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Companies and Securities Advisory Committee

Report to the Minister for Financial  
Services and Regulation

on

Charges over uncertificated securities

April 2001

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## **Request from the Minister**

The Minister for Financial Services and Regulation, The Hon Joe Hockey MP, asked the Advisory Committee to consider a proposal from the Australian Stock Exchange (ASX) that charges over uncertificated securities be exempt from the charges registration provisions of the Corporations Law.

## **Current law**

Currently, charges over certificated securities are exempt from the requirement to be registered where the chargee has taken possession of the certificates of title (s 262(1)(g)(i)). The deposit of the title document with the chargee prevents any transfer of the certificated securities by the chargor, in the absence of fraud or inadvertence (where duplicate certificates are issued).

There is no express equivalent exemption for charges over uncertificated securities. In consequence, any unregistered charge over uncertificated securities may be void against a liquidator or administrator of the chargor (s 266).

## **ASX proposal**

The requirement for registration of charges over uncertificated securities, such as CHESS securities, creates problems for margin lenders and other chargees who may receive multiple lodgments and withdrawals from numerous chargors. Registration can become administratively burdensome for chargees and costly for chargors.

Section 262 should be made “technology neutral” by exempting charges over uncertificated securities from the requirement to be registered where the chargee can control, to the exclusion of the chargor, the electronic message which effects the transfer of the uncertificated securities. The additional category of charges exempt from the registration requirement would be:

“a charge which only applies to the marketable security while the chargee, or a person who has agreed to act on the instructions of the chargee, has electronic control of the means to effect a transfer of the marketable security for the purposes of the charge” (the proposed provision).

A chargee should also have the option of registering a charge over uncertificated marketable securities under s 262.

## **Matters raised by the Legal Committee**

The Advisory Committee requested the views of its expert Legal Committee on the proposed provision.

The Legal Committee noted that, currently, chargees taking a charge over uncertificated securities are protected through registration on the charges register. Any proposal to exempt these charges from registration would need to provide equivalent protections for chargees, by preventing chargors from transferring previously charged uncertificated securities, or providing them as collateral, to other persons.

The Legal Committee considered that the proposed provision satisfied this principle, subject to the following matters that it raised with the ASX.

### **Public notice function**

*Legal Committee.* The existing charges register provides notice to the world that chargors have pledged their property. How would the proposed provision perform this notice function for prospective chargees given that, by exempting charges over uncertificated securities from the registration requirement, a prospective chargee would have no means of knowing by reference to a public register whether a prospective chargor has good title to uncertificated securities offered as collateral?

*ASX response.* The “electronic control” in the proposed provision would provide prospective chargees contemplating a charge over uncertificated securities with protection equivalent to registration.

A prospective chargee would only agree to accept a charge over CHESSE securities if that chargee obtained electronic control (by requiring the registered holder to move the CHESSE securities either to that chargee’s CHESSE control under a bipartite agreement [if that chargee is a CHESSE participant] or to a CHESSE participant which would hold control subject to that chargee’s interest under a tripartite agreement [if the chargee is not itself a CHESSE participant]). If the CHESSE securities were already subject to an earlier chargee’s interest, the earlier chargee would already have electronic control (as a CHESSE participant or under a tripartite agreement with a CHESSE participant), and the registered holder could not give electronic control of those CHESSE securities to the prospective chargee without the consent of the earlier chargee.

This result is also designed to be technologically neutral in that a prospective chargee, whether secured by certificated or uncertificated securities, would not accept a charge in reliance merely on the representations of the registered holder. A chargee taking certificated securities as collateral would only accept the charge if that chargee gained control of the paper certificates. Likewise, a chargee over uncertificated securities would only accept those securities as collateral if that chargee gained electronic control of the uncertificated securities.

In addition, the ASX proposal would allow for multiple chargees over the same CHESSE securities. The chargees could agree on priority and the controlling CHESSE participant could agree to apply that priority.

Further details on how an electronic control mechanism would operate are set out in Attachment 1 to this Paper.

Like chargees taking a charge over certificated securities by way of deposit of share certificates, prospective chargees contemplating a charge over uncertificated securities would still have to check the charges register in case an earlier chargee had decided to register its charge over those securities, rather than utilise the statutory exemption from registration.

## Preservation of priorities

*Legal Committee.* Another function of the charges register is to protect the priority of a chargee in any liquidation of a chargor. How would the proposed provision preserve this function?

*ASX response.* The priority issues involved in the proposed provision are the same as those that arise in relation to charges that fall within the existing exceptions to registration. Priorities between registrable and non-registrable charges are determined by the general law priority rules.

## Comments on the proposed provision

*“or a person who has agreed to act on the instructions of the chargee”*

*Legal Committee.* Should this phrase be omitted from the proposed provision, thereby ensuring that control rests solely with chargees, who could act either themselves or through their agents? Why should the proposed provision refer to the powers of agents, as seems to be contemplated by the quoted phrase?

*ASX response.* The above-quoted phrase should be retained. Its deletion would significantly limit the scope of the ASX’s proposed exemption from the registration requirement by permitting only chargees which were CHESSE participants to come within the exemption. Many chargees are not CHESSE participants. These non-CHESSE chargees currently use tripartite CHESSE sponsorship agreements to ensure that no dealings adverse to their charged interest occur. These agreements provide that the registered holder, the chargee and the CHESSE participant agree that the CHESSE participant will not act on the instructions of the registered holder of the charged CHESSE securities without the chargee’s consent. This arrangement is reflected in the above-quoted phrase.

*“has electronic control”*

*Legal Committee.* It is essential that a chargor be unable to provide to another person uncertificated securities that have been given as collateral. However, a problem arises if the original chargee allows the chargor to continue to hold legal title to those securities. Could this be overcome by changing the reference to “electronic control” by the chargee to “sole electronic control”?

*ASX response.* While recognising the logic behind including the word “sole”, the ASX does not support this change as:

- the word “sole” is clearly implied by the context
- its express inclusion might be taken as referring to the provider of the CHESSE platform, namely ASX Settlement and Transfer Corporation Pty Ltd, which ultimately processes the chargee’s CHESSE message given pursuant to the charge.

*“for the purposes of the charge”*

*Legal Committee.* What is the reason for including this phrase in the proposed provision?

*ASX response.* These words are intended to make it clear that the proposed provision relates only to control over transfers that arises because of a chargee’s rights as secured creditor, rather than, for instance, where any CHES participant has control in the ordinary course for the purpose of buying or selling for its client.

## **Industry response**

The International Banks and Securities Association of Australia (IBSA), the Securities and Derivatives Industry Association (SDIA) and Austraclear commented on the proposed provision. These three respondents supported the principles underlying the proposed provision. See Attachments 2, 3 and 4.

*Austraclear proposal.* Austraclear suggested the following changes to the ASX’s proposed provision:

“a charge which only applies to the ~~marketable~~ security while the chargee, or a person who has agreed to act on the instructions of the chargee, has electronic control of the means to effect a transfer of the ~~marketable~~ security to the chargee for the purposes of the charge.”

*ASX response to Austraclear.* The ASX limited its proposed amendment to “marketable securities”, given the amendment’s particular relevance to CHES securities and the ASX’s desire to see that the exemption that currently only applies to certificated marketable securities is made technologically neutral.

The ASX does not object to Austraclear’s suggested deletion of “marketable”. However, given the importance of achieving certainty for the ASX’s markets and their participants, the ASX would not like to see its current proposal delayed in the event that the Advisory Committee considered wider consultation was needed if the exemption was to apply to all securities. The ASX also understands that any delay arising from Austraclear’s suggestion would mean that any opportunity to obtain an amendment as part of the Financial Services Reform Bill will be lost.

As a matter of drafting, should Austraclear’s suggestion be entertained, the ASX considers it would be better to use the word “securities” rather than “security”. The proposed provision uses the term “marketable security” to be consistent with its existing use under s 262(1)(g). The deletion of “marketable” from the term “marketable security” may then create some confusion, given that “security” can also be used as a synonym for “charge”. The use of “securities” would then also exactly correspond with the definition in s 9 of the Corporations Law.

Austraclear’s suggestion to add the words “to the chargee” may unduly restrict the intended purpose of the proposed provision. The reference in the proposed provision to effecting a transfer encompasses the right to effect a transfer of the charged security

to the chargee and would in all probability also encompass any power of the chargee to sell that security, without the need to first transfer the security to the chargee.

### **Advisory Committee view**

The usual current practice is for lenders to take uncertificated securities as collateral. The Corporations Law needs to take this practice into account.

The Advisory Committee supports the principle that s 262 should be technologically neutral by providing the same charges registration exemption for uncertificated and certificated securities. The ASX's proposed provision would achieve this goal without reducing the protections for chargees taking a charge over uncertificated securities.

The Advisory Committee considers that the ASX has satisfactorily answered the Legal Committee's concerns. The Advisory Committee also agrees with the ASX's reasons for not supporting Austraclear's suggested changes.

The Advisory Committee makes one drafting suggestion. The phrase "for the purposes of the charge" could be moved, to make it clear that it applies to having electronic control. The proposed provision would therefore read:

"a charge which only applies to the marketable security while the chargee, or a person who has agreed to act on the instructions of the chargee, for the purposes of the charge, has electronic control of the means to effect a transfer of the marketable security".