

14 October 2020

Attorney General's Department
4 National Circuit
BARTON ACT 2600

By email: PPSAReform@ag.gov.au

Dear Sir/Madam,

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

This submission concerning industry consultation on financial products and the *Personal Property Securities Act 2009* (Cth) is made jointly by the Financial Services Committee and Insolvency and Restructuring Committee of the Business Law Section of the Law Council of Australia (the **Committees**).

Set out in the table below are our responses to the 22 specific questions that were raised in the Public Consultation Paper published in September 2020 (**Consultation Paper**). Abbreviations and terms defined in the Consultation Paper are used in our responses.

| Question | Response |
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| 1. If the PPS Act is amended so that Australian Clearing House Subregister System (CHES) securities are characterised as investment instruments rather than intermediated securities, would it be useful for the definition of intermediary [to] be amended so that it no longer expressly includes the operator of a CS facility? | Yes, assuming the definitions of investment instrument and intermediated security are not merged. Refer to our response to question 9 below. |
| 2. Should the licence requirement for an intermediary be removed from the PPS Act? If so, how could the nature of an intermediary for the purposes of these provisions be described (ie - in order to work out what is or is not an intermediated security under the PPS Act)? | Yes, the licence requirement should be removed from s 15(2)(a). The focus of the definition should be on the functions performed by the intermediary not the regulatory regime to which it is subject. |

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| <p>3. Should the PPS Act be amended to clarify the meaning of the 'rights' of a person who holds a securities account with an intermediary? For example, would it be sufficient to refer to the rights of a person who holds a securities account with an intermediary 'in relation to the financial products', or 'in relation to the financial products that are recorded in that securities account'?</p> | <p>Yes, to both questions.</p> |
| <p>4. Are there other ways in which the concept of an intermediated security could be simplified or clarified to ensure it is easier to apply in practice?</p> | <p>Refer to our response to question 9.</p> <p>An issue that is relevant is the current inability to effect a registration on the PPSR that applies to more than one collateral class. It should be possible to register a financing statement that covers more than one collateral class; for example, investment instruments, intermediated securities, general intangibles and ADI accounts, enabling all collateral classes related to a particular secured transaction to be covered by one registration (without having to resort to using the 'all present and after acquired property, with exceptions' collateral class).</p> |
| <p>5. Is it appropriate that the PPS Act should continue to define investment instruments by reference to the Corporations Act?</p> | <p>No. We believe that the definition in the PPSA should be self-contained and based on appropriate policy objectives for the PPSA.</p> |
| <p>6. If not, should the PPS Act define investment instruments using the general definition of financial product that is in s 763A of the Corporations Act, without the qualifications in Part 7.1, Division 3, Subdivision B of that Act?</p> <p>(a) Alternatively, should the PPS Act simply use the text in paragraph (b) of the definition of financial product in the PPS Act for all purposes of the PPS</p> | <p>No, we do not think that definition is appropriate for PPSA purposes.</p> <p>We prefer this approach.</p> <p>However, we note the following:</p> |

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| Act, including the definition of investment instrument? | <ul style="list-style-type: none"> • it should not be necessary to have two definitions (i.e. investment instrument and financial product) if they have the exact same meaning; • we expect it will still be necessary to exclude certain things from the definition of investment instrument (refer to paragraphs (k), (l), (m) and (n) of the definition as currently drafted); • if the definitions of investment instrument and intermediated security are merged (refer to our response to question 9 below) this approach may need adjustment. |
| 7. Should all of the paragraphs of the definition be retained? Can the definition be simplified in other ways? | No, the current definition of 'investment instrument' should not be retained. Refer to our responses to questions 5, 6, 6(a) and 9. |
| 8. In practice, is it more appropriate that securities held through CHES are classified as an investment instrument instead of an intermediated security? | Yes, assuming the definitions of investment instrument and intermediated security are not merged. Refer to our response to question 9. |
| 9. Would it be useful in practice if the definitions of investment instruments and intermediated securities were to be amalgamated? If so, the department welcomes comments as to how this may be achieved to reflect Australian commercial realities. | <p>As a practical matter this may overcome some of the difficulties of characterising certain property within one or the other of these two collateral classes.</p> <p>We think it should be possible to combine the concepts into a single definition if the control perfection requirements are also aligned. An amalgamated definition of 'investment property' is suggested below.</p> <p><i>'investment property' means any of the following or an interest in any of the following:</i></p> |

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- (a) *a share, participation or other interest in an issuer or in property or an enterprise of an issuer;*
- (b) *an obligation of an issuer (other than an obligation arising from the disposal of property to the issuer or the granting of a right to, or providing services to, the issuer);*
- (c) *any other financial instrument;*
- (d) *any other financial asset;*
- (e) *an account in which the grantor's interest in any of the above assets may be credited or debited,*

that may be transferred or dealt with (whether or not subject to conditions):

- (f) *by, in the case of an interest that is evidenced by a certificate, delivery of the certificate 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*
 - (g) *by an entry in the records of a clearing house or securities depository; or*
 - (h) *by an entry in the records maintained for that purpose by or on behalf of the issuer; or*
 - (i) *by an entry in the records or account maintained for that purpose by or on behalf of a nominee, intermediary or other person,*
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| | <i>but does not include cash, a document of title, a letter of credit or a negotiable instrument.</i> |
| <p>10. Would it be useful for the term 'negotiable instrument' [to] be aligned with the meaning at general law?</p> | <p>Yes. We think the definition should be confined to paragraphs (a), (b), (c) and (d)(ii) of the current definition.</p> <p>The exclusions in paragraphs (f), (g) and (h) of the current definition should not be necessary. However, it may be desirable to expressly exclude from the definition of negotiable instrument any promissory note that is recorded on a register and not issued as a physical instrument. This is aimed at ensuring such notes are treated as 'investment property' (as per the suggested definition in our response to question 9) and not excluded from that definition by virtue of being negotiable instruments.</p> |
| <p>11. Do you support aligning the mechanisms for perfection by control in ss 26 and 27 so they are as consistent as possible? If so, the department welcomes comments on how this alignment would be best achieved.</p> | <p>We support aligning the mechanisms for perfection by control in ss 26 and 27. This will be particularly useful if the definitions of investment instrument and intermediated security are merged.</p> <p>The concept of control should, in our view, simply focus on ensuring that the secured party, and no-one else, is able to deal with the relevant collateral. The concept should also seek to ensure that, absent fraud, only one secured party is in a position to control dealings with the relevant collateral. To the extent a secured party must rely on a third party (such as a CHES participant or intermediary) to ensure no-one other than the secured party can deal with the relevant collateral, any agreement between the secured party and that person should include provisions</p> |

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| | <p>which, if complied with by that person, would prevent another secured party obtaining control.</p> <p>The grantor should not be able to initiate or give effect to dealings in collateral that is subject to control unless the secured party has consented. The current drafting of ss 26 and 27 contemplates that such dealings may be permitted to occur (for example, s 26(2)(b)(ii) and s 27(6)). If relevant property is uncertificated and recorded on an account maintained by an intermediary or CHES participant, that party should be required to expressly agree or acknowledge the secured party's rights to control dealings with the collateral. Mere notification should not suffice.</p> |
| <p>12. How does perfection by control of intermediated securities and investment instruments operate in practice?</p> | <p>Secured parties seek to satisfy the requirements of ss 26 and/or 27, as applicable. However, a prudent secured party will also take measures to ensure no other person can obtain control of the relevant collateral and the grantor is unable to deal with the collateral without its express consent. That is to say, a secured party will often go beyond the minimum requirements of ss 26 and 27.</p> <p>Secured parties often also register one or more financing statements depending on the nature of the transaction and the collateral involved - refer to our response to question 13 below.</p> |
| <p>13. Would it be appropriate in commercial practice for the requirements for perfection by control to be amended to ensure that a secured party will only be perfected by control if it is able to ensure that the intermediated security or investment</p> | <p>Yes.</p> <p>In practice, it is not unusual for a secured party to establish control (as per ss 26 and 27) but also take steps to ensure the relevant collateral</p> |

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| <p>instrument cannot be dealt with without the secured party's consent, or</p> <p>The department welcomes other suggestions as to how the requirements for perfection by control can best achieve a notification objective.</p> | <p>cannot be dealt with without its consent.</p> <p>In addition, a secured party will often register one or more financing statements. This is to ensure that the security interest is properly perfected against after acquired property and proceeds in all forms and to ensure that original collateral or proceeds that are not of a collateral class that can be perfected by control are perfected by registration.</p> <p>Refer to our responses to questions 11, 12 and 13.</p> |
| <p>14. Should the PPS Act be amended to allow perfection by control over cash that is held through an intermediary?</p> | <p>It is unlikely that cash, as such, would be held by an intermediary. Money paid to the intermediary pending investment and the proceeds of investments would normally be held in a 'cash account' but technically this would be an ADI account maintained by the intermediary so the relevant asset is the investor's interest in an ADI account maintained by the intermediary rather than cash. Such amounts should also be held on trust by the intermediary for the benefit of the investor.</p> <p>Another consideration is that perfection in respect of proceeds generally requires a registration (s 33, PPSA) and perfection by control in respect of an ADI account as original collateral can only be achieved when the ADI is the secured party (s 25, PPSA). Departing from this position to enable any person to perfect by control in respect of certain proceeds of original collateral that can be perfected by control will have significant implications for both the</p> |

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| | <p>drafting of the PPSA and commercially.</p> <p>Proceeds of investment property should not necessarily be treated in the same way as the original collateral.</p> <p>The Public Consultation Paper (at page 25) refers to reforms recommended in Ontario to allow perfection by control over cash collateral accounts. However, it appears that these recommendations were not specifically directed at cash held by an intermediary and the proposal to allow perfection by control over cash collateral accounts in Ontario appears to be directed at a specific scenario, namely, where 'cash collateral' (i.e. typically money deposited in a bank account) is held in respect of OTC derivatives. The Ontario proposal seems intended to ensure such security has priority over certain preferred creditors who are entitled to a deemed statutory trust that would otherwise have priority (Ontario Business Law Advisory Council, Report to Minister of Government and Consumer Services, Fall 2016).</p> <p>On balance, we are not in favour of enabling a security interest in cash or ADI accounts to be perfected by control, other than as currently provided for in the PPSA (s 25).</p> |
| <p>15. Do uncertificated negotiable instruments (in the technical legal sense) exist in practice?</p> | <p>Not in a technical legal sense.</p> |
| <p>16. Should ss 21(2)(c)(iv) and 29 be removed from the PPS Act?</p> | <p>Yes. We agree with the points made by Bruce Whittaker at 5.3.8.1 and 5.3.8.2 of the Review.</p> |

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| 17. Is the concept of perfection by control over a letter of credit meaningful and appropriate for the PPS Act, or should ss 21(2)(c)(v) and 28 be deleted? | Although rarely seen in practice, we are aware of security being taken and perfected in the manner outlined in these sections. We support the retention of these provisions. |
| 18. If your answer to the previous question is that the sections can be deleted, should any of the other references in the PPS Act to letters of credit be retained, or can they all be deleted? | Refer to our response to question 17. |
| 19. Should the taking free rules under ss 50-51 ¹ be retained in the PPS Act? If so, why? | On balance we are of the view that ss 50 and 51 should be retained if security interests in investment instruments and intermediated securities are to continue to be capable of being perfected by control. It is common practice for a secured party wishing to obtain the best possible protection for security over investment instruments and intermediary securities to perfect by control and ensure that the collateral cannot be dealt with without the secured party's consent. This practice pre-dates the PPSA and the current PPSA position reflects long standing practices. If a secured party does not have effective control (or possession in the case of certificated investment instruments) we think the take free rule benefitting a purchaser is desirable from a policy perspective. |
| 20. If retained, should these sections operate in favour of another secured party? ² If so, why? | No. We believe s 50 is not intended to favour another secured party. Section 50(1) refers to a "purchaser... other than a secured party" but there is some ambiguity caused by s 42(b) and the definition of purchaser in s 50(3). |

¹ Incorrectly referred to as [17] on page 32 of Consultation Paper

² Incorrectly referred to as [18] on page 32 of Consultation Paper

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The drafting of both ss 50 and 51 should be amended to make it clear they do not operate in favour of another secured party.

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

- Section 21(2)(c)(i) - ADI accounts

Yes. As noted in the Review, ADIs can rely on set-off and combination of account rights so the ability of an ADI to perfect by control is consistent with these rights. We do not believe the ability to perfect by control in respect of an ADI account should be extended to secured parties other than the ADI itself.

- Section 21(2)(c)(iv) - a negotiable instrument not evidenced by a certificate

No. As noted above, we support the deletion of s 21(2)(c)(iv).

- Section 21(2)(c)(v) - a right evidenced by a letter of credit that states that the letter of credit must be presented on claiming payment or requiring the performance of an obligation

Yes. As noted above, we support the retention of s 21(2)(c)(v).

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

Security interests that can be perfected by control in respect of particular collateral should have priority over security interests perfected by other means such as registration. Otherwise, there is no real point to enabling perfection by control. The issue as to which types of collateral should be capable of being the subject of a security interest perfected by control is essentially a matter of policy having regard to the commercial consequences.

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In the case of ADI accounts, enabling an ADI to perfect by control and have priority over an earlier registered interest is commercially practical given that an ADIs set off rights are not governed by the PPSA and they will usually prevail over a registered security interest. ADIs often include both set off rights and security provisions in the terms and conditions applicable to ADI accounts and the other agreements between an ADI and its customers. In our view it would be cumbersome and commercially impractical to require an ADI to have to register and possibly enter into a priority deed with a secured party having an earlier registration in order for the ADI to ensure it has priority over an ADI account with itself in relation to any security interest that supplements its set off rights.

We understand the ability to perfect by control in respect of security interests over investment instruments, intermediated securities and letters of credit that must be presented for payment and achieve a super priority outcome reflects stakeholder input during the original consultation process leading up to the introduction of the PPSA. The continuance of these arrangements is an issue of policy rather than legal necessity.

In relation to the priority of security interests perfected by control, the wording of ss 57(2) and (2A) should be clarified. In particular:

- in s 57(2), it is not clear if the words “perfected by control” refer to the date of actual perfection in accordance with s 21 or the date

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| | <p>control is effected, regardless of the date the security interest becomes perfected;</p> <ul style="list-style-type: none"> in s 57(2A), there is a degree of circularity about the drafting. <p>Although not raised in the Public Consultation Paper, we think it would be preferable to exclude satellites and space objects from s 21(2(c)) and require security interests in such property to be perfected by registration. This would be consistent with the approach taken under the Space Protocol to the Cape Town Convention.</p> |
| <p>22. Would it be useful for s 109(3) [to] be:</p> <p>(i) retained in its current form</p> <p>(ii) amended so that it applies only to investment instruments and intermediated securities that are traded on a prescribed financial market</p> <p>(iii) expanded to cover all collateral that is traded on a prescribed financial market</p> <p>(iv) amended in some other way, or</p> <p>(v) deleted?</p> | <p>No.</p> <p>Yes, subject to any necessary amendments if these two collateral classes are merged.</p> <p>Yes.</p> <p>No.</p> <p>No.</p> |

The Committees would be pleased to discuss any aspect of this submission.

Please contact Craig Wappett, a member of the Financial Services Committee, on 0404 475 090 or Craig.Wappett@jws.com.au if you would like to do so.

Yours faithfully



Greg Rodgers
Chair, Business Law Section