel paper be removed from the PPS Act.

Intermediated securities, while closely related to financial property, are treated separately under the PPS Act.

Traditionally, an investor in a financial asset had a direct legal relationship with the issuer of the asset, for example where a share in a company is issued to an investor. This has changed over time and it is now accepted commercial practice for an intermediary to be registered as the holder of the shares. The intermediary establishes accounts in its records for other intermediaries and records in those accounts the number of shares it holds for each of them. This structure can continue further through middle-tier intermediaries and eventually to the intermediary maintaining the account for the end investor.

The PPS Act defines intermediated securities as the rights of a person in whose name an intermediary maintains a securities account.

This classification system is slightly different to comparable personal property securities regimes overseas, particularly in how intermediated securities, financial property and intangible property are divided up (as will be explored below in part 2).

How financial property and intermediated securities are categorised under the PPS Act has implications for how they are perfected and therefore how effectively secured parties have notified others of their security interest and have protected themselves in cases of a grantor's insolvency. Also, as these are mostly intangible types of property, there is an added risk to how types of financial property are perfected in cases where a security interest in them is **perfected by control** rather than being registered on the Register.

While registration is always available as a method of notifying third parties of a security interest, there are certain difficulties in ensuring the other methods of perfection (especially those available for security interests in financial property) are just as effective.

BOX 1: International developments

The provisions relating to intermediated securities were heavily influenced by two main international conventions:

1. The Convention on the law applicable to certain rights in respect of securities held with an intermediary (**the Hague Securities Convention**), and
2. UNIDROIT Convention on Substantive Rules for Intermediated Securities (**the Geneva Securities Convention**).

The department actively monitored progress on these conventions during the development of the PPS Act prior to 2009, and considered how their principles could be incorporated into the PPS Act.

The objective of the **Hague Securities Convention** is to provide certainty on conflict of laws questions for cross-border transactions in intermediated securities. It sets out choice of law rules for determining the applicable law for holding, transfer and enforcement of intermediated securities.

The objective of the **Geneva Securities Convention** is to provide a standardised set of substantive law rules on how to deal with intermediated securities, in order to reduce 'legal risk, systemic risk and associated costs in relation to domestic and cross-border transactions involving intermediated securities'. This Convention was a response to the increasing use and trade of intermediated securities in the global market. Australia is not a party to either Convention.

While it is intended that the PPS Act continues to be consistent with these international conventions, the department is considering how these conventions can work for the Australian marketplace and industry professionals.

North American and New Zealand law

The PPS Act was also influenced by personal property security regimes in Canada (particularly Saskatchewan), Article 9 of the United States Uniform Commercial Code and the New Zealand Personal Property Securities Act 1999 (New Zealand PPS Act) (which was based on the Canadian model). The Canadian and US regimes all address intermediated securities in one form or another. However those jurisdictions also have entire legislative frameworks that deal with intermediated securities outside of their personal property security laws, for example the Canadian Securities Transfer Acts and Article 8 of the Uniform Commercial Code. Those frameworks complement the provisions relating to intermediated securities in those jurisdictions' personal property securities legislation. Australia, on the other hand, does not have a full legislative regime for intermediated securities, and this is part of the reason it has been a challenge for the PPS Act to fully incorporate provisions dealing with intermediated securities.

2. Definitions

Different types of collateral have different methods of perfection. How a secured party categorises the collateral they hold has downstream implications for whether they have perfected their security interest properly. If the PPS Act categorises an asset as an intermediated security but a secured party incorrectly identifies the asset as an investment instrument, this could impact on how well the secured party has protected themselves. If the security interest in the asset is perfected in the manner required for investment instruments rather than intermediated securities, the secured party may think that they have perfected their interest when they have not. In cases of insolvency or bankruptcy, the secured party will have an unperfected interest and therefore a lower priority.

2.1 The definition of an 'intermediated security'

Recommendation 65 of the Review stated that Government should explore in consultation with experts in the financial investments industry, whether and if so how the concept of an intermediated security could be simplified.

Legislation

The term '**intermediated security**' is defined in s 15(1) to be:

- the **rights** of a person
- in whose name an **intermediary**
- maintains a **securities account**.

The PPS Act does not define the '**rights** of a person' in an intermediated security.

The term '**intermediary**' is defined in ss 15(2)—(6) to include:

- a person who holds a licence, whether Australian (an Australian Financial Services licence) or under a foreign jurisdiction, to maintain a securities account on behalf of others or themselves, or
- a person who operates a 'clearing and settlement facility' under an Australian Clearing and Settlement Facility (CS facility) licence as defined in Chapter 7 of the *Corporations Act 2001* (Cth).

The term '**securities account**' under s 15(7) is:

- an account to which financial products may be credited or debited, or
- for people who operate clearing and settlement facilities under an Australian CS facility licence, a record of holdings and transfers of interests in financial products.

Box 2: Comparison with international examples

The current PPS Act definition of an intermediated security reflects the approach of the Geneva Securities Convention.

Article 1 of the Geneva Securities Convention defines an intermediated security as a security 'credited to a securities account or rights or interests in securities resulting from the credit of securities to a securities account.' An intermediary is a person who in the course of a business or other regular activity maintains securities accounts for others and/or themselves. A securities account is an account maintained by an intermediary to which securities may be credited or debited.

Article 5 of the Geneva Securities Convention allows a contracting state to declare that the convention only applies to intermediaries that are subject to regulation or oversight by a public authority or a central bank.

One submission to the Review suggested aligning the definition with the approaches taken by the United States and Canada.[1] Under s 2(ee) of the Saskatchewan Securities Transfer Act a 'securities intermediary' is defined as a clearing agency or a person including a broker, banker or trust company, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity.

The Review

The Review notes that the definition of an intermediary in the PPS Act is very technical, and focuses not on the role performed by the entity that acts as the intermediary, but rather on the nature of the licences that the entity holds. One submission suggested the requirement for licences for intermediaries in the PPS Act should be removed. This would be consistent with the position in the United States and Canada.[2] However, as noted above, those jurisdictions have entire legislative frameworks that are dedicated to governing intermediated securities and their trade. In Australia, there is no corresponding framework, which means that the PPS Act needs to deal with all of the relevant issues.

[2] Joint Law Firms, Response to Consultation Paper 2 for the Review, page 10.

Relationship between parties

There are a number of different ways of conceptualising the relationship between an issuer, intermediary and a holder of a security and these are discussed in Box 3.[3]

Box 3: Rights in collateral

1. Security entitlements – where each client of an intermediary has a bundle of contractual and legal rights against their immediate intermediary. Every security entitlement is distinct and it is legally disconnected at each level of the intermediary chain. Article 8 of the Uniform Commercial Code in the US conceptualises the rights of an account holder in an intermediated security in this way.

2. Trusts – where the intermediary is a trustee for the investor and holds their property on trust. Each client of an intermediary is a beneficial owner and the intermediary is the legal owner with fiduciary duties. This is the current analysis that is used in Australia under ASIC's Regulatory Guide 133 which states that custodians hold property on trust (subject to exceptions).

3. Property co-ownership – where the investor is considered a co-owner of a property interest in the pool of securities held by the intermediary. The intermediary themselves have no interest or ownership in the property.

4. Property full ownership – where the intermediary has no legal significance and each investor is essentially a direct full owner of their own property interest.

[3] Jurisdictions conceptualise the rights of intermediated security holders in different ways under their national laws. For discussion of how these rights differ, see:

- Dale Rayner and John Stumbles, *Intermediated Securities and the Australian PPSA: Harmonious whole or Fragmented Complexity?* (2015) Banking and Financial Services Law Association <http://bfsla.org/wp-content/uploads/papers/2015/Plenary%204%20-%20Dale%20Rayner%20&%20John%20Stumbles.pdf>.
- Herbert Kronke, 'The Draft UNIDROIT Convention on Intermediated Securities: Transactional Certainty and Market Stability', (Seminar on Current Developments in Monetary and Financial Law, 23-27 October 2006) 4-5.
- Christophe Bernasconi and Thomas Keiser, 'The Hague and Geneva Securities Conventions: A Modern and Global Legal Regime for Intermediated Securities', 17 *Uniform Law Review* 549, 553.
- Jesus Garcia Aparicio, 'Enhancing Shareholder Rights in Intermediated Securities Holding Structures Across Borders' (2017) 13(2) *New York University Journal of Law & Business* 465, 492.

The Issues

1. Should clearing and settlement facilities be treated as intermediaries under the PPS Act?

The concept of an 'intermediated security' in the PPS Act encompasses two different types of intermediaries and securities accounts. The first relates to maintaining an account to which interests in financial products may be credited or debited on behalf of others or themselves (s 15(2)(a),(c)). The second relates to operating a CS facility, and maintaining records as part of that operation (s 15(2)(b). This second part of the definition could potentially be deleted.

Broadly, a CS facility clears and settles transactions in financial products.[4] When market participants enter into a transaction, clearing is where a central counterparty interposes themselves between counterparties to a trade to ensure all obligations are performed, and settlement is where the obligations or instructions are discharged.[5] The Australian Securities Exchange (ASX) Group provides clearing and settlement services for Australian stock markets.

The licensing requirement was specifically added to s 15(2)(b) of the PPS Act to ensure that ASX and the Clearing House Electronic Subregister System (CHESS) would be categorised as an intermediary under the PPS Act. However, as discussed further below (at part 2.3), CHESS securities may be better categorised as investment instruments rather than intermediated securities. If this categorisation is correct, it would mean that the CS facility licence aspect of the intermediated securities definition in s 15(2)(b) might not be needed.

2. Should the concept of an intermediary be limited to entities that hold an appropriate licence?

The other part of the definition of an intermediated security requires an entity to hold an Australian Financial Services licence or foreign equivalent in order to be an intermediary under the PPS Act. Australian Financial Services licensees have particular obligations under the Corporations Act and are assessed by ASIC to ensure that they are competent and have sufficient financial resources to carry on the proposed business.

However, the Review queried whether it was appropriate to retain this licensing requirement, or whether the main consideration for determining if someone was an intermediary should be the nature of the task performed by the entity, rather than the nature of any licences it might hold. The current approach prevents unlicensed entities from being an intermediary (and so prevents investments held through those entities from being intermediated securities under the PPS Act).

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[4] Australian Securities & Investments Commission, *Licensed and exempt clearing and settlement facilities* <https://asic.gov.au/for-finance-professionals/market-infrastructure-licensees/licensed-and-exempt-clearing-and-settlement-facilities/>.

[5] Sheelagh McCracken et al, *Everett and McCracken's Banking and Financial Institutions Law* (Thomson Reuters (Professional) Australia Limited) 129.

3. Should the PPS Act clarify what is meant by an investor's 'rights' in this context?

Section 15 defines an intermediated security as being the 'rights' of a person who has a securities account with an intermediary. This is a reference to the person's rights in relation to that securities account (or in relation to the financial products that are recorded in that securities account), but this is not explicit.

4. Can the definition of an intermediated security be improved in other ways?

The Review also asked whether the concept of an intermediated security could be simplified in other ways and recommended further consultation with industry on this issue.

Questions

1. If the PPS Act is amended so that Australian Clearing House Subregister System (CHESS) securities are characterised as investment instruments rather than intermediated securities, would it be useful for the definition of intermediary be amended so that it no longer expressly includes the operator of a CS facility?
2. Should the licence requirement for an intermediary be removed from the PPS Act? If so, how could the nature of an intermediary for the purposes of these provisions be described (i.e. in order to work out what is or is not an intermediated security under the PPS Act)?
3. Should the PPS Act be amended to clarify the meaning of the 'rights' of a person who holds a securities account with an intermediary? For example, would it be sufficient to refer to the rights of a person who holds a securities account with an intermediary 'in relation to the financial products', or 'in relation to the financial products that are recorded in that securities account'?
4. Are there other ways in which the concept of an intermediated security could be simplified or clarified to ensure it is easier to apply in practice?

2.2 The definition of an 'investment instrument'

Recommendation 69 of the Review recommended that Government explore whether the definition of investment instrument in s 10 of the PPS Act could be simplified, for example along the same lines as paragraph (b) of the definition of financial product in s 10 of the PPS Act.

The Review

The Review notes that the definition of 'investment instrument' in s 10 is unwieldly. Section 10 defines the term by means of a lengthy and detailed list of specific financial instruments and assets. The meanings of the items in the list rely in turn on further definitions in the Corporations Act, and those definitions are themselves complex. This makes it difficult to work out whether or not a particular financial asset is an investment instrument. The Act would be easier to work with if the term could be defined in a simpler and more user-friendly way.

The Review also asked whether it was appropriate from a policy perspective to define 'investment instrument' for the purposes of the PPS Act by means of technical definitions from the Corporations Act, as those definitions are in a form intended to serve corporations law regulatory objectives, not secured transactions law objectives.

The Review also questions why certain types of financial products included in the definition of an investment instrument should enjoy the benefit of being able to be perfected by control. This is discussed further in part 3 below.

Legislation

The definition of an 'investment instrument' in s 10 of the PPS Act provides as follows:

> **investment instrument** means any of the following **financial products**:
> (a) a share in a body, or a debenture of a body
> (b) a debenture, stock or bond issued or proposed to be issued by a government
> (c) a derivative
> (d) a foreign exchange contract that is not a derivative
> (e) an assignable option to have an allotment of an investment instrument (apart from this paragraph) made to the holder of the option
> (f) an interest in, or a unit in an interest in, a managed investment scheme
> (g) a unit in a share in a body
> (h) a financial product that is traded on a financial market that is:
> i. operated in accordance with an Australian market licence, or
> ii. exempt from the operation of Part 7.2 of the *Corporations Act 2001*

(i) any other financial product that is prescribed by the regulations, and
(j) any financial product that consists of a combination of any 2 or more of the financial products mentioned in paragraphs (a) to (i),

but *does not* include any of the following:
(k) the creation or transfer (including a successive transfer) of a right to payment in connection with interests in land, if the writing evidencing the creation or transfer does not specifically identify that land
(l) a document of title
(m) an intermediated security, or
(n) a negotiable instrument.

A word or expression in this definition has the same meaning as in the *Corporations Act 2001*.

Section 10 defines the term '**financial product**' in two parts:

1) For the purposes of the definition of investment instrument, the term financial product has the same meaning as in the Corporations Act.
2) For any other purpose, the term financial product means shares, bonds, any other financial instrument and any other financial asset.

Section 763A of the Corporations Act defines a financial product as being, broadly, 'a facility through which, or through the acquisition of which, a person does one or more of the following:

- makes a financial investment
- manages financial risk
- makes non-cash payments.'

Part 7.1, Division 3, Subdivision B of the Corporations Act contains a list of items that should be considered as financial products, and Subdivision C provides a list of items that should not be considered as financial products.

The Issues

1. <u>What should the definition of a financial product be?</u>

The Explanatory Memorandum to the Financial Services Reform Bill 2001 (Cth), which amended the Corporations Act to include these financial product provisions, stated that the definition of financial product in the Corporations Act needed to be broad and sufficiently flexible to encompass a large number of transactions and products and reflect new products as they are developed. [6] However, the definition is complicated by the long lists of specific inclusions and exclusions.

[6] Explanatory Memorandum, Financial Services Reform Bill 2001 (Cth), [2.26] and [6.37].

Also, these inclusions and exclusions reflect corporate law regulatory policy objectives, and may not be relevant or appropriate for personal property securities law objectives.

This means that using the Corporations Act definition adds complexity to the PPS Act without necessarily achieving an appropriate policy outcome. It also requires practitioners to refer to another piece of legislation (the Corporations Act), and to the regulations made under it, to get the full definition of an investment instrument. It may be preferable to have a self-contained (and less complex) definition of financial product in the PPS Act that does not cross-refer to the Corporations Act.

For example, it might be appropriate to use the general definition of a financial product from s 763A of the Corporations Act (without the inclusions and exclusions), or to apply the definition in paragraph (b) of the definition of financial product in s 10 for **all** purposes of the PPS Act, including for the definition of investment instrument.

2. Are there other ways in which the definition of an investment instrument could be simplified?

The definition of investment instrument in s 10 is a lengthy list of different types of assets. The term is used in a number of sections in the PPS Act, but the most pertinent provisions are:

- ss 21 and 27, which allow a security interest over an investment instrument to be perfected by control
- s 31, in the definition of 'proceeds', and
- ss 49 and 50 (taking free rules).

Questions

5. Is it appropriate that the PPS Act should continue to define investment instruments by reference to the Corporations Act?

6. If not, should the PPS Act define investment instruments using the general definition of financial product that is in s 763A of the Corporations Act, without the qualifications in Part 7.1, Division 3, Subdivision B of that Act?

   a. Alternatively, should the PPS Act simply use the text in paragraph (b) of the definition of financial product in the PPS Act for all purposes of the PPS Act, including the definition of investment instrument?

7. Should all of the paragraphs of the definition be retained? Can the definition be simplified in other ways?

2.3 The classification of CHESS securities

Recommendation 67 of the Review stated that the PPS Act should be amended so that shares or other securities listed on the Australian Stock Exchange and held through the CHESS system are investment instruments, rather than intermediated securities.

The Review

The Review recommended that the Act be amended so that shares or other securities listed on the ASX[7] and held through the CHESS system are classified as investment instruments, rather than intermediated securities.

The Issues

1. Should CHESS securities be intermediated securities or investment instruments?

CHESS is the ASX's computerised settlement system used to record holdings and manage the settlement of securities and transactions. The main functions of the CS facility operated by ASX are to maintain a subregister of quoted securities on behalf of each ASX-listed company and to provide a mechanism for the parties to transactions in those securities to meet settlement obligations to each other.

The CHESS subregister has two kinds of securities holdings under the ASX Settlement Operating Rules:

- direct holdings, and
- participant sponsored holdings where a sponsoring participant and the holder (the investor) enter into a sponsorship agreement. Any transfer can only be effected by a participant in CHESS.

The Review noted that the classification of an ASX-listed security held through CHESS as an intermediated security and not an investment instrument was counter-intuitive. This is because the manner in which securities are held in the CHESS system is very different to the type of custody arrangement that is at the heart of the concept of an intermediated security.

The CHESS operator does not hold pools of securities as custodian for individual investors. Rather, the CHESS operator functions as a register for the entities that issue the securities, in that it maintains a subregister of the entity's shares or other securities as an agent of the issuing entity. This is almost the reverse of a custody arrangement, as the CHESS operator is acting for the issuer of the securities, not the person who has invested in them.

[7] For the purposes of this paper, the department has considered the ASX however, similar principles can apply to other public exchanges.

The role of the sponsoring participant is to control the sending of electronic messages in CHESS, and the effect of the sponsorship agreement is to give practical control to the sponsoring participant. The sponsorship agreement is between the sponsoring participant and the investor, not with the ASX, and so does not impose contractual restrictions or obligations on ASX in relation to handling instructions.

There is a level of intermediation in a non-technical sense in these arrangements, in that the sponsoring participant 'intermediates' between the investor and CHESS, or because the CHESS system 'intermediates' between the investor or sponsoring participant and the company that issued the investment instruments. However, this is not intermediation in the sense otherwise contemplated by the concept of an intermediated security, as the investor is still the direct holder of the underlying investment asset.

2. Could the concepts of an 'intermediated security' and 'investment instrument' be amalgamated?

Alternatively, it has been suggested that the concepts of intermediated securities and investment instruments could be collapsed into one, given the substantial overlap between them. It was put that this would also better reflect market practices, where at the 'flick of a switch' a share can cease to be on CHESS and become issuer sponsored holdings and therefore an investment instrument. The concern about the consequences of moving securities from the CHESS register to the issuer register (or vice versa) would go away, if CHESS securities are re-characterised for the purposes of the PPS Act as investment instruments.

Even if the concepts of investment instruments and intermediated securities are not combined, one submission to the Review suggested the tests for control of the two classes of asset be aligned. The Review also recommended that the mechanisms for control of intermediated securities and investment instruments be aligned, as much as possible (this is discussed below at part 3.1).

Box 4: International examples of investment instruments

In the New Zealand PPS Act, direct holdings in listed shares are called 'investment securities' which are defined in s 16 as a writing that evidences a futures contract, warrant, option, share, right to participate, or other interest in property or an enterprise, or that evidences an obligation of an issuer. Investment securities can be transferred in a number of ways including in the records of the issuer, a clearing house or securities depository or other records. There is no concept of an intermediated security or its equivalent.

Questions

8. In practice, is it more appropriate that securities held through CHESS are classified as an investment instrument instead of an intermediated security?

9. Would it be useful in practice if the definitions of investment instruments and intermediated securities be amalgamated? If so, the department welcomes comments as to how this may be achieved to reflect Australian commercial realities.

2.4 The definition of a 'negotiable instrument'

Recommendation 210 states that the definition of 'negotiable instrument' in section 10 be deleted, to allow the term to have the same meaning as at general law.

The Review

The Review states that the definition of a 'negotiable instrument' under s 10 of the PPS Act is significantly wider than the definition as it is understood under general Australian law. While the current definition is consistent with the definitions of negotiable instruments included in the Canadian and New Zealand personal property security legislation, the majority of submissions to the Review were in favour of bringing the definition back in line with the general law meaning.

The Law

The term '**negotiable instrument**' is defined in s 10 of the PPS Act as being any of the following:

- a bill of exchange
- a cheque
- a promissory note
- any other writing that evidences a right to payment of currency, if:
    - the writing is of a kind that, in the ordinary course of business, is transferred by delivery with any necessary endorsement or assignment, or
    - the writing satisfies the requirements for negotiability under the law governing negotiable instruments
- a letter of credit that states that it must be presented on claiming payment.

The issue

The definition of negotiable instrument encompasses a number of types of instruments that would not be regarded as negotiable instruments at general law.

The PPS Act refers to negotiable instruments in a number of provisions. The main references are in:

- ss 21 and 29, providing for perfection by control (over uncertificated negotiable instruments only)
- s 31, dealing with proceeds
- s 70, in a priority/taking free rule
- s 120, dealing with the realisation of liquid assets on enforcement, and
- s 340, dealing with circulating assets.

The key provision is s 70, the priority/taking free rule. Section 70 broadly replicates the 'holder in due course' provision in s 43 of the *Bills of Exchange Act 1909* and in s 49 of the *Cheques Act 1986*. As those rules are broadly replicated in the context of the PPS Act, the department is seeking views on whether it is appropriate for s 70 to apply to instruments that are not covered by the Bills of Exchange Act or the Cheques Act, or at least are not negotiable instruments at general law.

Questions

10. Would it be useful for the term 'negotiable instrument' be aligned with the meaning at general law?

3. Perfection by control

The Review raises a number of questions about whether a security interest over different types of financial collateral should be able to be perfected by control, how perfection by control works in practice, and what the priority consequences of perfection by control should be.

The types of collateral over which a security interest can be perfected by control are listed in s 21(2)(c) of the PPS Act. They are:

i) an ADI[8] account
ii) an intermediated security
iii) an investment instrument
iv) a negotiable instrument that is not evidenced by a certificate
v) a right evidenced by a letter of credit that states that the letter of credit must be presented on claiming payment or requiring the performance of an obligation, and
vi) satellites and other space objects.

Perfection by control can be considered a functional equivalent of perfection by possession but in respect of intangible property. This brings up a number of difficulties. If the primary goal of perfection is notification to third parties of the existence of a security interest in collateral, perfection by control does not do this as effectively as perfection by possession.

It is not always clear to outside parties who has control of an intangible asset. It is easier to discern when someone has possession of a tangible asset. Where parties are unaware that a security interest exists in an asset, this can disadvantage potential buyers of that asset who may buy it without realising that it is encumbered. This runs the risk of losing that asset (or a portion of it) in the case of an insolvency of the grantor of that security interest.

[8] ADI is short for an Authorised Deposit-Taking Institution. Any institution that accepts deposits from members of the public needs to be an ADI under the *Banking Act 1959* (Cth).

Additionally, security interests perfected by control have priority over security interests perfected by any other method. The rationale for this was to allow free trading of market-based securities. However, the Review has raised questions about whether this superior priority is needed when security interests in financial collateral are dealt with outside of a market-based setting.

3.1 Consistent method of perfection by control?

Recommendation 71 asks the Government to explore how the mechanisms for perfecting by control for intermediated securities and investment instruments could be made as consistent as possible.

The Review

The PPS Act provides two different sets of methods for perfecting by control, depending on whether property is an 'intermediated security' or an 'investment instrument'.

The majority of submissions to the Review agreed that it would be desirable to align the mechanisms for perfection by control between intermediated securities and investment instruments, to the extent this is practicable.

Legislation

The mechanisms for perfection by control for intermediated securities (s 26)[9] and investment instruments (s 27) are similar, but also different in some major respects.

Method of control for Intermediated security – perfection by control (section 26)

- **Registered as the owner -** The securities account is maintained in the name of the secured party or someone on the secured party's behalf.
- **Possession – nil**
- **Agreement -** There is an agreement in force between:
    - The grantor, secured party and intermediary;
    - The grantor and the intermediary; or
    - The grantor and secured party, with notice to the intermediary.
- **The agreement** has the effect that:
    - The intermediary must not comply with instructions given by the grantor without seeking the secured party's consent
    - The intermediary must comply with instructions given by the secured party, without seeking the consent of the grantor.

[9] The definition of control of an intermediated security in s 26 of the PPS Act was based on the Geneva Securities Convention definition which allowed a secured party to have control without the need for an agreement between the grantor and the intermediary.

- **Evidence in writing -** A secured party holds a security account in their own name or have acknowledgment in writing that they hold the account.
    - There is an agreement that the secured party can send some or all electronic communications relating to the intermediated security.

Method of control for Investment instrument – perfection by control (section 27)

- **Registered as the owner -** The issuer of the instrument registers the person as the owner of the instrument.
- **Possession -** For instruments evidenced by certificates:
    - the controller has possession of the instrument, and
    - the controller can transfer the instrument or deal with the instrument.
- **Agreement** - For instruments not evidenced by certificates:
    - There is an agreement in force between the person and the grantor, and
    - The agreement has the effect that the person can control sending instructions by which an investment instrument could be transferred or dealt with.
- **Evidence in writing -** Where the registered owner is different, a person has control of the instrument:
    - If there is an acknowledgement in writing that they are the controller of the instrument
    - there is an agreement that the secured party can send some or all electronic communications relating to the investment instrument.

The Issue

While the methods for perfection by control are similar, there are some variations between ss 26 and 27. In brief:

- Section 26 ('control' in relation to intermediated securities) focuses on the rights that arise from crediting a financial product to a financial product account. The necessary steps for control depend on the nature of the intermediated security and the manner in which it is held.
- Section 27 ('control' in relation to investment instruments) focuses on the possession and transfer of an instrument (certificated) or agreements that allow a person to deal with the instrument (uncertificated).

However, they both rely heavily on the proposition that there needs to be some kind of registration in the controller's name, an agreement between relevant parties or an acknowledgement in writing.

In order to simplify the operation of these provisions, and alleviate the risk that a secured party might not perfect their interest because it was not clear whether the collateral was an intermediated security or investment instrument, the Review recommended looking at how these two methods of control could be made as consistent as possible.

Questions

11. Do you support aligning the mechanisms for perfection by control in ss 26 and 27 so they are as consistent as possible? If so, the department welcomes comments on how this alignment would be best achieved.

3.2 Publicity objective of perfection by control

Recommendations 64 and **70** ask Government to consider how the mechanisms for perfecting by control over intermediated securities and investment instruments could be better structured to achieve the publicity objective of perfection.

The Review

Perfecting a security interest by control means that a secured party does not have to register a financing statement against the grantor in order to be perfected. The Review notes that perfection by control, unlike perfection by registration or possession, does not necessarily satisfy the publicity objective behind perfection, as it may be difficult for third parties to determine if an intermediated security or investment instrument is encumbered if the security interest is only perfected by control. The Review suggested exploring whether the publicity objective of perfection could be better achieved by ensuring that a security interest will only be perfected by control if it is able to ensure that the intermediated security or investment instrument cannot be dealt with without the secured party's consent.

The Issues

The PPS Act currently states that a secured party can perfect by control investment instruments or intermediated securities. However, the manner in which this is done does not necessarily publicise the existence of a secured party's security interest to third parties (for example, by being able to deal with the investment instrument or intermediated security itself, whether or not it can prevent dealings by the grantor).

This reflects the position under article 8 of the Uniform Commercial Code (US) and the Canadian Securities Transfer Acts, on which the perfection by control mechanism is based. However, it is likely that the policy settings in article 8 and the Securities Transfer Acts were focussed on establishing the rights of the parties to transactions involving intermediated securities, rather than on the publicity objective of perfection under their secured transactions laws.

For that reason, it could be asked whether the PPS Act should follow the North American approach to perfection by control, or should use an approach that better delivers on the publicity objective.

The Review suggested exploring whether the publicity objective of perfection could be better achieved by:

- only allowing one secured party at a time to be able to perfect by control (although this might be impracticable if the PPS Act is also amended to allow the intermediary to perfect by control as well, as proposed in Recommendation 66), or
- by ensuring that a secured party will only be perfected by control if it is able to ensure that the intermediated security or investment instrument cannot be dealt with without the secured party's consent.

Questions

12. How does perfection by control of intermediated securities and investment instruments operate in practice?

13. Would it be appropriate in commercial practice for the requirements for perfection by control to be amended to ensure that a secured party will only be perfected by control if it is able to ensure that the intermediated security or investment instrument cannot be dealt with without the secured party's consent, or

The department welcomes other suggestions as to how the requirements for perfection by control can best achieve a notification objective.

3.3 Cash held by an intermediary

Recommendation 68 asks Government to explore whether the PPS Act should allow perfection by control over cash that is held through an intermediary in the same way perfection by control is possible for other financial assets.

The Review

The Review asks whether the PPS Act should be amended to allow secured parties to be able to perfect by control a security interest over cash that is held in an account with an intermediary, in the same way as for other intermediated securities.

The Legislation

The PPS Act currently does not allow perfection by control over cash (including proceeds in the form of cash) that is held through an intermediary:

- Section 15(1) provides that an 'intermediated security' is the rights of a person in whose name an intermediary maintains a 'security account'.

- Section 15(7) provides that a 'securities account' is an account to which interests in 'financial products' may be credited or debited.
- Section 10 defines 'financial product' in a way that expressly excludes cash for this purpose.

The Issue

Proceeds from an intermediated security may come in the form of dividends or other cash entitlements. Proceeds could also flow from a disposal of the intermediated security. Secured parties in financial markets therefore face challenges if a security interest over an intermediated security can be perfected by control but the security interest over proceeds in the form of cash entitlements cannot. It is noted that the exclusion of cash is consistent with the Hague and Geneva Securities Conventions, but the reasons the conventions were drafted this way is unclear.

Under the PPS Act, a security interest over cash that is held in an account with an intermediary is not able to be perfected by control. If a secured party perfects by control over an intermediated security, and that security gives rise to proceeds in cash, the security interest over those cash proceeds would be unperfected, unless the secured party goes to the effort of perfecting by registration as well. Even if the secured party registers, its security interest in the cash proceeds would have a lower priority than its security interest in the intermediated security.

Box 5: International examples – cash held by an intermediary

As noted earlier, neither the Hague Securities Convention nor the Geneva Securities Convention allow for intermediated securities over cash. This is also the position in Canada under their PPS Acts and Securities Transfer Acts. However, since publication of the Review, the Business Law Advisory Council in Ontario has recommended that the Ontario PPS Act be amended to allow perfection by control over cash collateral accounts (see Ontario.ca/registry). This report followed the model set by Article 8 of the Uniform Commercial Code (US), which creates a broad definition of 'financial account' that includes all types of deposit accounts and other cash collateral taken by a bank or other financial institution.

Question

14. Should the PPS Act be amended to allow perfection by control over cash that is held through an intermediary?

3.4 Negotiable instruments not evidenced by a certificate

Recommendation 75 states that Government should explore whether provisions in the PPS Act relating to perfecting by control over negotiable instruments not evidenced by a certificate should be deleted.

The Review

The Review noted that negotiable instruments are by their nature physical instruments, at least in the eyes of general law, and that Australian law does not recognise such a thing as a negotiable instrument that is only in electronic form. However, under s 21(2)(c)(iv), 'negotiable instruments' that are not evidenced by a certificate are able to be perfected by control. This seems to be an anomaly.

Even if it is accepted that it could be possible for a negotiable instrument to exist in electronic form, it is also unclear why a security interest over such a negotiable instrument should be able to be perfected by control, when that option is not available for other payment intangibles (as defined in s 10).

The Review therefore asked whether the provisions in the PPS Act for perfecting by control over negotiable instruments not evidenced by a certificate should be deleted.

While some submitters to the Review agreed with the recommendation, a number found the provisions useful. It was submitted that due to dematerialisation, uncertificated negotiable instruments are common within the banking and finance industry, and therefore ss 21(2)(c)(iv) and 29 should be retained so that secured parties may perfect their interest in these instruments. Examples given of uncertificated negotiable instruments included electronic bills of exchange or electronic negotiable certificates of deposit. The Reviewer acknowledged the existence of these types of financial assets, but did not agree that they were negotiable instruments in the strict sense (they replicate the rights attaching to a negotiable instrument by means of contractual arrangements, but are not actually negotiable instruments because the rights are not incorporated in a physical instrument).

The term negotiable instrument is defined in s 10 in a way that is significantly broader than the meaning at general law. The Review also recommends aligning the PPS Act definition with the general law definition. See part 2.4 above.

Legislation

Under s 29 of the PPS Act, a secured party has control of a negotiable instrument that is not evidenced by a certificate if:

- it is able to be transferred in accordance with the operating rules of a CS facility; and
- there is an agreement in force which allows the secured party to control sending some or all electronic communications through which the instrument could be transferred.

This control is retained even if the registered owner can make substitutions, give instructions to the issuer or otherwise deal with the instrument.

The scope of the term 'negotiable instrument' is discussed in part 2.4 above.

The Issue

Originally negotiable instruments were developed as a way of giving credit and receiving payment in international sales transactions. Under general law[10], negotiable instruments must be transferable by delivery. This seems to be at odds with the idea of an uncertificated negotiable instrument and is not aligned with the way in which the PPS Act defines negotiable instruments in s 10.

While some stakeholders agreed with the recommendation in the Review that the provisions in the PPS Act for perfecting by control over negotiable instruments not evidenced by a certificate should be deleted, a number found the provisions useful. It was submitted that due to the increasing use of electronic documents, uncertificated negotiable instruments are common within the banking and finance industry, and therefore ss 21(2)(c)(iv) and 29 should be retained so that secured parties may perfect their interest in these instruments.

It should also be asked whether it is appropriate that a security interest over these types of assets be able to be perfected by control, and whether those security interests should benefit from the superior priority position that this would provide.

Box 6: International examples of perfection of negotiable instruments

Under the Canadian PPS Acts, a security interest over a negotiable instrument can be perfected by registration or possession, but not by control. Under s 18(2) of the New Zealand PPS Act, perfection of a security interest over a negotiable instrument can occur by registration or possession (either physically, or through the records of a clearing house or securities depository in the interest of the person). The New Zealand PPS Act does not mention uncertificated negotiable instruments, and appears to assume that negotiable instruments will be in certificated form.

Questions

15. Do uncertificated negotiable instruments (in the technical legal sense) exist in practice?

16. Should ss 21(2)(c)(iv) and 29 be removed from the PPS Act?

[10] *Crouch v Credit Foncier Co* (1873) LR 8 QB 374 and *London and River Plate Bank v Bank of Liverpool* [1896] 1 QB 7.

3.5 Letters of credit

Recommendation 76 states that Government explore, in consultation with experts in the law and practice of letters of credit, whether ss 21(2)(c)(v) and 28 are appropriate or whether they should be deleted.

The Review

Under s 21(2)(c)(v) of the PPS Act, a security interest in a letter of credit can be perfected by control. However, the Reviewer noted that it is not clear if the provisions in the PPS Act relating to letters of credit are relevant in the Australian context. Some stakeholders stated that they were not aware of financiers perfecting securities over letters of credit by control in Australia. Other submissions argued that the prospect of being able to perfect by control is relevant to some structured trade finance transactions in Australian markets.

Legislation

Section 21(2)(c)(v) provides that a security interest can be perfected by control over a right evidenced by a letter of credit, provided that the letter of credit requires that the letter must be presented on claiming payment or requiring the performance of an obligation.

Section 28 in turn provides that a secured party does *not* have control of a right evidenced by a letter of credit, unless the issuer or nominated person has consented to assigning the proceeds of the letter of credit to the secured party.

The Issue

Perfection by control provides the security interest with a superior priority position. The department is interested in views on whether perfection by control is necessary for security interests in letters of credit in commercial practice.

Box 7: International examples of perfection of letters of credit

Section 28 is modelled on a provision from article 9 of the US Uniform Commercial Code. However, under the New Zealand PPS Act and Canadian PPS Acts, a security interest in a letter of credit can only be perfected under the general rules (registration or possession), not by control.

Questions

17. Is the concept of perfection by control over a letter of credit meaningful and appropriate for the PPS Act, or should ss 21(2)(c)(v) and 28 be deleted?

18. If your answer to the previous question is that the sections can be deleted, should any of the other references in the PPS Act to letters of credit be retained, or can they all be deleted?

4. Other issues

4.1 Taking free rules for investment instruments and intermediated securities

Under Part 2.5 of the PPS Act, buyers of personal property are able to take that property free of any security interest that may be held in it, in certain situations and for certain types of assets. Broadly, these taking free rules generally apply where a buyer has given value for the asset and did not know about the security interest. As the ability to take collateral free of a security interest is a fairly significant benefit to purchasers, it is important to consider what situations the 'taking free' provisions should apply to and where it is actually needed.

Recommendation 201 states that Government consider further, in consultation with industry, whether there are good policy reasons for retaining s 50, and if not, that s 50 be deleted. **Recommendation 202** recommends that if s 50 is retained, that it be amended to clarify that it does not operate in favour of another secured party.

Recommendation 203 states that Government consider further, in consultation with industry, whether there are good policy reasons for retaining s 51 and, if not, that s 51 be deleted. **Recommendation 204** recommends that if s 51 is retained, that it be amended to clarify that it does not operate in favour of another secured party.

The Review

Section 50 provides broadly that a purchaser (broadly defined) can take an investment instrument free of a security interest if the purchaser gives value, takes possession or control of the investment instrument and does not know that the purchase is in breach of the security agreement that provides for the security interest.

Section 51 provides that a transferee of an interest in an intermediated security can take the interest free of a security interest if the transferee gives value, the transfer is made in accordance with a consensual transaction, and the transferee does not know that the transfer was in breach of the security agreement that provides for the security interest.

The Review questions whether ss 50 and 51 are needed, given that s 49 already provides for the taking free of these types of collateral in the ordinary course of trading on a prescribed financial market such as the ASX. It may be that ss 50 and 51 are meant to be focussed on intermediated securities and investment instruments that are not market-traded. However, the Review notes that it is not readily apparent why a transferee of an intermediated security or investment instrument in an off-market transfer should enjoy a protection that is not available to buyers or lessees of other types of personal property that are not market-traded.

Legislation

Part 2.5 of the PPS Act provides rules for taking personal property free of security interests.

Under s 49, a buyer who acquires an investment instrument or an intermediated security in the ordinary course of trading on a prescribed financial market **takes the property free** of any security interest. This protects the integrity of market transactions such as acquisitions on the ASX. There are no knowledge requirements under s 49.

Under s 50 of the PPS Act, a purchaser of an investment instrument (other than a secured party) can take the instrument free of a security interest if they:

- give value for the instrument, and
- take possession or control of the instrument, and
- do not have actual or constructive knowledge constructive knowledge that the taking constitutes a breach of the security agreement that provides for the security interest.

Under s 51 of the PPS Act, a transferee of an interest in an intermediated security takes it free of a security interest if:

- the transferee gave value for the interest, and
- the credit of the interest in the financial product to which the intermediated security arises is made in accordance with a consensual transaction, and
- the transferee does not have actual or constructive knowledge that the taking constitutes a breach of the security agreement that provides for the security interest.

The Issues

1. Should ss 50 and 51 be retained?

As s 49 already applies to market-traded collateral, the department seeks views on how useful ss 50 and 51 are in practice. Sections 50 and 51 can still apply to intermediated securities and investment instruments that are not market-traded. This protection is not available to buyers or lessees of other types of personal property that are not market-traded so these provisions may not be appropriate.

The majority of submissions made to the Review on this issue were of the view that these sections should be retained. Some submissions put that the provisions are useful in the case of compulsory acquisition of shares, and reflect industry practice where perfection by control is the mechanism for perfecting such interests.

2. Should ss 50 and 51 operate in favour of another secured party?

Another issue in relation to ss 50 and 51 is whether they operate in favour of another secured party. Currently the PPS Act does not make clear whether the provisions only apply to secured party-transferee disputes, or whether they can also apply to secured party–secured party disputes.
Section 42(b) states that taking free rules under Part 2.5 do not protect the acquisition of an interest that is itself a security interest. However, the section says that it does not apply to ss 50 and 51. This is reinforced, in the case of s 50, by s 50(3), which states that a purchaser for the purposes of that section can include a person who takes an interest in personal property by way of a consensual transaction, including by way of mortgage, pledge or lien. However, s 50(1) states that the provision only does not apply to a purchaser of an investment instrument *who is a secured party.*

Section 51 does not include similar language. While the intention is for the provisions to only apply to the secured party-transferee disputes, the department seeks views on whether it would be appropriate for the provisions to also apply to secured party-secured party disputes.

Box 8: International examples of taking free rules

Under Article 18 of the Geneva Securities Convention, a person who acquires intermediated securities by having them transferred to a securities account in its name will acquire the intermediated securities free of another interest in the intermediated securities, if they did not know and ought not to have known that the acquisition violated the rights of the holder of that other interest. This could presumably operate in favour of a secured party, if they took security by having the intermediated securities transferred to a securities account in its name.

There is an equivalent provision in the Canadian PPS Acts but not in the New Zealand PPS Act.

Questions

17. Should the taking free rules under ss 50-51 be retained in the PPS Act? If so, why?

18. If retained, should these sections operate in favour of another secured party? If so, why?

4.2 Super-priority

Recommendation 223 states that Government should consider, as part of the further consultations referred to in Recommendations 64-76, whether it is appropriate for a security interest that is perfected by control to be entitled to a super-priority, for each of the types of collateral listed in s 21(2)(c).

The Review

Under the priority rules of the Act, a security interest that has been perfected by control will have priority over security interests perfected by any other method (including registration) and any unperfected security interests. This includes security interests that were perfected prior to the security interest that is perfected by control. Recommendation 223 states that Government should consider whether it is appropriate for a security interest that is perfected by control to be entitled to a 'super-priority'. The Review generally takes the position that superior priorities are unnecessary for most types of collateral apart from authorised deposit-taking institutions (ADI's) obtaining super-priority through perfecting by control over their own ADI accounts, intermediated securities and investment instruments.

The Review questions whether if perfection by control is the functional equivalent of perfection by possession, why it should enjoy super-priority when perfection by possession does not.

Legislation

Under s 57 of the PPS Act, a security interest in collateral perfected by control has priority over a security interest in collateral perfected by any other means.

The Issue

The basis for giving super-priority to security interests perfected by control is to facilitate dealings in collateral without requiring relevant parties to have to conduct a search of the Register or go through more time-consuming processes. However, the department seeks views on whether this is appropriate for all of the types of collateral that can currently be perfected by control.

There are two main issues to consider regarding perfection by control and super-priority:

1. Whether ADI's, negotiable instruments not evidenced by a certificate and letters of credit should be able to be perfected by control (intermediated securities and investment instruments have been discussed above), and

2. If so, whether a security interest in the above three types of collateral should have the same preferred priority as for investment instruments and intermediated securities.

International examples

Similar to s 157 of the PPS Act, article 12 of the Geneva Securities Convention states that a secured creditor whose security interest has been made effective by control has priority over any security interest perfected by any other method.

Question

21. For the following types of collateral, should a security interest be able to be perfected by control? Please give reasons.

- Section 21(2)(c)(i) – ADI accounts
- Section 21(2)(c)(iv) – a negotiable instrument not evidenced by a certificate
- Section 21(2)(c)(v) – a right evidenced by a letter of credit that states that the letter of credit must be presented on claiming payment or requiring the performance of an obligation

Additionally, if you think a security interest over the collateral type should be able to be perfected by control, should it have a preferred priority position? Please give reasons.

4.3 Enforcement

Recommendation 278 states that Government consider, in further consultation with industry, whether s 109(3) should be amended to provide that Chapter 4 (other than ss 110, 111, 113 and 140) does not apply to an intermediated security or an investment instrument that is held on a prescribed financial market within the meaning given to that term by the Corporations Act.

The Review

Under s 109(3), the bulk of Chapter 4 of the PPS Act does not apply to a person who has a perfected security interest in:

a) an investment instrument by taking possession or control, or
b) an intermediated security by taking control.

Section 109(3) appears to be intended to allow a secured party with a security interest over market-traded financial collateral to be able to swiftly dispose of its collateral without having to comply with all the processes that might otherwise be required by the PPS Act. However, the Review notes that the section does not fully achieve this objective, in three respects.

First, it applies to all intermediated securities and investment instruments over which a security interest is perfected by control or (in the case of investment instruments) possession, whether or not they are market-traded. Secondly, the rule in s 109(3) does not assist security interests over intermediated securities and investment instruments that are perfected only by registration. Thirdly, it does not protect security interests in market-traded assets that are not intermediated securities or investment instruments.

Legislation

Chapter 4 of the PPS Act provides rules for the enforcement of security interests, including the procedures for seizure and disposal or retention of collateral. Those rules require a secured party to give notices to certain interested persons at various stages throughout the enforcement process, and to wait for prescribed periods of time before taking certain enforcement steps.

The Issue

The PPS Act included s 109(3) to reflect the unique nature of financial collateral, because of its liquidity and the ability for security interests in it to be rapidly enforced.[11] However, for the reasons given in the Review it may be more appropriate to base the exceptions on whether the collateral is market-traded, rather than limiting it to investment instruments and intermediated securities over which the security interest has been perfected in a particular way.

Box 9: International examples of enforcement

None of the Canadian PPS Acts nor the New Zealand PPS Act has a similar provision. Article 33 of the Geneva Securities Convention, has the effect that a security interest can be enforced easily and quickly. The PPS Act presumably included s 109(3) to reflect this. The European Union, in its Financial Collateral Directive (see Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements), has implemented a provision similar to the s 109(3) to remove barriers to enforcement of security interests in financial collateral and preserve liquidity but again, this was aimed towards market-traded collateral.

[11] Rayner and Stumbles, above n 3, 35.

Questions

22. Would it be useful for s 109(3) be:

(i) retained in its current form
(ii) amended so that it applies only to investment instruments and intermediated securities that are traded on a prescribed financial market
(iii) expanded to cover all collateral that is traded on a prescribed financial market
(iv) amended in some other way, or
(v) deleted?