Australia's new financial collateral laws – paramount protection for enforcing security over financial property.

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> "In order to improve the legal certainty of financial collateral arrangements, Member States should ensure that certain provisions of insolvency law do not apply to such arrangements, in particular, those that would inhibit the effective realisation of financial collateral or cast doubt on the validity of current techniques …" *Directive 2002/47EC of the European Parliament and of the Council of 30 June 2002 on financial collateral arrangements.*

> "It is therefore necessary to amend the PSN Act to ensure that the enforcement of security (including in the case of a default or insolvency of the counterparty) is allowed, regardless of provisions in other legislation including the Corporations Act, Banking Act, Insurance Act and PPSA. Otherwise, there is a range of existing Australian law issues which could prevent the collecting party exercising its rights under security-based margin arrangements." *Explanatory Memorandum to the Financial System Legislation Amendment (Resilience and Collateral Protection) Bill 2016.*

With the coming into effect of the *Financial System Legislation Amendment (Resilience and Collateral Protection) Act 2016* (Cth) (***Collateral Protection Act***) in June 2016, Australia created its own protection of financial property security similar to the European financial collateral directive. It represents a new security regime which can be applicable to financial property, in addition to the general principles of common law and equity and the *Personal Property Securities Act 2009* (Cth) (***PPSA***). Although it was created to meet international standards applicable to derivative transactions, its impact is not limited to the risk management markets. Further, because it has its effect despite what any other security regime might otherwise provide with respect to a piece of financial property, it is of broad relevance to the practice of banking and finance law.

The purpose of this paper is to summarise what banking and finance lawyers need to know, not only to gain the protection of the new financial collateral laws when they are needed, but also to know where care is needed to avoid their application if they would otherwise disrupt security structures in financing arrangements. As the new laws prevail over all existing Australian laws, including insolvency laws, an understanding of when they apply is critical in creating and managing any security arrangements which involve financial property.

This paper addresses:

- Why the new laws were needed
- Where the new laws can be found
- What the new laws protect
- What is needed for the new laws to work
- Where care is needed in using the new laws
- Where care is needed in avoiding the application to the new laws
- What the new laws bring to Australian banking and finance law

These are set out in turn.

Why the new financial collateral laws were needed

Like many recent changes in financial markets law, the *Collateral Protection Act* owes its existence to the occurrence of the global financial crisis of 2007 - 2009. In response to the crisis, the G20 nations decided on a number of international regulatory reforms.[1] The final one to be implemented,[2] which should be the most extensive in its ultimate effect, is the requirement that significant market participants must collateralise derivatives which are not cleared through a clearing house.[3] This means that these counterparties must provide collateral to each other to serve as margin[4] in respect of the outstanding derivatives into which they have entered. This is not a new concept. It is mandatory for derivatives which are cleared through a clearing house and was already common before the financial crisis for derivatives which were not cleared. What has changed is that there are international standards being imposed setting out when margin is required to be provided, how much is to be provided and the manner in which it is to be provided. It is no longer a matter for the parties' agreement. These international standards cause changes in the way collateral is provided to meet margin requirements.

The international standards require that two forms of margin be provided: *initial margin* which is designed to be given at the commencement of each transaction to cover potential future exposures, and *variation margin* which is given only during the lifecycle of each transaction as the parties' current exposure to each other under their derivatives changes. Relevantly to the new Australian laws, the international standards impose rules on the protection of, and the enforceability against, the collateral which is provided to meet these margin requirements. For example, it is necessary that initial margin collateral is provided on a gross basis between parties rather than a net basis (meaning that it is to be calculated without taking into account offsetting amounts of initial margin) and collected collateral must be segregated from the assets of the collateral receiver. Importantly, this means that initial margin will need to be provided by way of security over the collateral provided, rather than by way of an absolute transfer of the collateral.[5] This need for margin to be provided by way of taking security over collateral is supported by the further requirement under the international standards that the posting party is *fully protected* to the extent possible under applicable law in the event that the collecting party enters insolvency.[6] This move to providing margin by way of security over collateral is a change to the usual manner of providing collateral for derivatives in Australia and similar legal systems, like England and New Zealand, where provision of margin by absolute transfer of collateral is commonly used.

Of itself, this change to providing margin by granting security over collateral would not require changes to law. However, the international standards go further and also require

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[1] As originally set out and mandated in the declaration made by G20 members at the Summit on Financial Markets and the World Economy (15 November 2008, Washington) available online here: <http://g20.org/English/Documents/PastPresidency/201512/P020151225609230748803.pdf>.

[2] Basel Committee on Banking Supervision (***BCBS***) and Board of the International Organization of Securities Commissions (***IOSCO***), *Margin requirements for non-centrally cleared derivatives* (Bank for International Settlements: March 2015) available online at < http://www.bis.org/bcbs/publ/d317.pdf >.

[3] Clearing in this sense means the process of making a clearing house the counterparty to each original party to a derivative contract through a novation process which effectively "inserts" the clearing house between the two parties. It insulates each party from the credit risk on the other, replacing it with credit risk on the clearing house.

[4] In this sense, "margin" means property or collateral which is provided by one person to their counterparty as credit support for the performance of the person's future obligations to that counterparty.

[5] If initial margin were provided by way of absolute transfer then it would effectively be provided on a net basis, as the obligation to deliver margin by each party to the other would cancel each other out. Further, it could not be segregated from the other assets of the collateral receiver, as the very nature of the absolute transfer means that it must become part of those assets.

[6] *BCBS* and *IOSCO*, *Margin requirements for non-centrally cleared derivatives,* above n 2, "Key principles and requirements" and "Key principle 5".

that the collateral is held in a way which ensures that, in the event of the counterparty's default:

- it is immediately available to the collecting party; and
- they are able to be liquidated in a reasonable amount of time to generate proceeds that could sufficiently protect the collecting entity from losses on non-centrally cleared derivatives.[7]

The combination of these requirements conflicted with some long standing and very important Australian laws relating to how the property of particular types of entities are dealt with, or how property is dealt with in particular circumstances, such as insolvency. For example, Australian law provides that:

- the assets of an Australian Authorised Deposit-taking Institution (**ADI**) in Australia are subject to a priority regime in the *Banking Act 1959* (Cth) (***Banking Act***) which would prefer other creditors (e.g. holders of protected accounts) ahead of a secured party;[8]
- the assets of a foreign ADI in Australia are subject to a priority regime which would prefer liabilities of the foreign ADI in Australia ahead of a secured party;[9]
- the assets of a general insurer regulated under the *Insurance Act 1973* (Cth) (***Insurance Act***) in Australia are subject to a priority regime which would prefer other creditors ahead of a secured party;[10]
- under the *Corporations Act 2001* (Cth) (***Corporations Act***) a secured party is restricted from enforcing its security interest over an Australian company's property during the company's administration[11] and an administrator is given certain rights in respect of dealing with property subject to circulating security interests;[12]
- certain stays may apply in respect of an entity due to the recognition of a foreign insolvency proceeding under the *Cross-Border Insolvency Act 2008* (Cth);
- client money and client property rules contained in the *Corporations Act* may affect the way in which a secured party must hold, and enforce rights against, collateral provided to it;
- the *PPSA* imposes additional requirements governing the enforceability, validity and perfection of security interests;
- the *PPSA* and *Corporations Act* set out priority rules which may result in a secured party losing priority in respect of secured assets[13] and those Acts set out

[7] *BCBS* and *IOSCO*, *Margin requirements for non-centrally cleared derivatives,* above n 2, "Key principles and requirements" and "Key principle 4" and "Key principle 5".

[8] For example, subsection 13A(3) and section 16 of the *Banking Act* and section 86 of the *Reserve Bank Act 1959* (Cth).

[9] Section 11F of the Banking Act.

[10] Subsection 116(3) of the *Insurance Act*. Section 116A of the *Insurance Act* deals with assets and liabilities in Australia.

[11] Section 440B of the *Corporations Act*. A restriction on the exercise of third party property rights even applies in respect of possessory security interests. The exemption available in respect of possessory security interests (section 440JA) may not be applicable in all possible circumstances regarding dealings in OTC derivatives.

[12] Sections 442B, 442C, 442CA of the *Corporations Act*.

[13] For example, certain claims mandatorily preferred at law (e.g. employee entitlements) may take priority over certain secured parties' rights. Partial priority regimes are also set out in various sections of the *Corporations Act*, including section 433 (property subject to circulating security

circumstances in which property secured by a security interest may vest in the grantor;[14]

- other security interests may arise in respect of the property of a grantor by operation of law;[15] and
- the *PPSA* sets out rules governing the enforcement of security interests (including procedural requirements and duties).

These laws are important to Australia's security and insolvency regime. There are good policy reasons supporting them and they are not regarded as unusual. In part, it was their existence that had led to the practice in Australia of providing collateral for derivatives by way of absolute transfer instead of by security interest.

However, they conflict with the requirements of the new international standards for protecting and enforcing collateral provided as margin for derivative contracts. The consequence of this conflict would have been that, without changes to Australian law, Australian entities could not provide margin in a manner which would comply with the international standards. This would have been likely to cause a significant disruption to the access of Australian financial institutions to the international risk management markets in the United States and Europe. Accordingly, the application of our existing laws had to change.

Even so, with such a range of laws to be changed, a critical initial issue was how could such a change be made without disturbing the ordinary operation of these laws.

Where the new financial collateral laws can be found

At least two different approaches could have been taken to protect security over financial collateral in Australia in the way required by the international standards. One way was to amend each of the current laws which would conflict with the international standards. The other was to make a new law which provides the protection required by the international standards despite all of the current laws. There was precedent for the latter approach. The Australian *Payment Systems and Netting Act 1998* (Cth) (***Netting Act***) already provided protection for payments systems, clearing systems and close-out netting contracts "despite any other law". These "close-out netting contracts" are contracts such as the master agreements often used in derivative transactions, such as the master agreements published by the International Swaps and Derivatives Association, Inc, the Global Master Repurchase Agreement published by the International Capital Market Association and the Australian Master Securities Lending Agreement published by the Australian Securities Lending Association.[16]

There were a number of advantages to including the new protections for security over financial collateral in the *Netting Act*:

- ***Protections for absolute transfer and security interest collateral together.*** The *Netting Act* already creates the basis for the effectiveness of financial collateral margining arrangements which operate by way of absolute transfer. These take effect through the value of the transferred collateral being netted against the outstanding value of transactions, to reduce the amount which would

interest — payment of certain debts to have priority), section 443E (Right of indemnity has priority over other debts). The *PPSA* also sets out a priority regime which applies in respect of security interests (see e.g. Part 2.6 of the *PPSA*).

[14] For example, section 267 or 267A of the *PPSA* and section 588FL of the *Corporations Act*.

[15] See, for example, section 443F of the *Corporations Act* (lien to secure indemnity). To secure a right of indemnity granted to an administrator under section 443D, the administrator has a lien on the company's property, subject to the priority regime set out in subsection 443F(2).

[16] These agreements are not referred to by name in the legislation. Instead close-out netting contracts are defined in the *Netting Act* by reference to their characteristics.

otherwise be payable in respect of those transactions.[17] This netting is protected by the *Netting* Act. Having the protections in the same legislation would be helpful.

- ***Protections for systemically important rights together.*** The *Netting Act* already protects rights which are regarded as systemically important (including payment systems and clearing systems) and operates on the basis that it applies in priority to other Australian laws. The principles and policy requiring protection of new financial collateral laws were consistent with this.

- ***Netting Act applies to a broad range of external administration proceedings.*** The *Netting Act* is not limited in its application to particular insolvency proceedings with particular types of entities. Instead, it uses a broad definition of external administration which is not limited to particular insolvency legislation or particular entities.[18]

- ***Netting Act already part of a hierarchy of application of laws.*** The N*etting Act* already has provisions which apply "despite any other law". Also, the *PPSA* already expressly refers to the *Netting Act* prevailing over it to the extent of any inconsistency between them.[19]

- ***Netting Act has been applied and tested.*** The legislation has been in force since 1998 and it has been judicially considered and applied through the financial crisis.[20]

The new collateral protection provisions created by the *Collateral Protection Act* are now found in section 14 of the *Netting Act*, which is the same section that protects the close-out netting under "close-out netting contracts" (and which protects absolute transfer collateral arrangements under them). As described below, the presence of a close-out netting contract is fundamental to the availability of the new collateral protection.

The new collateral protection provisions came into effect on 1 June 2016.

What the new financial collateral laws protect

The words used in the *Netting Act* to confer the protection required by the international standards, and to create Australia's financial collateral protection regime, are surprisingly brief.[21] The core is contained in sections 14(1)(ca) and 14(2)(fa) of the *Netting Act*,[22] each of which sets out the following*:*

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[17] In these arrangements, the absolute transfer of collateral is exchanged for a contractual promise to deliver equivalent collateral of the same value when the parties' transactions no longer create credit exposure between them. In the case of a default, the value of this contractual promise is included in the close-out netting of those transactions, offsetting the amounts which would otherwise be payable on the termination of those transactions. This close-out netting is protected by the *Netting Act*, when structured properly.

[18] The definition of external administration was extended by variations made by the *Collateral Protection Act* to specifically include resolution proceedings which are taken in respect of Authorised Deposit-taking Institutions and insurers. It already included the insolvency proceedings under the *Corporations Act* and the *Bankruptcy Act 1966* (Cth). See footnote 27.

[19] Section 256 of the *PPSA*.

[20] *Lindholm, Re; Opes Prime Stockbroking Ltd (Administrators appointed) (Receivers and managers appointed)* (2008) 171 FCR 473.

[21] There were many other changes made to the *Netting Act* by the *Collateral Protection Act*. Some of these are also related to the protection of collateral, but are not the subject of this paper.

[22] There are equivalent sections in each of subsections 14(1) and (2) because these subsections can apply in different circumstances, depending on whether the governing law of the close-out

> *"security given over financial property, in respect of obligations of a party to the contract, may be enforced in accordance with the terms of the security, provided the terms of the security are evidenced in writing"*

This wording provides effective protection to the enforcement of security taken over collateral. The Explanatory Memorandum (***Explanatory Memorandum***) to the Bill for the *Collateral Protection Act* states:

> "*The references to 'enforced', and 'enforcement' of, security in the* [*Netting*] *Act should be interpreted to include the exercise by the secured party of a right, power or remedy existing because of the security arising under an agreement or instrument relating to the security (including the close-out netting contract), under a written or unwritten law or in any other way."*[23]

This broad protection of enforcement should also protect the satisfaction and discharge of the secured obligations through the exercise of those rights, powers and remedies for example by payment, set off or other application of value.

Despite any other law

However broadly drafted, the new protections created by the *Collateral Protection Act* would not have their intended effect if they remained subject to other laws. As has been noted already, section 14 of the *Netting Act* already had a priority of application over other Australian laws as this was needed for the protection of close-out netting under the close-out netting contracts. The actual words of subsection 14(3) of the *Netting Act* which provide the protections given to close-out netting and now the enforcement of security are as follows:

> "*have effect in relation to a close-out netting contract:*
>
> *(a) subject to a specified stay provision that applies to the contract; and*
>
> *(b) despite any other law (including the specified provisions).*"[24]

The reference to a "specified stay provision" in (a) is part of the other changes which were made to the *Netting Act* by the *Collateral Protection Act*. These relate to additional resilience tools which can be used in the resolution of an ADI or insurer which is in financial distress. Although these could be relevant in enforcing security against an ADI or an insurer in limited circumstances (as there is a stay on enforcement which has been triggered solely because of the resolution action taken in respect of that ADI or insurer) it should not be relevant to most enforcements of security.

The reference in (b) to "any other law" is supposed to mean exactly what it says. For example, the *Explanatory Memorandum* provides that:

> " *… if another law purported to prevent enforcement of the security in accordance with its terms, it would be inconsistent and must yield. Similarly, if any other law purported to impose conditions that must be satisfied before the security can be enforced, that other law would also be inconsistent and must yield …"*[25]

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netting contract is an Australian law and whether there is an external administration governed by an Australian law.

[23] *Explanatory Memorandum* to the Bill, [1.110].

[24] Subsection 14(9) of the *Netting Act* provides that, if security is given over financial property, in respect of obligations of a party to a close-out netting contract, subsection 14(3) applies in relation to the security in the same way as it applies in relation to the contract.

[25] *Explanatory Memorandum* to the Bill, [1.168]. Of course, this does not prevent a later law from being passed which applies despite the *Netting Act*. Such a later law would prevail to the extent of any inconsistency between the two: *South-Eastern Drainage Board (SA) v Savings Bank of South Australia* (1939) 62 CLR 603, 616 (Latham CJ).

In order to make this intention particularly clear, particular legislative provisions which are considered quite fundamental are listed as "specified provisions" which are subordinated in effect to the protection granted by section 14 of the *Netting Act* to close-out netting and the enforcement of security. These specified provisions include provisions of the *PPSA,* the *Corporations Act,* the *Bankruptcy Act,* the *Banking Act,* the *Insurance Act,* the *Life Insurance Act 1995* (Cth) (***Life Insurance Act***) and the *Superannuation Industry (Supervision) Act 1993* (Cth) relating to priorities to assets and the effect of insolvency. Set out next is a short discussion of the effect which this "super-priority" has on the *PPSA* and insolvency laws.

The effect on the PPSA

This priority over other laws means that the the new protections for financial collateral security permit enforcement despite any conflicting priorities provided for under other legislation such as the *PPSA*. Any such potentially conflicting priorities are effectively defeated. In order to make this particularly clear, the *Collateral Protection Act* includes a new provision in the *Netting Act* which states that the protection on enforcement of security applies despite the creation or operation of any encumbrance or any other interest in relation to the financial property.[26]

As noted above, the deference of the *PPSA* to the *Netting Act* has been contemplated in section 256 of the *PPSA* since its original enactment and there is no doubt that the new protections are supposed to act separately from, and in priority to, the *PPSA.* This is important because some of the additional requirements imposed by the PPSA in relation to the enforceability, validity and perfection of security interests and its priority framework could lead to complications in compliance with the international margining standards.

What this means, for example, is that the secured party is not required to comply with any of the requirements in the *PPSA* regarding perfection and priority (including registration) in order to obtain the benefits of the protection provided under the *Netting Act* in respect of enforcing security. However, as is noted later in this paper, there is some similarity between the conditions for obtaining the protection of the *Netting Act* and the *PPSA* concepts of protection by possession and control.

The effect on insolvency laws

As is the case for the long-standing protection of close-out netting provided by the *Netting Act,* the new security protections also apply despite Australia's insolvency laws, such as the *Bankruptcy Act* and the corporate insolvency provisions of the *Corporations Act*. As noted above, these laws are expressly included in a list of "specified provisions" which are called out by the legislation as being subject to the *Netting Act's* priority.[27] For even more clarity, Section 14(2)(g) of the *Netting Act*, as amended, provides that the enforcement of security under section 14(2)(fa) of that Act is not to be void or voidable in an *external administration* of one of the parties to the close-out netting contract.[28]

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[26] Section 14(h) of the *Netting Act*.

[27] Paragraphs (d) and (e) of the definition of "specified provisions" in the *Netting Act*.

[28] Section 5 of the *Netting Act* provides that "a person goes into external administration if:

(a) they become a body corporate that is an externally administered body corporate within the meaning of the [*Corporations Act*]; or

(b) they become an individual who is an insolvent under administration; or

(c) someone takes control of the person's property for the benefit of the person's creditors because the person is, or is likely to become, insolvent; or

(d) an ADI statutory manager takes control of the person's business under the [*Banking Act*]; or

(e) the person comes under judicial management under the [*Insurance Act*]; or

(f) the person, or a part of the person's business, comes under judicial management under the *Life Insurance Act 1995*."

In addition, there is a further extension of the protection relating to insolvency in section 14(2)(fb) of the *Netting Act*:

> *"if:*
>
> *(i) under section 267 or 267A of the Personal Property Securities Act 2009 or section 588FL of the Corporations Act 2001, a security interest would, but for this paragraph, vest in the grantor before the external administration begins; and*
>
> *(ii) where the security interest did not vest under one of those sections before the external administration begins, the security would be enforceable under paragraph (fa);*
>
> *the security interest does not vest under that section before the external administration begins;"*

This provision is designed to deal with the consequence of the vesting of a security interest before the grantor's external administration under the *PPSA* and the *Corporations Act.* If this vesting were to occur before the protection were engaged, then there would no longer be a valid security for *Netting Act* to protect.[29]

This insulation from the operation of Australia's insolvency laws puts the protection of enforcement of security over financial collateral with respect to obligations under close-out netting contracts on the same footing as the protection of close-out netting. For example, it means that the enforcement of security is not subject to the moratorium on enforcement of security against a company in administration which is ordinarily applicable under section 440D of the *Corporations Act*.

It also means that the ordinary voidable preference provisions in the *Corporations Act* do not apply. However, the *Netting Act* has always contained similar provisions which are designed to avoid the legislation being misused in circumstances where a preference exists which would otherwise be voidable. These are now contained in sections 14(4) to (6) of the *Netting Act* and the effect of these provisions is to displace the protection provided by the *Netting Act*:

- in respect of a right or obligation under a close-out netting contract by a person who acquired that right or obligation with notice of the counterparty's insolvency
- in respect of an obligation owed to a person under a close-out netting contract if in entering into the relevant transaction that person had not acted in good faith, or had reasonable grounds for suspecting the counterparty's insolvency or did not provide valuable consideration *and* the counterparty has actually become subject to insolvency proceedings.[30]

However, these are not the only limits to the scope of the priority provided by the *Netting Act* provisions. See further below.

[29] However, this risk is more remote than might be first thought. Vesting before the commencement of external administration is only practically possible in the case of foreign companies. For Australian companies and individuals vesting should not occur before the commencement of external administration at which time the *Netting Act* will have the effect of rendering the security enforceable despite the purported effect of the *Corporations Act* and the *PPSA.*

[30] These are very high-level summaries of quite technical provisions. Some care should be taken in applying these provisions.

Other limitations on the scope of priority

Although the protections of the amended *Netting Act* apply "despite any other law" it is not intended to exclude or limit the operation of Australian Commonwealth or State laws, or the general law of Australia, to the extent that those laws are capable of operating concurrently with the protections set out in the *Netting Act*. For example, under section 14A(1)(c) of the *Netting Act*, the protection under section 14(2)(a) of that Act only applies to the extent that the enforcement of security is carried out in a manner that complies with section 420A of the *Corporations Act* (if it applies) and any applicable general law duties that are not inconsistent with the terms of the security.[31] The *Explanatory Memorandum* also provided that:

> "*Whilst the security may be enforced in accordance with the terms of the security, the protections provided to the enforcement of security under sections 14(1) and 14(2) would not apply to the extent the terms of the security purported to allow a secured person to appropriate or sell financial property at zero, or nominal, value as the enforcement would not reflect any attempt to calculate, or value, the financial property in good faith or in a commercially reasonable manner.*"[32]

Further, the *Explanatory Memorandum* provides that the reforms to the *Netting Act* which protect the enforcement of security in accordance with the *Netting Act* (including the provisions of section 14A) should not be interpreted as limiting or otherwise restricting anything which would otherwise be available or protected at law (including any rights which a secured party would otherwise have by virtue of the *PPSA*, the exercise of those rights and any protection which applies to those rights or the exercise of those rights).[33]

With this scope of protection in mind, the conditions on obtaining the protection are set out next.

What is needed for the new financial collateral laws to work

There are a number of fundamental conditions to the application of the new protection:

- There must be a close-out netting contract
- There must be a security, in writing
- Over financial property
- Which is in the possession or control of the secured person or its nominee
- The secured obligations must be "eligible obligations"

These are dealt with in turn.

There must be a close-out netting contract

The existence of a close-out netting contract is important to the application of the new protection. The new protection is included in provisions of the *Netting Act* which focus on close-out netting contracts and the new protection applies to the "obligations of a party to the contract". In other words, the new protection of security enforcement is closely related to the protection of close-out netting. This means that in order for the enforcement of

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31 *Explanatory Memorandum* to the Bill, [1.159], which also stated that, for example, "the duties to which controllers are subject under Part 5.2 of the *Corporations Act* (e.g. section 420A regarding the controller's duty of care in exercising power of sale) may still apply".

32 *Explanatory Memorandum* to the Bill, [1.160].

33 *Explanatory Memorandum* to the Bill, [1.109].

security to be protected, there must also be a close-out netting contract which is eligible for protection under section 14 of the *Netting Act*.

There is a further relevance of the close-out netting contract, which is the jurisdictional application of the protection. Section 14 of the *Netting Act* has always applied differently to close-out netting contracts governed by an Australian law and those which where governed by another law. If the close-out netting contract is governed by an Australian law[34] then the protection of the close-out netting conducted in accordance with it is applicable whether or not a party is subject to external administration. However, if the close-out netting contract is governed by a non-Australian law then the close-out netting protection is applicable only if there is an external administration governed by an Australian law. In simple terms, if there is a foreign law close-out netting contract, then close-out netting is protected only when Australian insolvency proceedings (including those conducted in recognition of foreign proceedings) commence.

The new protection of security enforcement follows exactly the same structure. This means that if the security is related to a close-out netting contract which is governed by an Australian law, then the protection afforded to security enforcement applies whether or not there is an external administration. However, if the security is related to a close-out netting contract which is governed by a non-Australian law then the new protection applies only if there is an external administration which is governed by Australian law. Importantly, it is the governing law of the close-out netting contract which counts, not the security. A security created under New York law will be protected by the new provisions whether or not there is an Australian law insolvency if the close-out netting contract the obligations under which it secures is governed by an Australian law (and the contract was entered into in circumstances which are within Commonwealth constitutional reach). Likewise, a security created under an Australian law which secures amounts under a non-Australian law close-out netting contract will be protected by the new provisions only when one of the parties is subject to Australian insolvency proceedings. Before the time that the protection of the new laws is engaged, all of the ordinary Australian laws relating to enforcement of security would be unaffected by the new protection and enforcement would still be subject to other laws such as the *Banking Act,* the *Corporations Act* and the *PPSA.*

There must be a security, in writing

The new provisions protect enforcement of security, not its creation. They do not validate security which has not been validly created. For example, if a security has purported to have been created outside of the power of the grantor (for example in breach of a trust deed) then the new provisions will not be able to apply. This is because there is no security to enforce. This is similar to the protection of close-out netting, which requires a valid close-out netting contract in order to operate.

The new protections do not use the concept of a "security interest" used under the *PPSA*. Instead, they just use the concept of security. The *Explanatory Memorandum* explains that the reference to "security" in these sections contemplates the traditional forms of security, being the charge, mortgage, pledge and lien and analogous concepts under foreign law rather than non-traditional forms of "security interest" (as contemplated by the

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[34] Another requirement for the application of the *Netting Act* to Australian law governed close-out netting contracts is that the contract must be entered into in circumstances that are within Commonwealth constitutional reach. One of the circumstances which satisfies the requirement for a contract being entered into in circumstances that are within the Commonwealth constitutional reach is that a constitutional corporation is a party to the contract. A constitutional corporation is defined as a "foreign corporation" or a "trading or financial corporation formed within the limits of the Commonwealth". The *Netting Act* does not contain a definition of "foreign corporation". However, the High Court of Australia has held that the phrase "foreign corporation" as contained in the Australian Constitution means an entity incorporated in a country other than Australia (*New South Wales v Commonwealth* (1990) 169 CLR 482 at 497-8).

PPSA) such as a conditional sale agreement (including an agreement to sell subject to retention of title).[35]

Accordingly the requirements for the creation of security under traditional rules of common law and equity must exist. One element of this which is important is the possibility that, under those traditional rules, it has not been judicially clarified without doubt in Australia that it is possible to have a security interest over one's own obligation. Historical Australian case law followed the "conceptual impossibility" line of thinking on this which has not been finally put to rest.[36] Subsection 12(3A) of the *PPSA* has made this case law irrelevant for the security interests to which that legislation applies. Accordingly, an allowance is also made for this in the new provisions added by the *Collateral Protection Act*. New section 5A of the *Netting Act* provides that:

> *"If a person owes payment or performance of an obligation to another person (an* ***account holder****):*
>
> *(a) the account holder may give security over the account holder's right to require the payment or performance of the obligation; and*
>
> *(b) the persons to whom security may be given include the person who owes the payment or the performance of the obligation to the account holder.*
>
> Example: A person holds an account with a bank. The person may ***give security*** to the bank over the person's right to require the bank to pay the person money from the account."

The new protections also require that the security be evidenced in writing. The reference is intended to be broad enough to ensure that security arrangements which require that a subsequent act occur, after the 'security' is signed, in order for the security to arise or apply to particular financial property satisfy this requirement. For example where the parties enter into an agreement providing that one party can give the other security in financial property by delivering that financial property to that party.[37] This is important because this is a customary way for security to be provided over financial collateral in markets where absolute transfer is not common, such as the United States.

The security must be over financial property

To have the benefit of the new protections available under the *Netting Act*, the collateral over which security is granted must be "financial property". The "financial property" concept is intended to cover property which is commonly provided as collateral in financial markets transactions.[38] Section 5 of *Netting Act* defines financial property as any of the following property:

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[35] *Explanatory Memorandum* to the Bill, [1.105].

[36] This is a concern in the Australian context due to cases such as *Broad v Commissioner of Stamp Duties (NSW)* (1980) 2 NSWLR 40. The general proposition advanced in *Broad* and in *Re Charge Card Services* [1987] 1 Ch 150 — that a debt cannot be made the subject of a charge in favour of the debtor — was approved by the Full Court of South Australia in *Jackson v Esanda Finance Corporation Ltd* (1992) 59 SASR 416 at 418 and by Lee J in the Federal Court of Australia in *Griffiths v Commonwealth Bank of Australia* (1994) 123 ALR 111 at 120. It has also been applied at first instance in the NSW Court of Appeal: see *Wily v Rothschild Australia Ltd* (1999) 47 NSWLR 555 at 564 [28]-[29]. Except for certain comments in obiter by Spigelman CJ in *Cinema Plus Ltd (Administrators Appointed) and another v Australia and New Zealand Banking Group Ltd* (2000) 49 NSWLR 513, there has not been any clear resolution of this issue in Australian case law.

[37] *Explanatory Memorandum* to the Bill, [1.106].

[38] *Explanatory Memorandum* to the Bill, [1.117].

- a security;[39]
- a derivative;
- a financial product that is traded on a financial market that is either operated in accordance with an Australian market licence or exempt from the operation of Part 7.2 of the *Corporations Act*;[40]
- a negotiable instrument;[41]
- currency (whether of Australia or of any other country);
- gold, silver or platinum;
- property declared by the regulations to be financial property for the purposes of the *Netting Act*. This includes:
  - a document evidencing ownership of gold, silver or platinum;
  - cash collateral (including cash, certificates of deposit and bank bills);
  - highly rated debt securities issued by a government or central bank or certain supranational banking agencies;
  - highly rated or listed debt securities of an Australian or international bank;
  - units in a listed trust where the unit price of the trust is publicly quoted on a daily basis and the listed trust is limited to investing in particular instruments described above;
  - equities (included convertible bonds) that are included in a main index or listed on a recognized exchange and unit trusts that invest in them.[42]
  - a covered bond;[43]
- if a person (an intermediary) maintains an account to which interests in property or rights to payment or delivery of property of a kind mentioned in any of paragraphs above may be credited or debited — the rights of a person in whose name the intermediary maintains the account, to the extent that those rights relate to the interests in that property or the rights to payment or delivery of that property. These rights are referred to as ***intermediated financial property***.

  This is particularly important in the context of the arrangements which are intended to be protected by the new provisions. It is not limited to what is considered to be "intermediated securities" under the *PPSA,* although it does include intermediated securities accounts. For example, it covers accounts

[39] The term "security" has the meaning given in section 92 of the *Corporations Act* (but, for this purpose, sections 92(3) and (4) of the *Corporations Act* are to be disregarded).

[40] The terms "financial product", "financial market" and "Australian market licence" have the meaning given in the *Corporations Act*.

[41] The term "negotiable instrument" has the meaning given in the *PPSA*.

[42] The Regulation actually refers to property described in paragraph 5(b), (c), (d) or (e), or paragraph 25, of Attachment H to Prudential Standard APS 112 — Capital Adequacy: Standardised Approach to Credit Risk, made by the Australian Prudential Regulation Authority (***APRA***) under section 11AF of the *Banking Act* and as in force from time to time, as property that may be recognised as eligible collateral (ignoring any conditions set out in the Attachment).

[43] The term "covered bond" has the meaning given in the *Banking Act*.

where a bank holds money as banker for a customer in an account and the customer has a right to payment of the equivalent amount of currency;

- proceeds (including rights and property) of property that is financial property.

However, it does not include any property declared by the regulations to not be financial property for the purposes of the *Netting Act*. Property of the kind described above will constitute financial property regardless of whether the property (or, in the case of intermediated financial property, the intermediary or the account) is in Australia or elsewhere.

This limitation of the new protection to these forms of financial priority is important from a policy perspective as it ensures that the new priority security regime will not interfere with the existing regimes over other forms of property.

The financial property must be in the secured party's possession or control

There is a further "property-related" restriction on the application of the new protection. It applies only to the extent that, before the enforcement, the financial property is:

- transferred or otherwise dealt with[44]
- so as to be in the possession or under the control
- of the secured person, or another person (who is not the grantor) on behalf of the secured person
- under the terms of an arrangement evidenced in writing.

In this regard the Directive 2002/47/EC of the European Parliament and of the *Council of 6 June 2002 on financial collateral arrangements* and *The Financial Collateral Arrangements (No 2) Regulations 2003* (UK),[45] and associated commentary by industry associations such as the Financial Markets Law Committee were informative in the development of the Australian approach.[46]

The amended *Netting Act* sets out circumstances in which possession and control will *not* exist, and also, in an inclusive manner, circumstances in which possession and control will exist. It also clarifies the impact of a grantor having specific rights which are commonly found in financial market transactions on a secured party having possession or control.[47]

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[44] The broad phrase 'transferred or otherwise dealt with' provides flexibility to accommodate different types of exchange mechanisms and transfer arrangements that exist in the market and the difficulties in applying traditional transfer-cased analysis to modern financial markets, in which property may be held through chains of intermediaries as records in book entry accounts.

[45] As amended by *The Financial Collateral Arrangements (No 2) Regulations 2003 (Amendment) Regulations 2009* (UK) and *The Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations 2010* (UK).

[46] *Explanatory Memorandum* to the Bill, [1.145].

[47] The *Explanatory Memorandum* to the Bill acknowledged that "historical legal concepts of possession and control may need to, but do not currently (or adequately), deal with control structures used in modern financial market[s] and therefore the Bill provides certainty as to specific circumstances in which the control test in paragraph 14A(1)(b) will, and will not, be satisfied. These deeming provisions are intended to be inclusive and are not intended to restrict in any way the general application of the concepts of possession or control to financial market structures": [1.151].

When possession or control will not exist

Under section 14A(2) of the *Netting Act*, financial property is taken *not* to be in the possession or control of a person if, under the security, the grantor is free to deal with the financial property in the ordinary course of business[48] until the secured person's interest in the financial property becomes fixed and enforceable.[49] This applies even if the secured person's interest in the financial property becomes fixed and enforceable before the enforcement of the security over that property.[50] This has the effect that security under which the grantor was free to deal with the financial property in the ordinary course of business at some time on or after creation of the security is taken not to be in the possession or under the control of a person, even if the interest in the financial property becomes fixed and enforceable before the enforcement of the security. This provision is intended to ensure that a security which was historically considered to be a "floating charge" over all present and after-acquired property (or all present and after-acquired property of a particular class) would not, without more, satisfy the possession or control test in paragraph 14A(1)(b) of the *Netting Act*.[51] This is intended to limit the priority of the security to arrangements to those which are more confined than broad security over the security provider's working assets and capital.

When possession or control will exist

The descriptions in the *Netting Act* of when possession or control are taken to exist are intended to address the way in which the possession and control analysis applies to financial market structures. The concept of possession as expressly set out in the *Netting Act* does not track that used either in the common law, or the *PPSA*, as it is applicable whether or not the underlying property is tangible. Instead, the concept is similar to the concept of a legal mortgage, where the possession or title is transferred to the mortgagee but remains subject to the mortgagor's equity of redemption. For example, section 14A(4) of the *Netting Act* provides that financial property is taken to be in the *possession* of a person if:

- in a case where there is an issuer of the financial property, the person is registered by, or on behalf of, the issuer as the registered owner of the financial property; or

- in a case where the financial property is intermediated financial property, the person is the person in whose name the intermediary maintains the account.[52]

The first part of this is intended to cover the situations where the secured person or third party is registered by, or on behalf of, the issuer as the registered owner of the financial property, including where such registration happens on the Clearing House Electronic Subregister System (CHESS) subregister, maintained by ASX Settlement, or the issuer sponsored subregister, maintained by the issuer or a share registry on the issuer's behalf. The second part is intended to include circumstances where, if the financial property is traded or settled through a clearing house or securities depository, the clearing house or

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[48] The *Explanatory Memorandum* states that this concept reflects the "ordinary course of business" concept set out in *In re Yorkshire Woolcombers Association Limited; Houldsworth v Yorkshire Woolcombers Association Limited* [1903] 2 Ch 284 in respect of floating charges.

[49] The *Explanatory Memorandum* to the Bill stated that the reference to an interest in the financial property being "fixed and enforceable" means that circumstances arise such that the floating charge attaches to specific property and the grantor ceases to be able to deal with the property and the secured person has a presently exercisable right to take enforcement action in respect of the secured property: [1.147].

[50] This is similar to the approach taken in respect of the now repealed section 561 of the *Corporations Law* and the related definition of "floating charge".

[51] *Explanatory Memorandum* to the Bill, [1.147].

[52] This concept of "possession" can be seen to have a broader meaning than its technical customary meaning, which would be limited to bearer securities in certificated form.

securities depository, as the case may be, records the interest of the person in the financial property.

The express inclusions of control in the *Netting Act* are close to those used in the *PPSA*. Section 14A(5) of the *Netting Act* provides that financial property which is intermediated financial property is taken to be under the *control* of a person if:

- the intermediary is not the grantor (but may be the secured person or any other person); and

- there is an agreement in force between the intermediary and one or more other persons, one of which is the secured person or the grantor, which has one or more of the following effects:

  - the person in whose name the intermediary maintains the account is not able to transfer or otherwise deal with the financial property;

  - the intermediary must not comply with instructions given by the grantor in relation to the financial property without seeking the consent of the secured person (or a person who has agreed to act on the instructions of the secured person);

  - the intermediary must comply, or must comply in one or more specified circumstances, with instructions (including instructions to debit the account) given by the secured person in relation to the intermediated financial property without seeking the consent of the grantor (or any person who has agreed to act on the instructions of the grantor).

However, these are not the only possible circumstances under which a secured person or third party may have possession or control. Common law tests can apply. Further, section 14(6) the *Netting Act* sets out rights of the grantor which do not, of themselves, mean that sufficient possession or control is not present. These are:

- right to receive and withdraw income in relation to the financial property;

- right to receive notices in relation to the financial property;

- right to vote in relation to the financial property;

- right to substitute other financial property that the parties agree is of equivalent value for the financial property;

- right to withdraw excess financial property;

- right to determine value of financial property.

These were included because they are regularly part of modern security structures used in the financial markets and are not intended to deprive those securities from having the protection which they might not otherwise have.[53] However, as noted above, they are not supposed to be exclusive.

The regulations may also prescribe circumstances in which financial property is, or is not, transferred or dealt with so as to be in the possession or under the control of a person for

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[53] This has been a particular concern in the application in the United Kingdom of the *Financial Collateral Arrangements (No. 2) Regulations 2003 (UK)* as amended by the *Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations 2010.*

the purposes of section 14A(1)(b) of the *Netting Act*. As at the date of this paper, there are no regulations prescribing such circumstances.

The secured obligations must be "eligible obligations"

A further limitation to the application of the new protection relates to the obligations being secured by the financial property. The protection applies only to the extent that the obligations secured by the financial property, and discharged through the enforcement, are the obligations of a party to a close-out netting contract, which are:

- eligible obligations in relation to the contract; or
- obligations under the contract of a party to the contract to pay interest on an eligible obligation; or
- obligations of a party to the close-out netting contract to pay costs and expenses incurred in connection with enforcing security given in respect of an eligible obligation.

As noted above, this makes the presence of a close-out netting contract fundamental. Also, this makes the definition of "eligible obligation" critical. Under section 14A(8) of the *Netting Act* an obligation is an "eligible obligation" in relation to a close-out netting contract if the obligation is any of the following:

- an obligation under the contract of a party to the contract that relates to a derivative or foreign exchange contract[54] (each having the meaning which it has in Chapter 7 of the *Corporations Act*) or is of another prescribed kind;[55]
- an obligation that results from the netting of 2 or more obligations that are created under the contract that must include at least one obligation covered by the paragraph above and may include one or more incidental obligations that, taken together, do not form a material part of the net obligation;
- an obligation declared by the regulations to be an eligible obligation in relation to a close-out netting contract.[56]

This concept of eligible obligation is intended to focus the application of the new laws on derivatives which are subject to the international margining standards. The definitions in the *Corporations Act* are used for this purpose. However, the scope of application is clarified further. An obligation is not an eligible obligation in relation to a close-out netting contract if it is so declared by regulations. The *Payment Systems and Netting Regulations 2001* (Cth) (***Netting Regulations***), as amended by the *Financial System Legislation Amendment (Resilience and Collateral Protection) Regulation 2016* (Cth), provide that a range of obligations are not eligible obligations in relation to a close-out netting contract, for a range of purposes. Relevantly for the purposes of this paper, none of the following are eligible obligations in relation to a close-out netting contract:

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[54] Foreign exchange contracts are included so that short term foreign exchange contracts are also protected, even though they fall outside the definition of derivative in the *Corporations Act*.

[55] In this regard, the *Payment Systems and Netting Regulations 2001* (Cth) prescribe as an eligible obligation an obligation that relates to an arrangement that is a forward, swap or option, or any combination of those things, in relation to one or more commodities. This is important because of some of the exceptions in the definition of derivatives relating to sales of tangible property.

[56] As at the date of this memorandum, no such declaration has been made.

- an obligation under a credit facility,[57] including a margin lending facility;[58] and an obligation under a financial product that is declared by the Australian Securities and Investments Commission under section 761EA(9) of the *Corporations Act* not to be a margin lending facility;

- an obligation under a deposit taking facility;

- an obligation under a reciprocal purchase agreement (otherwise known as a repurchase agreement), a sell-buyback arrangement or securities loan arrangement.[59][60]

These regulations mean that the inclusion of transactions of these types in a close-out netting contract would complicate the ability to rely on the new protections for the enforcement of security granted in respect of that contract. This is because any close-out netting which takes place under the contract on default and prior to any enforcement of security which nets eligible obligations and non-eligible obligations would make it impossible to distinguish between the amounts which arise because of the different transactions which were terminated as part of the netting. If some of those transactions were not eligible obligations then it will be difficult to work out what part of the single net amount related to them. This means that, for example, if repo transactions were to be entered into under a close-out netting contract then it would be important that any margin were provided by absolute transfer of collateral, rather than by way of security so that the new security protection is not needed.

Given the need to satisfy all of these conditions to obtain the protection of the new laws for the enforcement of security, some guidance in using the new protections are set out next.

Where care is needed in using the new financial collateral laws

Fundamentally, the protections of the new regime are designed for use in complying with the international margining requirements. They will be needed for the granting of security over initial margin and may also be used for variation margin, if it is to be provided in the manner customary for US counterparties, which is by way of security. However, the new laws do not specify a direct linkage with those requirements, as that would be particularly unworkable given the number of foreign laws and regulations which will impose the international standards.

Accordingly, it is important that care is taken when structuring a security arrangement which needs to have the protection of the new financial collateral security regime. It should be expected that a court will require strict adherence to the conditions of the new protection given the priority which the protection has over other important Australian laws. Some key areas to be aware of are:

- *Master agreements which are not close-out netting contracts.* The keystone of the new protections is that there is a close-out netting contract between the parties. Everything relates to that. Not every derivative master agreement is a

[57] This term has the meaning given in the regulations made for the purposes of subparagraph 765A(1)(h)(i) of the *Corporations Act.*

[58] The term "margin lending facility" has the same meaning as in Chapter 7 of the *Corporations Act*.

[59] However, repos are prescribed obligations for the purpose of other new provisions of the *Netting Act* relating to the new "stay" provisions.

[60] *Netting Regulations,* rule 6(2). Under the *Netting Regulations*, each of the following obligations have also been declared not to be an eligible obligation: an obligation under a contract of insurance, including a life policy or a sinking fund policy within the meaning of the *Life Insurance Act*; an obligation under a managed investment scheme (within the meaning of the *Corporations Act*); an obligation under a lease or licence; an obligation under a guarantee; an obligation to pay money under a cheque, an order for the payment of money or a bill of exchange.

close-out netting contract and the conditions to constitute a close-out netting contract must be satisfied. For example, a contract which does not calculate a "true termination value"[61] or which determines that a close-out amount is payable only if it is payable by a defaulting party should not be considered to be eligible for the new protection.

- *Secured obligations which extend beyond derivatives.* As noted above, the enforcement of the security is protected only to the extent that the obligations which are secured are "eligible obligations". Primarily, this means derivatives and foreign exchange contracts, as defined in the *Corporations Act*. In considering this, care needs to be taken with the exclusions from these definitions. For example, the provision of credit. As noted above, this can become quite complicated if both eligible obligations and non-eligible obligations are included in the same close-out netting contract and *are netted with each other.* Prime brokerage agreements are an example of this. Another are master netting arrangements between derivatives and repos. The protection of the new provisions may not be available for security given in these circumstances.

- *Close-out netting contracts governed by foreign law.* The new protections adopt the same jurisdictional reach provisions as the existing protection of close out netting under the *Netting Act*. This means that they are always in operation for close-out netting contracts which are governed by an Australian law, but apply only to foreign law governed close-out netting contracts *if there is an external administration which is governed by an Australian law.* This means that it does not operate in the case of a foreign law governed contract unless there is an Australian law-governed insolvency proceeding. Until that time, the ordinary Australian laws can apply, such as the *PPSA*. For these contracts, it will be important to comply with the requirements of the ordinary Australian laws to protect enforceability (such as registration), should enforcement occur before any insolvency proceedings have commenced.

- *Security which is a traditional "floating charge".* Not too long after the concept of a floating charge was reduced in relevance due to the changes effect by the *PPSA,* it has been restored in the conditions to the protection afforded by the *Netting Act*. As noted above, the protections are not available if, under the security, the grantor is free to deal with the financial property in the ordinary course of business until the secured person's interest in the financial property becomes fixed and enforceable. Fortunately, the Act does specify some rights which do not amount to a contravention of this requirement, which provides considerable assistance in applying a traditional test to modern collateral arrangements. However, care will need to be taken in ensuring that additional rights which are retained by the grantor do not deprive the security of the new protection.

Where care is needed in avoiding the application of the new financial collateral laws

Just as there are circumstances where the protection of the new law is needed, there will also be circumstances where a creditor wants to ensure that the protection is not available. An example of this is where security is taken which does not have the benefit of the new protection is defeated in its priority by security which has that protection. In other words, how can creditors be sure that their security will not be defeated by a subsequent security which is able to be enforced "despite any other law"?

[61] The *Explanatory Memorandum* to the original *Payment Systems and Netting Bill 1998* sets out that "*A device of the kind used in Ex parte Mackay (1883) 8 Ch App 643 would not fall within the definition because it would not reflect any attempt to calculate the true termination value of the obligation under consideration.*"

The key to managing this risk is in the conditions which need to be satisfied in order for the new protection to apply. A holder of "ordinary" security over property can protect its security by ensuring that at least one of the conditions cannot be satisfied in respect of that property by another creditor. For example, if the relevant property is not financial property, then new security which would be protected by the new laws cannot be taken. However, if the relevant property is financial property then it won't be possible to ensure that any new security is either not in writing or not in existence.[62] Nor will it be possible to ensure that any new security does not secure eligible obligations. Accordingly, the key to guarding "ordinary" security over financial property from an unwanted operation of the new protection with a subsequent security is to ensure that no other person can take sufficient possession or control over that property in order to obtain the benefit of the new laws.

In this regard, the new law has been designed to be consistent with a key feature of the *PPSA*. It reflects that the priority is given under the *PPSA* to security interests which are perfected by possession or control. Under the *PPSA* a security interest which is perfected by control will have priority over a security interest which is perfected by registration.[63] This means that there is already a need to consider if other creditors have, or could take, possession or control of assets over which security is to be taken. The introduction of the new source of priority if possession or control increases the scope of potential competing creditors but does not change the need to take care in considering this possibility.

Of course, there is still room for discrepancy between the new protections and the *PPSA.* Primarily this discrepancy could arise in the property over which possession or control can be taken and the means of taking possession and control. There is room for the new security protection applying in a fashion which is not expected by a creditor familiar with the *PPSA* when the new protections allow possession or control to be taken over more property than the *PPSA* provides, or the methods of possession or control are broader than that provided for by the *PPSA.* In each of these two cases, the new protections for security in the *Netting Act* are engaged when perfection by possession or control would not have been available under the *PPSA.* These are considered in turn below.

Comparison of financial property

Under the *PPSA*, a security interest can be perfected by control over ADI accounts, intermediated securities, investment instruments and uncertificated negotiable instruments. This would cover some types of property which are not included in the definition of "financial property" in the *Netting Act.*[64] However, it would not include currency, gold, silver, platinum and proceeds from "financial property", cash collateral, and a document evidencing ownership of gold, silver or platinum. Each of these is included in the *Netting Act*. For these types of property, extra care should be taken as PPSA control would not normally be taken.[65]

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[62] As noted above, the new protection applies the protection on enforcement of security applies, despite the creation or operation of any encumbrance or any other interest in relation to the financial property.

[63] Sections 57 of the *PPSA*.

[64] Technically, the definition of "intermediated security" in the *PPSA* is broader than "intermediated financial property" in the *Netting Act*, in that in the *Netting Act* the term is limited to the account holder's rights only to the extent they relate to other types of financial property whilst in the *PPSA* the definitions goes further to include rights in an account to which interests in financial products may be credited or debited (which need not be interests in financial products themselves).

[65] There are special rules about possession in the *PPSA* for goods transported by a common carrier, negotiable instruments not evidenced electronically, chattel paper evidenced electronically and investment instruments evidenced by a certificate. Some "financial property" may be capable of being "possessed" under the *PPSA*.

Comparison of manner of obtaining possession or control

The first difference between the tests of possession and control in each of the *Netting Act* and the *PPSA* is that the specific tests for control in the *PPSA* are the only methods of obtaining control for perfection purposes whilst the specific tests set out in the *Netting Act* are not exclusive, and general law tests for control can still apply. In this regard, the *Netting Act* is similar to the approach taken in the *PPSA* with respect to control for the purposes of determining circulating assets.

The second difference is in the nature of some of the specific tests for control. For example:

- Under the *Netting Act* control with respect to intermediated financial property can exist where due to an agreement between the grantor, intermediary and secured party where the intermediary and secured party are the same entity. There has been some concern that, for technical drafting reasons, this may not be possible with respect to intermediated securities under the *PPSA*;

- Under the *Netting Act,* control can be obtained over intermediated financial property if the agreement has the effect that the person in whose name the intermediary maintains the account is not able to transfer or otherwise deal with the financial property. This is in addition to the alternative tests which are contained in the *PPSA* and the *Netting Act*;

- Under the *PPSA*, control can be taken over uncertificated investment instruments or negotiable instruments even if the grantor retains the right to make substitutions for the instrument, originate instructions to the issuer or otherwise deals with the instrument. [66] Under the *Netting Act* there is a more extensive list, which includes withdrawing income in relation to the property, the right to vote, the right to receive notices, the right to withdraw excess financial property and the right to determine its value.

The third difference is that under the *PPSA* there is no statutory test equivalent to that in the *Netting Act* which requires that the grantor not be free to deal with the financial property in the ordinary course of business. In this regard, the *Netting Act* follows closer the approach to control taken in the *PPSA* in determining whether there is a security interest over circulating assets.

These differences mean that it is possible for possession or control to exist over financial property under the *Netting Act* in circumstances where there would not be control for the purpose of perfection under the *PPSA.* Accordingly, creditors taking security which they are seeking to perfect by registration (or even by possession or control) under the *PPSA* need to be aware that their interest in that property could be defeated by a security which has the protection of the *Netting Act* even where that security is not able to be perfected by control under the *PPSA.*

Although awareness of this could protect a "*PPSA* security interest" from defeat from a subsequent "*Netting Act* security", it may not always be able to be relied on as a matter of practice. Due to the international standards which caused for the need for the need for the new laws, derivative counterparties are likely to require collateral with top priority in order to satisfy their margin obligations. In other words, the financial property may just not be available for any other "ordinary" security.[67]

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[66] Sections 27(6) and 29(2) of the *PPSA*.

[67] A discussion of how this might change financing structures themselves is beyond the scope of this paper.

What the new financial collateral laws bring to Australian banking and finance law

From the perspective of the financial markets, the new laws were critical. They provided consistency with overseas systems in a global marketplace and allowed compliance with mandatory international margining rules. They are the result of many years' work and were made just in time.

They may seem to mean less to the overall practice of banking and finance law. That is because the new security laws primarily relate to derivative contracts and foreign exchange contracts. Arguably, this limits the relevance of their application.

However, such a view of the new laws understates their true effect, for a number of reasons:

- derivative contracts and foreign exchange contracts are involved in so many financings that the new laws actually could apply in a broad range of transactions
- when the new margin regulations come into effect, they will change the way in which derivatives must be secured, even if those derivatives relate to other financings
- the effect of the new security laws are not limited to margin which is taken to satisfy the new margin regulations
- the new security laws could affect property over which other security has been, or is to be, taken.

This means that, in some cases, parties will want the protection of the new laws, and in other cases they will not. The necessary intricacy of their operation means that significant care needs to be taken.

Also, perhaps less practically but still interestingly, the new laws recall to practice a number of considerations which the *PPSA* had made less relevant. This is because the new laws refer more to traditional principles of common law and equity in determining what is security and when it is protected. In this way, Australia's new financial collateral security laws requires that banking and finance lawyers stay in touch with the roots of their craft.