Intermediated Securities and the Australian PPSA: Harmonious whole or Fragmented Complexity?

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Introduction[1]

This aim of this paper is to examine the manner in which the *Personal Property Securities Act 2009* ('PPSA')regulates security interests over intermediated securities. Part 1 analyses the juridical nature of an intermediated security at general law. In Part 2 we consider the manner in which Article 8 of the US Uniform Commercial Code[2] addresses security interests over intermediated securities and how the Canadian provinces have adapted that model for use in Canada through separate provincial securities transfer legislation[3] with consequential amendments to the Canadian PPSAs. With particular reference to CHESS securities listed on the Australian Stock Exchange ('ASX'), Part 3 contrasts those models with the current incomplete Australian approach, which relies in part on the PPSA and in part on the general law, and poses the question whether Australia should consider adopting the more comprehensive North American models. In Part 4 we analyse the taking of a security interest over an intermediated security and the significance of the Hague Securities Convention on the Law Applicable to Certain Rights in Respect of Securities Held with and Intermediary ('Hague Securities Convention') dealing with choice of law in relation to intermediated securities and the UNDROIT Convention on Substantive Rules for Intermediated Securities ('Geneva Securities Convention') in framing a new Australian model. For these purposes, we also examine the EU Settlement and Financial Collateral Directive. Part 5 assess the significance of these matters for banking regulation whilst Part 6 concludes.

Part 1

The Intermediated Security at General Law

(a) The move away from paper: immobilisation and dematerialisation

Traditionally, securities such as shares or bonds were evidenced by paper. As a consequence, securities dealings involved the execution of a written form of transfer accompanied by the delivery of the applicable share or debenture certificate. Towards the end of the last century, 'the delays and other inefficiencies associated with paper-based settlements became intolerable to the developed securities

[1] This Paper is still a working draft and is not to be cited without the authors' approval.
[2] The current form of Article 8 reflects the amendments made in 1994.
[3] See, eg, *Securities Transfer Act* 2006, S0 2006, c 8 ('Ont. STA'); *The Securities Transfer Act*, SS 2007, c S-42.3 ('Sask STA').

markets and the transition to electronic settlement gathered apace.'[4] In Australia, electronic settlement for dealings with listed securities commenced in 1995[5] in relation to dealings of CHESS securities listed on the ASX.

The settlement of transfers of securities is evidenced by book entries. Each participant in the system maintains a securities account in the system. Pursuant to the rules of the settlement system by which members are bound, transfers of securities between participants are effected by a debit entry to the account of the transferring participant and a credit entry to the transferee participant.

Accompanying this development, two trends emerged. First, securities became 'immobilised'. So in a typical note issue, a global note representing the entire debt obligation is held by a central depository such as Euroclear or Clearstream for an intermediary who in turn may hold the note for one or more other intermediaries or other investors. Any transfer of a portion of the entire debt obligation does not actually involve transferring or any other dealing with the global note itself. Rather, the transfer merely involves dealing with an interest in the global note by means of book entry. Typically, this type of transfer only occurs through participants in an exchange in which clearing and settlement of the dealing are processed.

Secondly, securities became 'dematerialised' in that ownership of a security is now only evidenced by an entry on a register without any certificate evidencing such ownership such as a share certificate. Quoted Securities which are held on the CHESS Subregister ('CHESS Securities') maintained by ASX Settlement Pty Ltd ('ASX Settlement')') are dematerialised in this sense. For this purpose, ASX Settlement operates a clearing and settlement facility under a CS facility licence within the meaning of Chapter 7 of the Corporations Act 2001 (Cth) ('Corporations Act'). The primary functions of the clearing and settlement facility operated by ASX Settlement are to maintain a subregister of quoted securities and to provide a mechanism for the parties to transactions in those securities to meet settlement obligations. These functions are managed by ASX Settlement through its computerised settlement system, which is known as 'CHESS' (the Clearing House Electronic Subregister System).

(b) Intermediated Securities

Accompanying these developments, a third trend emerged, namely for an intermediary (as distinct from the actual investor) to hold an interest in the immobilised or dematerialised security not just for one investor but for a group of investors. This role was assumed for a fee by banks and other financial institutions and has grown into a significant business for them. Historically, such institutions had acted as custodian for investors in respect of shares, other financial instruments and tangible property deposited with them for safe keeping. Significant efficiencies in trading and transfers of securities were

[4] J Benjamin and M Yates, *The Law of Global Custody* (Lexis Nexis Butterworths, 2nd ed, 2002).14.

[5] The need for a more efficient system was evident during the 1986/87 'bull' market. Settlement backlogs, caused by failure to deliver promptly, prevented free flow of funds and raised concerns about counterparty risk. In 1989 the 'Group of Thirty' (G30) international organisation identified the risks in securities settlements and subsequently set out standards and goals for the industry worldwide to alleviate those risks. In 1994, the CHESS electronic subregister was implemented. By the end of 1995, the subregister had been extended to include all securities of Australian domestic issuers (ref: *ASX Settlement Procedure Guidelines,* Version 2.2, May 2012) .

identified by having title to the securities held by a custodian while only interests in the underlying securities were traded or transferred (thereby avoiding constant updating registers of ownership or redelivering bearer securities).

However, the ‘modern’ role of the custodian and the structure of the custodianship differed in many significant respects. First, in place of a mere safe keeping role, title to assets under custody was vested in the custodian. Secondly, the custodian undertook certain duties to its clients, including ensuring that the client received any dividends and accretions such as bonus shares. The custodian was also required to consult with its client in connection with any votes required in relation to a shareholding. The custodian also provided settlement facilities for clients in relation to sales and purchases of securities. The modern professional custodian’s role is thus significant and requires the custodian to be both competent and adequately resourced.

In recognition of this development, Australian law requires that a custodian needs to hold an Australian Financial Services Licence in accordance with Chapter 7 of the Corporations Act and to comply with Regulatory Guide 133 (‘RG 133’) promulgated by the Australian Securities and Investments Commission (‘ASIC’) in November 2013. Amongst other matters, RG 33 requires custodians to satisfy certain minimum standards of conduct in discharging their duties, including agreeing expressly that it holds assets under custody on trust for their client and subject to certain exceptions, holding assets under custody separately from assets which they beneficially own. A number of class orders implement RG 33.[6] Most foreign custodians are required to hold an Australian Financial Services Licence. However, if the foreign custodian is satisfactorily regulated by an offshore regulator, it may avoid having to hold a licence pursuant to one of the ‘passport’ Class Order Exemptions pursuant to section 911A(2)(l) of the Corporations Act.[7]

This evolution of professional custodianship also had two further significant features. First, a custodian may itself hold the securities through a sub-custodian or series of sub-custodians and as represented in Figure 1

[6] See, eg, ASIC Class Order [CO 13/761] (15th August 2014) which imposes financial requirements for custodial or depository service providers. See also ASIC Class Order [CO 13/761] (7th January 2015) dealing with asset holding standards.
[7] See, eg, ASIC Class Order [CO 03/1099] in relation to UK regulated entities.

Holding chain where global note held by depositary

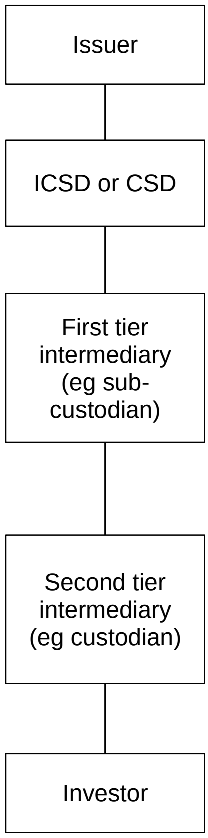
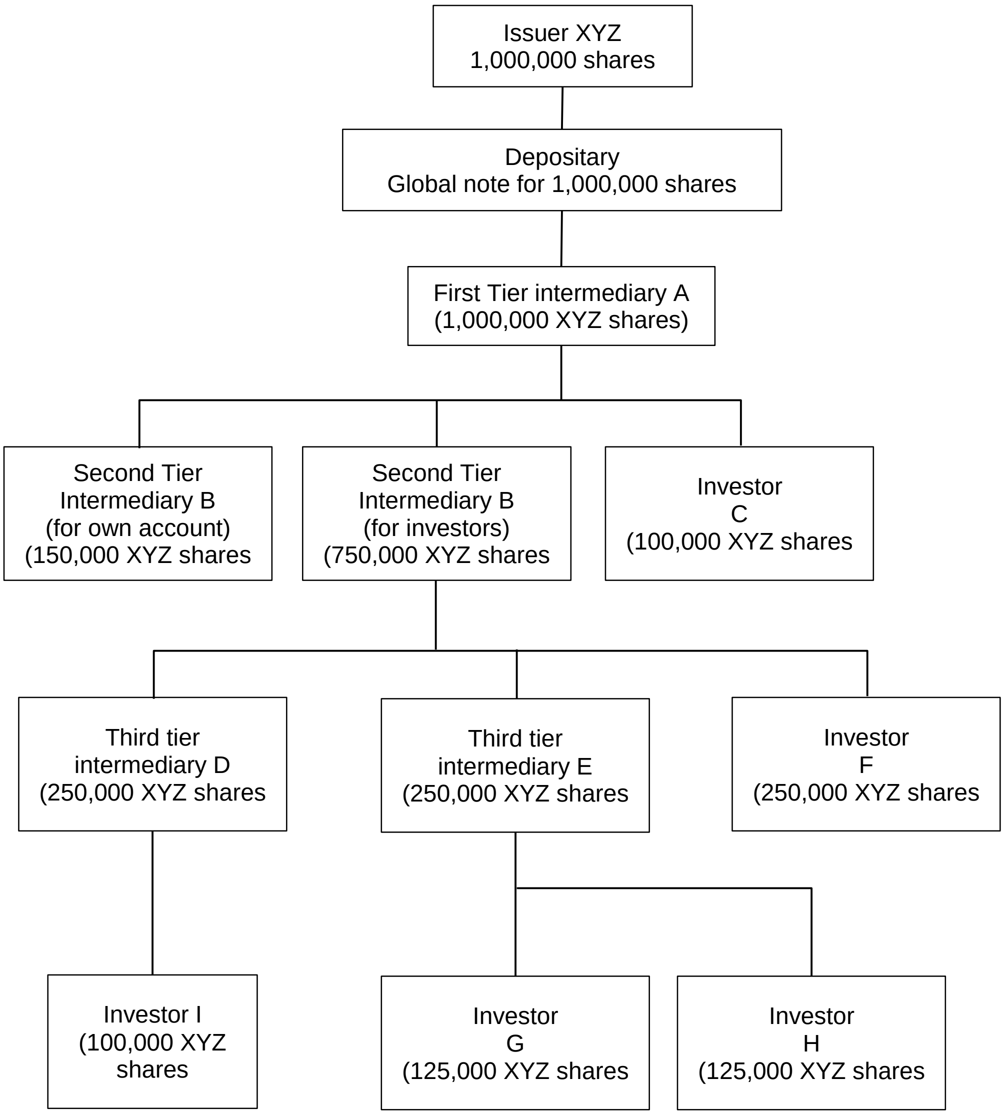


Figure 1[8] represents a simplified version of such a structure wherein it will be noticed that the instrument evidencing the security is deposited with a central security depository on behalf of the first tier intermediary (the sub-custodian) who holds that security on behalf of the second tier intermediary (the custodian) who has the direct relationship with the investor.

Secondly, a custodian may hold securities through various tiers of custodians or intermediaries on a pooled basis as represented in Figure 2.[9]

[8] L Gulliver and J Payne (eds), *Intermediated Securities Legal Problems and Practical Issues* (Hart Publishing Oxford, 2010) 3. Diagram is based upon a diagram prepared by the Financial Markets Law Commission: *Property Interests in Investment Securities* (Issue 3, July 2004) <http://www.fmlc.org/papers.html>.

[9] Ibid 13. Adopted from UNIDROIT, *Explanatory Notes to the First Draft of the UNIDROIT Convention*,(UNIDRIOT 2004, Study LXXVIII Doc 19) <http://www.unidroit.org/english/documents/2004/study78/s-78-019-e.pdf>.



Professor Gulliver comments on the above diagram as follows:[10]

> Here A, the first tier intermediary, holds all the shares for those below it in the chain. Its book entries will show that it holds 150,000 shares for B on its own account, 750,000 shares for B in its client account and 100,000 shares for C who is an investor. B therefore has two accounts, but the pooled one is the one of 750,000 shares. B will keep book entries as to how many shares in this account it holds for which client: in this instance 250,000 are held for D and E (who are intermediaries) and for F (who is an investor). Whether an account holder is an intermediary or an investor client will usually affect the terms of the contract between the intermediary and the account holder, and certainly affects the minimum rights which the account holder has under the Geneva Securities Convention D's account with B is a pooled account, but only I is an account holder (as to 100,000 shares) so the rest are held for D's own account

[10] L Gulliver and J Payne, above n 8,13 -14.

E's account with B is also pooled account, but here E holds 125,000 of the shares for G and 125,000 for H.

The ease of transfer can be demonstrated if G wishes to transfer 25,000 shares to H: this can be done by an entry in E's books without involving any of the higher-tier intermediaries. However, if H wishes to transfer 25,000 shares to I, this would involve entries in the books of the common intermediary higher up the chain, as follows: 25,000 shares will be debited to H's account with E, 25,000 shares will be debited to E's account with B, 25,000 shares will be credited to D's account with B and 25,000 shares will be credited to I's account with D.

The above described structures were driven by the desire for economic efficiencies. If such structures are in place, trading of securities is facilitated especially if accounts are pooled trades settled on a net basis. A custodian typically takes on the role of the second or third tier intermediary. Such a custodian facilitates the management of an investment portfolio and via its international network and enables investors to invest in securities listed on foreign stock exchanges. Where a security is held by a custodian, an investor's interest in the security is indirect and hence the use in this context of the expression 'indirectly held securities'. The custodian records an investor's interest those securities by entries in a securities account which it maintains. Because the securities are held by the custodian, as an intermediary for an investor, they soon became known as intermediated securities which the Geneva Securities Convention defines as 'securities credited to a securities account or rights or interests in securities resulting from the credit of securities to a securities account.'[11] As will be seen below, some of these concepts were taken up in the PPSA.

(c) The juridical nature of the rights of a holder of an intermediated security

Securities held by a custodian represent the classic example of an intermediated security although it will be readily appreciated that the definition of intermediated security is generic and may apply to any intermediary who holds securities under an arrangement of the type outlined above even though the intermediary may not describe itself as a custodian. In that sense, a custodian may be seen as but one type of intermediary.

In any event, an issue which has engaged much debate amongst legal practitioners and academic commentators is the precise nature of the rights which an investor has in the types of relationship described in Figures 1 and 2. In particular, does the investor have any property rights in the issued security? The latter issue is particularly important if any entity within the chain becomes insolvent or deals improperly with the security. Commencing with the simpler example illustrated in Figure 1, it will be observed that unlike the depository, the investor has no direct relationship with issuer of the security. The investor only has a direct relationship with its custodian (the second tier intermediary) who in turn only has a direct relationship with the first tier intermediary. Thus the investor's rights and hence its entitlement in relation to the intermediated security is limited to its rights against the intermediary with

[11] UNIDROIT, *UNIDROIT Convention on Substantive Rules for Intermediated Securities* ('Geneva Securities Convention') (9 October 2009), Article 1(b).

whom the investor deals directly. Those rights are against the intermediary personally. However, does the investor have any 'interest' in the rights of the second tier intermediary against the first tier intermediary and if so can such a right extend to the rights of the first tier intermediary against the entity in whose name the security is registered? Does the analysis alter if the investor's rights are pooled with other investors in the same security who also happen to be also customers of the second tier or further intermediaries?

Many of the international custodians are US entities and their custodian documentation is, strangely from an Australian lawyer's perspective, often silent on this issue. Furthermore, the US documentation is regularly used in foreign jurisdictions subject to minimal alteration. As will be seen below in Part 3, possibly this may be explained by the existence of Article 8 of the UCC.

The obvious answer is that the intermediary with whom the investor deals is a trustee for the investor in circumstances where the trust property is constituted by the rights which that intermediary has against its immediate upper tier intermediary.[12] In order for a trust to be established, the 'three certainties'[13] must exist, namely certain of intention, subject matter and object.

A perusal of the obligations imposed on a custodian under a typical standard custody agreement (which includes an obligation for the customer to act on the investor's instructions) and the fact that the investor is the source of funds for the acquisition of the security, coupled with a contractual obligation imposed on the custodian to segregate customer assets from those owned absolutely by the custodian, all tend to support the trust characterisation.

It is conceded that such an analysis becomes more problematical if the securities held by a customer are pooled. Looking at Figure 2, can the trust analysis be sustained? To take just one aspect of this illustration, reference may be made to the third tier intermediary E and its relationship with Investors G and H. If the trust analysis is to be made out, does certainty of trust property exist in these circumstances? Which portion of (or more precisely which portion of E's interest in) the 250,000 shares in XYZ is held for G and which portion is held for H?[14] Is the certainty of subject matter and object requirement satisfied or must E have allocated a designated portion thereof to each of G and H?

In *Hunter v Moss*,[15] a trust was declared by Moss over 5% of his unallocated shareholding in a particular company. The court construed this arrangement as creating a valid trust over some 50 of those shares. A possible key factor in the court's approach to this issue is its pragmatic recognition that such a 'trust' arrangement still remains sufficiently certain as to be susceptible to enforcement by court order in the

[12] For tangible assets a bailment analysis is possible but as bailment depends on the possession, it is an inapt for intangible property which is the focus of this paper. See M Yates and G Montagu, *The Law of Global Custody*, (Bloomsbury Professional Ltd, 2013) Ch 3.

[13] *Knight v Knight* (1840) 2 Beav 148.

[14] Although not discussed in the text, the same argument may be applied to each tier in the chain of intermediaries identified in Figure 2.

[15] *Hunter v Moss* [1993] 1 WLR 934;[1994] 1 WLR 452; [1994] 3 All ER 215.

sense that for fungible securities an order enforcing the trust may extend to any shares or interest in the shares despite the absence of allocation.

Nevertheless, the reasoning in *Hunter v Moss* was treated with reservation by certain commentators[16] whilst others supported the decision on the basis that shares were fungible in that they each represented an identical co-ownership interest in the company concerned[17]. Despite these reservations, the decision has been followed in England[18], Hong Kong[19] and Australia[20] on the grounds that the trust created in those circumstances is over the entirety of the identified fund with each beneficiary having a proportionate beneficial interest in the fund as an equitable tenant in common with other beneficiaries. More recently, the English High Court has summarised the position as follows[21]:

> There has not been unanimity among those courts which have followed *Hunter v Moss*, nor among the many academics who have commented upon it, as to the correct approach. The analysis which I have found the most persuasive is that such a trust works by creating a beneficial co-ownership share in the identified fund, rather than in the conceptually much more difficult notion of seeking to identify a particular part of that fund which a beneficiary owns outright.

The identity of each beneficial owner and the proportionate interest of each beneficial owner in the trust property will change as a consequence of dealings in the trust property as represented by the underlying assets. In a typical trading trust the trust portfolio is constantly changing such that at any point in time a beneficiary is unable to point to any asset over which it may assert an unqualified beneficial claim.[22] If anything, the interest of an investor/ beneficiary in a typical pooled custodian/intermediary arrangement is even more 'floating' in nature. That interest will be determined significantly by the investor's rights under the agreement. The right of an investor- beneficiary 'to have the property dealt with as the trust instrument, that is the custodian agreement, requires is regarded for the purposes of equity as equivalent to a right in the property itself, but only commensurate with the investor's particular right in personam.'[23]

If this reasoning deals with the certainties of subject and object, how in the absence of clear language is certainty of intention established? In contrast to earlier times[24], courts are now more willing to find a

[16] See, eg, David Hayton, 'Uncertainty of Subject-Matter of Trusts' (1994) 110 LQR 335.
[17] Roy Goode, 'Are Intangible Assets Fungible?', [2013] *LMCLQ* 379.
[18] *Re Harvard Securities* [1997] 2 BCLC 369.
[19] *Re CA Pacific Finance Ltd (in liq)* [2000] 1 BCLC 494.
[20] *White v Shortall* [2006] NSWSC 1379 (Campbell J).
[21] *Re Lehman Brothers International (Europe) (in administration): Pearson and others v Lehman Brothers Finance SA and other companies* [2010] EWHC 2914 (Ch) per Briggs J at [231]-[232]. On appeal, the Court of Appeal did not disapprove of this reasoning. See *In the matter of Lehman Brothers International (Europe) (in administration)* [2011] EWCA Civ 1544. This view has also been accepted by the leading texts. See, eg, Yates and Montague, above n 15, at 35. See also Hugh Beale, Michael Bridge, Louise Gulliver and Eva Lomnicka, *The Law of Security and Title-Based Financing*, (Oxford University Press, 2nd ed, 2012).
[22] Cf *CPT Custodian Pty Ltd v Commissioner of State Revenue* (2005) 224 CLR 98.
[23] *Glenn v Federal Commissioner of Land Tax* (1915) 20 CLR 490, 503.
[24] Cf du Parcq LJ's observations in *Re Schebsman* [1944] Ch 83; that a court should not too readily discover indications of an intention to create a trust.

trust where 'commercial necessity'[25] establishes an inference that a trust was intended. The Lehman litigation has clarified significantly the precise legal nature of the interest which an investor has in securities under custody. More specifically, in relation to custodian arrangements, the intention to create a trust is more readily established by reference to the language used in the custodian agreement, including the use of the words 'custody', 'custodian' and language indicating that the securities under custody belonged to the custodian's client.[26]

For Australia, the doubts associated with the above trust analysis have been largely resolved by the requirement under ASIC's RG 133 requiring custodians and similar asset holders to 'ensure that it and any other asset holder it engages hold the property on trust,'[27] but subject to certain exceptions.[28]

It is also possible to characterise the structures in Figures 1 and 2 as a series of sub-trusts which raises the question of whether it is possible to collapse the intervening trusts such that the investor is able to 'look through' the intervening tiers to the entity in whose name the investment is ultimately recorded. If the series sub-trusts only involved one person and one non-shifting asset and the intervening trustees have no duties to perform save that of holding asset then it is argued that the intervening sub-trustees may disappear[29] but the better view is that the intervening sub-trusts continue to exist and that the investor may only look to the intermediary with whom it deals directly.[30] Certainly this appears to be the case where the sub-trustee has active duties to perform.[31]

It will be seen in Part 4 below that there are a number of quite different ways other jurisdictions have rationalised such intermediary chains according to their local laws and the form of their national Common Securities Depositories (CSDs) Given the complexities of analysis exemplified by the Australian approach above, the importance of determining which laws govern which aspects of these relationships and the underlying securities themselves is key.

Part 2

Intermediated Securities under Article 8 of the UCC and in Canada

In the US and Canada, some of the doubts arising from assets held by an intermediary were resolved by statutory amendment rather than being left to the general law as is the case in England and Australia but in the latter case as supplemented by ASIC policy guidelines. The prime motivation appears to

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[25] *Eslea Holdings v Butts* (1986) 6 NSWLR 175. See also comments in *Trident General Insurance Co Ltd* v *McNeice Bros Pty Ltd* (1988) 165 CLR 107 and *Bahr v Nicolay* (No 2) (1988) 164 CLR in the context of trust over contractual rights for the benefit of third parties.

[26] *Re Lehman Brothers International (Europe)* [2009] EWHC 2545 (Ch. See also *Re Lehman Brothers International (Europe)* [2009] EWCA Civ 1161, where the English Court of Appeal assumed that an investor under a prime broking arrangement was a beneficiary under a trust whose rights the Court refused to be varied by a scheme of arrangement.

[27] Australian Securities and Investment Commission; RG 133 Managed investments and custodial or depository services: Holding Assets (21 November 2013) [133.45].

[28] Ibid. The exceptions are: where assets held outside Australia where a trust structure is not recognised; where a foreign law gives investors an equivalent form of protection in the event of insolvency; where there is an omnibus accounts used in relation to prime brokerage arrangements; and where the asset holder assumes liability for assets not held under a trust arrangement.

[29] See G Batttersby, 'Formalities for the Disposition of Equitable Interests under a Trust' [1979] *Conveyancer* 17,28.

[30] See Ben McFarlane and Robert Stevens, 'Interests in Securities: Practical Problems and Conceptual Solutions', above n 8, 46-48.

[31] Philip Pettit, *The Law of Trusts*,(Oxford University Press London, 5th ed, 2006) 32 .See also *Re Lashmar*[1891] 1 Ch 258.

have included uncertainties associated with the development of indirect systems in relation to US government securities, the holding of those securities by intermediaries in dematerialised form, the need to clarify precisely the nature of an investor's rights in relation to assets held under custody and the granting of security interests in relation those assets. Clarification of the former determines significantly the quality of any security interest over the investor's interest in those assets.

As will be seen in Part 3, some but by no mean all of the elements in the US and Canadian legislative schemes[32] are reflected one way or another in the Australian PPSA.

Uniform Commercial Code

For the US, the amendments are reflected in changes made in 1994 to Article 8 of the UCC (accompanied by consequential amendments to Article 9) which had the following basic elements:

1. The interest of an investor in an asset held under custody is defined as a 'security entitlement': §8-102(a)(17).

2. A person who acquires a security entitlement for value and without notice of any adverse claim takes free of that claim: §8-502.

3. A person acquires a security entitlement when the intermediary credits a financial asset to the person's securities account: §8-501. For these purposes, the term 'financial asset' is defined very broadly to include securities such as shares, participation interests and property held by an intermediary: §8-101(9). A 'securities account' is an account to which a financial asset is credited 'under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset': §8-501-(a).

4. All financial assets held by the intermediary 'are held by the securities intermediary for the entitlement holders, are not property of the securities intermediary, and are not subject to the claims of creditors of the securities intermediary [subject to certain exceptions]': §8-503.

5. An intermediary is required to maintain a sufficient quantity of financial assets to satisfy the claims of all of its security entitlement holders: §8-503. Subject to the mutual agreement of the parties, Part 5 of Article 8 also imposes duties on the intermediary which in Australia are typically regulated by the custody agreement: §8-505-§8-509.

6. If an intermediary becomes insolvent, the entitlement holder's priority is maintained except where the intermediary itself borrows on a secured basis on its own account where the latter

[32] Our analysis is by no means complete and is only aimed at highlighting the key differences in the approach to this subject between North American and Anglo-Australian law.

security interest is perfected by control: §8-511.[33] This circumstance would cover security interests granted by intermediaries in favour of clearing houses.

The above bundle of rights has been described as follows[34]:

> Thus, a security entitlement is itself a form of property interest not merely an *in personam* claim against the intermediary. The concept does include a package of *in personam* rights, subject to specification by agreement and regulatory law.

As the last element in the package, a new definition of 'investment property' was inserted into Article 9 of the UCC: §9-102(a)(49). The latter definition included securities and securities entitlements. A security interest over a security entitlement can be perfected by control: §9-314(a) and a security interest perfected in this fashion has priority over any other security interest in the same property: §9-328.

Canada

In combination with changes to provincial business corporation statutes, the Canadian provinces have adopted the Articles 8 and 9 models for use in that country. To take Saskatchewan as an example, that province enacted the *Securities Transfer Act, 2006* ('Sask STA')[35] and consequential amendments to *The Personal Property Security Act 1993* ('Sask PPSA')[36]. The basic elements of the Canadian Sask STA are very similar to Article 8 and are as follows:

1. A security entitlement means 'the rights and property interest of an entitlement holder' with respect to a 'financial asset': s1(1)(hh). A person holding a security entitlement is an 'entitlement holder': s1(1)(m). If the assets under custody are pooled, entitlement holders have a proportionate property interest in the pooled assets: s97(2). Subject to any agreement between the parties, a financial asset includes property held by an intermediary including a credit balance in an securities account: s1(1)(o).

2. A person acquires a 'security entitlement' if a securities intermediary 'indicates by book entry that a financial asset has been credited to the person's securities account: s 95(1)(a). A person who acquires a security entitlement for value and without notice acquires the entitlement free of any adverse claims: s 96.

[33] US law also has a raft of other legislation which may operate on an insolvent intermediary. See 'Core Issues under the UNIDRIOT (Geneva) Convention on Intermediated Securities: Views from the United States and Japan', above n 8, 80.
[34] Carol Chomsky, Christina Kunz. Linda Rusch and Elizabeth Schiltz, *Selected Commercial Statutes*, (Thomson Reuters, 3rd ed, 2012) 547.
[35] *Securities Transfer Act,* above n 3, *c S*-42.3.
[36] *The Personal Property Security Act 1993*, SS 1993 c P-6.2 ('Sask PPSA').

3. Subject to 4 below, all interests held by the intermediary in financial assets are held for the entitlement holders are not the intermediary's property and are not subject to the claims of any creditors of the securities intermediary: s97(1).

4. An intermediary is required to obtain and maintain a sufficient quantity of financial assets under custody corresponding to all the security entitlements which the intermediary has established for that financial asset (s98(1)) and except as agreed to by the entitlement holder may not encumber those assets. In the latter circumstances, the security interest held by the intermediary's secured creditor ranks ahead of any claim of an entitlement holder if the security interest is perfected by control (s105). Again this could occur in connection with security interests granted in favour of clearing houses. The legislation stipulates methods whereby control for these purposes may be achieved: s24 and s25.

5. Part VI of the legislation imposes statutory duties on the intermediary similar to those which one typically finds in a custodian agreement. Some of these obligations are subject to any contrary agreement between the parties including the terms of any security agreement created over the security entitlement:s103(2);

6. If an intermediary becomes insolvent an entitlement holder's property interest with respect to a financial asset may be enforced directly against a purchaser of the financial asset from the intermediary under an unauthorised sale (s97(4)) except where the purchaser acts in good faith, obtains control of the asset and does not act in collusion with the intermediary.

The Sask PPSA was amended (s2 (1.1)) to enable a security interest over a security entitlement and the securities account to which they are credited, to be perfected by control through one of the control procedures referred to in the Sask STA. At the same time, a special priority rule was included in the former Act giving first ranking priority to the holder of a security interest over an investment property, which includes a security entitlement, perfected by one of the stipulated control methods: s35.

The leading Canadian text characterises these rights as largely personal but with one 'heavily qualified exception'[37] which, as indicated in paragraph 3 immediately above, recognises that financial assets held for an entitlement holder are not available to the intermediary's creditors in the event of the latter's insolvency. Similarly to the position under the UCC, the rights are a *sui generis* mixture of *in personam* and property rights.

Part 3

Intermediated Securities under the Australian PPSA

[37] Ronald Cuming, Catherine Walsh and Roderick Wood, *Personal Property Security Law*, (Irwin Law, Toronto, 2nd ed, 2012) 31.

The brief summary of the position under US and Canadian law in Part 2 is useful for assessing the current Australian position in relation to security interests over assets held for an investor by an intermediary such as a custodian. A further comparison with the Geneva Securities Convention and the European Financial Collateral Directive is set out in Part 4 below. We begin with a review of the relevant Australian statutory provisions followed by an assessment as to whether Australia should continue to rely in part on the trust analysis referred to in Part 2 as the means for protecting investors or whether Australia should consider adopting a more fundamental reform similar to the model currently in use in North America and whether this will give greater comfort to financiers taking security interests over those rights. This recognises that the security interest granted in such circumstances is only as good as the underlying property the subject of the security interest. Other intermediated securities holding models are also canvassed in Part 4 .

A new classification of intermediated securities under the PPSA?

Section 15 of the PPSA defines an intermediated security as 'the rights of a person in whose name an intermediary maintains a securities account.' For these purposes a 'securities account' is defined as 'an account to which interests in financial products may credited or debited.' The definition is the same as that in the Geneva Securities Convention[38] save that the word 'securities' is used in place of the word 'financial products'. This definition would encompass the traditional intermediation arrangements as described in Figures 1 and 2 above and uses the securities account as the evidence of the rights of the holder of the intermediated security and to which debits and credits are made to record dealings with those rights. The definition also requires the account to be maintained by an intermediary as defined in section 15(2) of the PPSA. A typical custodian as described earlier in the text is an intermediary for these purposes provided they hold a licence of the type described in the provision.

In addition the definition of securities account includes 'a record of holdings and transfers of interests in financial products.' This provision was included to 'clarify that CHESS securities are intermediated securities and the means by which CHESS securities can be subject to control.'[39] ASX Settlement operates the CHESS subregister and holds a CS facility licence. Strictly speaking, a CHESS subregister security, when viewed from the perspective of the person in whose name the security is directly recorded, is not an intermediated security as that term is generally understood. Rather a security on the CHESS subregister is an example of an uncertificated security. At the same time, a quoted security recorded on the issuer's subregister is classified by the PPSA as an investment instrument. Thus a quoted security has two possible classifications under the Act depending on the identity of the register on which it is recorded. Although workable in practice, the PPSA's approach to quoted CHESS securities is confusing in two respects. First, a CHESS security is described as intermediated when it is actually directly held by the investor. Secondly, a security is not an

[38] Geneva Securities Convention, above n 14, Article 1(b).
[39] *Personal Property Securities (Corporations and Other Amendments) Act 2011* (Cth), Explanatory Memorandum, 2.

intermediated security if recorded on the separate register maintained by the issuing company. Should this approach be amended and if so by what should it be replaced?

The UNCITRAL Draft Model Law on Secured Transactions[40] may be of assistance in resolving this issue. For collateral purposes, the Draft Model Law divides securities into intermediated securities and non-intermediated securities. In turn, non-intermediated securities are divided into certificated non-intermediated securities and uncertificated non-intermediated securities. Although these descriptive terms are not models of plain English, they do result in a more accurate characterisation of the security. In an Australian context, a quoted security recorded on the issuer subregister would be an uncertificated non-intermediated security whilst a quoted security recorded on the CHESS subregister would be an uncertificated [non]-intermediated security. The latter may be perfected by means of a control agreement containing provisions similar to those found in section 26(2)(b) of the PPSA.

Codification of the rights of the holder of an intermediated security

As part of the criticism of the confusion associated with the classification of intermediated securities, it has also been suggested that the rights of the holders of such interests should be codified in a manner similar to the Article 8 of the UCC and in the Canadian securities transfer legislation. We see this as a distinct question from the manner in which securities are classified for PPSA purposes. Such a codification is not a necessary pre-requisite for altering the classification of property under the PPSA.

As we indicate in Part 2, the rights of the holder of an intermediated security are currently regulated by the general law's protection of trust law as supplemented by ASIC Regulatory Guides. Does trust law provide adequate protection for investors holding intermediated securities? Would a codification improve investor protection? This issue has occasioned a lively debate in England where, as in Australia, the protection of investors is sourced in trust law as supplemented by specific regulatory intervention. Some commentators favour a codification[41] whilst others consider that codification provides little additional protection over and above that provided by the general law.[42] Indeed, it is possible in any event to characterise the codification as a form of statutory trust designed to protect investors. As against that, it has also been asserted that trust law does not necessarily provide a predictable and easily enforceable regime in the event of insolvency. A codification provides clarity for those unfamiliar with the technicalities of trust law; it also permits easy identification of the nature of the secured property if an Investor offers the intermediated security as collateral.

Part 4 below examines alternatives to the trust model adopted in other jurisdictions and explores some of the issues which arise in the context of cross border holdings. In doing so it also examines some of the policy drivers behind offshore approaches and whether any of these might form a relevant basis for developing an Australian framework consistent with the PPSA.

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[40] See United Nations Commission on International Trade Law ('UNCITRAL'), *Draft Model Law on Secured Transactions*, Article 2.
[41] Gabriel Moss, 'Intermediated Securities: Issues arising on Insolvency', above n 8, 61.
[42] Ben Macfarlane and Robert Stevens 'Interests in Securities: Practical Problems and Conceptual Solutions', above n 8, 33.

Issues regarding the precise nature of the interest of a holder or investor in the intermediated security (and the law which governs that question together with issues concerning its creation, transfer, validity and perfection) have been the subject of much discussion in recent years. The decision in *Macmillan Inc v Bishopgate Investment Trust plc*[43] in 1996 indicated how acute these difficulties become where there are multiple jurisdictions involved in a chain of intermediaries. Part 4 also examines the threshold question as to what law will govern these issues and the uncertainties following the *Macmillan* case.

Part 4

Collateral over Intermediated Securities and the PPSA

Australia has been an active participant in the development of the Hague Securities Convention (dealing with choice of law in relation to intermediated securities) and the Geneva Securities Convention (on substantive rules for intermediated securities). These proposed supranational regimes provide a backdrop for Australia's own deliberations on its approach in further developing a an intermediated securities framework. The EU Settlement Finality Directive (SFD)[44] and Financial Collateral Directive (FCD)[45] are also examined below in relation to substantive rules affecting financial collateral more generally.

These reform efforts indicate that in framing an Australian approach there are threshold questions to ask:

- What is financial collateral and why is financial collateral different to other collateral? What impact do intermediation and dematerialisation impose on the framework?
- When should Australian law apply? Why should it apply? Who should it apply to? Which issues should be covered? In fact, should Australia adopt the Geneva Securities Convention? Or the UCC Article 8 approach to choice of law issues?
- What do any changes to the Australian laws in respect of financial collateral mean for other collateral types, or other local laws (for example, taxation, property, corporate and insolvency laws etc), or accounting/balance sheet treatments?
- Is the need to protect investors from intermediaries (insolvency, misappropriation, etc) to be given greater or lesser priority than the need to protect good faith acquirers (including collateral takers) from interests of the investor? Is financial collateral a special case requiring policy differences?
- As discussed in Part 3 above, what is the nature of the interest of the investor in the intermediated security, is it based on property or obligation? Can this be reconciled with existing law or the laws of other relevant jurisdictions? Does it need to be articulated at all?

[43] *Macmillan Inc v Bishopgate Investment Trust plc* [1996] 1 WLR 387
[44] EU Directive 98/26/EC on settlement finality in payment and securities arrangements systems (the "SFD")
[45] EU Directive 2002/47/EC on financial collateral arrangements ("the FCD")

- If a unified approach based on property concepts is not possible, could a functional approach which legislates for outcomes (as is the approach under the Hague Securities Convention) effectively address these issues without creating more uncertainty?
- Whether harmonization with other regimes is necessary, desirable or even possible?

These questions are canvassed below in the context of intermediated securities and financial collateral generally.

Once these threshold concepts are settled, the interplay of the Australian rules and those of other jurisdictions relevant to an intermediary chain will need to be applied. In combination these laws must be capable of determining issues[46] as to whether, for example, if an intermediary or collateral taker goes insolvent:

- the transfer of an outright transfer of the securities earlier in time or at a point upwards in the intermediary chain is valid and enforceable?
- the intermediated security itself is valid and enforceable?
- a bona fide acquisition at any point in the chain is valid and enforceable?
- there could be an unwind or reversal of any disposition and how would it affect the chain (and according to which law)?
- ranking in priority against other interests in the same asset can be determined under a given law?
- the protection of client assets is and the effectiveness of the arrangements against creditors of the intermediary can be addressed?

Looking firstly at the key threshold questions outlined above in more detail:

What is financial collateral and why is financial collateral different to other collateral?

Generally financial collateral consists of security over cash (other than bank notes) and securities. Cash will include amounts in accounts and other claims to money[47]. Historically much of the value of financial collateral is derived from its liquidity[48] and therefore rapid prospect of realisation. It also allowed for constant margining (collateral top-ups and substitutions) to enable more efficient collateralisation of exposures and markets generally. Arguably even the early development of the law was driven by attempts to preserve this key attribute (albeit in a slow and at times haphazard way). For example in the United Kingdom at one time fixed securities over shares and debt securities were not registrable[49].

[46] P Paech, *Market Needs as a Paradigm: Breaking Up the Thinking on EU Securities Law*, (LSE Law, Society and Economy Working Papers 11/2012) <www.lse.ac.uk/collections/law/wps/wps.htm and the Social Sciences ResearchNetwork electronic library at: http://ssrn.com/abstract=2150156.>
[47] These asset types together with credit claims are financial collateral as defined in the EU Financial Collateral Directive (see further below).
[48] Cf section 120 of *Personal Property Securities Act 2009* (Cth) which does not extend to intermediated securities.
[49] Although in a complication not dissimilar to the uncertainties introduced by exceptions and special provisions introduced to accommodate financial collateral under the Financial Collateral Directive, the registration question became complicated by the

Similarly title transfer security arrangements or repo transactions were never brought with in the registration regime (not being characterised as interests despite having a similar practical effect). A charge over a debt security and a charge over a book debt were subjected to different registration treatments (presumably with a view to preserving the liquidity in the case of the debt security).

Given the nature of a debt security or a share they may have been characterised as bundles of obligations as opposed to property, but to address liquidity securities became negotiable and incorporated into certificates to assist in the creation of secondary markets. It has been suggested that there was a "coating of the original set of obligations with a property hull to allow for good faith acquisition in particular."[50] Given modern patterns of intermediation, the preservation of good faith acquisition becomes more important, however this is to be balanced against the interests of the investor and protection from unauthorised acts or bankruptcy of the intermediary. Whether property concepts (and in Australia's case, trust law) are best suited to resolve these issues is according to some commentators still open to debate. The Geneva Securities Convention deliberately avoids property concepts by adopting a functional approach (discussed further below).

Aside from liquidity and the related need to protect the good faith purchaser, financial collateral has also been singled out for a difference in treatment more recently due to its importance in risk management in new post GFC regulatory regimes. These issues will remain key to policy considerations in developing a framework going forward. These regulatory regimes require reasoned legal opinions to support capital and regulatory treatments claimed by financial institutions and therefore the need for more legal certainty in relation to financial collateral in particular is likely to remain.

In view of financial collateral being largely held in cross border intermediary chains and the importance of financial collateral in regulatory regimes to support systemic stability, reforms will be driven by the need for uniformity, improving legal certainty and the need to protect good faith acquirers. These objectives set financial collateral apart from other asset types with liquidity being the key attribute the law must preserve.

Effect of Intermediation

As indicated in Parts 1 to 3, intermediation has a significant effect on the legal nature of the rights of the holder in securities. Any attempt to formulate a legal framework for financial collateral has traditionally been thought to require a settled understanding of the nature of rights of an intermediated security holder (for example, property vs obligation vs trust as set out above).

A wholesale rationalisation of the nature of these rights in a cross border context has proved difficult. A diversity of existing approaches have developed in response to national systems. A number of national

need to register securities over book debts or floating securities which could be found in many security arrangements over shares (eg by reference to provisions relating to reinvestment of dividends or coupons constituting book debts).

[50] P Paech, above n 47, 23.

legal frameworks have developed in response to the nature of the local CSD. These differ across jurisdictions in a number of respects, for example as to:

- how investors' rights in the underlying are enforced against an issuer;
- the transparency of the system (and how the holders' rights are recorded);
- management of multiplication of interests where interests are not entirely devolved to lower levels in a chain; and
- differences in how the interests are determined in commingling arrangements (or omnibus accounts).

In response laws have developed separately to deal with transfer methods, priorities, and the position of third party bona fide acquirers without reference to the need to accommodate cross border arrangements or other legal systems. Five different approaches have been identified[51] for example:

1. The trust-based analysis which applies in England and Wales and also Australia discussed in Part 3. In the system the participants are considered legal owners of the securities which are held as trustee on behalf of the investor. Across multiple levels in a holding, chain sub-trusts are created at lower tiers (giving rise to equitable interests in equitable interests up the chain).

2. In the USA and Canada, legislative intervention has created a concept of 'security entitlement' as set out in Part 2. This provides for every account holder to have rights against its account provider at every level of the intermediary chain. The security entitlements are separated from the insolvent estate of an intermediary. Every security entitlement against each intermediary is a separable and distinct legal interest and claims are legally disconnected at each level of the intermediary chain. In contrast, beneficiaries under the English law trust analysis hold some form of equitable interest derived from the (often equitable) interest held by the intermediary. The trust analysis implies that the holder cannot obtain any greater interest than those at the higher levels in an intermediary chain. Therefore a defect or adverse priority interest up the intermediary chain may have consequences for the individual interests of holders further down the chain.

3. In France, the model confers a full undivided property interest directly on the investor. The investor has a property interest in the securities which are deemed to be held directly in the account maintained for it by its direct intermediary. No intermediaries in the chain have any rights in the securities.

4. Another model exists which has developed to specifically address the issues caused by the pooling of securities. This is the approach in Germany, Austria and Japan. The approach developed when hyperinflation forced banks in Germany to find different ways pooling large securities holdings. Under this approach the holder has a direct co-ownership property interest in the pool of securities. The

[51] P Paech, above n 47.

intermediaries have no interest or ownership in the securities (acting akin to registrars). Rules of property applicable to chattels govern transfers and creation of security.

5. Finally, the Nordic countries and Greece have been identified as having what is characterised as a transparent approach. China and Brazil are also considered to have this approach. In this arrangement there are no intermediaries involved except the CSD. Every investor holds its account directly in the CSD and Bank intermediaries do not maintain accounts for their customers. The investor is said to have a direct property interest in the securities without any co-ownership.

The conceptualisation of intermediated securities at law often draws from the character of the national CSD. These CSDs have developed in an insular way [52] long before cross border or whole of market issues could influence the process. This history has resulted in substantial differences between systems and frameworks. For this reason, it has proved extremely difficult to formulate a unifying legal framework to deal with cross-border situations. Whether it is necessary to base a framework on a conceptual approach (by reference to a proprietary or obligation based foundation) is open to question. As is discussed further below, a functional approach has been adopted in the formulation of the relevant treaties (designating outcomes as a means to achieve legal certainty) but this also gives rise to difficulties when transposed to national systems[53].

A recent case example highlights how outcomes are impacted by the local law view of the nature of rights in intermediated securities. In the *Eckerle*[54] case the English High Court looked at whether an application could be made under section 98 of the *Companies Act 2006* (UK) for the re-registration of a company. That section requires a certain number of "holders of shares" to apply for the re-registration. The applicant in this case, Mr. Eckerle and two others held the ultimate economic interest in the underlying shares which were held by BNY as custodian. BNY acted as a depository of the issued shares, and held them on trust for Clearstream account holders. These account holders were required to be banks or financial institutions. In effect, the interests in accounts in Clearstream are traded between participants rather than the shares themselves. Clearsteam participants then hold the interests for individual end investors. Under English law, Eckerle only had a beneficial interest in a specified percentage of the shares held by BNY on trust for Clearstream.

The court held that the applicants were not "holders of the shares" as the shares were registered in the name of the BNY. Ordinarily, BNY could have made the application however the *Companies Act 2006* (UK) prohibited an application by a holder of shares who had voted in favour of the relevant resolution. Therefore to the extent BNY had voted in favour of the resolution on the half of other investors on whose behalf it held shares, it would be prevented from making the application. The decision reached by Norris J caused him to remark that he had not reached 'a particularly comfortable conclusion, but

[52] Initial CSDs date as far back as 1878 in Vienna and 1882 in Berlin (Peach, above n 47 at 7) and therefore the development of the law relating to intermediated securities was set on its course before international securities trading was the priority.
[53] Arguably a functional outcomes based approach underlies the *Personal Property Securities Act 2009* (Cth) however in practice this is not universally accepted and the relevance of existing law to current PPSA concepts can be uncertain.
[54] *Eckerle and others v Wickeder Westfalenstahl GmbH and another* [2013] EWHC 68 (Ch).

reaching any other conclusion would involve an impermissible form of judicial legislation'. The whole analysis was predicated on an English law conceptualisation of the relevant relationships however as indicated above, German concepts may have permitted a look through approach.

Such examples and the differences between systems noted above, indicate the importance of determining the which laws are to be applied to a cross-border holding of intermediated securities.

Which law should apply?

Even before consideration of the underlying analysis, considerable legal uncertainty results from current choice of law rules in different jurisdictions which differ and in many cases do not address which law governs book entry pledges of intermediated securities. Different laws may be found to govern ownership, perfection requirements, validity of transfers, third party rights, and enforcement issues, all at each level of the intermediary chain. In Australia, the PPSA sets out a comprehensive choice of law regime for most personal property types but does not address the position for intermediated securities.

The latest PPSA review notes that the absence of a choice of law rule for intermediated securities is unsatisfactory. Under Section 6(1A), the PPSA will apply to a security interest over intermediated securities if the grantor is an Australian entity, or if the intermediary is located in Australia. Therefore the PPSA will apply to such interests irrespective of other connecting factors outlined above. This avoids the need to determine the place of the property itself. The report recommends that Part 7.2 of the PPSA be amended to provide that questions relating to the validity, perfection and effect of perfection or non-perfection of a security interest over an intermediated security be determined by the law (other than the law relating to conflict of laws) of the jurisdiction in which the intermediary maintains the securities account[55].

There are a number of laws which could potentially govern interests and transactions in financial collateral, including the law of the place where:

1. the issuer of the security is incorporated;
2. the securities are registered;
3. the physical certificates (if any) are held;
4. the grantor is located or incorporated;
5. the book entry rights of the collateral taker are recorded;
6. the collateral taker is located or incorporated;
7. the transaction took place; or
8. the parties agree its governing law applies.

[55] B Whittaker *Review of the Personal Property Securities Act 2009 - Final Report*, (Commonwealth of Australia, 2015)

All these approaches become difficult to apply in the context of financial collateral which is typically intermediated, dematerialized and also held in portfolios. Applying any individual test above to a portfolio would lead to multiple different laws applying to the same investment account between the one holder and its intermediary. It arguably then becomes impossible to determine with certainty how to effectively pledge such a pool of securities according to all the potentially applicable laws (which change with each trade).

The common law position was to apply the *lex situs*[56] or the law of the place of the security which generally produced clear outcomes in the case of direct holdings (eg by reference to the location of certificates in the case of bearer securities, or the register or place of incorporation in the case of uncertificated securities). As indicated above, determining the *situs* of securities in holding systems that involve intermediaries gives rise to acute difficulties and much of the case law on the issue remains uncertain[57].

As a result measures have been adopted in various jurisdictions (largely since the *Macmillan* decision in 1996 which alerted the financial and regulatory community to the uncertainties). From the perspective of formulating an Australian approach, the most relevant are the Hague Securities Convention, the EU SFD and FCD and the United States' UCC Article 8.

UCC Article 8

The solution in UCC Article 8 for indirect securities is to apply the law of the jurisdiction of the intermediary from whom the investor holds the relevant 'security entitlement'. The relevant provision (§8-110(b)) states that the local law of the intermediary's jurisdiction governs:

1. the acquisition of the security from the intermediary;
2. the rights and duties of the intermediary and the investor arising out of a security entitlement;
3. whether the intermediary owes any duties to an adverse claimant to a security entitlement;
4. whether an adverse claim can be asserted against a person who acquires a security entitlement from an intermediary or a person who purchases a security entitlement or an interest from an investor.

To determine the intermediary's jurisdiction, UCC Article 8 specifically excludes location of certificates, jurisdiction of incorporation of the issuer and location of data or record keeping from the analysis.

The jurisdiction of the intermediary is determined by reference to (§8-110(e)):

[56] *Macmillan Inc v Bishopgate Investment Trust plc* [1996] 1 WLR 387 adopted the law of the place of the underlying securities as the relevant test but was then split on whether place of incorporation or the place of registration applied in determining the situs the underlying share.
[57] Ibid; *Re Harvard Securities* [1997] 2 BCLC 369

1. the governing law of the agreement between the investor and the intermediary;
2. if there is no governing law, the jurisdiction of the location of the office where the agreement states the account will be maintained;
3. if neither of the above apply, the jurisdiction stated in account statements as serving the investor's account; or
4. if the above do not apply, jurisdiction of the office of the Chief Executive Office of the intermediary.

UCC Article 8 rules are often equated with the Place of the Relevant Intermediary Approach or 'PRIMA' a variant of which is also adopted in the Hague Securities Convention. A difference arises as to how to determine the place of the relevant intermediary itself. EU Member States have traditionally opposed the US approach of allowing parties to choose any jurisdiction (referred to in paragraph 1 above)[58]. Their concern presumably arises in view of the fact that English or New York law will generally then govern most arrangements given market documentation is so often governed by either English or New York law.

EU Directives

The EU has provided in Article 9(2) of the EU Settlement Finality Directive for PRIMA but locates the relevant intermediary by reference to the Member State where the register, account or centralised deposit system is located. Article 9(2) does not permit the parties to elect to apply the law of a particular state in the account agreement. Article 9(1) of the Financial Collateral Directive adopts the same approach.

The Hague Securities Convention

The Hague Securities Convention however also adopts PRIMA but enables the parties to choose a law to govern issues under the Hague Securities Convention but as a compromise to EU delegates, the right to choose is subject to the proviso that it is the law of a state in which the intermediary has an office that is involved in maintenance of securities accounts[59].

The Hague Securities Convention is a pure conflict of laws convention and does not prescribe any substantive rules governing interests in securities (which remain subject to the rules of the differing domestic systems). It only applies to issues relating to securities held with an intermediary and specifies that the law determined by the PRIMA will govern:

[58] Companies and Securities Advisory Committee, *Jurisdictional legal risk for Collateral Securities*, May 2000
[59] Convention of 5 July 2006 on the Law Applicable to Certain Rights in Respect of Securities held within an Intermediary, *Hague Securities Convention*, Article 4.

1. the legal nature and effects against the intermediary and third parties of crediting securities to an account or their disposition;
2. classification of rights as contractual or not once credited to an account (to the extent relevant under the substantive law);
3. perfection requirements;
4. whether an interest distinguishes or has priority over another person's interest (including a good faith purchaser)
5. whether the intermediary has any duties to a person other than an account holder (including in relation to attachments on an account holders interest from a tier higher in the intermediary chain);
6. the requirements for realisation of an interest in securities held with the intermediary; and
7. whether a disposition extends to proceeds of sale or redemption or rights to dividends, coupons or other distributions.

The Hague Securities Convention does not determine the law applicable to purely contractual or other rights between the investor and the intermediary or the duties of an issuer or administrative party in connection with a securities issue. It also does not determine the regulatory regimes relating to the issue or trading of securities. The applicable insolvency laws are not impacted by the Hague Securities Convention (which applies to all of the above issues in relation only to pre-insolvency events). The question then, is to what extent should Australia adopt such choice of law rules and whether the time has come for inclusion of a similar regime in the PPSA?

The differences in approach between EU and US outline above may be the explanation for the limited implementation of the Convention which is currently inconsistent with the FCD and the SFD (as to voluntary choice of law). The Hague Securities Convention was adopted in 2002. The European Commission recommended in July 2006 that its Member States sign the Convention and support was indicated from Japan in 2011[60] yet, the Convention has only been ratified by Mauritius and Switzerland (in 2009). The USA signed the convention in 2005 but is yet to ratify it.

In Australia, the Companies and Securities Advisory Committee recommended in May 2000[61] that legislation be introduced to specify PRIMA for determining the law to be applied by an Australian court in any perfection of title matter involving a collateral giver (other than a registered securities holder) and a collateral taker. Like the EU approach the report recommended that the parties should not be permitted to determine the applicable law merely by agreement.

The committee also recommended that PRIMA should not extend to insolvency matters. A court in the jurisdiction of any insolvent party would still apply its own insolvency laws. This was said to overcome

[60] Wani, A. "Impact of the Hague Securities Convention on Market Practice – A Japanese Practitioner's View", <http://www.rikkyo.ne.jp/grp/ribls/symposium/2004hague/Wani.pdf>
[61] Companies and Securities Advisory Committee, *Jurisdictional legal risk for Collateral Securities*, May 2000, at p.7

the possibility of a collateral giver in Australia avoiding the insolvency provisions by transferring interests prior to their insolvency through an arrangement that would be governed by a foreign law under PRIMA principles.

The original exposure drafts of the Bill to enact the PPSA included governing law provisions for intermediated securities however these were removed between the first and second drafts. The Bill was then said to have been advanced on the basis that it would not comprehensively address intermediated securities, and that decisions on how Australia should legislate in relation to intermediated securities should be deferred until at least the conclusion of Hague and Geneva Securities Conventions. The recent review of the PPSA has recommended that the concept of intermediated securities be retained in the PPSA but further consultation be undertaken in relation to the laws applicable[62].

Adopting a PRIMA approach has the advantage that the focus on the intermediary in determining applicable law identifies one applicable law for a portfolio (notwithstanding the multiplicity of other jurisdictions that will have a nexus with the underlying collateral).

However where there are multiple intermediaries in a chain, there will still be differing laws applicable at each level and this has been difficult to reconcile in the look-through (or transparent) jurisdictions identified above (eg Germany or France). Given general trust law concepts underpin the Australian analysis, these issues should not arise. However, the PRIMA approach leads to different laws applying across the intermediary chain to effectively the same securities. This can cause difficulties in application where the PRIMA law at one level determines that an intermediary has no interest (eg in France). In that case, each intermediary at a lower level in the chain would be unable to assert by using a PRIMA analysis, rights under the laws applicable to lower tiers in the custody chain (eg trust interests requiring identifiable trust assets). Loss of interests at a point higher in the chain may in some cases thus render it impossible to assert the relevant interests under a different law lower in the chain.

The difficulty in predicting the effect of these interactions with substantive securities and other laws (corporate, property, tax etc) at each level in a chain of holdings and the fact that a unified global approach to choice of law questions has not yet emerged, may have impeded the ratification of the Hague Securities Convention. This appears to have stalled the inclusion of a governing law regime for intermediated securities in the PPSA.

However the rapidly changing way in which securities are held, traded and settled arguably requires that states modernise their laws. Unfortunately while the EU and US have implemented differing schemes, issues as to which scheme Australia should introduce (or whether a scheme is required at all) remain.

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[62] B Whittaker *Review of the Personal Property Securities Act 2009 - Final Report*, (Commonwealth of Australia, 2015)

What should Australia's substantive law be?

Once a choice of law regime is adopted which points to Australian law to govern a given situation, further questions arise as to what those substantive laws should be. For example where the relevant intermediary is in Australia, how would Australian law (and in particular the PPSA) resolve the issues addressed by Hague Securities Convention referred to above?

Having regard to the unique nature of financial collateral (dematerialised, intermediated, immobilised, and intangible) and the importance of:

- maintaining liquidity;
- the need to protect the interests of the good faith third party; and
- the sometimes inconsistent need to protect investors' interests against the insolvency or actions of the intermediary,

a number of jurisdictions have enacted various concessions and removed requirements in respect of financial collateral which are otherwise applicable to security generally. Under the Geneva Securities Convention and the EU FCD these approaches are relevant to whether Australian law and in particular the PPSA should adopt similar changes. The policy need for such changes, the scope of application, and whether they improve legal certainty or reduce transaction costs at all remains a point for debate[63] and may explain the limited uptake of the Geneva Securities Convention.

Geneva Securities Convention

The Geneva Securities Convention represents an international attempt at clarifying the rights of holders of intermediated securities. In some respects, the Convention goes much further than the existing codifications. In particular, it deals with an investor's rights in the event of insolvency in an upper tier of the intermediary chain. It also deals with a custodian's right of re-hypothecation and re-use of existing collateral, a matter also currently regulated in Australia by the general law and which is an important component in prime broking arrangements.

Whereas the Hague Securities Convention addresses private international law concepts in setting out a uniform choice of law regime for intermediated securities, the Geneva Securities Convention addresses 'substantive law' matters. In effect these regulate how a security is dealt with (and historically have been dealt with) by the law of the place of the security (as described above, eg *lex situs* or PRIMA) in contrast to 'intrinsic law' matters which relate to rights under the security itself (eg against the issuer for non-payment) which are dealt with by the law of the place of incorporation. Substantive law rights focus on dealing with the security. Addressing these, the Geneva Securities Convention sets out:

[63] L Gullifer, *What do we do about Financial Collateral? Current Legal Problems* (2012) 1-34; Eva Miceler LSE Law, *Intermediated Securities and Legal Certainty, Society and Economy Working Papers 3/2014*, London School of Economics and Political Science Law Department

1. the rights resulting from the credit of securities to a securities account;
2. methods to transfer securities and to establish security and other limited interests in the securities;
3. the rules regarding the binding nature of instructions to make book entries and the finality of those book entries;
4. rules to prevent "upper-tier attachment" which in effect adopts the UCC Article 8 approach of disconnecting claims;
5. a priority ranking among competing interests with respect to securities;
6. rules to protect a good faith acquirer of securities from adverse claims;
7. the rights of the account holder and the responsibilities of the intermediary in the event of insolvency;
8. a regime for loss allocation; and
9. the nature of the relationship between collateral providers and collateral takers where securities are provided as collateral.

At present despite there being 40 negotiating states and the Geneva Securities Convention being adopted on 9 October 2009, only Bangladesh has signed the treaty.

However, having regard to Australia's progression towards a framework for intermediated securities, a view of the effectiveness of the Geneva Securities Convention and potential reasons for its limited uptake are set out below.

The aim of the Convention is to protect persons who acquire or otherwise hold intermediated securities.[64] As discussed below, in many circumstances these are inconsistent objectives. For example, a holder and a third party acquirer cannot both be protected if the intermediary transfers an intermediated security without authority. The Convention states that is it designed to reduce legal risk, systemic risk and associated costs in relation to domestic and cross border transactions involving intermediated securities[65]. The Commentary to the Convention does not identify the particular legal uncertainty given provisions are drafted to address. The Commentary suggests that the process of settling the Convention involved delegates looking to preserve their national systems rather than addressing legal or systemic risk specifically[66]. Example is made of the French and German delegates taking this approach. Spain and Argentina's submissions also specifically referred to the need to preserve their own registry systems and local law book entry transfer rules without consideration of global conformity or legal risk generally. It has been speculated that the "national delegations were mindful to preserve the business interest of their respective national industries"[67].

The drafting process for the Convention had originally contemplated two documents, one addressing the uncertainties in cross border intermediated structures and the other providing a set of best practice standards to enable national systems to improve their own rules[68]. However this process was not

[64] Geneva Securities Convention, above n 14, Recital 2.
[65] Geneva Securities Convention, above n 14, Recital 3.
[66] E Micheler, Intermediated Securities and Legal Certainty, LSE Law, Society and Economy Working Papers 3/2014 London School of Economics and Political Science Law Department.]
[67] Ibid, 11-12.
[68] Ibid 12, UNIDROIT 2003, Study LXXVII – Doc 11]

ultimately adopted. There was no process to benchmark the changes under the Convention against the criteria of legal certainty, systemic risk or efficiencies in the market.

Furthermore, the Convention process did not consider whether through modern technology it would be possible to remove the need for intermediation altogether (returning the investor to its original bilateral relationships with issuers). An interesting development in the G20[69] response to the GFC has been to mandate the use of Swap Execution Facilities (known as SEFs) to remove intermediation in the OTC derivatives market is a specific acknowledgement of the power of technology to connect market counterparties and record their dealings. This reform will substantially rewrite the manner in which swaps are entered into and has the potential to disintermediate the financial sector (which was part of the policy objective). It is indicative of how substantial reform can be achieved with technology. Central Counterparty Clearing is also being mandated for OTC derivatives but in contrast novates bilateral arrangements to the clearing house. The legal nature of this intermediation is underpinned by the governing laws of the contracts (without property concepts intervening).

This is relevant in terms of Australia formulating its own framework and the extent to which the Geneva Securities Convention can be viewed as a starting point. As indicated in Part 3 the Australian CHESS system for holding shares does not involve intermediation in the sense that the Convention is seeking to address. Therefore whether it is necessary implement the Convention in its current form or something similar in Australia is open to debate. It may be that to improve legal certainty, including a choice of law regime in the PPSA is a greater priority.

The Geneva Securities Convention adopts a functional approach and does not attempt to rationalise the differing existing approaches and rules surrounding intermediated securities. This was necessary as the Convention drafting process had multiple national agendas to accommodate. An Australian substantive law framework need not be so affected (assuming choice of law rules are clear).

A functional approach is consistent with the approach in the PPSA. The functional approach in the global context has been criticised and may explain why the Convention has only been signed by one country. The Convention prescribes the outcomes that are required to be implemented pursuant to local legislation. Therefore each of the adopting states will need review its existing laws and national approaches and amend as required. Unfortunately difficulties in reaching agreement on substantive points during the negotiation of the Convention resulted in many issues being left to 'non-convention' law[70]. As a consequence, the implementation requires each Contracting State to determine those matters which fall within or outside the concepts governed by Convention. For example the Convention does not affect any procedural or substantive insolvency law;[71] it is left to local law to determine where this divide lies. Examples of such laws are stated in the Convention (which in Australia would include

[69] At the *2009 Group of Twenty (G20) Pittsburgh Summit*, the Australian Government joined other jurisdictions in committing to substantial reforms to practices in over-the-counter (OTC) derivative markets.

[70] See UNDROIT, "Information for Contracting States in respect of the Conventions References to sources of law outside the Convention" S78B/CEM/2/Doc.2 (November 2011) as cited in Eva Micheler Eva Micheler, Intermediated Securities and Legal Certainty, LSE Law, Society and Economy Working Papers 3/2014 London School of Economics and Political Science Law Department, 14.

[71] Geneva Securities Convention, above n 46, Article 14(2).

our voidable preference rules[72] and the moratorium on appointment of an administrator[73] under the Corporations Act).

Similarly, concepts critical to the protection of the good faith acquirer (ie determination of constructive notice of prior interests or concepts of good faith itself) are left to local law. If we look at the Australian position on these elements, the PPSA sets out a regime for dealings with an intermediated security interest, but in relation to the acquisition of absolute rights in intermediated securities, purchasers may find they acquire that intermediated security subject to an existing security interest (if they have actual or constructive knowledge that the acquisition constitutes a breach of the security agreement which created the security interest in which case PPSA section 51(2) applies) unless the acquisition is in the ordinary course of trading in which case PPSA section 49 applies and the acquirer takes free of the security interest.

Further in taking a security interest over an intermediated security, there are elections left to Contracting States as to which of three possible methods of perfection[74] is adopted (which have flow on impacts in the remainder of the convention eg as to priorities). Again, this requires a detailed knowledge of the combined effect of these elections and the elements left to non-convention laws in multiple states to determine outcomes in any event.

The scope for differences to arise in implementation effectively requires the taker of security in a Contracting State to continue to have an understanding of the details of the regime in other relevant Contracting States. The outcomes are provided for but the conditions for their application and the limits of their operation will still be impacted by national implementation. It has been noted that "these notions will require further clarification at a national level and it is unlikely that they will be understood in the same way across the globe"[75]. The Convention itself cannot be implemented by simply incorporating its text[76] into local law due to its functional approach and this difficulty in implementation will impact Australia's own adoption in terms of achieving consistency with other Contracting States (to the extent that is a policy consideration) and attempting to conform to existing national laws (including the PPSA, trust laws, property concepts etc).

Having stepped through these difficulties, it can be seen that a resolution to adopt the Convention will not of itself address all of the issues Australia would need to consider in formulating a framework.

Although few nations have adopted the Convention, the EU FCD has been implemented in the EU and takes a similar approach[77]. In contrast to the Convention, the FCD also has been implemented as part of the regulatory architecture which includes a supranational interpretive governing body and court

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[72] See, eg, Division 2, Part 5.7B of the *Corporations Act 2001* (Cth).
[73] See, eg, Division 6 Part 5.3A of the *Corporations Act 2001* (Cth).
[74]Geneva Securities Convention, above n 46, Article 12(3) and Article 12(5).
[75] E Micheler, above n 69, 20.
[76] E Micheler, above n 69. Micheler notes Russia indicated it would be difficult for it to adopt the convention which would automatically become law as 'the terms and legal conceptions used in the draft Convention are unknown to the Russian law"citing UNDROIT 2006 – Study LXXVIII, Doc. 52, p1
[77] EU Directives differ to EU regulations in that leave it to the Member States to determine the content of the legislation required to implement the Directive.

system which might be expected to ultimately address some of the implementation issues holding back adoption of the Convention.

Other International Approaches - Financial Collateral Directive[78]

The FCD was introduced with similar aims to the Geneva Securities Convention outlined above, namely, attempting to establish a uniform regime to reduce barriers to the taking of effective security over financial collateral and to create a more secure legal framework for financial collateral. The reforms were settled and implemented in the early 2000's, before the financial crisis and the development of the Geneva Securities Convention. This early intervention was led in part by EU motivations to establish a single market more generally (which affects the applicability of some of the policy considerations relevant to Australia). The description below refers to the provisions as implemented in the United Kingdom in 2003[79] unless otherwise indicated.

The FCD defines financial collateral[80] as:

1. cash[81];
2. financial instruments[82]; and
3. credit claims[83].

These categories are not coextensive with intermediated securities but are covered here in the broader context of financial collateral (which may include intermediated securities). The FCD is considered by way of example of a cross border initiative to conform substantive rules on the types of collateral which policy makers have determined are crucial to common markets. Some of the provisions of the FCD which are directed at facilitating the taking of financial collateral in market transactions resemble those already contained in the PPSA. However but slight differences and the knowledge required to apply the PPSA may reduce their facilitative effect in cross border transactions.

In FCD is limited in scope and applies only to arrangements where one party is a:

1. public authority;
2. public sector body;
3. a central bank; or

[78] Directive 2002/47/EC on Financial Collateral Arrangements implemented in the United Kingdom by the Financial Collateral Arrangements (no.2) Regulations 2003.
[79] Directive 2002/47/EC on Financial Collateral Arrangements implemented in the United Kingdom by the Financial Collateral Arrangements (no.2) Regulations 2003.
[80] Article 2(1) Financial Collateral Directive.
[81] Referring to money credited to an account as opposed to banknotes.
[82] Shares in companies and other securities equivalent to shares in companies and bonds and other forms of debt instruments if these are negotiable on the capital market, and any other securities which are normally dealt in and which give the right to acquire any such shares, bonds or other securities by subscription, purchase or exchange or which give rise to a cash settlement (excluding instruments of payment), including units in collective investment undertakings, money market instruments and claims relating to or rights in or in respect of any of the foregoing.
[83] Pecuniary claims arising out of an agreement whereby a credit institution grants credit in the form of a loan (added to Art 2(1) of FCD in 1999).

4. a financial institution (defined by reference to other directives),

and the other party is any person other than a natural person[84].

The FCD applies to “financial collateral arrangements” which includes both traditional security[85] and title transfer[86] arrangements (eg repos and securities lending agreements).

The FCD is premised on financial collateral being ‘provided’ or the ‘provision’ of financial collateral, which is defined to refer to the financial collateral being delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker (or of a person acting on the collateral taker's behalf)[87].

The FCD is intended to remove procedural and substantive law differences between title transfer financial collateral and security financial collateral so as to allow them to take affect according to their terms.[88] This removes the constant need for parties to assess the risk of re-characterisation of their arrangements in different Member States (which lead to differing perfection and enforcement requirements)[89]. Given added concerns since the financial crisis and the collapse of Lehman Brothers in relation to the credit risk of the collateral taker, title transfer arrangements are becoming less accepted and such provisions also enable market participants to choose the substantive incidents of the relationship without enlivening the difficult question of characterisation of their relationship across multiple jurisdictions.

As the FCD is a directive, the Member States have discretion as to how to enact provisions in their national laws to give effect to its requirements. Therefore implementation differs substantively from country to country. Despite this, the directive is considered to have been a success[90]. The FCD is concerned to achieve uniformity between EU Member States, but even setting aside that policy goal, the substantive changes are designed to assimilate different types of financial collateral arrangements into a single regime to improve efficiency and legal certainty surrounding such collateral types. Australia could consider adopting similar concessions for intermediated securities which are crucial to market operations (eg between dealers or financial institutions) in any revisions to framework in the PPSA.

[84] Article 1(2) of Financial Collateral Directive, the Member States could opt out and include natural persons. The United Kingdom has not made this election.

[85] Art 2 (1)(c) of the FCD provides that a ‘security financial collateral arrangement’ means an arrangement under which a collateral provider provides financial collateral by way of security to or in favour of a collateral taker, and where the full or qualified ownership of, or full entitlement to, the financial collateral remains with the collateral provider when the security right is established.

[86] Art 2(1)(b) of the FCD provides that a ‘title transfer financial collateral arrangement’ means an arrangement, including repurchase agreements, under which a collateral provider transfers full ownership of, or full entitlement to, financial collateral to a collateral taker for the purpose of securing or otherwise covering the performance of relevant financial obligations.

[87] Art 2(2) of the FCD which further provides that any right of substitution, right to withdraw excess financial collateral in favour of the collateral provider or, in the case of credit claims, right to collect the proceeds thereof until further notice, shall not prejudice the financial collateral having been ‘provided to the collateral taker’ as mentioned in the FCD.

[88] Art 6 of the FCD.

[89] Title transfer arrangements did not require registration (which in part explains the prevalence of the English law title transfer Credit Support Annex (‘CSA’) as opposed to the Credit Support Deed or New York law governed Pledge.

[90] The European Commission issued an evaluation report on the FCD in 2006. The report concludes that the Directive has made the use of financial collateral and the enforcement of collateral obligations simpler and more efficient. Internal Market and Services Commissioner McCreevy said: "The past few years have seen a spectacular increase in the cross-border use of financial collateral, making EU financial markets even more liquid and integrated. Investors can now access funds more efficiently, and credit institutions can provide lending more efficiently. The introduction of the Financial Collateral Directive three years ago has contributed to this success, which is why I am now open to extending its scope to include other types of collateral." Before it was extended to credit claims in 2009.

Whether the PPSA should be amended in this way will depend on the relative weight given to the policy need to conform to global rules. For example, if changes are made with the policy goal of improving liquidity and legal certainty specifically in cross border markets, the more focussed task may lead to different changes.

The FCD requires Member States to enact "rapid non-formalistic" enforcement procedures which will limit contagion effects in the event of default by one of the parties to an arrangement. Member States may not make the creation, perfection, validity, enforceability or admissibility of a financial collateral arrangement subject to any formal act. Member States are also required to ensure that the collateral taker is able to realise financial collateral in one of the following ways:

- **for cash**: by setting off the amount against or applying it in discharge of the relevant financial obligations;
- **for financial instruments**: by sale or appropriation and by setting off their value against, or applying their value in discharge of, the relevant financial obligations;
- **for credit claims**: by sale or appropriation and by setting off their value against, or applying their value in discharge of, the relevant financial obligations.

Member States are responsible for ensuring the right of use of financial collateral and for ensuring that a financial collateral arrangement can take effect in accordance with its terms. Member States must recognise the applicable close-out netting provisions, even if the collateral taker or provider is subject to winding-up proceedings or reorganisation measures. Equally, the application of close-out netting provisions may not be blocked by any purported assignment, judicial or other attachment, or other disposition in respect of such rights.

The Directive also stipulates that certain insolvency provisions do not apply.

The Directive also lays down provisions applicable in the event of a conflict of laws adopting PRIMA but as discussed above, without accepting the American formulation or more limited Hague Securities Convention approach to allow choice of the relevant law in the agreements between the parties.

The FCD removes a number of traditional requirements which have developed as part of the general law relating to the taking of collateral. The rules which have been altered for financial collateral principally fall into the following categories[91]:

1. Formal requirements for the creation of financial collateral arrangements;
2. Requirements for the perfection of the interest transferred under a collateral arrangement;
3. Rules regarding re-hypothecation or rights to reuse the collateral;
4. Rules impacting close out netting;
5. Enforcement procedures and rules applicable on Insolvency.

[91] L Gullifer, above n 66, 1-34.

Many of these rules were founded in policy considerations relevant to collateral and protection of grantor, the collateral taker and the good faith acquirer in the context of securities law generally. Looking at each of these changes in detail and the issues surrounding alteration for financial collateral:

1. Formal Requirements

Art 3 of the FCD requires the removal of all formal requirements for the creation, validity, perfection, enforceability or admissibility in evidence of a financial collateral arrangement (or the provision of collateral under such an arrangement) other than the requirement to evidence the arrangement in writing. A similar result is already achieved by the PPSA but only upon reading a number of provisions together[92] which in itself may limit the legal certainty available to cross border security takers.

2. Perfection requirements

Australia has recently revisited its requirements for perfection and publication of interests in personal property under the PPSA. The FCD removes the requirement for financial collateral arrangements to be registered. Similarly section s.21(2) of the PPSA also provides for perfection of a security interest in an intermediated security by control. However this does not extend to proceeds under s.33 of the PPSA which will require registration to be undertaken within 5 business days to maintain perfection under s.33(2) (eg if the intermediated securities are sold). Local law advice would need to be obtained to meet these perfection requirements hampering cross border transactions (a uniform concept of control may otherwise have allowed without enquiry).

In Australia an analysis must also be undertaken as to whether a financial collateral arrangement is a circulating security interest. Intermediated security unlikely to be a circulating asset within s.340(1)(b) of the PPSA. Again, these questions would need to be determined by the collateral taker in any cross border transaction to which the PPSA may apply.

The removal of the registration requirement has been accepted by Member States having regard to the "possession and control" requirement of the FCD.

Possession and control is not defined[93] (although in 2010 the FCD was amended to make clear rights to substitute collateral by the grantor are not inconsistent with control in the collateral taker).

However in an example of the difficulties in framing cross border responses to legal uncertainty, this has introduced particular issues in the United Kingdom as to whether a floating charge holder

[92] For example, reading together ss. 20(1)(b)(ii), 21, 254 and 263 of the *Personal Property Securities Act 2009* (Cth).

[93] In *Gray v G-T-P Group Ltd* [2010] EWHC 1772 the court construed the meaning of in possession and control narrowly requiring a high degree of control to qualify as a 'security financial collateral arrangement'. Administrative or practical control of the collateral is not sufficient to establish possession or control. A failure to achieve the required degree of control carries a risk that the security interest will be void against a liquidator or administrator for lack of registration (if it were assumed that the security was subject to the FCD. It would also cause the collateral taker it to lose the benefit of the rights of use, appropriation, and enforcement on insolvency and close out netting under the FCD).

has ‘control’. The concept has introduced interpretive risks in one jurisdiction which Member States will need to evaluate and accept adding to cross order risks in any event[94] similar to those outlined above under the PPSA. The difficulties are such that it is not clear that margin provided to a clearing house in the United Kingdom is within the coverage of the FCD (despite the 2010 amendments catering for top up and substitution of securities)[95]. For financial collateral arrangements to which the PPSA may apply, a separate analysis of the control tests for intermediated securities in section 26 of the PPSA would need to be undertaken in respect of an security to which the PPSA may apply.

As a result, registration is typically undertaken notwithstanding the concession in the FCD (given the consequence of non-registration is invalidation of the security against the liquidator). On this basis it has been argued that registration itself may not be an impediment to market operations and liquidity and that “on a cost/benefit analysis[96] we could say that there are not good reasons for dis-applying the rules. This most important thing is that the position is certain”[97]. In Australia, advice in firms has also been to undertake protective registrations despite the control test due to s.33(2) of the PPSA referred to above.

Therefore as a policy matter any Australian framework will need to weigh such outcomes (including the prospect of precautionary registrations which are already prevalent under the PPSA) against the policy reasons for publication of security interests. EU policy is also concerned to achieve uniformity between Member States. Australia will not be as constrained by multistate considerations[98].

3. Right of Use

In order to ensure that title transfer securities and other security financial collateral arrangements are functionally equivalent thus sparing markets the need to address issues as to characterisation and title in each Member State, the FCD requires Member States to ensure that a collateral taker is entitled to exercise a right of use (or re-hypothecation) provided for in the financial collateral arrangement[99].

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[94] In *Re Lehman Brothers International (Europe) (In Administration)* [2012] EWHC 2997 (Ch) it was held that even where a collateral taker is holding the collateral this alone is insufficient and the control exercised by the collateral taker must be such that the collateral given is taken to have been “dispossessed” of the collateral. This expression is used in recital 10 of the preamble to the FCD.

[95] See Financial Markets Law Committee (FMLC) comments in Part 5 below.

[96] This is so especially where the registration process and cost has been made more efficient in the United Kingdom recently and in Australia under the PPSA.

[97] Gullifer, above n 66, 16.

[98] An attempt has already been made to address the differences in registration requirements between title transfer and other security by applying an ‘in substance’ security test under PPSA. However the application of the test is not always clear; nor is the extent to which prior law is relevant to the characterisation of a PPSA security interest (given the functional approach behind the concept).

[99] Article 5 of the Financial Collateral Directive.

It provides that where a collateral taker exercises a right of use, it incurs an obligation to transfer equivalent collateral to replace the original financial collateral at the latest on the due date for the performance of the relevant financial obligations covered by the security financial collateral arrangement. This concept is not addressed by the PPSA expressly[100], however in view of the rationale to conform the incidents of financial collateral arrangements without invoking difficult local law re-characterisation issues (as to security verses transfer), a right of use regime might be considered.

Interestingly, in the case of collateral granted other than by way of title transfer, conceptually any a right of use regime will require a review of Australian policy considerations relevant to foreclosure remedies and clogs on the equity of redemption (which arguably case law is already progressing[101]). The protections still available at general law or under the PPSA to the account holder/investor against the collateral taker (albeit potentially limited by the concept of unconscionability) complicate right of use concepts where a security arrangement is characterised other than as a title transfer arrangement. To assist cross border analysis, removal of this re-characterisation risk is often recommended. The PPSA has gone some way towards this by including title transfers as potential security interests in section 12. However the exclusion of title transfer arrangements which constitute close-out netting contracts under the *Payment Systems and Netting Act 1999* in section 8, still requires cross border collateral takers to analyse very specific aspects of Australian law.

As indicated above, a cross border context may determine the ambit of any revised framework to accommodate financial collateral. For example, it will be easier to remove protections provided against clogs on the equity of redemption to enable a universal recognition of rights of use, if this is limited to banks and participants in wholesale financial markets. Where any financial collateral regime extends to margin lending to individuals, the general law position may be preferred[102].

Any substantive reform of the rules relating to intermediated securities or financial collateral will need to address the approach on re-hypothecation and right of use given the aim of any regime to protect the good faith acquirer and while setting out the rights held by the account holder.

4. Close out Netting

Consistent with the approach in relation to right of use, the FCD ensures that close out netting (contractual or statutory) is protected: (i) in the case of insolvency (opening of reorganisation or winding-up proceedings); and (ii) against judicial or other attachments. Given title transfer

[100] Enforceability of such provisions in a contract may be assisted by reference to s.18(1) of the PPSA (subject to s. 254 of the PPSA). See also *Lift Capital Partners Pty Ltd v Merrill Lynch International* [2009] NSWSC 7.
[101] *Lift Capital Partners Pty Ltd v Merrill Lynch International* [2009] NSWSC 7 acknowledged the need to ascertain whether equity must regard the relevant clauses allowing re-hypothecation as having an unconscionable operation in favour of the collateral taker, procured by unconscionable conduct the collateral taker, and therefore as imposing an impermissible fetter upon the right of each client defendant to redeem its mortgaged shares. The clauses were therefore held to be to that extent inoperative and void (at [151]).
[102] Above n 104

arrangements typically rely on a set off of the obligation to redeliver equivalent securities against a transferor's debts to the collateral taker, as the main means of enforcement, such protections have successfully advanced legal certainty in cross border situations.

Australia's *Payment Systems and Netting Act 1999* adopts a similar approach and is based on a model law directed at removing legal uncertainty. Therefore policy considerations relevant to this aspect of financial collateral might seem settled given the degree of cross border conformity and consistency of outcomes the model netting acts create. However recent moves to include a short 24-48 hour moratorium on netting and set off against financial institutions[103] in a number of jurisdictions to limit contagion and allow for an orderly resolution of claims may yet yield new avenues of difference undermining legal certainty when it is most needed.

These moratorium proposals are counter to the general aims of the FCD and in some respects the original policy considerations for singling out financial collateral for different treatment (eg liquidity and speed of enforcement). As a result, any attempt to formulate a framework for intermediated securities may need to await the results of bank resolution reforms (currently being considered by the Australian government)[104].

5. Enforcement procedures and rules applicable on insolvency

As noted above the critical feature of financial collateral and its importance to regulators as a risk mitigation tool in financial markets is its liquidity. Rapid enforcement is key having regard to price sensitivity to changes in market conditions. In the case of financial collateral where there is a market and an assumed means to instantly obtain an arm's length price, removal of barriers to enforcement (imposed largely to ensure fair market value on enforcement) are arguably justified (although this justification is not quite so clear in the case of credit claims now covered by the FCD[105]). Chapter 4 of the PPSA also sets out an enforcement regime for PPSA security interests with a number of the procedural provisions being disapplied for intermediated securities under s.109(3). However the specific nature of financial collateral in terms of liquidity and risks associated with delays in enforcement may require further changes. For example to remove the moratorium applicable on the appointment of an administrator[106] for collateral takers without security over the whole or substantially the whole of the grantor's assets.

As indicated above, set-off and netting are also supported by the FCD. The FCD also requires Member States to protect financial collateral from certain insolvency rules including in relation to

[103] *Financial Sector Amendment (Netting Contracts) Bill 2013* (Cth). See also ISDA submission on Bill consultation by letter dated 23 June 2014.
[104] *Strengthening APRA's Crisis Management Powers:* Consultation Paper, Commonwealth of Australia, (Treasury 2012) Canberra; and Recommendation 5 of *Financial System Inquiry Final Report,* Commonwealth of Australia (November 2014)
[105] D Turing, *Red Hot or Red Herring*, (2007) 5 JIBFL 254.
[106] Above n 78

stays or freezes[107]. These reforms have been thought necessary to ensure the goal of preserving liquidity and uniformity[108], however as indicated above, post GFC considerations relevant to bank resolution, may result in stays being reintroduced in where counterparties are financial or systemically important institutions.

These policy positions may prove difficult to reconcile going forward if financial collateral is impacted by bank resolution reforms. Such reforms will also make the need to have settled choice of law rules all the more pressing.

Part 5

Significance of the Issue for Banking Regulation

Financial collateral is relied upon in the BASEL III capital adequacy regime for credit risk mitigation, the management of liquidity and central bank open market operations (via repos). It also forms a key part of the reform of OTC derivatives markets following the GFC. As a result financial collateral is likely to become more prevalent and the gross amount will increase substantially leading to a continued focus on how legal uncertainty can be addressed. The question remains whether intermediated securities or financial collateral more generally should be singled out (including under the PPSA) for a different treatment having regard to its growing importance to the operation of markets, the need for certainty across borders and the original policies behind laws governing the validity, perfection and effect of perfection of securities.

The Financial Markets Law Committee (FMLC) has sent a letter[109] to the UK Treasury detailing the effect of the legal uncertainties in the FCD. Similar uncertainties arise in under the PPSA. As an example of the uncertainties which still arise even where a comprehensive functional approach to the reform of law on financial collateral has been implemented, the FMLC notes the following issues:

- **Registration**: Local law issues remain in the United Kingdom as to what collateral arrangements are required to be registered even where control is introduced as a means of perfection (as it is under the PPSA) despite efforts to mandate uniform laws. The meaning of control will differ between states as will the extent to which a security will be taken to have been perfected (e.g. is the security perfected in respect of proceeds?[110]).

[107] Article 8 of Financial Collateral Directive.
[108] Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (October 2011); An update was published in October 2014: <http://www.financialstabilityboard.org/2014/10/r_141015/>
[109] *Letter to HM Treasury on the Impact of Uncertainty Regarding the meaning of "Possession", "Control" and "Excess Financial Collateral" under the Financial Collateral Arrangements (No 2) Regulations 2003 (13 April 2015)* <http://www.fmlc.org/uploads/2/6/5/8/26584807/letter_to_mr_richard_knox_(hmt)_regarding_fcars.pdf>
[110] See s.33(2) of the PPSA. Interestingly a similar problem arises in the context of the *Convention on International Interests in Mobile Equipment* (the Cape Town Convention), where proceeds are dealt with under the PPSA but not the Cape Town Convention requiring local law differences despite the uniform laws.

However without possession and control concepts, it is not clear that current policy objectives would support the removal of a registration requirement altogether. To avoid having to determine registration requirements (irrespective of whether an arrangement is subject to the FCD) the market tendency may be to rely on title transfer arrangements[111] or, to the extent choice of law rules are clear on laws governing perfection, register out of caution. As the next point demonstrates, these options are not always available to address the uncertainty.

- **Impact on derivatives markets**: The G20[112] reforms of OTC derivatives markets mandate the clearing of swaps. Rules have been developed for the recommended collateralisation of Central Counterparty Clearing Houses (or CCPs[113]). Exposures to a qualifying CCP incur lower capital charges[114] under Basel III rules. Similarly the new rules will require the provision of mandatory levels of margin (which will take the form of financial collateral) for uncleared swaps. Bankruptcy remoteness from the collateral taker will need to be a feature of these arrangements. Currently such collateral is generally provided pursuant to title transfer arrangements, however this will not meet bankruptcy remoteness requirements. Therefore it will become imperative that registration requirements for security financial collateral arrangements are clarified.

- **Legal opinions**: From the legal practitioner's perspective, these uncertainties give rise to acute difficulties as BASEL Accord capital treatments require financial institutions to hold written and reasoned legal opinions confirming bankruptcy remoteness, enforceability or for example, the qualifying status of a CCP. Legal uncertainties have prevented law firms issuing clean legal opinions, for example in relation to the availability of the protections available under the FCD or even in some cases whether the law governing the opinion in fact applies. This can affect how transactions are structured as the clean opinion is required for capital treatments which are determinative of the ultimate pricing of a deal.

Issues regarding intermediated securities are becoming more prevalent in practice as a result of the increased importance of collateral in financial markets. Difficult questions are often having to be addressed as to which laws govern issues even before it can be decided which jurisdictions need to be covered by the legal opinions regulatory capital treatments require. As a condition to joining a CCP as

[111] See footnote 89

[112] At the *2009 Group of Twenty (G20) Pittsburgh Summit*, the Australian Government joined other jurisdictions in committing to substantial reforms to practices in over-the-counter (OTC) derivative markets. Three of the key G20 commitments for OTC derivatives were the:

1. reporting of all OTC derivatives transactions to trade repositories
2. clearing of all standardised OTC derivatives through central counterparties, and
3. execution of all standardised OTC derivatives on exchanges or electronic trading platforms (SEF), where appropriate. See further: http://asic.gov.au/regulatory-resources/markets/otc-derivatives-reform/background-to-the-otc-derivatives-reform/

[113] Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO), Committee on Payment and Settlement Systems Technical Committee of the International Organization of Securities Commissions, *Principles for financial market infrastructures* (April 2012)

[114] APRA Prudential Standard, APS112, Attachment C, *Capital Treatment of Posted Collateral*, [26].

a clearing member, CCPs also require opinions canvassing these issues in relation to financial collateral which the participant would provide as margin. These opinions are rarely clean. Issues as to the location of an interest in an intermediated security arise in many contexts. For example, Australian requirements to register under the Corporations Act if carrying on business in Australia, can require a trustee or custodian to determine the location of assets they hold[115]. This can give rise to acute difficulties having regard to the trustee analysis (vs look through treatment) referred to in Part 3 above. Tax and accounting considerations are beyond the scope of this paper but also may hinge on legal advice as to the location of an intermediated asset (eg in structured finance transactions) which begs the question as to what the asset is (and which law decides).

Part 6

Conclusion

As can be seen from the above there are many policy issues to consider in attempting to develop an Australian framework in respect of intermediated securities or financial collateral more generally.

However the issues are relevant to the daily operation of markets and likely to become more so given the prevalence of financial collateral in post GFC reforms.

The PPSA does not address choice of law rules (possibly for reasons affecting the implementation of the Hague Securities Convention set out above). There are also a number of substantive law reform models in offshore jurisdictions which give rise to diverse policy (and commercial) considerations. The United States' UCC Article 8, Canada's implementation of similar rules, the Geneva Securities Convention, and the EU's FCD all attempt to achieve outcomes guided by a need to ensure the preservation of liquidity, systemic stability, legal certainty and, for the supranational reforms, uniformity. The outcomes of these initiatives may indicate the limits of law reform in addressing the legal problems caused by intermediation.

Australia will need to determine its relative policy priorities before adopting offshore models or developing its own framework.

Given the difficulty developing laws addressing intermediated structures, an option may be to embrace technological advances to disintermediate the markets (and limit further legal reforms of the kinds set out above). This has been the approach under the Target2 Securities project in Europe[116] and under the G20 reforms introducing SEF execution platforms for OTC derivatives (in a different context)[117].

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[115] Section 21(2)(b) of the *Corporations Act 2001* (Cth)
[116] European Central Bank, *T2S,* <https://www.ecb.europa.eu/paym/t2s/html/index.en.html>
[117] Above n 121

As has been seen from other regulatory reforms impacting financial market infrastructure[118], such projects can engender significant commercial interest from stakeholder intermediaries which may slow any reforms directed at reducing intermediation in any event.

In a sense, were substantial disintermediation to occur as a result of technological change, it would be a return to the bilateral issuer and investor relationships (which provided the original conditions for development of securities laws to begin with).

[118] Competition for clearing house mandates and licences across Asia Pacific jurisdictions has impacted the process and timing of reform, For example, see LCH Clearnet, *Submission to Review of Competition in Clearing Australian Cash Equities*, 28 March 2015.