Companies and Securities Advisory Committee

Jurisdictional legal risk for collateral securities

May 2000

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Request from the Minister

The Minister for Financial Services and Regulation, The Hon Joe Hockey MP, by letter of 11 February 2000, asked the Advisory Committee to report to him by 12 May 2000 on jurisdictional legal risk for securities given as collateral.

Book entry transfer of interests

It is commonplace for persons to take or give interests in securities (collateral) through book entries with intermediaries, without these interests being registered or recorded with the original issuer of the securities.[1] Collateral can, over time, be transferred through holders in many jurisdictions. A collateral taker needs to know at the time of taking the collateral which law to apply to determine the validity of the transfer of interest from the collateral giver to the collateral taker.

There are various possible laws that can govern perfection of title:

(i) the law of the jurisdiction where the issuer of the underlying securities is incorporated

(ii) the law of the jurisdiction where the securities are registered

(iii) the law of the jurisdiction where the physical certificates (if any) are kept

(iv) the law of the jurisdiction where the book entry rights of the collateral taker are recorded

(v) the law of the jurisdiction of the collateral giver, or

(vi) the law of the jurisdiction of the collateral taker.

This jurisdictional issue may arise, for instance, if there is a dispute over the legality of a transfer of interests from a collateral giver to a collateral taker or a collateral giver wrongfully or negligently pledges the collateral more than once and each of the collateral takers claims to have a perfected interest.

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[1] However, in Australia, equitable mortgages over uncertificated securities must be registered as charges. The s 262(1)(g) registration exception only applies to equitable mortgages over certificated securities.

United States

Section 8-110 of the US Uniform Commercial Code, adopted by 48 of the 50 States, including New York in 1997, distinguishes between direct and indirect holdings in determining the governing law for perfection of title, where an action is commenced in a US court. In effect, the direct holding approach applies (i) and (iii) above, while the indirect holding approach applies (iv) above. Neither the direct nor the indirect holding approach applies to insolvency issues.

Direct holding

The direct holding rules apply to any matter that involves the validity of original securities, the original issuer of those securities, the registered holder of those securities, any person who holds any certificates for those securities, or anyone who is making a claim against those persons. In those circumstances, the jurisdiction of incorporation of the corporate issuer, a jurisdiction specified by the issuer, or the location of the security certificates determines the applicable law, depending on the issue.

The relevant provisions are as follows.

"(a) The local law of the issuer's jurisdiction [as defined below] governs:

(1) the validity of a security;

(2) the rights and duties of the issuer with respect to registration of transfer;

(3) the effectiveness of registration of transfer by the issuer;

(4) whether the issuer owes any duties to an adverse claimant to a security; and

(5) whether an adverse claim can be asserted against a person to whom transfer of a certificated or uncertificated security is registered or a person who obtains control of an uncertificated security.

(c) The local law of the jurisdiction in which the security certificate is located at the time of delivery governs whether an adverse claim can be asserted against a person to whom the security certificate is delivered. [Adverse claimants do not include liquidators.]

(d) 'Issuer's jurisdiction' means the jurisdiction under which the issuer of the security is organized or, if permitted by the law of that jurisdiction, the law of another jurisdiction specified by the issuer. An issuer organized under the law of this State may specify the law of another jurisdiction as the law governing the matters specified in subsection (a)(2) through (5)."

Indirect holding

The indirect holding rules apply where the relevant investor has a security entitlement not covered by the direct holding rules. In this case, the applicable law is that of the jurisdiction of the intermediary from whom the investor holds that entitlement.

The relevant provision is as follows.

"(b) The local law of the securities intermediary's jurisdiction [as defined below] governs:

(1) acquisition of a security entitlement from the securities intermediary

(2) the rights and duties of the securities intermediary and entitlement holder arising out of a security entitlement

(3) whether the securities intermediary owes any duty to an adverse claimant to a security entitlement; and

(4) whether an adverse claim can be asserted against a person who acquires a security entitlement from the securities intermediary or a person who purchases a security entitlement or interest therein from an entitlement holder. [Adverse claimants do not include liquidators.]"

The legislation has two further provisions defining a securities intermediary's jurisdiction. One provision, namely (f), makes it clear that some tests that are relevant to the direct holding rules do not apply to the indirect holding rules. It provides:

> "(f) A securities intermediary's jurisdiction is not determined by the physical location of certificates representing financial assets, or by the jurisdiction in which is organized the issuer of the financial asset with respect to which an entitlement holder has a security entitlement, or by the location of facilities for data processing or other record keeping concerning the account."

The other provision, namely (e), sets out various fall-back tests for determining a securities intermediary's jurisdiction. It provides:

> "(e) The following rules determine a 'securities intermediary's jurisdiction' for the purposes of this section:
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> (1) If an agreement between the securities intermediary and its entitlement holder specifies that it is governed by the law of a particular jurisdiction, that jurisdiction is the securities intermediary's jurisdiction.
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> (2) If an agreement between the securities intermediary and its entitlement holder does not [come within] paragraph (1), but expressly specifies that the securities account is maintained at an office in a particular jurisdiction, that jurisdiction is the securities intermediary's jurisdiction.
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> (3) If an agreement between the securities intermediary and its entitlement holder does not [come within] paragraphs (1) or (2), the securities intermediary's jurisdiction is the jurisdiction in which is located the office identified in an account statement as the office serving the entitlement holder's account.

(4) If an agreement between the securities intermediary and its entitlement holder does not [come within] paragraphs (1), (2) or (3), the securities intermediary's jurisdiction is the jurisdiction in which is located the chief executive office of the securities intermediary."

Section (e)(1) permits the parties to choose any jurisdiction, whether or not either of them are located in that jurisdiction, or the transaction has any relationship to that jurisdiction. By contrast, sections (e)(2)-(4) apply various nexus tests.

The rules in practice

The following example demonstrates how a court would determine what law it had to apply under the direct and indirect holding rules.

Capital Inc, incorporated in the US, issues certain securities. Speculator, a resident of Germany, purchases some of those securities from Capital and is registered as the holder on the books of Capital. Speculator subsequently transfers its beneficial interest in Capital securities to the Paris office of Global Bank, which is incorporated under UK law [Speculator remains at all times as the holder on the Capital securities register]. The Paris office of Global Bank subsequently enters into an agreement to transfer its equitable interests to Clearing Corp, whose chief executive office is located in Belgium. The agreement between Clearing Corp and Global Bank stipulates that it is governed by French law. Clearing Corp subsequently enters into an agreement to transfer its equitable interests in the Capital securities to Intermediary, located in Auckland. The agreement between Clearing Corp and Intermediary makes no reference to the governing law. Investor, an Australian resident, enters into an agreement with Intermediary to acquire the equitable interests in Capital. The agreement does not refer to the governing law, but account statements issued by Intermediary to Investor identify the Auckland office of Intermediary as the office serving Investor's account.

Any perfection of title dispute between Capital Inc and Speculator is governed by US law under rule (a)(3).

Any perfection of title dispute between Speculator and Global Bank is governed by US law under rule (a)(5).

Any perfection of title dispute between Global Bank and Clearing Corp is governed by French law under rules (b) and (e)(1). [If the agreement between these parties had made no reference to jurisdiction, any perfection of title dispute would still be governed by French law under rules (b) and (e)(3).]

Any perfection of title dispute between Clearing Corp and Intermediary is governed by Belgian law under rules (b) and (e)(4).

Any perfection of title dispute between Intermediary and Investor is governed by New Zealand law under rules (b) and (e)(3).

Europe

Europe has also considered the applicable law issue. Two approaches were considered:

- the place of the underlying securities approach, that is (i), (ii) or (iii), supra p 1
- the place of the relevant intermediary approach, that is (iv), supra p 1.

An alternative approach has also been put forward by the UK Financial Law Panel.

The place of the underlying securities approach

This applies the law of the location, either where the company issuing the securities is incorporated (that is, (i)), where the securities are registered (if different) (that is, (ii)), or where the certificates (if any) are kept (if different) (that is, (iii)).

The UK Court of Appeal in *Macmillan Inc v Bishopgate Investment Trust plc* [1996] *British Company Cases* 453 adopted the place of the underlying securities approach, but was split on whether the place of incorporation or the place of registration applied and also mentioned that in some circumstances the place of the physical certificates may be relevant. This creates a difficult burden for the collateral taker, who may have to satisfy the law of a number of jurisdictions to be sure of having a perfected security interest. The difficulty for a collateral taker may be even greater where, as is often the case, the collateral taker has received a pool of securities as collateral from the collateral giver. Those securities may be issued by companies incorporated or registered in different jurisdictions or whose certificates are deposited in different jurisdictions. The collateral taker may potentially have to satisfy the perfection requirements of many jurisdictions in a particular transaction. In such situations, the place of the underlying securities approach becomes unworkable.

The place of the relevant intermediary approach ("PRIMA")

The other approach, which has now been adopted in all EU countries to protect central banks as collateral takers and is in the process of being adopted in most EU countries for all collateral takers, is to apply the laws of the jurisdiction where the rights of the collateral taker to that collateral are recorded by its immediate intermediary. This is consistent with the indirect holding approach adopted under the US Uniform Commercial Code.

The PRIMA approach is reflected in Article 9(2) of the EU Settlement Finality Directive (the EU Directive) which provides:

> "Where securities (including rights in securities) are provided as collateral security to [a collateral taker] … and [the collateral taker's] right … with respect to the securities is legally recorded on a register, account or centralised deposit system located in a [EU] member State, the determination of the rights of [the collateral taker] in relation to those securities shall be governed by the law of that member State."

The reference to determination of rights in the Directive is not intended to include insolvency laws.

The relevant register, account or centralised deposit system is the one that records the transfer of the interest in the securities from the collateral giver to the collateral taker. That entry would be recorded on the books of the intermediary on whom the collateral taker relies for title to its interests.

PRIMA presumes that it is possible to determine the location of the relevant register, account or deposit system. A difficulty can arise, however, where the relevant intermediary that maintains the register etc that records the transfer of interests has offices in various jurisdictions and the relevant register etc is simply an electronic account accessible in any of those jurisdictions. A draft UK provision proposed by an ad hoc working group of legal practitioners and academics in London has suggested the following criteria for solving this location problem. The suggested criteria are similar to those in paragraphs (e)(2)-(4) of section 8-110 of the US Uniform Commercial Code. These UK criteria are:

- the location of the register etc will be the site of a particular office if the intermediary and the collateral giver have expressly agreed that the account is maintained at that particular office

- in the absence of that agreement, but where a particular office is identified as the office at which the account is maintained in the most recent statement relating to the account sent by the intermediary to the collateral giver, the location of the register etc will be the office so identified, or

- where neither of the above applies, the location of the register etc will be the head office of the intermediary.

Most importantly, the suggested UK criteria contain no equivalent of paragraph (e)(1) of the US provisions, which allows a securities intermediary and the entitlement holder to specify that their agreement is governed by the law of a particular jurisdiction, whether or not it has any direct nexus with those parties. The Europeans oppose the US approach of permitting parties to choose any jurisdiction.

Article 9(2) of the EU Directive only applies PRIMA where the relevant register, account or centralised deposit system that identifies the collateral taker's right is located in an EU member State. This shortcoming has been recognised in Europe, and a revised Directive to apply PRIMA to any jurisdiction is expected by 2003. In the meantime, the European Commission has requested EU countries to apply PRIMA in their legislation, regardless of where in the world the relevant intermediary's register etc is located. Germany, Belgium, Sweden and Finland have done so.[2] On one view,

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[2] The relevant amendment to the German Securities Deposit Act is as follows:

> "Dispositions relating to securities or holdings in collective securities deposits which have been entered with legal effect into a register or booked to an account shall be subject to the law of the country supervising the register, in which the entry with legal effect is made directly in favour of the beneficiary or in which the headquarters or branch of the custodian managing the account is located which undertakes the credit with legal effect to the beneficiary."

the UK common law already applies PRIMA principles in this broader context.[3] This more general approach is also applied under the US Uniform Commercial Code.

The PRIMA principles apply only to perfection of title issues. They are not intended to interfere with the insolvency laws of any member State. The ordinary jurisdictional nexus rules would apply to the insolvency of any relevant party.

UK Financial Law Panel

The Panel has put forward a "ring-fence" approach as an alternative to the PRIMA rules. The ring-fence approach would require all jurisdictions that wish to participate to identify the activity to be protected and apply to that activity common agreed rules. These rules would override the insolvency law of each participating jurisdiction.

The success of any future ring-fence approach would depend on how many jurisdictions were prepared to adopt it instead of the PRIMA approach and the ability of those jurisdictions to agree on the content of the ring-fence rules. The likelihood and timing of any move to a ring-fence approach are unclear at this stage.

Advisory Committee Recommendation

The Advisory Committee considers that Australia should introduce legislation to deal with cross-border issues arising from the taking of securities as collateral. This will assist Australia's competitive position in the global financial market by overcoming possible legal impediments to the transfer of securities through multiple tiers of intermediaries.

The Advisory Committee considers that the most appropriate immediate step to deal with this cross-border issue is to adopt rules similar to those currently in force in Europe and the United States. These rules provide a concise and workable method of determining rights to securities held through layers of intermediaries. They would only need to be replaced if at some future time the ring-fence approach was adopted internationally.

The Advisory Committee therefore recommends that legislation be introduced in Australia to:

- specify direct holding principles for determining the law to be applied by an Australian court in any perfection of title matter involving the validity of an original securities issue or any action against a registered securities holder, and

- specify PRIMA or indirect holding principles for determining the law to be applied by an Australian court in any perfection of title matter involving a collateral giver (other than a registered securities holder) and a collateral taker. The principles in the proposed UK legislation, or in paras (e)(2)-(4) of the US Code, could be applied to determine the location of the relevant register, account or centralised deposit system.

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[3] Dicey & Morris, *The Conflict of Laws* (13th edition, 1999) Chapter 24.

In neither of the above situations should the parties be permitted to determine the applicable law merely by agreement.

The Advisory Committee has also considered the implications of any legislation for insolvency law. The Committee notes that the US provisions and PRIMA do not extend to insolvency matters. Instead, a court in the jurisdiction of any insolvent party can still apply its own insolvency laws.

The Committee supports this approach. The retention of the insolvency law jurisdiction would overcome the possibility of collateral givers in Australia avoiding the insolvency provisions by transferring interests just prior to their insolvency through an arrangement that would be governed by a foreign law under PRIMA principles.