5 August 2009

Mr Peter Hallahan
Committee Secretary
Senate Legal and Constitutional Affairs Committee
Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600

By email: legcon.sen@aph.gov.au

Dear Mr Hallahan

Personal Property Securities Bill

The Australian Financial Markets Association (AFMA) welcomes the opportunity to provide comments to the Senate Legal and Constitutional Affairs Committee Inquiry on the Personal Property Securities Bill (PPS Bill).

AFMA represents the interests of participants in Australia's wholesale banking and financial markets. Our members include banks, stockbrokers, treasury corporations, fund managers, traders in specialised products and industry service providers. Their business places them at the centre of the equities market; brokering transactions, arranging and underwriting capital raisings, structuring products, trading and investing.

The comments in this submission are directed to several specific issues and do not touch upon our broader policy concerns with the design and implementation strategy for the personal property securities regime. These were dealt with in our submission to the Committee's consultations on the exposure draft of the PPS Bill in December 2008.

Investment Entitlements

Investment entitlements as defined by clause 15 of the PPS Bill are dealt with in a way that is not extensive enough.

Coverage

It appears that that PPS Bill does not appear to include an 'investment entitlement' within its scope. Clause 6 defines the coverage of the PPS Bill, which expressly includes an 'investment instrument' but not an 'investment entitlement'. The definition of investment instrument in clause 10 expressly excludes 'investment entitlement' in subclause 10(m). Accordingly, clause 6 should expressly refer to 'investment entitlement'.

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Registration

Clause 26 deals with when a secured party would have control of an investment entitlement. Control only occurs if there is an agreement in force between the secured party, the grantor and the investment entitlement intermediary who maintains the account to the effect that the intermediary:

(a) must not comply with instructions in relation to the investment entitlement given by the grantor without consent of the secured party; and

(b) must comply with the instructions of the secured party in relation to the investment entitlement.

Clause 27 in turn deals with control of an 'investment instrument'. Under subclauses 27(2) and (3) where the investment instrument is registered in the name of a third party it is regarded as being under the control of that party. It is desirable for an equivalent provision to be added to clause 26 to enable a secured party to have control of an investment entitlement when registered in its name to the same extent that it can have control when it registers an investment instrument.

Limitation on recoverability

Subclause 32(2) enables a security interest to continue in the collateral. This allows a secured party to enforce their security interest against either or both of the collateral or the proceeds. Where a secured party proceeds against both the collateral and the proceeds, the amount recoverable would be limited to the market value of the collateral immediately before the collateral gave rise to the proceeds, unless the collateral is an investment instrument or, at the time of the transfer, the transferee knew that the transfer was in breach of the security agreement. It is unclear what the policy rationale is for only exempting investment instruments from the operation of subclause 32(2) and not investment entitlements.

The value recoverable with respect to investment entitlements should be governable by the terms of an agreement and not only by resort to market value. For example credit support annexes (CSA) provide credit protection by setting out the rules governing the mutual posting of collateral. CSAs are used in documenting collateral arrangements between two parties that trade over-the-counter derivatives and are annexed to ISDA Master Agreements. Such agreements contain highly technical internationally, standardised provisions dealing with the calculation of recoverable amounts in the event of default.

Accordingly, subclause 32(2) should add an exception for 'investment entitlement' in similar terms to that for investment instrument.

There is a wider issued raised below in connection with repurchase arrangements, securities loans and CSAs. In our view they should be generally excluded from the operation of the PPS Bill.

Knowledge of interest in investment entitlements

The Explanatory Memorandum to the PPS Bill comments that a person would acquire an interest in an investment entitlement free of a security interest if:

- the person gave value for the interest (unless the interest acquired is a security interest);
- the person acquired their interest in a consensual transaction;
- the person had no actual or constructive knowledge that the acquisition of the interest was a breach of a security agreement that provides for a security interest in any investment entitlement or financial product.

This appears to contemplate that the person in question is the transferee. This would be consistent with current law. However, the way the exception is expressed in subclause 51(2) it creates an ambiguity that should be clarified. While clause 51(1) identifies the person clearly as the 'transferee', subclause 51(2) uses the circumlocution 'the person in whose name an investment entitlement intermediary maintains the investment entitlement'. It should be made clear that the requisite knowledge is that of the 'transferee' and not the intermediary. The equivalent provision applying to 'investment instrument' in subclause 50(2) is quite clear on this point.

Exclude Flawed Asset Arrangements

Paragraph 8(1)(d) in the Bill appropriately excludes rights of set-off from being a form of interest to which it applies. However, paragraph 12(2)(l) includes 'a flawed asset arrangement' in the definition of a 'security interest'. It has been noted in our previous submissions to the Government that a flawed asset should not be included as a security interest as it constitutes a feature of an asset rather than dealing with an asset and is never enforced as such. A flawed asset structure simply sets up the exercise of a subsequent right of the lender with regard to the flawed asset.

The December 2008 exposure draft of the PPS Bill properly did not include 'a flawed asset arrangement' in the definition of 'security interest'. There is no explanation in the Explanatory Memorandum to the PPS Bill regarding the policy reason for its inclusion in the introduced version of the bill.

Flawed asset structures are used in financial markets in a variety of circumstances, such as in futures broking arrangements. Nearly all futures broking agreements contain a combined obligation to provide collateral on demand, combined with a flawed asset arrangement and the set-off clause, to achieve, as far as possible, a net exposure. It would be untenable if the proposed regime was to interfere with these arrangements, which are central to the safe and efficient operation of the market.

One serious practical consequence that needs to be avoided is the situation where ISDA Master Agreements would need to be registered, as they contain a flawed asset provision.[1] Registration which may be required under the draft

[1] Section 2(a)(ii) of the ISDA Master Agreement provides that the obligation of a party to make a payment or delivery is subject to the condition precedent that no 'event of default' or 'potential event of default' with respect to the other party has occurred or is continuing.

Bill should be avoided given the costs and practical consequences, which are inconsistent with the objectives of the proposed reform.

Exclude Absolute Transfers

The reference to arrangements that 'in substance' secure payment or performance of an obligation will generate uncertainty in an area of law in which traditional distinctions of legal form are respected by the courts and are relied on by parties to commercial and consumer transactions. Unless the PPS Bill provides greater clarity about how 'substance' is to be assessed, the current definition of security interest is likely to unsettle negotiated allocations of contractual risk. It is not appropriate for the PPS regime to affect arrangements where absolute title passes and the transferor only has a contractual right to the return of an asset that is equivalent to the particular asset that was transferred.

The PPS Bill should expressly exclude repurchase agreements (repos), securities lending arrangements and CSAs. The meaning of 'in substance' could be clarified so as to exclude particular arrangements that might arguably be included in the definition, but (a) are not generally regarded as security interests, or (b) should not be included as security interests. This is how the December 2008 Exposure Draft of the PPS Bill was drafted. See paragraphs 6(1)(f)(ix) and (x) of the exposure draft. There is no explanation in the Explanatory Memorandum to the PPS Bill regarding the policy reason for the changed drafting in the introduced version of the bill.

Negotiable Instruments

Clause 70 provides that the interest of a holder of a negotiable document of title has priority over a perfected security interest in the instrument if the holder gave value for the instrument and the person acquired the document of title without knowledge of the security interest. As a result, priority between two persons is only dealt with. A consequence of approaching this as a priority issue in Division 5 of Part 2.6 of the PPS Bill is that dealings in negotiable instruments are not fully compatible with the *Payments System and Netting Act 1998,* the *Bills of Exchange Act 1909,* the *Cheques Act 1986* and existing law because rights are not generally extinguished. While both these acts will prevail to the extent of any inconsistency by virtue of the operation of clause 256 of the PPS Bill, the better way to approach this matter in a way that is compatible with them is to treat the issue under Part 2.5 of the PPS Bill so that a person acquiring a negotiable instrument for value and without knowledge of an existing security interest acquires free of the security interest.

Improved Regulation Remediation Powers

The PPS Bill when implemented will have complex impacts on the way the law of securities works in Australia. A large amount of legal analysis still needs to be done and the large body of legal documentation governing trading in the financial markets needs to be evaluated in the light of the provisions of the PPS Bill. Financial market participants and their legal advisers still have an enormous task in front of them in carrying out this work and identifying consequences. As a result, only more obvious issues have been identified so far. While review the legislation will be reviewed after three years this does not address the need to ensure that in the implementation phase the reforms

do not detrimentally affect financial market activity as a result of unintended consequences that come to light when businesses seek to put it into operation. Such problems cannot be allowed to hinder business activity for the extended period that the review and reform legislation process would require.

Greater capacity should be built into the PPS Bill to deal with teething problems in the course of its implementation. A way to address this concern is to build in an improved regulation making power to remediate problems by substantive variation of the law. The PPS Bill contains a general regulation making power in clause 303. It is questionable whether this generic provision would provide enough authority to create remedial regulations that substantively vary the operation of the law in answer to specific problems that arise after passage.

The *Corporations Act 2001* provides a model on how this issue can be addressed. Sections 1364 and 1368 of the Corporations Act allows substantive modification and variation of that act and it also contains more circumscribed provisions such as section 1020AF that enable the law to be modified by regulation to deal with specific parts of the law. More flexibility needs to be built into the PPS Bill to allow it to work in favour or commercial activity and not unintentionally harm it with unintended consequences.

Please do not hesitate to contact me at dlove@afma.com.au or (02) 9776 7995 if further clarification or elaboration is desired. Thank you for consideration of our submission.

Yours sincerely

David Love
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