

**LAW COMMISSION
PROJECT ON
INTERMEDIATED INVESTMENT SECURITIES**

First Seminar – Objectives for a Common Legal Framework

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British Bankers' Association
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PROJECT SEMINARS

INTRODUCTION

Provisional Seminar Topics

- 1.1 This project is concerned with how investment securities are held and transferred by financial intermediaries on behalf of investors. The project will propose a “common” legal framework for the ownership, pledging and transfer of indirectly held, or ‘intermediated’, securities. The framework will be in a form that is applicable to the differing legal systems within the European Union and could be used as the basis for a Directive.
- 1.2 Before drafting a Consultation Report setting out these proposals, we intend to hold a number of seminars with interested parties to discuss the various legal issues that relate to this project.
- 1.3 In an attempt to apply a logical method to determining which topics should be dealt with in each seminar, we have decided to group them in the following way. The first seminar will explore the general legal issues and market needs of participants in an intermediated holding system.¹ This should provide us with a set of objectives that will frame our legal analysis. Thereafter, we have provisionally grouped the issues for discussion in terms of legal risks that apply to particular classes of participant in a securities settlement.² Accordingly, we plan that the subsequent seminars will go on to consider risks to the account holder, risks to the intermediary, risks to the transferee and risks to the collateral taker.
- 1.4 More specifically, we have provisionally grouped the legal issues for discussion as follows:

- (1) Seminar 1: Objectives for a common legal framework.

As stated above, we will examine the market needs of the participants as set against the policy issues affecting intermediated holding systems. This should allow us to create a provisional list of issues that a common legal framework should cover and of objectives it should aim to achieve.

- (2) Seminar 2: Risks to the Account holder and the Intermediary

We will examine:

- (a) The scope and enforceability of an account holder’s rights;

¹ By ‘intermediated holding system’, we mean a structure within which securities are issued by an issuer to an intermediary which holds them directly, or indirectly through lower tier intermediaries, for an investor who is ultimately entitled to the rights and value that flow from them (the ‘ultimate investor’).

² Admittedly, a number of the legal issues raise a risk for more than one class of participant. Where they do, we have attempted to link them to the class of participant with whom they are most closely associated.

- (b) The protection of an account holder's interest in securities from the claims of an insolvent intermediary's creditors;
- (c) The application of the 'no look through' principle in relation to claims against higher tier intermediaries as well as the related issues of upper tier attachment;
- (d) The treatment of shortfalls;
- (e) The potential liability arising from intermediaries acting on instructions from persons other than their client.
- (f) The seminar may also consider the scope and level of duties owed by an intermediary where not contractually specified.
- (g) Set-off as between account holder and intermediary and between investor and issuer.

(3) Seminar 3: Risks to the Transferee

The seminar will consider issues relating to the timing and finality of transfer, the formalities of transfer and the defences available to a transferee.

(4) Seminar 4: Risks to the Collateral-taker

The final seminar will examine methods of taking, perfecting and enforcing an effective security interest over investment securities. We will also consider priorities between competing security interests in intermediated securities.

OBJECTIVES FOR A COMMON LEGAL FRAMEWORK

INTRODUCTION

- 1.5 This project differs in its scope and approach from previous projects undertaken by the Law Commission. Whereas the Law Commission is typically concerned only with the reform of English law, this project will consider the need for law reform throughout the European Union.
- 1.6 The scope of the project is broad in order to respond to the work that is currently being carried out by the European Commission in this area. In 2001, a consultative group appointed by the European Commission published a report on cross-border clearing and settlement arrangements within the European Union (the "Giovannini Report").³ The report identified 15 important barriers to efficient cross-border clearing and settlement. One of the legal barriers reported by the group was the absence of an EU-wide framework for the treatment of interests in securities (including procedures for the creation, perfection and enforcement of security). The report concluded that the absence of a common legal framework represented the most important source of legal risk in cross border transactions.⁴ In its second report, published in April 2003, the Giovannini Group proposed that the European Commission should establish a project to look at how the legal nature of ownership of intermediated securities could be harmonised across the EU.⁵ As a result, in early 2005, the EU Commission appointed a Legal Certainty Group of experts to consider the need for legislation to establish a common legal framework for the ownership and transfer of intermediated securities in the European Union.⁶
- 1.7 It would make little sense for us to propose specific changes to English law at this point, while the work of the Legal Certainty Group is still on-going. A number of consultees have already expressed the concern that we avoid a situation in which domestic legislation is passed only for it to be modified shortly thereafter as a result of new European measures. Instead, the current status of the European initiative offers us a valuable opportunity to make our own proposals on how and to what extent national laws relating to intermediated securities should be harmonised. Our aim is for these proposals to contribute to the work of the Legal Certainty Group and to assist the Treasury in negotiating and implementing any forthcoming European legislation.

³ The Giovannini Group, 'Cross-Border Clearing and Settlement Arrangements within the European Union' (November 2001).

⁴ Ibid, p 56.

⁵ The Giovannini Group, 'Second Report on EU Clearing and Settlement Arrangements' (April 2003) p 16.

⁶ See EU Commission, 'Communication from the Commission to the Council and the European Parliament: Clearing and Settlement in the European Union- The way forward' (COM (2004) 312), p 22.

- 1.8 While the aims of the project require us to review the national law of EU Member States, we will subject English law to particular scrutiny. In doing so, we will take into account the issues raised by the Financial Markets Law Committee in its report on intermediated securities published in 2004.⁷ It is through this analysis that we aim to provide greater clarity as to the current law in England and Wales.
- 1.9 If European legislation is not forthcoming or appears to be likely to be seriously delayed, we may make specific proposals for domestic legislation.

APPROACH

- 1.10 Extending the scope of our project to a study of securities law in the 25 member states of the EU presents a significant challenge. In order to manage this task we will focus initially on the practical objectives that a common legal framework on intermediated securities should achieve. Only then will we review the law in the respective countries to examine how these objectives can be implemented through a common set of legal rules.
- 1.11 In order to establish these practical objectives, we must first identify in general terms the needs of market participants in relation to the ownership and settlement of intermediated securities. Where these needs conflict with one another, they must be balanced by reference to the overarching policy issues that influence the development of securities markets.
- 1.12 Once these practical objectives have been determined, we will look across the domestic laws of EU member states to ascertain to what extent these objectives are already achieved. How and to what extent each objective should be translated into a common legal framework for intermediated securities through the EU will depend upon this analysis.

UNIDROIT approach

- 1.13 In determining how best to undertake the analysis, we have taken into account the methodology adopted by UNIDROIT⁸ in relation to its work on intermediated securities. The UNIDROIT project shares markedly similar aims to our project and to the work of the Legal Certainty Group. UNIDROIT's Preliminary Draft Convention on Harmonised Substantive Rules Regarding Intermediated Securities (the "Draft Convention") has as its purpose, 'to promote legal certainty and economic efficiency with respect to the cross-border holding and disposition of securities held with an intermediary, by harmonising certain legal aspects in this regard'.⁹ Through the nature of its work generally, UNIDROIT has considerable experience of analysing different legal systems and traditions in order to establish a common set of rules that can be implemented universally.

⁷ FMLC, 'Analysis of the need for and nature of legislation relating to property interests in indirectly held investment securities, with a statement of principles for an investment securities statute' (July 2004).

⁸ The International Institute for the Unification of Private Law.

⁹ UNIDROIT Preliminary Draft Convention on Harmonised Substantive Rules regarding Securities Held with an Intermediary, Explanatory Notes (December 2004), p 4.

Internal soundness and cross-border compatibility

- 1.14 UNIDROIT has noted that the modernisation and harmonisation of substantive law in this area should be viewed from two angles. It should be considered first from the point of view of promoting 'internal soundness' within each domestic legal framework.¹⁰ The modernisation should have the effect of ensuring that each system is robust and meets the general needs of the system participants through clear and simple rules and procedures. Secondly, the harmonisation of the substantive law must ensure the 'compatibility' of different legal systems so as to provide for consistent and predictable outcomes where the laws of one or other legal system are applied to securities settled or pledged cross-border. By attaining the twin goals of internal soundness and cross-border compatibility, legal risk is reduced both for domestic participants and for investors that settle securities cross-border.
- 1.15 Internal soundness and cross-border compatibility will not always go hand in hand. Improvements in one may come at the expense of the other. A settlement system that achieves internal soundness through clear and modern settlement rules may nevertheless be incompatible with other systems. Likewise, a common legal framework will be counter-productive if implementing it has the effect of damaging the legal coherency and stability of national settlement systems.

Functional approach

- 1.16 Part of the answer to accommodating different legal systems and legal traditions within a common framework lies in adopting a functional approach to the drafting of harmonising rules. UNIDROIT describes the functional approach as
- ...one that uses neutral language in consideration of the various legal traditions involved and formulates rules by reference to facts, with a view to facilitate the accommodation of the different legal concepts in place in different jurisdictions.¹¹
- 1.17 Formulating rules by reference to facts rather than by reference to abstract legal principles is an essential technique for avoiding the need to impose unfamiliar or incompatible legal concepts on different legal regimes. We agree that a common framework should, wherever possible, be silent on the legal basis for a harmonising rule. National legal systems should, instead, be left to apply their own legal concepts and terminology provided that these do not contradict other harmonising rules. Similarly, we should avoid using words and phrases that carry a specific and esoteric legal meaning in certain legal systems even if to do so requires a more lengthy description of a rule and its application.
- 1.18 The interaction between a common legal framework and national laws is clearly a sensitive matter. Member States are likely to be particularly reluctant to agree to harmonised rules that encroach upon national insolvency laws and financial regulatory policy. However, even a functional approach will inevitably require most individual states to make some amendments to existing law and to local settlement system rules.

¹⁰ Ibid, p 18.

¹¹ Ibid, p 18.

Policy Issues for Securities Markets

- 1.19 We consider there to be at least two fundamental policy themes that will inform any debate as to the respective rights of market participants in intermediated holding systems. These are:
- (1) to increase confidence in the ownership and settlement of intermediated securities by reducing legal and systemic risk; and
 - (2) to increase the efficiency of the settlement system.
- 1.20 In many respects these two policy objectives enjoy a symbiotic relationship. The reduction of legal risk through strong legal certainty not only increases market confidence but can substantially reduce administrative costs and delays, thereby increasing market efficiency. Greater efficiency meanwhile inspires market confidence, for example, by reducing credit risk through shorter settlement cycles.

Market Confidence

- 1.21 Legal risk arises in financial markets where the rules applicable to market practice are incomplete, ambiguous or otherwise difficult to understand or access. Market practice is constantly evolving to accommodate financial innovations and to improve efficiency. If the law is unable to keep pace with these developments, legal uncertainty can increase to the point where counterparties become unwilling to carry out transactions or must incur burdensome costs and delay in obtaining the necessary assurances. If an institution is unable to quantify or to limit its exposure to potentially damaging outcomes, it may find itself liable for a sum that causes it to fail in its financial obligations to third parties. The knock-on effect on interdependent institutions could potentially trigger a systemic crisis in a financial system.
- 1.22 The obvious solution to legal and systemic risk is to establish clear, reliable and readily accessible rules that provide for consistent and predictable outcomes to particular fact situations. In the case of a common legal framework these rules must be framed in functional terms. They must also be sufficiently flexible to accommodate innovations in the market and so avoid the need for constant updating. More specifically, the law must allow for account holders and intermediaries in a market to ring fence or reduce their exposure to liability from the losses and insolvency of others. In the case of account holders this includes protecting an investor's assets in the event of its intermediary's insolvency. In the case of intermediaries, this means the ability to avoid strict liability for events outside of their control other than in clearly defined circumstances.

Market Efficiency

- 1.23 The ability to effect securities transactions simply and speedily is a policy objective in its own right and one that may conflict from time to time with the objective of market confidence. A more efficient market improves the liquidity of securities and therefore enhances their value. It should also mean cheaper settlement costs for the user and more business for the intermediary.

1.24 Speed of settlement can, however, result in an increased risk of fraud and administrative error through the removal of formal checks and authorisations. It can also lead to compromises in the system's ability to attribute fault and to allocate risks and losses fairly. The need for settlement finality and the avoidance of delays in settlement can restrict a participant's ability to trace and recover misappropriated securities. Where these compromises arise, participants must be fully aware of them if market confidence is not to be affected.

GENERAL NEEDS OF MARKET PARTICIPANTS

1.25 Broadly speaking, participants in an intermediated holding system can be classified into four groups: investors, intermediaries, transferees and collateral takers. Issuers should also be added to this list but, as they are in many respects unaffected by whether their securities are held directly or indirectly, they are not treated separately in this analysis.

1.26 For the purposes of this paper, we have ascribed the following meanings to the terms below:

(1) 'intermediated securities' refers to an account holder's entitlement, as evidenced or constituted (depending on the legal system) by a credit in the account of its intermediary;

(2) 'Intermediary' means a person that maintains a securities account for an account holder. A securities account for these purposes does not include any account that constitutes the primary record of entitlement against an issuer.¹²

(3) 'Account holder' means any party that holds securities, or interests in securities, through a credit in the account of its intermediary. This may include an account holder that is, itself, holding as intermediary on behalf of another account holder.

(4) 'Investor' refers to an account holder that is not also an intermediary and is therefore ultimately entitled to the benefits derived from the securities.

1.27 Often a participant will fall into more than one classification while operating within the system; a custodian bank will be both an intermediary for its client and an account holder in relation to the depositary or sub-custodian through which it holds its client's securities. The custodian bank will daily act as both buyer and seller and may take securities collateral in relation to certain transactions.

1.28 We intend to explore the various needs of each class of participant in turn before considering what issues need to be addressed by a common legal framework.

¹² This qualification is intended to exclude system operators of direct holding systems, such as CREST, which maintain a register that is the primary record of entitlement. CREST participants who are entered on the register hold their securities directly from the issuer and not through CREST as intermediary (other than in the case of CREST Depositary Instruments).

Recognition of intermediated securities

- 1.29 First, however, we must consider a wider issue affecting intermediated securities in general. A common legal framework for intermediated securities depends upon the laws of each state recognising an investor's ability to hold securities and effectively exercise rights in them through an intermediary. A legal system that prevents or restricts the exercise of rights through an intermediary impedes cross-border settlement of securities by depriving the counterparties of the efficiencies that intermediation generates.
- 1.30 National laws and settlement rules can prevent investors from holding intermediated securities in one of two ways; first, they can explicitly prohibit, or at least refuse to recognise, the holding of securities through an intermediary. The investor may be left, at best, with a contractual claim against its intermediary to pass on the benefit of the securities. Secondly, the laws and settlement rules may, often unintentionally, limit an investor's ability to fully exercise its rights through an intermediary. This may commonly arise where the intermediary holds securities for more than one investor and wishes to exercise rights on behalf of its investors in different ways. For example, an intermediary wanting to split the voting of its holding to reflect the wishes of its different account holders may be prevented from doing so by national law. The law would therefore effectively discriminate against the investor that holds its securities through an intermediary.
- 1.31 Enabling an intermediary to hold securities through an intermediary does not mean that a legal system must recognise the investor as the legal owner. English company law, for example, does not recognise an investor who holds shares through an intermediary as having any rights against the issuer. Only the intermediary named in the register of shareholders is entitled to vote shares and receive dividends.¹³ Where, however, the indirect owner is not granted direct rights as against the issuer, the law must provide an effective means for an investor to enjoy these rights through its intermediary.
- 1.32 A recent report by a UNIDROIT working group has recorded the divergence of opinions between states on this matter.¹⁴ It is generally accepted that where an investor is permitted by law to hold securities through an intermediary, the law should not discriminate against the investor by restricting its ability to benefit from the securities. Disagreement arises however as to the extent to which national laws should require issuers to permit their securities to be held through an intermediary. Some states argue that this is a necessary step for cross-border settlement; others believe that issuers should be given a choice as to whether to allow their securities to be held through intermediaries. A possible compromise is to require issuers to permit investors to hold securities through intermediaries if the securities are traded on public exchanges or markets. This should at least ensure that securities traded cross-border in settlement systems can be held through an intermediary without discrimination.

¹³ Companies Act 1985, s. 360 prohibits notice of any trust being entered on the register of members.

¹⁴ UNIDROIT Report of the Ad hoc Working Group on Article 19.1 of the preliminary draft Convention on Harmonised Substantive Rules Regarding Intermediated Securities (February 2006), Study LXXVIII – Doc. 25.

Needs of the investor

- 1.33 An investor in intermediated securities will want to replicate the rights and protections enjoyed by an owner holding directly from the issuer. The investor's basic concerns relate to protecting and realising the value of the obligations embodied by the securities.
- 1.34 Interposing one or more intermediaries between the investor and issuer can greatly enhance the operational efficiency of a settlement system as well as provide the account holder with greater access, or possibly its only access, to national and international capital markets. However, intermediation necessarily results in a weakening of the rights and protections afforded to account holders.
- 1.35 By dematerialising securities or immobilising them in the vaults of a depository, the historical risk that underlying securities might be physically lost, stolen or destroyed is now practically eliminated. The risk that the issuer may be unable to perform its obligations is a risk shared by investors in direct and intermediated holding systems alike. Instead, the risks particular to intermediated securities arise from the creation of competing rights and interests belonging to higher tier intermediaries and to the third parties with whom these intermediaries contract in relation to the securities. The five principal risks that weigh on an investor who holds securities through an intermediary are that:
- (1) Its rights are unclear and/or insufficient to protect and realise the value of its interest in securities.
 - (2) In the event of the insolvency of its intermediary (or of an upper tier intermediary) its interest in securities may not be protected from the claims of the intermediary's general creditors.
 - (3) It will be unable to recover all of its intermediated securities to the extent that there is a shortfall in the pool of securities available to account holders.
 - (4) The securities held by the intermediary may be lost in circumstances where the intermediary is able to disclaim responsibility for the loss.
 - (5) It will be unable to set-off its obligations owed to the issuer against the securities in the event of the issuer's insolvency.
- 1.36 Not all of these risks are risks that can or should be avoided. In many jurisdictions, the risks will be clearly defined and allocated to a particular market participant to reflect the balance of competing interests. In some cases the outcome of the balancing exercise will be uncontentious. In others, there may be sound legal and policy arguments on either side for where the risk should lie which may lead different legal systems to reach different solutions.
- 1.37 In some legal systems, however, the risk to each market participant may be increased by avoidable factors. These factors may include uncertainty or ambiguity in the application of the existing law. Where the law is settled it may nevertheless be rooted in traditional legal concepts that are inappropriate for modern securities arrangements.

The rights of the investor

- 1.38 The personal rights enjoyed by a direct holder of securities against an issuer are governed by the terms of the issue and by the law under which the securities are constituted. We refer to these rights below as the 'terms' of the securities.
- 1.39 The terms of the securities may encompass a wide range of obligations. These may include:
- (1) The right to receive income through dividends (for equity) or interest payments (for debt);
 - (2) The right to the return of capital upon such events as the maturity of the debt or the winding up of the company for equities;
 - (3) The right to vote at meetings of the issuer or at meetings of the holders of that series of securities;
 - (4) In the case of convertible and exchangeable debt securities, the right to have debt securities exchanged for equity securities;
 - (5) The rights to exercise put and call options;
 - (6) Pre-emption rights.
- 1.40 An investor that chooses to purchase securities directly from an issuer does so in the knowledge that it can enforce these terms directly against the issuer. Where securities are held through an intermediary, the investor will need legal assurance that it can enjoy the benefit of the terms of the securities. In some civil law jurisdictions, the investor is still considered the direct owner of the underlying securities despite holding the securities through an account maintained by an intermediary. In other legal systems (including the English common law system), the investor will not have directly enforceable rights against the issuer.¹⁵ The investor will have rights only against its own intermediary. These rights should be sufficiently robust to provide the investor with the legal assurance it requires.
- 1.41 The difference in approach between allowing an investor to enforce the terms directly or indirectly is largely reflected in the different legal traditions' treatment of the legal position of the intermediary. Under the common law, legal and beneficial ownership is split between the intermediary and the account holder by means of a trust. The intermediary's active duties and powers as a trustee and its proprietary interest in the trust assets are sufficient to sever the relationship between issuer and investor. In civil law, the intermediary may have possession but no ownership interest or rights in the securities. It has merely a depositary function and the relationship between issuer and investor can be more easily preserved.

¹⁵ Exceptionally, an investor will have legal title and therefore direct rights against the issuer under English law if the intermediary holds bearer securities as bailee. Intermediated securities cannot be held through bailment (as they are not tangible) and therefore this exception falls outside the project.

- 1.42 In keeping with a functional approach, a common legal framework need only state that an investor should have the right to receive and enjoy the terms of securities. There is no need to specify the means by which individual legal systems should facilitate this objective. A common legal framework should state the persons against whom these rights are enforceable and the circumstances in which these rights arise.¹⁶
- 1.43 In addition to this right of enjoyment, investors will also want the law to provide them with at least two other basic, minimum substantive rights as against its intermediary. These are:
- (1) the right to oblige their intermediary to transfer securities, or interests in securities outright or by way of security interest to third parties (including other intermediaries and collateral takers); and
 - (2) the right, subject to the terms of the securities, to require the intermediary to withdraw the securities from its account so that they can be held directly.

Protection against the Intermediary's insolvency

- 1.44 The protection of an account holder's interest in securities from the claims of its intermediary's creditors is fundamental to the viability of an intermediated holding system. The investor will want the credit risk of the intermediary, or series of intermediaries, through which the investor holds its securities to play no role in the investor's assessment of the economic worth of the securities credited to its account with the intermediary.
- 1.45 Accordingly, the investor will want to ensure that the rights owed to it by its intermediary and derived from the underlying securities are protected at all times from the claims of the intermediary's creditors and liquidator. Furthermore, where securities are held through a series of intermediary accounts located in different jurisdictions, the investor will also want assurance that this insolvency protection applies to each account holder's rights in the chain. A custody arrangement that fails to provide protection in this way would discourage investors from holding their securities indirectly, especially in long chains of custody.

¹⁶ We will need to further consider whether an intermediary is able to contract out of these minimum rights. While freedom of contract suggests that it should, the effect would be to deprive lower tier account holders of the assurance that the necessary rights existed all the way up the chain.

- 1.46 There are strong economic justifications for protecting an account holder's interest in securities from the creditors of its intermediary. An intermediary does not participate in the speculative risk taken by the ultimate investor in purchasing securities. The purchase price is borne by the ultimate investor and the intermediary will not typically credit the securities to the account holder until it is confident that the purchase price has been paid or that its liability is covered by collateral. The intermediary's function is to facilitate the settlement of securities and to act as a conduit for capital and income and for other benefits derived from the underlying securities. Its economic interest lies in the fees paid for this and other custody services it provides. To permit an insolvent intermediary's general creditors to enjoy the value of the securities that it holds for its customers would be to provide the intermediary's creditors with a windfall at the expense of the investor and to distort the economic reality of the situation. Provided that accounting rules adequately prevent the intermediary from stating that it owns these assets, creditors cannot claim to have relied upon their value when entering into a creditor/debtor relationship with the intermediary.
- 1.47 Nevertheless, the protection of an account holder's interest in securities from the claims of its intermediary's creditors may not always be a straightforward matter. In particular, it may be unclear at which point in time this protection against creditors arises. Where, as in common law jurisdictions, the protection given to the account holder arises as a result of the account holder receiving a proprietary interest in the securities (or interests in securities) through a trust, the question remains as to exactly when this proprietary interest passes to the account holder. In the absence of clear rules, an investor that instructs its intermediary to acquire securities may think that it has obtained property rights in those securities when in fact it still has only the benefit of a personal promise from the intermediary to credit its account. We deal with the issue of the timing of transfer in more detail in our discussion of the needs of intermediaries.¹⁷

The treatment of shortfalls

- 1.48 A shortfall will arise in circumstances where the number of securities credited to account holders in the records of an intermediary exceeds the number of securities of the same description to which the intermediary is entitled. If a shortfall arises and the intermediary is insolvent or otherwise not able, or required, to discharge its obligation to make up the shortfall, the question arises as to how the shortfall should be borne between the innocent account holders.
- 1.49 In summary, the treatment of shortfalls raises three central issues for consideration:
- (1) How can an account holder effectively segregate, or otherwise ring fence, itself from having to share in a shortfall that is traced to transactions connected to another account holder?

¹⁷ See para 1.63 below.

- (2) Where the interests in securities of more than one account holder are pooled in an omnibus account, how should a shortfall be allocated? Should it automatically be allocated pro rata amongst the account holders even when the shortfall can be traced to a specific account holder? If an account holder is accused of misconduct leading to the shortfall how should the intermediary allocate the shortfall?
 - (3) Where an insolvent intermediary holds securities of the same description for its own account, in what circumstances, if at all, should a shortfall be taken first from the intermediary's own securities? Does it matter whether the intermediary's securities are in a separate account or whether or not the intermediary was at fault for the shortfall?
- 1.50 The last of these three issues raises a particularly problematic policy decision. Should the account holders be entitled to take priority over the intermediary's other creditors? Unlike intermediated securities held in a customer account, these securities are assets of the intermediary and may be reflected as such on the intermediary's balance sheet.¹⁸
- 1.51 We will need to consider whether or not there is a need to establish a uniform policy for the allocation of an intermediary's securities in each of these circumstances or whether they can be determined on a national basis.

Exclusion of the Intermediary's personal liability

- 1.52 An intermediary's personal duties to an investor arise under contract, financial regulation and general law (for example, in its capacity as a fiduciary or agent). Generally speaking, these duties will relate to the maintenance of account holder's securities and to the intermediary's due and the effective discharge of the account holder's rights.
- 1.53 An intermediary may seek to exclude or limit its personal liability arising from its failure to fully discharge these duties. It may also seek to exclude its liability for losses caused by intermediaries higher up the chain, some of which may be sub-custodians appointed by the intermediary. While its ability to do so may be restricted in each case by law and by financial regulation, the intermediary should have freedom to negotiate the terms on which it agrees to maintain the account holder's interest in securities. These exclusions and limitations have the effect of transferring the risk to the account holder. If the account holder is itself an intermediary it may seek to pass on these risks to the account holder below by excluding or limiting its liability in the same manner.

¹⁸ Article 17 of the UNIDROIT Draft Convention (Doc. 24 – June 2005) provides that any shortfall would first be allocated to securities of the same description that are held by the intermediary for its own account. This result appears to be irrespective of whether the securities are held in a segregated house account or whether or not the intermediary was at fault for the shortfall.

- 1.54 The investor's risk is affected by each of the custodian agreements made by upper tier intermediaries. As a result it may not be easy for the investor to assess the risk it bears if it has no knowledge of the terms of the contractual relationship between intermediaries higher in the chain. If, for example, a higher tier intermediary negotiates a far greater exclusion of liability with its account holder than that brokered between the investor and its own intermediary, the higher tier intermediary's ability to escape liability will affect the investor if the investor's own intermediary can show that it was not itself responsible for the losses incurred higher in the chain.

Set-off

- 1.55 Where an issuer is insolvent and has defaulted on the terms of its securities, the investor will want assurance that any rights of set-off that would ordinarily be available to it if it held the securities directly will not be affected by the intermediation of the securities.¹⁹ This could particularly be the case where the investor's interests in the securities are pooled with securities of other account holders. An issuer will likewise want the opportunity to set-off its exposure to an insolvent investor against obligations that the investor owes to it.

Needs of the Intermediary

- 1.56 An intermediary's role in an intermediated holding system is to provide a range of custody services for account holders in return for a fee. The intermediary's principal concerns therefore relate to the scope of its duties and liabilities and include:
- (1) The ability to specify precisely its duties and quantify its liabilities for the purposes of risk management;
 - (2) The need for clear and simple rules for acquiring and disposing of interests in securities;
 - (3) The need for certainty as to the treatment of shortfalls;
 - (4) The need for a clear regime for determining the authority of instructions given to it;
 - (5) The ability to effect a net settlement of transactions between its own account holders;
 - (6) The availability of set-off as against its account holder.

¹⁹ Specifically, this could arise as a result of a loss of mutuality between the two obligations being set-off.

The Intermediary relationship

- 1.57 The need to identify the rights and duties arising from an intermediary's relationship with its account holder is one shared by both parties. An intermediary will want a precise understanding of the extent of its duties and liabilities and the identities of those persons to whom they are owed. In most jurisdictions, the intermediary will have no knowledge of the identity of other participants in the chain other than the issuer, the intermediary immediately above it (if any) and the account holder immediately below it. It will therefore not want the law to impose duties on it that extend beyond the legal relationships it has with its account holder below and its intermediary (or issuer) above.
- 1.58 Many legal systems achieve this by recognising a multi-tiered holding structure as a set of bilateral legal relations. For example, the principle that obligations at each level of a tiered holding structure are independent of those at the next level forms a central part of US Revised Article 8. This also broadly reflects existing English trust law which adopts a 'no look through principle' under which the rights of a beneficiary under a sub-trust are normally exercisable only against its own trustee. In other EU Member States, statute or general legal concepts achieve this result.
- 1.59 The advantages of defining an intermediary's role in this way are plain to see. It allows an intermediary to quantify and manage its risk by reducing most system risks to bilateral risk assessments.²⁰ Joseph Sommer describes the simplification offered by privity in Revised Article 8 as follows,
- With strict privity, intermediaries can concentrate on their role as *intermediaries*. They need not worry why the transaction occurs, only that the transaction must be done.²¹
- 1.60 In some Member States, however, the holding structure may allow the upper tier intermediary to identify a lower tier account holder. In these cases, where accounts have been set up systematically to ensure transparency, there may be an argument for permitting upper tier attachment. The effect of accommodating both of these alternatives in a common legal framework would need to be assessed with regard to their compatibility in a cross-border context.

Clear and simple rules for the settlement of securities

- 1.61 All market participants share in the need for simple and unambiguous rules for the acquisition and disposal of intermediated securities. However, we consider the issue in this section as it is an intermediary that must carry out the necessary credits and debits on its books in order to effect transfers of intermediated securities.

²⁰ J Sommer, 'A Law of Financial Accounts: Modern Payment and Securities Law Transfer, The Business Lawyer; Vol. 53 (August 1998) p 1205. Where a third party takes a security interest in an account held by an intermediary, the intermediary would have a legal relationship with the security interest taker as well as the account holder.

²¹ Ibid, p 1206

- 1.62 Two fundamental, inter-related questions arise in relation to transfers of intermediated securities. First, what actions must be taken to transfer intermediated securities? Secondly, at what point are intermediated securities treated as passing from one party to another for the purposes of giving the transferee rights in them? The exact timing of a transfer may be of critical importance in determining whether the transferee is protected from the insolvency of the transferor or of an intermediary through whom the intermediated securities are transferred. It may also have a bearing on corporate action processing such as dividend payments as well as deciding priority between competing interests.
- 1.63 In practical terms, the transfer of intermediated securities is effected by crediting and debiting computerised accounts. In most EU legal systems, the transferee's rights in the intermediated securities are *constituted* by the book entry and therefore do not take effect until the transferee's intermediary credits the transferee's account.²² In some legal systems, the transfer may occur earlier. Under English law, the credit to an account held by an intermediary merely *evidences* that the intermediary is holding the intermediated security for the account holder. The account holder's rights in the intermediated security arise at the point at which the account holder's intermediary receives the intermediated securities in its own account and a trust is created. The account holder may therefore have a proprietary right in the intermediated securities as a beneficiary under a trust despite the intermediary's failure to credit its account.
- 1.64 This difference in approach highlights an important dichotomy in the way legal systems characterise an investor's entitlement. Significantly, they may not reach the same conclusion on the timing of a transfer based on the same set of facts. We will need to consider whether an approach based on the primacy of the book-entry can co-exist with a trust analysis in a common legal framework.

Duty to avoid shortfalls

- 1.65 One of the intermediary's principal duties to its account holders is to maintain a sufficient number of securities of the correct description to satisfy the amounts credited to their accounts. A common legal framework should provide clarity as to what actions an intermediary is obliged to take in order to maintain sufficient securities and in what circumstances it is liable for shortfalls that do arise. The rules may also need to give guidance as to the effect of the provisional crediting of accounts by intermediaries offering a contractual settlement service to customers.
- 1.66 Guidance as to the allocation of shortfalls is desirable for both investors and intermediaries alike. Where a shortfall arises and the intermediary is not required or is unable (due to insolvency) to meet the shortfall, the intermediary (or its liquidator) will want to be certain as to how the losses should be allocated among its account holders. Should a solvent intermediary be found to have misallocated the loss, it may be compelled to restore the account holders to the correct position out of its own funds.

²² In addition, both the Hague Convention on the Law Applicable to Certain Rights in respect of Securities Held with an Intermediary and the Draft UNIDROIT Convention assert that rights result from a credit of securities to a securities account.

Instructions

- 1.67 An intermediary may receive instructions from a range of persons other than the account holder. Persons who claim to be authorised to act on behalf of the account holder may contact it with instructions. It may receive demands from third parties claiming to have an interest in the securities. It may be subject to a court order requiring it to freeze or hand over the securities to a third party.
- 1.68 In each case, the intermediary will want simple and unambiguous rules as to whether or not it can follow these instructions without exposing itself to liability. It will want the rules to be clear and reliable so as to allow for it to reach the correct conclusion quickly and easily. The rules must also be compatible with the operational mechanics of the different national settlement systems.

Net settlements

- 1.69 UNIDROIT describes net settlements as follows

...to the extent that there are matching debits and credits to accounts maintained by the intermediary for its account holders, there need not be precisely matching entries in the intermediary's accounts maintained with the upper-tier, but such entries should simply reflect the net overall change in aggregate balances of its account holders taken together.²³

- 1.70 Net settlement reduces operational risk by reducing the number of transactions that must be recorded within the intermediated holding system. It also allows for the division of labour between different tiers of an intermediated holding system rather than centralising the task within a single depository.

Set-off

- 1.71 An intermediary will want clarity as to whether it has a right of set-off against the investor. In addition, where an intermediary has a lien over an investor's interest in securities (for example, in relation to the intermediary's fees) it will want this lien to act as a clog on the investor's right of set-off against the issuer until the investor's obligation to it is discharged. By contrast, the investor will want its right of set-off against the issuer not to be blocked altogether by an intermediary's security interest. We will need to consider whether a uniform approach needs to be taken in deciding the outcome of these competing needs.

Needs of the Transferee

- 1.72 The needs of the transferee of intermediated securities are relatively straightforward to identify.
- (1) The transferee will need to know what steps it must take to effect a valid transfer of intermediated securities.²⁴

²³ Uniform Law Review 2005-1/2, Explanatory Notes to the Preliminary Draft UNIDROIT Convention, p 76.

²⁴ This need is discussed at paragraphs 161-164 above.

- (2) The transferee will want legal assurance that the securities or interests in securities transferred to it under the terms of the sale are free from any prior claims of ownership or of any restrictions other than those of which it is aware;
- (3) The transferee will not want to have to investigate the title of the securities it is acquiring;
- (4) The transferee will want legal assurance that settlement is final and cannot be revoked;

Defence against prior claims

- 1.73 The balancing of a transferee's rights against those of a person with a pre-existing interest throws up a fundamental conflict within commercial law. The allocation of loss between two innocent parties is ultimately a policy decision as to whether security of transfer should prevail over security of title.
- 1.74 Broadly speaking, the approach taken by most common and civil law jurisdictions is to protect the transferee where it has acted in good faith and for value (that is to say, not gratuitously). A purchaser that has notice of a prior interest is unlikely to satisfy this good faith requirement and may be vulnerable to a claim.
- 1.75 Revised UCC Article 8 goes further in protecting a transferee. Section 8-503 of Article 8 prevents an investor from making a claim against a transferee other than where its intermediary is insolvent and the transferee has colluded with the intermediary in violating the intermediary's obligation to maintain sufficient securities. The investor cannot simply join both the intermediary and the transferee in an action or pursue a transferee if its intermediary is still solvent. The Note to Revised Article 8 of the Uniform Commercial Code justifies the limitations on claimants to bring claims against transferees as follows:

The limitations...on the ability of a customer of a failed intermediary to recover securities or other financial assets from the transferee are consistent with the fundamental policies of investor protection that underlie this Article and other bodies of law governing the securities business. The commercial law rules for the securities holding and transfer system must be assessed from the forward-looking perspective of their impact on the vast number of transactions in which no wrongful conduct occurred or will occur, rather than on the post hoc perspective of what rule might be most advantageous to a particular class of persons in litigation that might arise out of the occasional case in which someone has acted wrongfully. Although one can devise hypothetical scenarios where particular customers might find it advantageous to be able to assert rights against someone other than the customer's own intermediary, commercial law rules that permitted customers to do so would impair rather than promote the interest of investors and the safe and efficient operation of the clearance and settlement system.²⁵

²⁵ US Uniform Commercial Code, Revised Article 8 (1994 Rev), Section 8-503, Note 3.

- 1.76 This limitation may further enhance liquidity by protecting the transferor but is likely to be at odds with the national laws of most EU member states.

Investigation of title

- 1.77 Different legal systems will employ different tests to determine a transferee's notice of adverse claims. A transferee for value that has no actual prior knowledge of a claim may nevertheless be treated as having notice of claims that it should have discovered ('constructive notice').
- 1.78 We will need to consider whether a uniform test of 'notice' is necessary to ensure certainty in the context of cross-border settlement. Should notice extend beyond actual knowledge, the purchaser will want clear rules as to the circumstances in which it will be treated as having notice of a claim. Clearly it is in the interests of market efficiency that a transferee should not be required to take proactive steps to establish title. Modern market arrangements such as multi-lateral netting may, in any event, make it impossible to identify prior claims. However, where a transferee has actual notice of grounds for suspecting an adverse claim, constructive notice may be appropriate in certain circumstances. It is worth noting the test of knowledge adopted in the UNIDROIT Draft Convention. Article 11(3) states:

3.- For the purposes of this Article a person acts with knowledge of an adverse claim if that person:

- (a) has actual knowledge of the adverse claim; or
- (b) has knowledge of facts sufficient to indicate that there is a significant probability that the adverse claim exists and deliberately avoids the information that would establish the existence of the adverse claim.

- 1.79 The test for constructive knowledge in (b) requires both actual knowledge of sufficient facts and a deliberate avoidance of information. This may be a useful model for us to consider.
- 1.80 Corporate purchasers will also want clarity as to the circumstances in which notice of claims by certain of its employees and agents will be attributed to the transferee itself.

Settlement finality

- 1.81 A transferee will want assurance that the transfer of securities, or interests in securities cannot be reversed or otherwise treated as unenforceable. Most typically, this risk arises in circumstances where the transferor becomes insolvent around the time of the transaction. Settlement finality may also be affected by the need to correct erroneous credits or to remedy a fraud or misrepresentation. The purchaser will want either legislation and system rules to provide for settlement finality or freedom to negotiate contractual terms to reduce or remove the risk of a transfer being unwound.

Needs of the Security Interest Taker

- 1.82 The liquidity of securities makes them a very attractive form of collateral. Most securities used as collateral in the financial markets will be held and delivered through settlement systems in the form of intermediated securities.
- 1.83 Different jurisdictions may offer a range of alternative methods for taking collateral. These can range from an outright transfer to the collateral taker or to an escrow account through to a simple annotation of the security interest in the account of the collateral provider.
- 1.84 A party that receives an outright transfer of collateral will share many of the needs initially of a purchaser and thereafter of an investor. A collateral taker that acquires a security interest in the collateral other than through transfer of title will have separate concerns. It will want clear and simple rules for taking effective security over collateral and for realising the value of the collateral as quickly as possible in the event of a default.

Financial Collateral Directive

- 1.85 The EU has already passed legislation to improve the legal certainty of financial collateral arrangements. In summary, the Financial Collateral Directive²⁶ has the following effect:
- (1) It requires Member States to disapply certain provisions of insolvency law that would inhibit the effective realisation of financial collateral or would prevent such techniques as bilateral close-out netting, top-up collateral or substitution of collateral;
 - (2) It removes the need for registration or other formalities in order to create, validate, perfect and enforce security interests in book-entry securities in settlement systems. Perfection of the security interest as against third parties relies instead upon the collateral being in the possession or control of the collateral taker or a person acting on its behalf; and
 - (3) It provides for the right to reuse securities during the period that they are pledged as financial collateral.
- 1.86 The Financial Collateral Directive was a minimum harmonisation directive allowing Member States to enact its provisions either restrictively (by confining its scope to dealings among financial professionals) or broadly to all persons. A common legal framework would need to accommodate the different choices taken by Member States in implementing the Financial Collateral Directive in relation to the classes of persons that it affects.

²⁶ Directive 2002/47/EC.

Meaning of 'control'

- 1.87 The Financial Collateral Directive does not provide a precise definition of what amounts to 'possession or control' of financial collateral. Control could have a number of possible meanings. Control can be 'positive', that is to say, it can confer on the collateral taker the ability to realise the collateral without the consent of the collateral provider. On the other hand, control could be 'negative' in effect by conferring on the collateral taker the right to prevent the collateral provider from disposing of the collateral. It is not clear whether one or both of these positive and negative elements of control are required to satisfy the meaning in the Financial Collateral Directive.
- 1.88 The Law Commission in its recent report on Company Security Interests concluded that 'negative control' was the sole requirement under the Directive. However, this conclusion was reached only by interpreting the relevant article of the Directive in light of its recitals.²⁷ Without further legislation or a ruling by the European Court of Justice, the definition remains uncertain.
- 1.89 A common legal framework could provide greater clarity by giving a precise definition of control or, at the very least, setting out the practical means by which a collateral taker can perfect a security interest by taking control.

Priorities

- 1.90 The Financial Collateral Directive does not specifically deal with the priorities of successive dealings in financial collateral. A common legal framework should aim to provide clarity and consistency as to priorities between and among the competing interests of purchasers and security interest takers. This should also include the priority of interests taken by intermediaries in the securities that they hold as well as the effect on priorities of liens and other security interests arising by operation of law.
- 1.91 As we have stated above in relation to the needs of purchasers, the policy adopted by most states is to permit an innocent purchaser to prevail over an existing owner of intermediated securities. A similar policy decision must also be made between the competing interests of a person that perfects a security interest in securities (other than by an outright transfer) and a subsequent innocent purchaser.
- 1.92 Attributing priority to the prior taker of a security interest would damage the absolute protection afforded to innocent purchasers. On the other hand, to allow a subsequent interest to take priority over an existing, perfected security interest simply on the grounds that the subsequent interest belongs to an innocent purchaser rather than to another collateral taker could be viewed as arbitrary. It would have the effect of discouraging collateral takers from taking a security interest other than by transfer of the collateral.
- 1.93 The situation is further complicated if the security interest taker and the purchaser continue to share the same intermediary. Should the loss, in these circumstances, be shared *pari passu* or should one bear the loss in full?

²⁷ For further discussion of the meaning of control see Law Commission, Company Security Interests (2005) Law Com No 296, pp 137-138.

ISSUES TO BE ADDRESSED

- 1.94 Having identified the needs of each class of market participant within an intermediated holding system, we can compose a provisional list of the legal issues that need to be addressed in a common legal framework. At this stage of the project, we consider them to be as follows:

General

- (1) How should we define 'securities' for the purposes of a common legal framework?
- (2) As we have already stated, the common legal framework will be limited to intermediated securities. We will need to distinguish operators of direct holding systems (such as CREST) from intermediaries in an intermediated holding system. This may not always be straightforward especially in direct holding systems where the system operator's books are not the definitive register of entitlement against the issuer.²⁸
- (3) Legal systems should not discriminate against investors that legitimately hold securities through an intermediary. However, we will need to decide whether securities should be capable of being held through intermediaries in every case or whether national law should be able to refuse to recognise that an investor holding in this way has anything more than simple contractual rights against its intermediary.

Account holder's Rights

- (4) We must consider what basic minimum rights an account holder should possess against its intermediary in order for it to maintain and realise the value of the underlying securities. These rights against the intermediary can be split into two categories:
 - (a) Rights attaching to the securities. These are the terms of the securities and include rights to the economic benefit in the securities through dividends, interest payments and repayment of capital. They also include voting and pre-emption rights.
 - (b) Rights to deal with the intermediated securities. These rights include a right to compel the intermediary to transfer the intermediated securities or to withdraw them from its account so that they can be held directly.
- (5) An account holder should be prevented from exercising these rights against an intermediary other than the intermediary directly above it. Furthermore, unless the account agreement provides otherwise, an account holder should only be able to enforce the first category of rights - the rights attaching to the securities – against its intermediary if the investor has no direct right against the issuer.

²⁸ For example, the CREST register is not the definitive register of entitlement for Irish securities settled in CREST. Accordingly, transfers effected on the CREST register do not convey legal ownership until they are reconciled with the issuer's register.

- (6) An account holder should be prevented from claiming an interest in intermediated securities that are held in a higher tier of the chain (“upper tier attachment”).

Intermediary’s insolvency

- (7) Intermediated securities held by an intermediary for an account holder should be protected from the intermediary’s liquidator and creditors.

Duties of the Intermediary

- (8) A common legal framework must clearly prescribe what actions an intermediary must take to maintain sufficient securities for its account holders.
- (9) There should also be clear rules setting out the circumstances in which an intermediary should comply with instructions from persons other than its account holder.

Shortfalls

- (10) We will need to consider the appropriate method for allocating shortfalls. This must take into account circumstances where:
 - (a) Account holders have separate accounts with the intermediary;
 - (b) The shortfall arises in a pool of securities held for a number of account holders;
 - (c) The intermediary has securities of the same description either in its own house account or in a pooled account with customers.

Transfers

- (11) The legal framework will need to address a number of issues that arise in connection with the legal effect of crediting and debiting accounts.
 - (a) At what point does a transfer of intermediated securities take place?
 - (b) Does a book-entry require the consent of the account-holder in order for it to take effect?
 - (c) Do corresponding debits and credits need to be identified for a transfer to be effective?
 - (d) Should settlement systems be required to recognise net settlement of debits and credits of the same securities between securities accounts?
 - (e) What is the effect of conditional credits to an account?
 - (f) In what circumstances should credits and debits be reversed or invalidated?

Innocent Transferees

- (12) We will need to establish a test for innocent transferees. What constitutes 'notice' for the purposes of establishing a defence to prior interests in securities? Does the defence extend to a collateral taker or other purchaser that does not take outright transfer of the intermediated securities?

Collateral

- (13) Clear rules are required for the perfection of security interests over intermediated securities. These rules must take into account the following issues:
- (a) Should there be separate rules for the perfection and priority of security interests taken by an intermediary over the intermediated securities that it holds?
 - (b) Should the rules apply to all security interests or only consensual security interests (thereby excluding security interests that arise by operation of law)?
 - (c) What constitutes "control" for the purposes of perfection?
 - (d) If a security interest is not intended to attach to all securities in a pool, do the relevant securities need to be identified?
- (14) A common legal framework should also provide clear rules of priority as between competing interests.

Set-off

- (15) We will need to consider whether a uniform rule for set-off between issuer and investor is required. Where intermediated securities are subject to a security interest in an upper tier, how should this affect an investor's right to set-off against the issuer?