TAKING SECURITY OVER DEMATERIALISED SECURITIES IN NEW ZEALAND – THE LAW AND THE CHALLENGES

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1. INTRODUCTION

1.1 There was a time when many securities were issued and traded in a physical form, with payments made to the holder of a certificate and trades executed by signing physical transfer forms. Belgian dentists would invest in bearer bonds, which they would take to a country with no withholding tax and receive a tax free, untraceable payment. Those days are now long gone, including in New Zealand. Very few securities are issued in a physical form, and trading most often takes place without any physical exchange of paper. Further, increasingly such securities are held through intermediaries.

1.2 These characteristics of modern securities present some real challenges for financiers and others wishing to enter into security arrangements with the holders of securities.

1.3 This paper examines how security can and should be taken over dematerialised securities in New Zealand. The paper is structured as follows:

(a) a description of what is meant by a dematerialised security, including a discussion of the common forms of dematerialised security and the effects of securities depositories and other arrangements involving intermediation;

(b) a brief description of the law governing security over dematerialised securities in New Zealand;

(c) an analysis of how security interests in dematerialised securities are created;

(d) an analysis of how security interests in dematerialised securities are perfected;

(e) a discussion of the challenges for a secured party in protecting against purchasers and other secured parties taking priority;

(f) a summary of uncertainties in the law and suggestions for reform; and

(g) a brief analysis of how conflict of laws issues are resolved.

2. DEMATERIALISED SECURITIES

2.1 In this paper I have adopted a wide definition of dematerialised securities, which is any securities that are not and cannot be held in bearer form. That is, securities in relation to which ownership is determined by reference to records in a register or account system rather than by reference to a physical certificate. Evidence of ownership of such a security may be provided by presenting a certificate, but holding such a certificate will not constitute ownership of the security - it will merely be evidence of what the relevant register or account system states.

2.2 Put another way, my working definition of dematerialised securities is any securities that are not bearer securities.

2.3 In New Zealand, most securities are dematerialised securities. In particular:

(a) Shares in companies are dematerialised securities, because the company's register is the definitive source of ownership of shares.[1] Although certificates may be issued by the company as evidence of ownership, it is still the company's register that determines ownership.[2]

(b) Almost all debt securities issued in New Zealand are dematerialised securities, because it is market practice for debt securities to be issued in registered, rather than bearer, form. Therefore, ownership of most debt securities in New Zealand will, as with shares, be determined by reference to a register, rather than by reference to a certificate of title.

2.4 It is common in New Zealand (as it is in many other jurisdictions) for a person to hold securities indirectly. That is, to hold them without being the actual holder of the legal title.

2.5 There are two main types of such indirect holding common in New Zealand. The first is through a securities depository and the second is through a custodian.[3]

Securities Depositories

There are two main securities depository systems in New Zealand. The first is the NZClear System and the other is a system operated by New Zealand Depository Limited, a subsidiary of NZX Limited (which I refer to in this paper as the NZX Depository System).

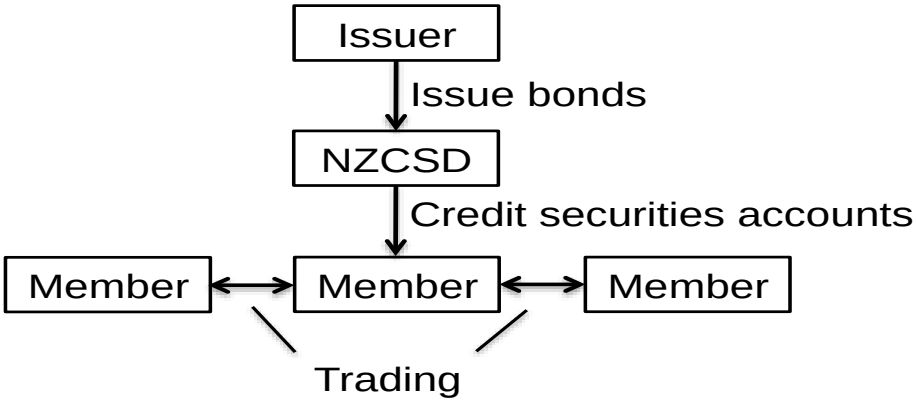
NZClear System

2.6 The NZClear System is currently operated by the Reserve Bank of New Zealand. When securities are lodged in the NZClear System, the legal title to those securities is transferred to New Zealand Central Securities Depository Limited (NZCSD), which is a wholly owned subsidiary of the Reserve Bank. Where the issuer maintains a register of holders, which will be in almost all cases, that register will show NZCSD as the sole holder. Within the NZClear System, the securities are credited to the accounts of NZClear members. Interests in those securities can then be traded between NZClear members by debits and credits in their securities accounts within the NZClear System. Such trades are generally referred to as trades of the securities, though technically they take place without any change in the legal ownership of the relevant securities.

2.7 The system is analogous in some ways to what happens to cash when it is deposited with a bank. The holder of the cash gives the cash up and instead receives an account receivable in the form of a bank account. Payments are then made in the banking system by the debiting and crediting of

[1] Technically section 89 of the Companies Act 1993 (Companies Act) only states that the share register is prima facie evidence of legal title, but there is no other source that overrides the register, and the remedy if a person can show that by law title has passed to another person is to have the register rectified.
[2] Under section 95 of the Companies Act, share certificates may be issued to shareholders, which may be used as evidence of ownership. However, they are not bearer securities. Transfer of ownership must be effected through a change to the register, and cannot be effected by a mere transfer of the share certificate.
[3] Technically a securities depository system involves the use of a custodian, but the reference to custodians here is to those that are not part of a securities depository system.

account balances, but the actual cash does not change hands. Similarly, securities can be traded in NZClear by crediting and debiting securities accounts of NZClear members, but at all times the legal title of the actual securities (which I will refer to as the "underlying securities" in this context and others involving intermediated securities) remains with NZCSD. However, despite the conceptual similarity, there is one very significant difference, which is that the NZClear members have rights in relation to the underlying securities (in contrast to cash deposited with a bank in which a depositor retains no rights). This is discussed in more detail below.[4]



2.8 The NZClear System holds about $200 billion of equity and debt securities traded by institutional investors.

2.9 In this paper, I refer to the account interests in NZClear (and other similar arrangements referred to below) as "intermediated securities" to reflect that the legal title in the underlying securities is held by an intermediary (in the case of NZClear, NZCSD).[5]

NZX Depository System

2.10 The NZX Depository System is a system operated by New Zealand Depository Limited. For all purposes relevant to this paper, it operates in much the same way as the NZClear System, with legal title in underlying securities vested in New Zealand Depository Nominee Limited (NZDN) or another entity appointed by New Zealand Depository Limited or NZDN. As with the NZClear System, members of the NZX Depository System can trade interests in securities within the system by debits and credits to their securities accounts without there being any change in the legal ownership of the underlying securities.

2.11 The NZX Depository System is generally used to hold and trade shares and derivatives quoted on markets operated by NZX Limited.

[4] As per the discussion below, despite a clear intention that NZCSD, and other nominee/custodians hold securities on trust for their account holders, there is some doubt about whether a trust does, in fact, exist.
[5] In Australia, "intermediated securities" is a term defined by statute. That is not the case in New Zealand, and the meaning given to it in this paper is a bit different from the meaning given to it in the Australian Personal Property Securities Act 2009, which refers to rights against an intermediary.

Custodians

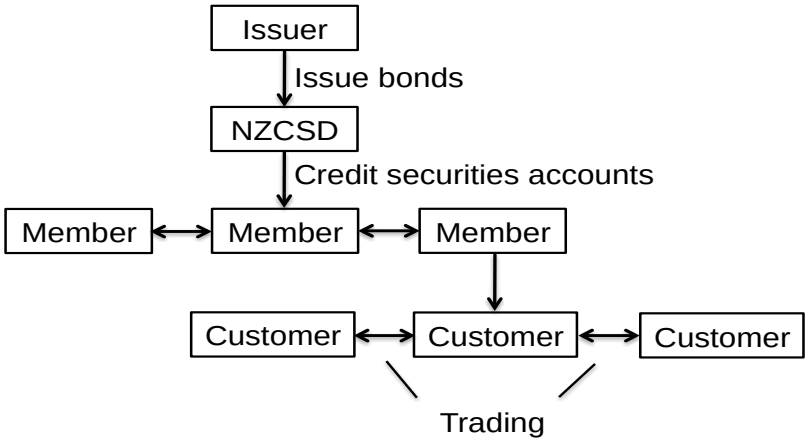
2.12 In some cases, securities are held for an end investor (who I refer to in this paper as the "ultimate holder" both in relation to securities depositories and custodial arrangements) outside a securities depository system, but still by a custodian. This is usually a similar ownership arrangement to the arrangement for securities held in the NZClear System or NZX Depository System in that the legal title to the securities is held by the custodian, but investors hold a beneficial interest in them.[6] In some cases, the custodian will permit trading between its customers, and will effect any such trading by changing the identity of the customer it holds for in its records. Again, this is very similar to the way in which the NZClear System and NZX Depository System work.

2.13 Custodial arrangements are used for many different reasons. For example, in some cases it is because the securities are difficult for the investor to hold because they are held through a clearing system that the investor is not a member of. Another example is that the custodian may also be engaged to manage the securities in a particular way, such as to meet regular margining requirements, and it is most efficient for the custodian to hold the securities for this purpose. Yet another example is as a way of clearly segregating the assets held in custody from other assets of the ultimate holder, such as where the ultimate holder is, itself, holding those assets on trust. For the purposes of this paper, however, the particular reason for a custodial arrangement to exist is not particularly significant.

Multi-level intermediation

2.14 It is relatively common for an ultimate holder to be more than one level removed from ownership of the underlying security. For example, the underlying security might be lodged in the NZClear System and the relevant account within the NZClear System might be held by an NZClear member that is, itself, a custodian. There could be further levels beyond this by virtue of the introduction of sub-custodians. To distinguish all of these arrangements, I refer to intermediated securities where the ultimate holder has a direct contractual relationship with the legal owner (as in the case of an NZClear member's holding) as first level intermediated securities and other cases as second level intermediated securities.

[6] Note the discussion in paragraphs 2.17 to 2.32 below about the uncertainty about whether a trust actually exists in some cases.



Nature of intermediated securities

2.15 For reasons that will become clear later in this paper, it is necessary to understand the nature of the property actually held by an ultimate holder of intermediated securities.

2.16 There are really two possibilities:

(a) The first possibility is that the custodian holds the underlying security on trust for the ultimate holder.

(b) The second possibility is that the holder of the intermediated security (the ultimate holder) has a mere contractual claim against the holder of the legal title in the underlying security (the underlying holder).

2.17 The first possibility is the one that is generally assumed. However, for this to be right there must be a valid trust and the existence of such a trust is not always clear.

2.18 The three essential requirements of a valid trust are:

(a) certainty of intention;

(b) certainty of subject-matter; and

(c) certainty of objects.[7]

Certainty of intention

2.19 Certainty of intention refers to the need for the settlor's intention to create a trust to be sufficiently clear. It is not necessary for the word "trust" be used but a clear substantive intention is required.[8]

2.20 In the case of intermediated securities, the satisfaction of this "certainty" must be assessed on a case by case basis. In the case of the NZClear System and the NZX Depository System, it requires an interpretation of the NZClear System Rules and the New Zealand Depository Limited Depository

[7] *Knight* v *Knight* (1840) 3 Beauv 148, 49 ER 58 (Ch) at 173 per Lord Langdale.
[8] See for example *Paul* v *Constance* [1977] 1 WLR 527.

Operating Rules respectively, as these govern the securities depositories' obligations in relation to underlying securities. In other cases it will depend on the specific custody agreement involved.

2.21 In the case of the NZClear System, there is clearly a certainty of intention. Rule 9.1.2 provides that, on lodging a security in the system, "such Security shall be deemed to be held by the System Operator as trustee for that Member". Rule 9.2 goes on to state that "The System Operator shall be managing trustee and appoints the Depository as the custodian trustee". Consequently, the Reserve Bank (as System Operator) is the managing trustee and NZCSD (as Depository) is the custodian trustee.

2.22 Similarly, in the case of the NZX Depository System, there is clearly certainty of intention. Rule 3.5.5 provides that when an "Admitted Product" is recorded in the account of a depository participant, it is "deemed to be held by CDO[9] and/or Nominee[10] as trustee" for the depository participant.

2.23 In relation to other custody agreements, an analysis must be undertaken on a case by case basis. Based on a scan of custody agreements I have worked with, all have, in some way, evidenced an intention to hold securities on trust, which is what one would expect in an arrangement in which a person purports to be a "custodian".

Certainty of subject-matter

2.24 The requirement for certainty of subject matter is a requirement that it be clear what property is the subject of the purported trust. This requirement can be quite troubling in the context of intermediated securities. The issue is that, in many cases, a custodian (including within a securities depository system) holds a group of securities that are not separately identifiable, and purports to hold different parcels of them for different underlying holders.

2.25 For example, in the NZClear System, if 1 million bonds are issued by Issuer A, there will typically be one entry on Issuer A's register, which records NZCSD as the holder of all 1 million bonds. There may then be ten NZClear members that each have 100,000 such bonds recorded in their accounts with NZClear, but there is no way of distinguishing which of the 1 million bonds each member holds.

2.26 In practical terms this usually has little significance, because the number of bonds held in accounts will match the total number of bonds on issue. However, when analysing whether there is a trust it raises the issue of whether there is sufficient certainty of subject-matter. Which 100,000 bonds are the subject of each trust?

2.27 This specific issue was considered (though not in the context of a securities depository) in the English Court of Appeal case of *Hunter* v *Moss*.[11] In that case there were 950 identical shares and a declaration of trust had been made in relation to 50 of them. The court held that the trust was valid and that the case could be distinguished from earlier cases with similar facts relating to tangible property in which there was found not to be certainty of subject matter. The case has

[9] New Zealand Depository Limited
[10] NZDN or another person appointed by New Zealand Depository Limited.
[11] [1994] 1 WLR 452 (Ch)

subsequently been argued to stand for the proposition that where property is intangible and fungible a trust over a specified amount of the property (albeit not separately identifiable) is possible.

2.28 This case provides a neat solution here, but unfortunately it has been heavily criticised and it is unclear whether it would be followed in New Zealand. It has been followed (though with some express reluctance) in the English High Court[12] and referred to without disapproval in the English Court of Appeal.[13] However, it was expressly not followed in the Supreme Court of New South Wales.[14] In New Zealand I am only aware of one reference in the case law, which was in the Court of Appeal case of *Proprietors of Wakatu* v *Attorney General*.[15] That case was distinguished from *Hunter* v *Moss* on its facts, but the court also expressed doubt about whether it was good law in New Zealand, noting that it had not been followed in Australia.

2.29 Despite these issues with *Hunter* v *Moss*, the alternative view advanced in Australia in *White* v *Shortall* did still find there was a trust in such circumstances. In that case it was held that all of the intangible fungible property was held on trust in proportions that reflected the intended trust(s). As with *Hunter* v *Moss*, this approach has also faced some academic criticism. However, such criticism has typically suggested other ways in which the same result could be reached. In light of this, it seems likely that, when faced with such a clear intention to hold securities on trust as is typically presented with intermediated securities, a New Zealand court would interpret a trust as having been created, whether by following *Hunter* v *Moss* or otherwise.

2.30 Consequently, I believe that a New Zealand court would find a trust to exist despite the potential lack of certainty of subject matter. However, the matter is not clear.

Certainty of objects

2.31 The requirement for certainty of objects refers to the need for it to be clear who the beneficiaries of the trust are. This will not be an issue for intermediated securities.

Conclusion on trusts

2.32 On balance I believe that a trust would be held to exist where there were intermediated securities under which the underlying securities were expressly held on trust for the ultimate holders. However:

(a) this will be dependent on the terms of the specific custody arrangements, and there is a possibility that in some cases there will be no trust because of a lack of intention to create one; and

(b) there is a possibility that a court would find that there was no trust because of a lack of certainty of subject matter where the custodian held more of a particular security than was credited to a specific ultimate holder.

[12] *Re Harvard Securities Ltd* [1997] EWHC Comm 371, [1997] 2 BCLC 369
[13] *Re Lehman Brothers International (Europe)* [2010] EWCA Civ 917 per Lady Justice Arden at para 167
[14] *White* v *Shortall* [2006] NSWSC 1379
[15] *Proprietors of Wakatu* v *Attorney General* [2015] 2 NZLR 298

2.33 If there is no trust, then an ultimate holder merely holds *in personam* contractual rights against the custodian (or, in the case of a securties depository, generally against the system operator).

3. WHAT LAWS GOVERN SECURITY OVER DEMATERIALISED SECURITIES IN NEW ZEALAND?

3.1 In New Zealand, security in personal property is governed by the Personal Property Securities Act 1999 (PPSA), and securities, including dematerialised securities, are personal property.

3.2 Personal property is defined in section 16 of the PPSA as including "chattel paper, documents of title, goods, intangibles, investment securities, money, and negotiable instruments".

3.3 All dematerialised securities fall within the definition of "investment securities", but the application of that definition to the specific rights of an ultimate holder raises some issues. That application is discussed below.

What is an investment security?

3.4 The term investment security is defined as follows:[16]

> ***investment security-***
>
> *(a) means-*
>
> *(i) a writing (whether or not in the form of a security certificate) that is recognised in the place in which it is issued or dealt with as evidencing a … share, right to participate, or other interest in property or an enterprise, or that evidences an obligation of the issuer, and that, in the ordinary course of business, is transferred or withdrawn by-*
>
> *(A) delivery with any necessary endorsement, assignment, or registration in the records of the issuer or agent of the issuer, or by compliance with restrictions on transfer or withdrawal; or*
>
> *(B) an entry in the records of a clearing house or securities depository; or*
>
> *(C) an entry in the records maintained for that purpose by or on behalf of the issuer; or*
>
> *(D) an entry in the records maintained for that purpose by or on behalf of the nominee:*
>
> *…*

3.5 There are three limbs to this definition:

(a) Is there a writing?

(b) Does that writing evidence one of the required things (eg a share)?

[16] Section 16 of the PPSA.

(c) Is the property transferred or withdrawn (in the ordinary course of business) in one of the required ways (eg by entry in the records of clearing house or securities depository)?

Application to directly held dematerialised securities

3.6 The first limb of the definition requires the relevant property to be a "writing". A "writing" simply means that the relevant interest is recorded in writing and the PPSA helpfully has a definition that clarifies that an electronic recording is included.[17] An entry in a register is clearly sufficiently "written" to fall within the meaning of that term.

3.7 The second limb of the definition describes the types of interests that must be evidenced by that writing. One of those types is a "share", which means that equity securities are covered. Another one of those types is "an obligation of the issuer" (ie a right to performance of an obligation of the issuer). Debt securities are covered by this, as a debt security is an obligation of the issuer to repay money. Consequently, both debt and equity securities are within the second limb of the definition.

3.8 In the case of a directly held dematerialised security, the issuer of the security will be the "issuer" and the writing will be the register entry maintained by the issuer or its agent that records who holds each security.

3.9 The third limb of the definition describes the ways in which the interests must be transferred to fall within the definition. The first of these includes "registration in the records of the issuer or an agent of the issuer". This clearly applies to directly held dematerialised securities.

3.10 Consequently, directly held dematerialised securities fit squarely within the definition of "investment security" with no complications.

Intermediated Securities

3.11 The application of the definition to intermediated securities is a little more complicated.

3.12 At a glance, it appears that there is clearly a writing, and that it is the recording in the records of the securities depository or custodian that the ultimate holder holds an interest in the underlying security. However, the complication created by this analysis is that that recording does not really evidence either a share issued by the underlying issuer or an obligation of that underlying issuer – certainly not one that would be recognised by the underlying issuer in any event.

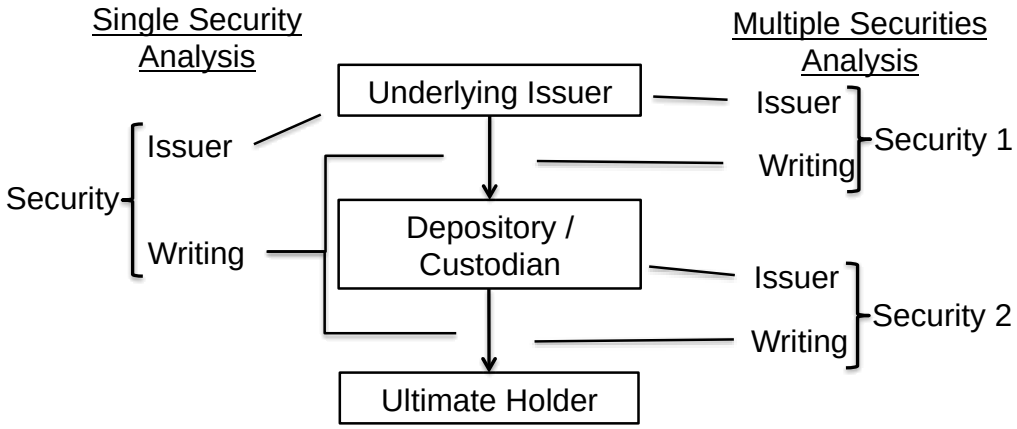
3.13 Alternatively, the writing could be the recording in the register maintained by the underlying issuer or its agent. This does clearly evidence a share or obligation of the underlying issuer, but it shows the holder as a custodian, and not the underlying holder.

3.14 Therefore, the analysis does not seem to work for either interpretation of what the relevant writing is. There are, however, two other possibilities:

(a) First, the writing could be the records of the underlying issuer *together with* the records of the securities depository or custodian (the "single security analysis).

[17] Section 16 of the PPSA.

(b) Secondly, there could be two distinct investment securities – one the directly held security held by the securities depository nominee or custodian (for which the writing would be the register entry of the underlying issuer or its agent) and the other the separate rights held by the ultimate holder against the securities depository or custodian (for which the writing would be the records of the securities depository or custodian). (The "multiple securities analysis".)



3.15 I believe one of these must be right, and that the better view is that it is the single security analysis. However, I believe the single security analysis is only sustainable if the trust analysis for intermediated securities set out above (which I will refer to simply as the "trust analysis") is correct. If the trust analysis is not correct, the connection between the underlying issuer's register entry and the records of the securities depository or custodian (who I will refer to as the intermediary) becomes a lot weaker. In that case, the ultimate holder's claim does not reach through the intermediary's records to give the ultimate holder a proprietary right in the underlying securities recorded in the register; rather the ultimate holder's rights stop at the intermediary against whom it may be limited to a claim for damages.

3.16 Assuming the trust analysis is correct, the reason I prefer the single security analysis over the multiple securities analysis is a matter of statutory interpretation. Other provisions relating to investment securities in the PPSA implicitly suggest that the single security analysis (or some other interpretation of the definition that renders the same result) is the one that was intended. However, although I believe the single security analysis is the one arrived at by statutory interpretation, I also believe it is flawed, and creates unresolvable issues in some situations.

3.17 An illustrative example of a section in the PPSA that supports the single security analysis is section 18(1)(d) of the PPSA (which contains a rule about taking possession of investment securities). This section states that a person takes possession of an investment security if "in the case of an investment security that held by a nominee, the records of the nominee record the interest of the person in the investment security". This clearly contemplates a person (the "nominee") in an intermediary role, and there is no intermediary role that is recognised under the multiple securities analysis. For this reason, if the multiple securities analysis was the correct analysis, and there were two separate investment securities, section 18(1)(d) would make no sense in relation to either of them. In relation to the underlying security, section 18(1)(d) would mean that the holder (the

nominee) could take possession by entering its interest in its own records, which would be a very strange outcome. In relation to the intermediated security, section 18(1)(d) would be referring to the nominee, who would be the "issuer" for the purposes of the definition of investment security, as the holder, which they clearly would not be.

3.18 It seems clear from sections like section 18(1)(d) (which is just one of a number of examples) that the intention was that an intermediated security be viewed as one investment security, with the underlying issuer as the issuer and the ultimate holder as the holder.

3.19 The third limb will be easily satisfied because intermediated securities will be transferred by an entry in the records of a clearing house or securities depository or in the records maintained for that purpose by or on behalf of the nominee.

3.20 Consequently, it appears that the ultimate holder of an intermediated securities holds, for the purposes of the PPSA, an investment security for which the issuer is the underlying issuer.

Second level intermediated securities

3.21 The analysis above can be extended to second level intermediated securities, so long as there is a chain of trusts from the ultimate holder to the underlying security. If this condition is met, then the analysis above applies, but with an extra layer of records included in the relevant "writing".

4. HOW IS A SECURITY INTEREST IN DEMATERIALISED SECURITIES CREATED?

Creating a security interest

4.1 A security interest is created under the PPSA when "an interest in personal property [is] created or provided for by a transaction that in substance secures payment or performance of an obligation".[18]

4.2 The first part of this test is satisfied by the granting of an interest, by contract or deed, in the relevant property by the person intending to create the relevant security interest. The second part will be satisfied if that interest, in substance, secures payment or performance of an obligation. Most simply it is done in a security agreement with a clause like the following:

> *[Debtor] grants [Secured Party] a security interest in all of its right, title and interest in the [Relevant Securities] to secure payment of the [Secured Money] and performance of the [Secured Obligations].*

4.3 Such a clause need not describe the interest as a "security interest", although it is general practice to do so. Similarly, the interest need not only be in the relevant securities. Many security agreements, for example, grant a security interest in "all present and after acquired personal property".

4.4 It is possible that a court may not apply the single security analysis in relation to intermediated securities. This could be because the trust analysis breaks down on specific facts, or the multiple securities analysis may be preferred. Consequently, when dealing with intermediated securities, it

[18] Section 17 of the PPSA. There are other limbs to the definition of "security interest", but they are not relevant here.

would be wise to widen the description of the secured property to take account of this possibility. One way to do this, using the wording set out above, would be with a wide definition of Relevant Securities like the following:

> *"Relevant Securities" means all of the Debtor's right, title and interest in the Floating Rate Notes issued by [Underlying Issuer] with the ISIN [ ] (the "Notes"), including any rights the Debtor has in relation to those Notes under the NZClear System Rules (or any rules that replace those rules).*

Attachment

4.5 A security interest will not attach unless the requirements of section 40 of the PPSA are met. These are that:

(a) value is given by the secured party;

(b) the debtor has rights in the collateral; and

(c) … the security agreement is enforceable …

4.6 The satisfaction of the requirements in 4.5(a) and 4.5(c) will be the same as for other security arrangements and is straight forward, but the requirement in 4.5(b) is more complicated for intermediated securities.

4.7 It is well established that "rights in the collateral" do not refer only to legal title. There are clear contextual clues to this effect in section 40(3), which has rules, for example, for when a debtor that leases goods has "rights in" those goods. This has also been confirmed by the courts.[19] I am not aware of any New Zealand case that has considered whether a beneficial owner is considered to have "rights in the collateral" that is subject to a trust. However, a beneficial owner will have an equitable interest in the collateral, which could be sufficient to constitute "rights" for the purposes of section 40 based on the plain meaning of the words in section 40. The leading New Zealand text, *Personal Property Securities In New Zealand*, reaches the following conclusion:[20]

> *Another element necessary for attachment is that the debtor must have "rights in the collateral". The clearest case will occur where the debtor has full ownership of the collateral. However, something less than full ownership will suffice. Any legal or equitable proprietary interest qualifies as "rights in the collateral".*

4.8 My view is that the courts will require a little more than a mere trust relationship to find there are "rights" in the collateral. If a mere trust relationship was sufficient, any beneficiary would be able to grant security interests in trust property.[21] This could mean, for example, that unitholders of a unit trust might be able to argue that they could grant security in the fund property, and seems like too wide an interpretation.

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[19] See, for example, *Rabobank New Zealand Ltd* v *McAnulty* [2011] 3 NZLR 192.
[20] M Gedye, RCC Cuming QC and RJ Wood, *Personal Property Securities In New Zealand* (Brookers Ltd, Wellington, 2002) at [40.3].
[21] Beneficiaries can clearly grant security interests in their beneficial interests, but granting security in the trust property itself is a significant step beyond this.

4.9 However, there are two important features of the trust arrangements for intermediated securities that together, in my view, provide a good argument for ultimate holders having "rights" in the underlying securities. These are that:

(a) there is no discretionary aspect to the trust – a specific number of securities are held on trust for a specific person; and

(b) the ultimate holder is generally able to insist, at any time, that the legal ownership of the underlying securities be transferred to it.

4.10 In my view, this makes the rights that the ultimate holder has very clearly rights in the underlying securities.

4.11 Of course, if the trust analysis is rejected, the ultimate holder will have mere contractual rights against the intermediary and no rights in the underlying securities. The ultimate holder will not, under those circumstances, be able to grant a security interest in the underlying securities and will only be able to grant a security interest in the ultimate holder's *in personam* contractal rights under the custody agreement or securities depository rules.

5. HOW IS A SECURITY INTEREST IN DEMATERIALISED SECURITIES PERFECTED?

5.1 It is not generally enough to take a security interest in property, because another person may be granted a better security interest in the same property. In New Zealand, the most basic rule of priority is that a perfected security interest has priority over an unperfected security interest. Consequently, any secured party should perfect a security interest in dematerialised securities.

5.2 There are two principal ways in which security can be perfected under the PPSA. The first is by registering a financing statement and the second is by taking possession of the secured property. In the case of dematerialised securities, there are complications with both.

Registering a financing statement

5.3 A financing statement must, among other things, describe the secured property. It is not invalid if it describes a wider class of property than the secured property, but to the extent that any secured property is not included in the description, the financing statement does not perfect the security.

5.4 The complication with intermediated securities is ensuring that the registration is sufficient if the single security analysis is rejected. Securities are generally described with reference to the issuer of those securities. However, if the PPSA recognises two levels of investment security, as would be the case if the single security analysis was rejected, a description that referred to the underlying issuer may not be held to describe the investment securities in which the ultimate holder had granted security.

5.5 To be safe about this, my suggestion is that the collateral description should mirror the suggested security agreement wording above as follows:

All of the Debtor's rights, title and interest in the Floating Rate Notes issued by [Underlying Issuer] with the ISIN [ ] (the "Notes"), including any rights the Debtor has in relation to those Notes under the NZClear System Rules (or any rules that replace those rules).

Taking possession

5.6 Although it may not sound possible to take possession of a dematerialised security, the PPSA does contemplate that possession may be taken and provides specific rules for how it can be done. These are set out in section 18, and the relevant parts read as follows:

> **18 Meaning of possession in certain cases**
>
> (1) For the purposes of this Act, a person takes possession of an investment security, other than an emissions unit, if,-
>
> (a) in the case of an investment security that is evidenced by a security certificate, the person takes physical possession of that certificate; or
>
> (b) in the case of an investment security that is traded or settled through a clearing house or securities depository, the clearing house or securities depository, as the case may be, records the interest of the person in the investment security; or
>
> (c) in the case of an investment security that is not evidenced by a security certificate and that is not traded or settled through a clearing house or securities depository, the records maintained by the issuer, or on behalf of the issuer, record the interest of the person in the investment security; or
>
> (d) in the case of an investment security that is held by a nominee, the records of the nominee record the interest of the person in the investment security.
>
> …
>
> (3) For the purposes of this Act, a secured party is not in possession of collateral that is in the actual or apparent possession or control of the debtor or the debtor's agent.
>
> …

5.7 These rules are quite clear, but there are some practical issues. I look at each way of taking possession in turn.

Physical possession of certificate

5.8 If it is possible to have a physical certificate issued, this is an easy way to take possession, but this will not always be possible.

5.9 In relation to shares, the Companies Act contemplates the issuance of physical certificates. The Companies Act even makes the issuance of physical certificates compulsory in some cases, including where a shareholder requests one and the company is not a listed company. However, in some situations there is no requirement for the company to issue a certificate. In particular, no certificates are required where the relevant shares can be transferred in accordance with the rules

of a designated settlement system, or under a system approved under section 376 of the Financial Markets Conduct Act 2013.

5.10 In the case of debt securities, there is no statutory requirement to issue certificates in most situations.[22] Furthermore, in relation to intermediated securities, the ability for a secured party to obtain a certificate may be limited even if one is issued to the intermediary.

5.11 If the single security analysis does not apply, such a certificate would need to be issued by the intermediary, and I am not aware of a custodian that offers this service and neither the rules of the NZ Clear System nor the NZX Depository System contemplate it.

5.12 Consequently, while this is a clear way of obtaining possession, in many situations it will not be possible for a secured party to take possession in this way, and it will only really be an option if the single security analysis is correct.

Recording the interest in clearing house/securities depository records

5.13 As described above, the two main securities depositories through which securities are traded in New Zealand are the NZClear System and the NZX Depository System.[23]

5.14 Clause 10.1 of the NZClear System Rules provides for a recording of "Encumbrances" within the NZClear System. Such a recording is probably sufficient to meet the requirements of section 18(1)(b) of the PPSA, though it is not without doubt. "Encumbrance" is defined in the rules as "the restrictions under these Rules which affect an Encumbered Security". "Encumber" is defined as follows:

> *in relation to a Security means the identification and constructive delivery of that Security to a Member as security or collateral for an obligation, debt or liability using the functionality of the System …*

5.15 This definition, therefore, describes an Encumbrance by reference to the functionality of the NZClear System and not the PPSA. Consequently, there is a technical argument that the recording of an Encumbrance is not a recording of "the interest of the person in the investment security" referred to in the PPSA.

5.16 In addition, the rules only seem to contemplate Encumbrancees that are, themselves, members, because they refer to the relevant securities appearing in the Encumbrancee's securities account. This further restricts the ability of secured parties to use this system to take possession under section 18.

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[22] Under section 54 of the Securities Act, certificates must be issued to holders of securities offered to the public. However, there is an exception where the securities are approved for transfer under a system approved under the Securities Transfer Act 1991 or through a designated settlement system. To the extent that this required certificates in some situations it is of diminishing relevance because the requirement has not been carried into the Financial Markets Conduct Act. Under that Act the equivalent provision requires confirmation information to be sent to holders, rather than a security certificate. (It is also unclear whether a certificate issued under section 54 of the Securities Act is, in fact, a "security certificate" contemplated by the PPSA.)

[23] Section 18 allows for the recording of interests in both a securities depository and a clearing house. However, this has little meaning where a clearing house is divorced from a securities depository, because there is no ownership interest against which to record a security interest. The legislative intent appears to be to ensure that systems that operate as both, such as the NZClear System, are covered.

5.17 In the case of the NZX Depository System, the notifying of security interests is more clearly dealt with from a PPSA perspective. Rule 4.5 expressly allows for a security interest to be recorded "for the purposes of section 18 of the PPSA".

5.18 However, such a recording can only be made if the secured party is a Depository Participant, so, as with the NZClear System, in many cases it will not be available to secured creditors.

5.19 If the single security analysis is not correct, this way of taking possession will not be available to an ultimate holder's secured creditor, because any security interest noted will relate to the investment security held by the securities depository nominee and not the investment security held by the ultimate holder.

Issuer records

5.20 If an investment security is neither evidenced by a security certificate nor traded or settled through a clearing house or securities depository, possession may be taken by recording the security interest in the records maintained by the issuer or its agent.

5.21 There is no statutory requirement for an issuer to note security interests on its register, so the availability of this method of taking possession will depend on the willingness of the issuer to do so. In some cases the issuer may have an interest in facilitating the secured transaction and may, therefore, be willing to note a security interest on its register. In other cases it may simply refuse to do so. Some trust deeds expressly provide that no security interest may be noted on the register. Consequently, this way of taking possession will probably be unavailable, except in relation to some bespoke transactions.

5.22 Further, the unavailability of this way of taking possession where the security is traded or settled through a clearing house or securities depository will mean it cannot be used in many cases. For example, all securities quoted on an exchange will be settled through a clearing house. This could often make this method of taking possession unavailable in situations in which there is no alternative, because there may be no way of noting the interest in the records of the securities depository or clearing house either.

5.23 If the single security analysis is not correct, this method of taking possession could be important. On the multiple securities analysis, the investment security held by the ultimate holder is not traded through a clearing house or securities depository, despite the fact that the underlying security may be. The investment security held by the ultimate holder would have, as its "issuer", the intermediary, and the only ways a secured creditor of the ultimate holder could take possession would be by convicing the intermediary to issue a security certificate or record the secured creditor's interest in its records.

Nominee records

5.24 The term "nominee" here was presumably intended as a reference to a custodian that is not the nominee within a securities depository system. However, there is technically an overlap between

(b) and (d) because the custodian within a securities depository system is (assuming the trust analysis to be correct) a nominee. However, this probably has little significance.

5.25 My understanding is that many providers of custodial services will be unwilling to note security interests in their records, so this is unlikely to be a way of taking possession that has wide use.

Possibility of dual possession

5.26 The methods of taking possession contemplated in section 18(1) make it possible for more than one person to have possession of an investment security at the same time. For example, if an investment security is held by a nominee and a security certificate has been issued in relation to it, one secured party could be noted in the nominee's records and another could hold the certificate, giving both simultaneous possession. Equally, both secured parties could have interests noted in the records of the nominee, meaning both had possession in the same way.

5.27 This issue is highlighted if the single security analysis is extended to second level intermediated securities. In that case you could envision different people taking possession at each level – with one noted in the records of the issuer; one in the records of the securities depository; one entered in the records of a custodian, and so on.

5.28 This has little significance when it comes to two secured parties perfecting security interests, because the perfection of one secured party's security interest is unaffected by the perfection of another secured party's security interest.[24] However, the fact that having possession does not prevent another having possession does have some significance in the context of section 97 of the PPSA, which is discussed below.

The troubling section 18(3)

5.29 Section 18(3) of the PPSA provides that:

> *For the purposes of this Act, a secured party is not in possession of collateral that is in the actual or apparent possession or control of the debtor or the debtor's agent.*

5.30 The point of this section is presumably to avoid a secured party perfecting a security interest by possession (and thus avoiding registering a financing statement) when it appears to the world that the debtor is in possession (and therefore the relevant security interest has not been perfected). This certainly makes sense in the context of tangible property.

5.31 However, a debtor that is recorded in the records of the issuer, securities depository or nominee as the owner of an investment security will have possession of the investment security by virtue of section 18(1). On this basis, under section 18(3), a secured party will not be able to take possession even if it takes a step prescribed by section 18(1) because the debtor will have possession. For example, if the debtor is recorded as the owner of a bond in the NZX Depository System and the secured party is recorded as holding a security interest, both will satisfy a

[24] For example, multiple secured parties may register financing statements and perfect their security interests in that way, without any registration preventing another secured party from attaining perfection by also registering.

requirement for possession under section 18(1) but the secured party will not gain possession because of the debtor's possession.

5.32 If this interpretation was correct, it would mean that a secured party could practically never take possession of an investment security, because in almost all situations the debtor will have possession. It seems unlikely that this was intended, particularly given that the PPSA clearly contemplates secured parties holding possession of investment securities.[25]

5.33 One possible interpretation of section 18(3) is that it refers to exclusive possession. This would preserve the protection for the world in relation to tangible property, in which there can be only one person in actual or apparent possession, but would also preserve the ability for a secured party to take possession as contemplated by the Act despite the debtor having (non-exclusive) possession. However, unfortunately, there is nothing in the express words that readily supports this interpretation.

Is registration or possession better?

5.34 A secured party should always register a financing statement. This is an unambiguous way to perfect a security interest and, as noted above, taking possession does not provide the same certainty.

5.35 However, where possible, a secured party should also take possession, because there is some advantage in taking possession under section 97 of the PPSA as discussed below.

5.36 As also discussed below, taking possession also has some consequences for the conflict of laws analysis under the PPSA.

6. "PURCHASERS" DEFEAT PERFECTED SECURITY INTERESTS

6.1 Section 97 of the PPSA provides special protection for "purchasers" of investment securities. Section 97 reads as follows:

97 Priority of purchaser of investment security

(1) The interest of a purchaser of an investment security has priority over a perfected security interest in the investment security if the purchaser—

(a) gave value for the investment security; and

(b) acquired the investment security without knowledge of the security interest; and

(c) took possession of the investment security.

(2) For the purposes of subsection (1), the purchaser of an investment security who acquired it under a transaction entered into in the ordinary course of the transferor's business has knowledge only if the purchaser acquired the interest with knowledge that the transaction is a breach of the security agreement to which the security interest relates.

[25] See, for example, section 26 of the PPSA, which sets out conflict of laws rules for possessory interests in investment securities.

6.2 This means that, in some circumstances, a "purchaser" can defeat a perfected security interest.

6.3 This section is wider than it looks, because the term "purchase" (and by express extension, "purchaser") is widely defined. In particular, a person that takes a security interest is a "purchaser".

6.4 This creates two issues for a person taking a security interest in an investment security:

(a) First, there is an advantage in perfecting by taking possession, because that will give the secured party the benefits conferred by section 97.

(b) Secondly, a secured party must take steps to ensure that no other person can become a "purchaser" and defeat their perfected security interest.

6.5 The way in which possession may be taken is discussed above, but stopping another person from taking possession is a separate challenge.

Holding a security certificate

6.6 For the reasons discussed above, it will often not be possible to take possession of a security certificate. However, where a secured party can do this, it provides significant protection. If the security is a share, the share may not be transferred without the certificate being produced.[26] If the security is a debt security, the value of holding a certificate will depend on the status provided to it by the terms of the debt security, but a similar rule to that for shares will usually apply.

6.7 Despite this, holding a security certificate does not provide absolute protection. It may block a "purchaser" in the ordinary sense of the word from taking possession, but it will not necessarily stop another secured party. For example, if the security is traded through a securities depository, that other secured party may be able to get its interest noted in the records of the security depository, and thereby take possession despite the other secured party holding a certificate. This would not deprive the original secured party of possession, but would give the new secured party the benefit of section 97, allowing it to defeat the earlier perfected security interest.

Blocking trades in a securities depository

6.8 If a security is held in a securities depository, it may be possible to block trades in that security through the depository.

6.9 The NZClear System Rules provide that if securities are encumbered under the rules, they cannot be transferred without the encumbrancee's consent. This is, therefore, an effective way to prevent a purchaser in the traditional sense from taking possession. It also provides some protection against a new secured party taking possession because, while it is not express in the rules, it is unlikely that a second person will, in practice, be able to take an encumbrance within the NZClear System.

6.10 However, there is still a risk that another secured party could take possession by taking a security certificate. Consequently, it does not completely protect a secured party from section 97. Further, it

[26] Section 95(5) of the Companies Act.

will only be an available step for secured parties that are NZClear members, because only NZClear members can register encumbrances in the system.

6.11 A similar position applies under the NZX Depository Rules. If a Depository Participant has a security interest noted against a security, it cannot (in most circumstances) be traded. Again, this is a helpful step for a secured party, but does not guard against another secured party taking a security certificate and priority under section 97.

Blocking trades through the issuer or its agent

6.12 In some situations it may be possible for a secured party to arrange for an issuer or its agent to block trades on the issuer's register. For example, where securities are quoted on an NZX exchange, the two main securities registrars in New Zealand, Link Market Services and Computershare, will allow a block to be placed on trades. As with the blocking of trades in a securities depository, this provides a practical block to traditional purchasers, but does not provide absolute protection.

Blocking trades with a custodian

6.13 My understanding is that in most cases custodians will not block trades for secured parties in their systems. Consequently, securities trading through a custodian may be difficult to constrain. One possible solution to this issue is to require the debtor to instruct the custodian to deal with securities only where authorised signatories authorise the dealing, and specify officers of the secured party as those authorised signatories.

6.14 As with the possible safeguards discussed above, this is not an absolute safeguard against "purchasers", but will provide some level of practical protection.

In conclusion

6.15 In conclusion, there appears to be no failsafe way to guard against "purchasers", but the steps referred to above will provide practical safeguards that substantially reduce the risk of a "purchaser" being able to defeat a perfected security interest.

7. UNCERTAINTIES IN THE LAW AND A CASE FOR REFORM

7.1 The law relating to taking security over dematerialised securities has not, to my knowledge, been the subject of any New Zealand cases. Nor has there been much academic discussion. However, security is given over such property fairly often in New Zealand, and it seems inevitable that at some point the law will be tested. As should be clear from this paper, there are a number of uncertainties in that law, and it would be helpful for policy makers to address those before the inevitable dispute.

Clarifying what security is granted in

7.2 As explained in this paper, it is not entirely clear, when a secured party takes security in intermediated securities, what that secured party is actually taking security in. Is it the underlying

security, or the rights of the debtor against a nominee or custodian? In this paper I have made a case for it being the underlying security, but it is by no means certain.

7.3 In the United States, the rights that an ultimate holder has against a custodian/nominee is separately recognised.[27] The consequence of this is that secured parties do not take security in the underlying security, they take security in the separately recognised security entitlement.

7.4 A similar approach seems to be taken in both Saskatchewan[28] (which is of particular interest, because New Zealand originally based the PPSA on the equivalent laws in that state) and Australia.[29]

7.5 The immediate attraction of this is that it eliminates the ambiguity about what security is being taken in and it makes the uncertain trust analysis unnecessary. However, without further legislative steps, it does have some drawbacks.

7.6 First, it makes a secured party a lot more dependent on the rights that the ultimate holder has against its intermediary, because the secured party no longer has a direct security interest in the underlying security.

7.7 Secondly, it allows a secured party of an ultimate holder to be defeated by the secured party of the – effectively structurally subordinating an ultimate holder's security.

7.8 In the US, these issues have been addressed in two key ways. First, a new set of rights and obligations in relation to security entitlements have been codified. Essentially their law has not just separately recognised the rights of an ultimate holder against an intermediary; they have created a whole new instrument around those rights. Statutorily defining the rights and obligations eliminates the uncertainty we face in New Zealand around the trust analysis because the statutory rights can be relied on instead of such an analysis.

7.9 Among other things the rules require the custodian/nominee to ensure that it holds sufficient underlying securities for all of the ultimate holders, and only allows the intermediary to grant security over underlying securities to the extent they are in excess of the number it is required to hold. If a custodian/nominee breaches the rule in relation to security, the person it gives security to ranks behind the ultimate holder in relation to the underlying security.[30]

7.10 Again, a similar approach is taken in Saskatchewan, with obligations of a "securities intermediary" codified, though it does not appear to have been taken in Australia.[31]

7.11 An approach like this would certainly solve some of the principal issues identified in this paper. However, it is a reform that goes beyond the PPSA, because it requires changes that affect

[27] Article 8 of the Uniform Commercial Code.
[28] Section 2 of the Personal Property Securities Act 1993 (Sask.) includes a defined term "security entitlement", which is defined by reference to the Securities Transfer Act 1983 (Sask.) and essentially refers to the rights that an ultimate holder has against an intermediary.
[29] Section 15 of the Personal Property Securities Act 2009 (Aus) defines a term "intermediated security". This refers to the rights of an ultimate holder against an intermediary.
[30] Although there is an exception to this rule for clearing corporations.
[31] My understanding is that there are licensing arrangements for intermediaries in Australia, which is a vehicle for some control over the practices of intermediaries, albeit not a codified set of rules like those in the US that define the relationship.

securities law generally and not just security arrangements. Given that New Zealand's security laws have recently been completely overhauled, it may be some time before legislators are willing to consider reforms of this nature.

Making it easier to protect against "purchasers"

7.12 One of the issues with the current regime that I have highlighted in this paper is the difficulty for a secured party in guarding against a "purchaser" defeating its security interest under section 97.

7.13 The policy behind section 97 is to facilitate securities trading by ensuring that purchasers do not need to make extensive inquiries about whether the relevant securities are encumbered. The required level of inquiry is set by the requirements for being able to rely on section 97, being that the purchaser:

(a) gave value for the investment security; and

(b) acquired the investment security without knowledge of the security interest; and

(c) took possession of the investment security.

7.14 The difficulty in New Zealand is that the requirements of section 97 are perhaps a little too easy to satisfy because the third limb probably does not achieve its policy objective. My view is that the point of a possession requirement is that a secured party can guard against the purchaser by itself taking possession, and thus denying anybody else that possession. Alternatively, it can tag the property in some way so that no other person can take possession without acquiring knowledge of the security interest. However, section 18 allows a "purchaser" to take possession despite a secured party already having possession, and the variety of ways in which the purchaser can take possession mean that a purchaser could take possession in an entirely different way to the earlier security holder and acquire no knowledge of the earlier security.

7.15 The United States has a similar concept to facilitate trade. The main difference between the United States approach and the New Zealand approach is that in the United States, to gain a "protected purchaser" status, the purchaser must take "control" of the collateral. Although "control" is similar to the New Zealand requirement of "possession", it does require the secured party being granted more. In contrast to New Zealand's "possession" requirement, which can be satisfied by the noting of a security interest, "control" in the United States effectively requires that the secured party be able to deal with the property. For example, control will be taken if a securities intermediary has agreed that it will act on the instructions of the secured party without the consent of the holder.

7.16 Similar approaches are taken in Saskatchewan and Australia.

7.17 The "control" approach appears to be a better approach than New Zealand's approach, because it imposes a higher threshold for a subsequent interest to defeat an earlier one, but still without impeding trade. Although it does still appear to allow control to be held by more than one secured party, the hgiher threshold for control should make this less likely and easier to guard against.

7.18 In my view, the requirements of section 97 should be amended to impose a control requirement (which could still allow a lower threshold for perfecting by possession) or we should adjust the

requirements for possession under section 18 to set a test for possession more like the United States requirements for control. Of the two, the latter would probably be preferable, because perfection by possession should really be a step that presents big red flags to the world – something more like the United States concept of control.

7.19 Arguably the law change should go further, to ensure that only one person at a time can have possession/control.

Section 18(3) should be amended

7.20 If no other change is made, section 18(3) should at least be clarified so that it is clear whether both the holder and the secured party for an investment security can have possession.

8. CONFLICT OF LAWS

8.1 An analysis of the New Zealand PPSA has been set out above. However, there will often be factors that connect the relevant security transaction to jurisdictions other than New Zealand, so the first issue in an analysis may be to ascertain which jurisdiction's laws actually apply.

8.2 The PPSA has attempted to codify the rules relating to conflict of laws.

8.3 The basic rule is set out in section 26(1), which reads as follows:

> **26 When New Zealand Law Applies**
>
> (1) Except as otherwise provided in this Act, the validity, perfection, and the effect of perfection or non-perfection of a security interest in goods or a possessory security interest in chattel paper, an investment security, money, a negotiable document of title, or a negotiable instrument, is governed by the law of New Zealand if,—
>
> (a) at the time the security interest attaches to the collateral, the collateral is situated in New Zealand; or
>
> (b) at the time the security interest attaches to the collateral, the collateral is situated outside New Zealand but the secured party has knowledge that it is intended to move the collateral to New Zealand; or
>
> (c) the security agreement provides that New Zealand law is the law governing the transaction; or
>
> (d) in any other case, New Zealand law applies.

8.4 This basic rule applies only to a "possessory security interest" in investment securities. For other security interests in investment securities, section 26 has no application.

8.5 "Possessory security interest" is not defined, but it seems clear that it refers to a security interest where the secured party has taken possession of the relevant investment securities.

8.6 Paragraph (a) provides that New Zealand law applies if the investment securities are situated in New Zealand at the time the security interest attaches. As noted above, this happens when:

(a) value is given by the secured party;

(b) the debtor has rights in the collateral; and

(c) … the security agreement is enforceable …

8.7 These requirements are largely unrelated to the taking of possession by the secured party.[32] It is entirely possible that a security interest could attach without the secured party taking possession (meaning section 26 had no effect) but that possession could subsequently be taken, prompting an inquiry into the situation of the collateral at the earlier time that attachment occurred. This seems odd, though not unworkable.

8.8 The first question this rule raises is how to determine where investment securities are situated. Helpfully, the PPSA addresses this, albeit not in a complete manner. Section 26(2) provides that:

(2) For the purposes of subsection (1), an investment security that is not in the form of a security certificate is situated where the records of the clearing house or securities depository are kept.

8.9 Thus, where the investment securities are traded through a clearing house or securities depository, the location of the records will be key. Where they are not, no rules are provided. (There is a strange implicit assumption, not reflected elsewhere in the Act, that all dematerialised securities will be held in a clearing house or securities depository.) However, one would expect that a court would apply the same rule where a custodian was involved and look to the location of the records of the custodian. In the case of a securities certificate, one would expect the location of the certificate to be determinative.

8.10 One problem with this rule is that, in an age of cloud computing, the location of the records of a clearing house, securities depository or custodian can be ambiguous. For example, the operator of the system may lease server space on a server in the US, but the interface to access the system may be exclusively located in New Zealand. In such a case it is not clear where the records are "kept" for the purposes of the PPSA. My view is that a court would examine where the entry and editing of those records primarily took place, rather than the almost incidental location of the server holding the records.

8.11 Another problem with this rule is that, if the single security analysis is correct, second level intermediated securities could technically be situated in more than one jurisdiction. For example, one custodian might be in New Zealand, and a sub-custodian in Australia.

8.12 Section 26(1)(b) is unlikely to be significant for investment securities in most cases as such records are rarely moved. However, there could be a situation in which, for example, an Australian custodian was selling part of its business to a New Zealand operator, in which case the section could have some significance.

8.13 Section 26(1)(c) contains the clearest of the rules.

[32] The requirement that the security agreement be enforceable does refer back to section 36, which requires the security agreement to be in writing or the secured party to have taken possession for enforceability, so there is some linkage of the concepts, but it is a loose linkage.

8.14 It is not clear what seciton 26(1)(d) is intended to achieve, although presumably it is that where none of the rules in sections 26(1)(a) to 26(1)(c) apply, common law rules will apply and, if those rules point to New Zealand law as applying, it will.

8.15 Section 26 is expressly subject to other rules in the PPSA.

8.16 Section 30 sets out the second basic rule. This reads as follows:

> **30 Validity, perfection, etc, of security interests in intangibles, movable equipment, etc**
>
> The validity, perfection, and effect of perfection or non-perfection of a security interest is governed by the law, including the conflict of laws rules, of the jurisdiction where the debtor is located when the security interest attaches, if the security interest is—
>
> …
>
> (c) a non-possessory security interest in … an investment security …

8.17 If there was any overlap between sections 26 and 30, section 30 would prevail, but in relation to investment securities, there can be no overlap. One deals exclusively with possessory security interests and the other exclusively with non-possessory security interests. Consequently, both will have full effect.

8.18 In contrast to the rule under section 26, which applies New Zealand law in specific circumstances, section 30 applies the rules of the jurisdiction where the debtor is located. Consequently, New Zealand law will only apply if:

(a) the debtor is located in New Zealand; or

(b) the conflict of laws rules in the jurisdiction where the debtor is located specify that New Zealand law will apply (a *renvoi*).

8.19 Section 29 provides the following rules for determining the location of the debtor:

(a) a debtor that is a body corporate is located in the country of incorporation; and

(b) a debtor that is not a body corporate is located at—

(i) the debtor's place of business; or

(ii) the debtor's principal place of business (if the debtor has more than 1 place of business); or

(iii) the debtor's principal residence (if the debtor has no place of business).

Hague securities convention

8.20 In relation to conflict of laws issues, there are clearly advantages in having all jurisdictions implementing the same or substantially similar rules. With this objective in mind, a convention to deal with intermediated securities conflict of laws issues was prepared in 2006 under the auspices of the Hague Conference on International Law, of which New Zealand and 78 other countries are members. That convention (the Convention On The Law Applicable To Certain Rights In Respect

Of Securities Held With An Intermediary (the "Hague Securities Convention")) has, to date, only been ratified by Switzerland and Mauritius. However, the United States has signed it, and the European Commission has recommended that its members sign it.

8.21 The primary rule promoted under the Hague Securities Convention is that the law applicable to security related issues is the law that governs the account agreement between the intermediary and the ultimate holder or, if different, the law expressed as being applicable to such issues under the account agreement. However, for the primary rule to apply, the intermediary must have an office in the state that's laws are to apply. Further, that office must perform certain prescribed functions relating to the management of the relevant securities accounts.

8.22 The first fall-back rule if the primary rule cannot apply is that, if the account agreement expressly and unambiguously states the location of the office through which the intermediary entered into the account agreement, the laws of jurisdiction where that office is located will apply. Some rules for determining whether there is such an express and unambiguous statement are included in the convention.

8.23 The second fall-back rule is that the laws of the jurisdiction in which the intermediary was incorporated when the account agreement was entered into apply. (If there is no account agreement, the relevant time for determining its jurisdiction of incorporation is instead when the securities account was opened. If it is incorporated in more than one jurisdiction (for example because it is incorporated in a country, but that country has more than one legal jurisdiction in it), the principal place of business is used instead.)

8.24 Finally, the third fall-back rule is that the laws of the jurisdiction in which the intermediary has its only or principal place of business apply.

8.25 The rules promoted by the Hague Securities Convention are quite different from the rules in the PPSA. For example, the application of the PPSA rules will often, under section 26(1)(c), lead to New Zealand law governing because that is expressed to be the governing law of the relevant security agreement. In contrast, under the Hague Securities Convention, the governing law of the securities agreement is not relevant, so a different result could well be reached.

8.26 Assuming the Hague Securities Convention is eventually signed and ratified more widely, it is likely that New Zealand, as a member of the Hague Conference on International Law, will follow suit. Indeed, in the context of the recent overhaul of New Zealand's securities law, the ratification of the Hague Securities Convention was discussed as an option, although it was not ultimately adopted, presumably because it was too removed from the core thrust of the reforms.

8.27 It would certainly be beneficial for New Zealand to harmonise its laws in this area with international practice. However, given the focus in the Hague Securities Convention on the separate account arrangements between an intermediary and an ultimate holder, some additional overhaul of New Zealand's laws will also be needed to recognise a similar concept in the PPSA.