

Law Commission Project on Intermediated Investment Securities

Second Seminar:

Issues affecting Account holders and Intermediaries

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ISSUES AFFECTING ACCOUNT HOLDERS AND INTERMEDIARIES

Executive Summary

- 1.1 We set out below a summary of the preliminary conclusions reached in this seminar paper.¹

Protection from an Intermediary's creditors

- 1.2 The protection of an account holder's interest in securities from the claims of its intermediary's creditors is at the core of the relationship between account holder and intermediary. To permit creditors to have an equal claim to securities that the intermediary holds on behalf of its customers would distort the economic realities of this relationship. Accordingly, once intermediated securities have been credited to an account maintained by an intermediary for its account holders, the securities should not be subject to claims of the intermediary's creditors.
- 1.3 The different legal systems have developed various means of ensuring that the commingling of customer securities in a pooled account does not affect the availability of this protection against creditors. While many systems prohibit the commingling of customer and intermediary assets, this segregation should not be a prerequisite for protection against creditors in a harmonised legal framework.
- 1.4 The protection granted by the legal framework rules should take effect upon the crediting of the account holder's account. This protection is without prejudice to earlier and additional rights that an account holder may have under domestic law to the extent that such rights do not conflict with the legal framework rules.

The allocation of losses

- 1.5 Potential losses arising from fraud, operational error and settlement failure can occur in all systems. If the intermediary is unable or not obliged to remedy the potential loss, it becomes an actual loss borne by one or more account holders. How intermediated holding systems account for this potential loss tends to be a function of how they track dispositions in and out of accounts. Systems that match every corresponding debit and credit prevent account imbalances (shortfalls) from existing by allocating the potential loss automatically to a particular account holder. By contrast, non-matching systems permit shortfalls to exist and thereby only allocate a potential loss to account holders once it has become an actual loss. It is these non-matching systems that currently provide for methods of risk distribution (for example, pro rata sharing) between account holders in a pooled account.
- 1.6 Subject to domestic law, an account holder should be able by arrangement with its intermediary to segregate its account and avoid sharing in shortfalls in other accounts.

¹ These conclusions are preliminary only and are intended to provide a focus for discussion at the seminar.

- 1.7 If an intermediary is unable or not obliged to replace securities or otherwise compensate an account holder as a result of an unauthorised transaction, the loss should be allocated between account holders in the same account. We see no reason why this risk sharing should apply only to non-matching systems and not also to matching systems.
- 1.8 Where losses must be allocated between account holders, the loss should be shared in proportion to the size of each account holder's entitlement at the date of the commencement of insolvency of its intermediary (or of the relevant upper tier intermediary as the case may be). This method best reflects the common risk undertaken by account holders holding through one or more intermediaries.
- 1.9 Where an intermediary has commingled its own securities with those of its account holders, a loss arising from the intermediary's insolvency or breach of duty should first be allocated to reduce those securities held for the intermediary's own account. If the intermediary is not responsible for the loss (for example, because it originated at a higher tier), it is arguable that the intermediary should only share the loss pro rata.
- 1.10 Where an intermediary has segregated its house securities in a separate account, a loss in its customer account should first be allocated to the intermediary's house account only if the loss arises from the intermediary's own breach of duty. If the intermediary is not responsible, it is difficult to justify the allocation of any of the loss to its house securities.

Scope and enforceability of account holders' rights

- 1.11 Some legal systems permit an investor to enforce rights not only against its immediate intermediary but also directly against the issuer. Others do not. There is no reason why direct and indirect enforcement systems cannot operate alongside each other within a harmonised legal framework. It would be unrealistic to expect to achieve consensus within the EU by favouring one over the other.
- 1.12 The valid credit of securities to an account should grant the account holder with a right to instruct its intermediary to transfer the securities or withdraw them from its account. The right is effective against third parties and enforceable only against its own intermediary.
- 1.13 The valid credit of securities to an account should grant the account holder with a right to receive the benefit of any corporate and economic rights in the underlying securities. This right is effective against third parties and is enforceable against its own intermediary. Subject to national law, the right may also be enforceable against the issuer.
- 1.14 Subject to the terms agreed with its account holder, an intermediary must take reasonable actions to obtain the corporate and economic benefits generated by the underlying securities and to comply with the account holder's instructions for the transfer or withdrawal of securities credited to its account.

No-look-through principle

- 1.15 An account holder may enforce its rights in relation to the intermediated securities only against its own intermediary and, if national law permits, the issuer. This limitation removes the need for intermediaries to substantiate third party claims which purport to be based on rights in securities but which cannot easily be traced back to the securities that the intermediary holds.
- 1.16 An account holder should however be able to bring a claim against the issuer or an upper tier intermediary if it can demonstrate that the one or more intermediaries in between are disabled from bringing an effective action.

Upper tier attachment

- 1.17 An account holder (and persons claiming through it, including creditors) should be prohibited from bringing an attachment order in relation to securities that are not credited to an account held by the account holder's intermediary. This is necessary to enhance market efficiency and to ensure a clear order of priorities between different tiers in a holding chain.

The scope and level of duties owed by an intermediary

- 1.18 Most of the key duties owed by an intermediary are established from the perspective of account holder's rights enforceable against the intermediary. These include rights to receive corporate and economic benefits and to have the securities transferred. In addition, an intermediary is obliged to maintain a number and amount of securities that at least equals the aggregate number and amount of securities of the same description that are credited to securities accounts that it holds for account holders. This would permit the intermediary to count house securities towards satisfying its duty since any losses arising from the intermediary's breach of duty would first be allocated to these house securities.
- 1.19 If at any time an intermediary does not maintain sufficient securities to satisfy this duty, it should be obliged to promptly obtain additional securities.
- 1.20 Subject to the terms of the account agreement, the intermediary should be able to satisfy these obligations if it has acted with such care as is required by reasonable market standards.

Instructions

- 1.21 An intermediary may receive instructions from a range of person other than its account holders. In these circumstances, the intermediary needs clear rules as to whether it can act on, or ignore, instructions without incurring liability. Accordingly, we propose that an intermediary should act, and act only, on the instructions of its account holder in relation to securities that it holds for that account holder.
- 1.22 This duty should, however, be subject to the terms of any agreement between the parties, the rights of collateral takers, any order of court, any mandatory domestic rules and any settlement system rules.

- 1.23 Notwithstanding any mandatory rule of domestic law, an intermediary acting honestly should be able to rely on authorised instructions despite any notice it may have of third party claims.
- 1.24 Subject to domestic law, an intermediary may be liable if it acts on forged instructions but not if it acts on authorised instructions given by a person in violation of its duties provided that the intermediary acts honestly.

INTRODUCTION

- 1.25 This is the second of our series of seminar papers analysing legal issues that affect the ownership, transfer and pledging of 'intermediated' investment securities. The seminars and seminar papers form the preliminary stages of the Law Commission's project aimed at proposing a harmonised legal framework for investment securities held and transferred by financial intermediaries within the European Union. The seminar papers and consultees' responses to them will provide the basis of the Law Commission's Consultation Paper on Intermediated Securities which we expect to publish in early 2007. Further information regarding the scope and context of the project as well as the approach we have adopted to tackling these issues is set out in the first seminar paper available on the project's web-page (at www.lawcom.gov.uk/investment_securities.htm).
- 1.26 In the first seminar held in March 2006, we examined the general market needs of participants in intermediated holding systems as set against the twin policy objectives of increasing confidence and efficiency in the intermediated securities market. The primary aim was to establish a list of issues that we should address when considering an EU-wide legal framework. For ease of reference this list is set out in the Appendix.
- 1.27 This second seminar paper will analyse the legal issues most often associated with participants acting in their capacities as account holders and as intermediaries. These can be summarised as follows:
- (a) The protection of an account holder's interest in securities from the claims of an insolvent intermediary's creditors;
 - (b) The allocation of losses between account holders;
 - (c) The scope and enforceability of an account holder's rights;
 - (d) The application of the 'no-look-through' principle in relation to claims against higher tier intermediaries as well as the related issue of upper tier attachment;
 - (e) The scope and level of duties owed by an intermediary where not contractually specified; and
 - (f) The potential liability arising from intermediaries acting on instructions from persons other than their client.²
- 1.28 In each case, we have attempted to set out the key practical concerns that the law should address. We examine each issue from the point of view of English law as well as identify fundamental themes and differences in the way that other Member States approach the issue. We also look at the way the issue has been handled by each of:

² While we had originally stated our intention to deal with set-off in this seminar paper, we will now cover it in the fourth seminar on Collateral.

- (1) the Financial Markets Law Committee's report on indirectly held securities,³
- (2) Revised Article 8 of the United States Uniform Commercial Code; and
- (3) The UNIDROIT Preliminary Convention on Substantive Rules regarding Intermediated Securities (the 'Convention').⁴

1.29 Finally, we make some brief conclusions at the end of each section. These conclusions are merely preliminary and are intended to provide a focus for discussion.

Terminology

1.30 Consistent with the terminology adopted in the first seminar paper, we have ascribed the following meanings to the terms below:

- (1) 'Intermediated securities' refers to an account holder's entitlement to securities, 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.
- (3) 'Account holder' means any party that holds intermediated 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 its own account holders.
- (4) 'Investor' refers to an account holder that is not acting as an intermediary in respect of the securities and is therefore ultimately entitled to the benefits derived from them.
- (5) Except where specifically stated, 'pledging' is used in this paper as a generic term to describe the use of securities (or intermediated securities) as collateral. It is not intended to distinguish between the taking of collateral by way of charge, mortgage, pledge or outright transfer. Obviously, each of these possessory and non-possessory methods gives rise to different property rights in the intermediated securities as will be discussed in later seminars.

³ *Issue 3, Property Interests in Investment Securities*, July 2004. Available at http://www.fmlc.org/papers/fmlc1_3_july04.pdf.

⁴ March 2006, UNIDROIT 2006, Study LXXVIII – Doc 42.

PROTECTION FROM THE CLAIMS OF AN INTERMEDIARY'S CREDITORS

- 1.31 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.⁵ If an account holder's intermediary falls insolvent or is subject to a judgement debt,⁶ the law must prevent the creditor or liquidator from recourse to the account holder's interests in securities. An investor ultimately entitled to securities must have confidence that this protection against creditors applies to account holders at every level in the custody chain and regardless of the jurisdiction in which the securities account is located.⁷

Economic justification

- 1.32 There are compelling economic reasons for protecting an account holder's interest in securities from the claims of its insolvent intermediary's creditors. Investors are unlikely to want to hold securities through an intermediary if the intermediated holding systems does not reflect the allocation of economic risks and rewards that result from investing in securities. The investor takes a speculative risk by choosing to purchase specific securities. The intermediary does not participate in this risk and is not liable to the account holder if the issuer defaults or the sale value of the securities falls. Other than in exceptional cases, the intermediary does not borrow the securities from the investor in a manner analogous to a bank deposit. Nor will it typically credit the securities to the investor's account unless the purchase price has been paid or the intermediary's liability is covered by collateral.
- 1.33 The intermediary acts instead as a conduit for the capital, income and other economic benefits that flow from the underlying securities. Its economic interest lies solely in the fees it receives for the custody and other banking services it provides to account holders. Allowing the intermediary's creditors to have an equal claim to securities that the intermediary holds on behalf of its account holders would distort this economic reality. The intermediary's creditors would, in effect, receive a windfall. Assuming accounting rules in each Member State prevent the intermediary from stating the account holder's investments as its own, creditors cannot claim that they relied upon these assets when deciding whether or not to enter into a creditor/debtor relationship with the intermediary.

⁵ See J S Rogers, 'Policy Perspectives on Revised UCC Article 8' 43 UCLA L Rev (1996) 1431, 1450 in which he argues that the first element of the "core of the package of rights and duties that define the relationship between a securities intermediary and a person...who holds a securities position through that intermediary" is that such person "does not take the credit risk of the intermediary's other business activities; that is, property held by the intermediary is not subject to the claims of the intermediary's general creditors". See also S Schwarcz and J Benjamin, 'Intermediary Risk in the Indirect Holding System for Securities', 12 Duke Journal of Comparative and International Law (2002) 309.

⁶ Hereafter in this paper we refer to claims from creditors arising only in the context of an intermediary's insolvency. We acknowledge however that an intermediary may be subject to a claim by an execution creditor prior to insolvency.

⁷ This was acknowledged by the European Central Bank/Committee of European Securities Regulators in Standard 12 of their report *Standards for Securities Clearing and Settlement in the European Union*, September 2004, p 60.

- 1.34 We should note at this point that while the ring-fencing of an account holder's assets from the liabilities of its intermediary substantially reduces the relevance of the intermediary's credit risk, it cannot eliminate it altogether. Simply put, the account holder's intermediated securities can only be protected from the intermediary's insolvency to the extent that they are actually retained in the intermediary's account. If a shortfall⁸ arises in an intermediary's account as a result of fraud, operational error or settlement failure, the account holder will be vulnerable to the intermediary's credit risk in respect of this shortfall amount for as long as the missing securities are not replaced. If the intermediary becomes insolvent before additional securities are bought in, the account holder may be left only with a claim as a general unsecured creditor in respect of this shortfall amount. The allocation of losses where a shortfall and insolvency combine in this way is dealt with in detail later in this paper.⁹
- 1.35 Provided the account holder has confidence in its intermediary's professional competence and integrity (as well as the financial regulation and oversight of the system), these residual risks should not materially affect the investor's decision as to whether or not to hold securities through an intermediary. With the benefit of protection against the intermediary's creditors in insolvency, the account holder need not base its choice of intermediary solely on its financial strength. This both assists competition in the custody industry and acts as a comfort to an account holder that has no knowledge of the solvency of intermediaries higher in the chain of ownership.

⁸ For the definition of a shortfall, see para 1.94 below.

⁹ See pp 27-44 below.

Consensus as to the need for protection against intermediary insolvency

- 1.36 In January 2001, the International Organisation of Securities Commissions (IOSCO), together with the Committee on Payment and Settlement Systems (CPSS), issued its 'Recommendations for Securities Settlement Systems'.¹⁰ Recommendation 12 recognised that "it is essential that customers' securities be protected against the claims of the custodian's creditors".¹¹ This was endorsed by the G30 'Plan of Action' on global clearing and settlement¹² and by the European Central Bank (ECB) and the Committee of European Securities Regulators (CESR) in their report 'Standards for Securities and Settlement in the European Union'.¹³ The European Commission,¹⁴ supported by the Giovannini Group,¹⁵ also considers that insolvency protection is an essential feature of a pan-European legal framework for intermediated securities.

The legal nature of an account holder's interest

- 1.37 An investor that chooses to hold securities directly from an issuer, whether by entry in a register for registered securities or by possession of bearer securities, does so in the knowledge that it has personal rights against the issuer arising from its proprietary interest in the securities.
- 1.38 Where an investor holds securities through an intermediary, the nature of its interest and the extent to which this interest is protected from the claims of third parties will necessarily differ in certain respects from directly held securities. How different legal systems provide this protection depends in large part on how the account holder's interest is characterised in law.
- 1.39 A particular challenge faced by both common law and civil law traditions in protecting account holders arises where interests are commingled within the same account. For the sake of administrative convenience and efficiency, an intermediary may choose to open only one account with the intermediary or issuer above it in which are credited all the securities of the same description that the intermediary holds for its account holders. These 'omnibus' or 'pooled' accounts are by far the most common method used by intermediaries to hold intermediated securities.

¹⁰ Available at <http://www.bis.org/publ/cpss42.pdf>.

¹¹ Above p18.

¹² The Group of Thirty, *Global Clearing and Settlement – A Plan of Action*, January 2003.

¹³ September 2004, available at <http://www.ecb.int/pub/pdf/other/escb-cesr-standardssecurities2004en.pdf>.

¹⁴ European Commission, *Communication from the Commission to the Council and the European Parliament: Clearing and Settlement in the European Union – The Way Forward*, April 2004, p 25. Available at http://europa.eu.int/eur-lex/en/com/cnc/2004/com2004_0312en01.pdf.

¹⁵ The Giovannini Report, *Second Report on Cross-Border Clearing and Settlement Arrangements in the EU*, April 2003, p 15. Available at http://europa.eu.int/comm/economy_finance/publications/giovannini/clearing_settlement_arrangements140403.pdf.

- 1.40 The effect of commingling in this way is generally to preclude the continuing existence of direct property rights of individual owners in the specific securities held prior to commingling.¹⁶ In the absence of direct property rights, an account holder may be left with no more than a contractual right to the delivery of equivalent securities. In such circumstances, the account holder would merely rank as a general creditor in the insolvency of its intermediary.
- 1.41 To a greater or lesser degree, all national legal systems in the EU have developed means of protecting the account holder's rights in a commingled omnibus account either by legislation or by the application of existing legal principles. Some Member States apply this protection to any securities credited to an account¹⁷ while others grant protection only to specific types of investment security.
- 1.42 We set out below some examples of these methods and some of the common distinctions between different jurisdictions. With the aim of offering some clarity to certain issues arising in English law, we will pay particular attention to the legal analysis in England and Wales.

England and Wales – proprietary protection by way of trust

- 1.43 An intermediary that operates an account governed by English law will, in the great majority of cases, hold securities (or intermediated securities, if it is a lower tier intermediary) on trust for its account holder.¹⁸ General trust principles will protect client assets held on trust from the claims of a trustee's creditors by treating them as assets outside of the trustee's estate. To avail themselves of this protection, account holders must have confidence that a valid trust has been created. If it has not, they may be left only with a personal contractual right of redelivery in respect of their intermediated securities and will rank as general creditors in the intermediary's insolvency.
- 1.44 A trust of securities (or intermediated securities) requires no formalities in order for it to be validly created.¹⁹ It must however satisfy three certainties: the certain intention to create a trust; the certain identity of the beneficiaries (that is to say, the account holders) and the certain identity of the trust assets. Satisfying the first two of these certainties should not present difficulties in the context of securities accounts. However, where intermediated securities are commingled in a single account, there is a lack of consensus as to how the subject matter of the trust can be identified. We summarise some of the different approaches to this issue below.

¹⁶ *Cross Border Collateral: Legal Risk and the Conflict of Laws*, R Potok (2002) p 21.

¹⁷ Eg Czech Republic (s. 34 of the Securities Act 1991), Denmark (Article 72(7) of the Financial Business Act).

¹⁸ Exceptionally, the delivery of securities into an account can be characterised by agreement or circumstance as (1) a purely contractual right to redelivery by the intermediary, (2) an equity of redemption where the investor has given the intermediary a security interest in the asset, or (3) a bailment if the securities are bearer securities delivered to the bailee for safe-keeping. See FMLC Report, note 1 above at p 10.

¹⁹ *Paul v Constance* [1977] 1 All ER 195.

Pooled securities held by tenants in common

- 1.45 The mere fact that assets are commingled in a pool should not prevent an investor from enjoying a proprietary interest in those assets under a trust. However, the general rule is that one cannot acquire a proprietary interest in a definite number of pooled units in the absence of specific allocation of the units to which such interest attaches.²⁰ The question arises as to how one can specifically allocate fungible securities to an account holder where the securities are by definition interchangeable with one another. As an evidential matter, this is complicated further where an account holder cannot demonstrate that it contributed specific securities into the pool but has, instead, simply purchased an interest in securities already commingled in the pool.²¹
- 1.46 As a means of circumventing the need for specific allocation of part of the pool, many academics and practitioners would support the view that the account holders of a pooled account are equitable tenants in common of the entire account.²² Under this approach the requirement that trust assets be identified with sufficient certainty is satisfied because the trust property comprises the entire holding in the pool. Each account holder has a fractional share in the entire pooled account rather than an individual equitable proprietary interest over allocated securities within the pool.²³
- 1.47 The co-tenancy analysis does raise some further considerations in practice. Treating account holders' entitlements as fractions of a pool may not accord with an account holder's commercial intention to purchase a definitive number of securities. Furthermore, an account holder's need to dispose of 'co-owned' securities without the consent or encumbrance of other co-owners does not fit comfortably with the traditional concept of tenancy in common. A pooled account arrangement would need to incorporate a deemed consent of sale by co-tenants in relation to transfers out of the account as has been done by statute in the case of sales of tangible goods.²⁴

²⁰ *Re London Wine Company (Shippers) Limited* [1986] PCC 121, 137, by Oliver J.

²¹ AO Austen-Peters *Custody of Investments Law and Practice* (2000) p 42.

²² We query what the legal position would be if customers within a pooled account enter into account agreements with the intermediary that have different terms, however slight. Are they still subject to the same trust?

²³ See J Benjamin, *Interests in Securities* (2000) p 56 and J Benjamin & M Yates, *The Law of Global Custody* (2nd ed, 2002) pp 31-32.

²⁴ See s 20B of the Sale of Goods Act 1979 introduced by Sale of Goods (Amendment) Act 1995, which treats co-owners of unascertained goods in an identifiable bulk as consenting to dealings in the bulk goods by other co-owners.

- 1.48 It is a corollary of the co-tenancy analysis that should an intermediary commingle its customers' intermediated securities with equivalent securities that it holds for its own purposes, the trust will fail for lack of certainty. In these circumstances, it becomes impossible to identify the securities which are held on trust for account holders and the securities which belong to the intermediary.²⁵ Segregation of customer and intermediary assets becomes a prerequisite to the creation of a valid trust and therefore to protection from the intermediary's creditors.²⁶

Hunter v Moss approach

- 1.49 The courts have taken a different approach in their analysis of commingled securities by distinguishing between tangible and intangible assets. In the leading authority *Hunter v Moss*,²⁷ Moss declared himself trustee of 50 of his 950 shares in a private company for Hunter. A familiar problem arises: which 50 of the 950 shares are subject to the purported trust? As Hayton observes:

If Moss subsequently sells 50 shares how do the revenue know whether he is selling his own shares, so that he is chargeable to capital gains tax, or if he is selling Hunter's shares so that Hunter is so chargeable? If the proceeds of sale are profitably or detrimentally reinvested does the new investment belong in equity to Hunter or Moss?²⁸

- 1.50 The judge at first instance, concluded that the certainties requisite for the establishment of a trust over tangibles were not necessarily applicable to a trust over intangibles. Specific identification of fungible assets was,

unnecessary and irrelevant...Any suggested uncertainty as to subject matter appears to me to be theoretical and conceptual rather than real and practical.²⁹

- 1.51 Referring to the difficulty in ascertaining whether subsequent dealings were with trust property or the settlor's property, the judge held that

If any such uncertainty were to arise, that would not be because the trust fund was uncertain as to subject matter, but rather because the trustee failed to keep proper account showing how he had subsequently dealt with it.³⁰

²⁵ See *Stapylton Fletcher Ltd* [1995] 1 All ER 192.

²⁶ UK financial intermediaries are subject to custody rules to ensure that assets are adequately safeguarded from misappropriation or insolvency risk. CASS Rule 2.2.3 provides that an intermediary "must segregate safe custody investments from its own designated investments." Furthermore, under CASS Rule 2.2.5 an intermediary "must ensure that if a safe custody investment is recorded with itself, the title of that account makes it clear that the safe custody investment belongs to a client, and is segregated from the firm's designated investments."

²⁷ [1993] 1 WLR 934; [1994] 3 All ER 215, CA.

²⁸ D J Hayton, 'Uncertainty of Subject-Matter of Trusts', (1994) 110 LQR 335, p 336.

²⁹ [1993] 1 WLR 934 at p 946.

³⁰ [1993] 1 WLR 934 at p 946.

- 1.52 The Court of Appeal affirmed the decision at first instance that Moss had declared a valid trust.³¹ It held that the requirement of certainty of subject matter did not necessarily entail the segregation of assets and that since the shares were indistinguishable from each other the declaration of trust was sufficiently certain.
- 1.53 *Hunter v Moss* has been the subject of much academic criticism. There is clear authority that a trust over tangible assets (such as gold bullion or wine) that have not been segregated from the general stock fails for uncertainty of subject matter.³² Some critics see no basis in law for treating trusts of intangibles differently from trusts of tangible assets and suggest that it is unsafe to rely on the reasoning that property rights can arise under a trust without attaching to any particular asset.³³ In addition, they point to contrary authority confirming the requirement of certainty of subject matter for trusts of other kinds of intangible asset.³⁴
- 1.54 Nevertheless *Hunter v Moss* has been followed in *Re Harvard Securities*³⁵ and *Re CA Pacific Finance Ltd*³⁶ and stands as the current law.³⁷

³¹ [1994] 3 All ER 215.

³² See *Re London Wines (Shippers) Ltd* [1986] PCC 121; *Re Goldcorp Exchange Ltd v Privy Council* [1995] 1 AC 74.

³³ See J Benjamin, *Interests in Securities* (2000) p 58. See also DJ Hayton *Underhill and Hayton, Law Relating to Trusts and Trustees* (15 ed 1995) p 65.

³⁴ For example, building contract retention trust cases show that a company cannot create a trust of money in a bank account unless it segregates the money by depositing it in a separate trust account. See *Mac-Jordan Construction Ltd v Brookmount Erostin Ltd* [1992] BCLC 350; *Re Jartray Development Ltd* (1982) BLR 134; *Rayack Construction v Lampeter Meat Co Ltd* (1979) 12 BLR 30; *Neste Oy v Lloyds Bank plc* [1983] 2 Lloyd's Rep 658; *Concorde Constructions Co Ltd v Colgan Ltd* (1984) 29 BLR 120.

³⁵ [1997] 2 BCLC 369.

³⁶ [2000] 1 BCLC 494.

³⁷ J Benjamin has argued that the ideas implicit in *Hunter v Moss* can be reconciled with the traditional principles of property law. Both property obligations and intangible assets are by their nature notional not physical and therefore the notional property right automatically attaches to the book-entry security, which is its notional reification. Both come into being together without need for allocation. Benjamin advocates that this line of reasoning should be judicially developed. See J Benjamin, *Interests in Securities* (2000) p 308.

Shares as a single indivisible bulk

1.55 Sir Roy Goode puts forward another analysis based both upon co-ownership and upon a distinction between tangible and intangible assets.³⁸ He argues that it is a misconception to speak of holding and transferring particular book-entry securities as if they were physical assets capable of segregation. Securities are not like gold bars or bottles of wine that can be physically separated from a bulk so that specific securities can be identified as the subject of a trust.³⁹ Securities cannot be held or transferred separately from the rest of the securities of the same issue. The issue is one indivisible bulk; transfers of part of the bulk are simply transfers of a proportion of the bulk rather than of identifiable units of it. As a result, all owners of securities are co-owners with other investors of securities in the same class, whether or not the securities are held in the same account.

1.56 If an intermediary opens a separate account with the intermediary (or issuer) above it in order to segregate the entitlement of one of its account holders from the others, then, in Goode's words,

[t]he customer's interest remains an indirectly held co-ownership interest with other investors in securities of the same class. The issue of the securities constitutes a single asset which can only be held in sole ownership or co-ownership. The shareholding is segregated only in the sense that it is identifiable in the books of the intermediary's own intermediary...The status of an account as a non-fungible account does not mean the holder is the sole owner of the separate asset, only that his or her interest is excluded from the common pool and is identifiable in the records of higher tier intermediaries and may therefore be traced up the chain to the issuer.⁴⁰

1.57 If Goode's analysis is correct and one accepts that shares of the same issue are all simply a fraction of an identified bulk, arguments about lack of identification of particular securities become redundant. Certainty of subject matter is always satisfied (provided the specific issue of securities can be ascertained). 'Segregation' of securities becomes meaningful only when determining how shortfalls should be treated amongst account holders in different accounts.

³⁸ R Goode 'Are intangible assets fungible' LMCLQ [2003] 379.

³⁹ Goode argues that numbering of securities is irrelevant as they remain completely interchangeable.

⁴⁰ LMCLQ [2003] 379, pp 387-388.

Possible solutions

- 1.58 As we have explained above, there are solid economic reasons for protecting the assets of account holders from the claims of an intermediary's creditors. To do so, modern securities holding arrangements must currently conform with the requirements of general trust law principles in order for them to rely upon the protection afforded by the creation of a valid trust. In nearly all respects, this poses no problem. Even in the case of commingled securities, the divergent analyses referred to above all provide a solution for satisfying the certainty of subject matter requirement in order for a valid trust to exist. The one exception is in the case of an account that commingles the account holders' and intermediary's securities. Such an account would not be protected from the intermediary's creditors if the co-tenancy analysis is followed.
- 1.59 The securities markets would clearly benefit from clarifying the position both generally as regards commingled securities and specifically in the case of accounts that mix customer and intermediary assets. We propose that securities credited to an account holder's account should be considered outside of the intermediary's estate without need to consider further whether or not they can be allocated for the purposes of a trust. This general rule would apply to mixed customer and intermediary accounts so as to protect the customer securities credited in the account. While financial regulation should generally prevent intermediaries from mixing their assets with those of their customers, there can be no guarantee that such a scenario will not arise. Account holders should not be penalised as a result of the intermediary's breach of its requirement to segregate its own assets from those of its customers. In the allocation of loss upon the intermediary's insolvency, the effect is to protect the investor whose funds were used to purchase the securities at the expense of the intermediary's unsecured creditors. While both are innocent parties, the investor, unlike the unsecured creditor, enters into a legal relationship with the intermediary based upon an expectation that the obligation owed to it (namely the return of its securities) will be protected in the event of the intermediary's insolvency.
- 1.60 A second issue arises if the intermediary has misappropriated the account holder's securities but retained its own securities within the account (or in a segregated house account). This is a question relating to the allocation of shortfalls. As some commentators have observed, equitable tracing rules may already provide account holders with adequate protection by way of a constructive trust or a presumption that a trustee will dispose of its own investments first.⁴¹ We will revert to this issue when examining the treatment of shortfalls.⁴²

Other Member States

- 1.61 While the legal justifications adopted by Member States for protecting account holder assets do not allow for simple classification, it is possible to identify at least four legal characteristics that are helpful in distinguishing one system from another. None of these characteristics are mutually exclusive.

⁴¹ Worthington, 'Sorting Out Ownership Interests in Bulk', *Journal of Business Law* (1999), 21.

⁴² See paras 1.140-1.145 below.

Ownership by the intermediary

- 1.62 In Member States with a civil law tradition, an intermediary that maintains a securities account for account holders generally retains no legal ownership interest in the intermediated securities within the account. Sole ownership of the securities resides with the investor at the bottom of the chain of holding.
- 1.63 In Member States such as the United Kingdom, Ireland, Cyprus and Malta that recognise trusts, ownership may be split.⁴³ The highest tier intermediary keeps possession of the bearer securities or is registered as owner of the securities in the primary register operated by or on behalf of the issuer. This intermediary is nominally entitled to the securities and retains the legal title to them. It holds its entitlement in the underlying securities on trust for the benefit of the account holder immediately below it. In the case of multi-tiered custody, that account holder holds a non-beneficial equitable interest in intermediated securities on sub-trust for the account holder below it and so on down the chain.⁴⁴ The investor at the bottom of the chain has a beneficial equitable interest in the entitlement of the intermediary directly above it.⁴⁵

Legal protection based on co-ownership

- 1.64 In a number of Member States, account holders are given proprietary rights (or the equivalent protection) by treating their interests in a commingled account as co-ownership (or co-proprietary) interests in a fungible pool.
- 1.65 In Belgium, statute converts what would otherwise be a mere contractual claim against the intermediary into an intangible co-ownership right in a pool of fungible book-entry securities held by the intermediary.⁴⁶ This co-ownership right confers on the account holder a right of “revendication” which entitles him to the return of the relevant kind and quantity of securities in the event of the intermediary’s insolvency.⁴⁷ There is a similar statutory protection for account holders in Luxembourg.⁴⁸

⁴³ Under German law, securities that are held in safe custody abroad and credited to an account holder’s account under the WR-Credit system are also held by the intermediary in the capacity of fiduciary trustee (*Treuhänder*).

⁴⁴ In creating a sub-trust over an equitable interest, each sub-trustee carves out a new equitable interest leaving the sub-trustee with a bare equitable title. See A O Austen Peters, *Custody of Investments, Law and Practice* (2000), p 66.

⁴⁵ Some academics have argued that where a sub-trust is a bare trust (ie the sub-trustee has no active duties), the sub-trust is ignored and the head trustee holds directly for the beneficiary below. *Grainge v Wilberforce* (1889) 5 TLR 426 appears to offer direct support to this theory of collapsing sub-trusts. The theory and the use of *Grainge* in support of it has been rejected by A O Austen Peters who argues that the ultimate beneficiary’s entitlement is a new equitable right derived from its own intermediary and not from a trustee holding for another tier above. See A O Austen Peters, *Custody of Investments, Law and Practice* (2000), pp 66-68.

⁴⁶ Article 2, Belgium Royal Decree No 62.

⁴⁷ Articles 12 and 13, Belgium Royal Decree No 62.

⁴⁸ Article 7, Securities Act 2001.

1.66 In Germany, an account holder in an omnibus account is the co-owner of a pool of fungible securities held in collective safe custody (typically in bearer form) with the central securities depository (CSD). The intermediary acts as an indirect bailee for the account holder and has “constructive possession” of the account holder’s co-ownership rights in the pool of securities.⁴⁹ As the intermediary has only possession and not ownership of the securities, the account holder’s securities do not fall into the intermediary’s insolvency estate and are therefore immune from the claims of its creditors. The account holder also has a “revendication” right which entitles it to a pro rata delivery of securities from the pool at any time. The account holder can enforce this right against the intermediary in the event of its insolvency.⁵⁰

Legal systems requiring segregation of customer and intermediary assets

1.67 In a number of EU legal systems, the insolvency protection given to account holders through statute or general legal principles (such as co-ownership) may also require, as a precondition of the protection, that the customer’s and intermediary’s assets are segregated. As we have noted above, segregation of trustee and beneficiary assets may be necessary in English law to establish a valid trust if account holders are treated as equitable tenants in common.⁵¹

1.68 In Hungary, the provisions of the Civil Code and the Capital Market Act 2001 require that an investment service provider (which acts as an intermediary) must segregate an account holder’s securities from its own assets to protect the account holder securities from the claims of the investment service provider’s creditors.

1.69 Italian law also provides that the intermediary must segregate an account holder’s securities from its own assets.⁵² If the account holder’s securities are not segregated from the intermediary’s own securities the account holder’s rights are not protected. The intermediary or its representatives are criminally liable for the breach of the segregation rules.

⁴⁹ See para 1.201 below.

⁵⁰ Section 985 Civil Code and sections 7 and 8 of the Securities Deposit Act. See also section 47 of the Insolvency Code. The insolvency protection is essentially the same for securities held in collective safe-custody outside Germany. In cross-border custody, the intermediary has co-ownership rights in the pool of fungible securities held with a foreign CSD and exercises them as the account holder’s fiduciary (Treuhänder). However, as the economic benefit of the securities accrues to the account holder (Treugeber), the account holder is still entitled to enforce a vindication right against the intermediary in the event of its insolvency.

⁵¹ See paras 1.46-1.47 above.

⁵² The Financial Law Consolidated Act 1998 and Legislative Decree 213 of 1998.

- 1.70 French law grants the investor with the sole right to enforce the underlying securities as legal owner and to call for them to be redelivered (“droit de restitution”).⁵³ Custody of the securities or intermediated securities by an intermediary does not transfer title from the investor to the intermediary provided that it is possible to distinguish the investor’s securities from those held by the intermediary for its own account. If fungible securities are not segregated but are commingled with other assets held by the intermediary, there is a risk that the deposit could be characterised as a transfer of title in favour of the intermediary, leaving the account holder without protection from the intermediary’s creditors.
- 1.71 Other Member States requiring segregation include Lithuania,⁵⁴ Malta and Greece⁵⁵.

Statutory protection limited to settlement system participants

- 1.72 In some Member States statutory protection for intermediated securities is limited to accounts opened with the CSD or the CSD’s participants (or nominees).⁵⁶
- 1.73 As is explained in more detail below,⁵⁷ an account holder that holds dematerialised Spanish listed securities through an Iberclear participant can be identified in the Spanish two-tier registry system as legal owner. Its property interest is unaffected by the insolvency of the participant save that it must move its account to a solvent participant. However, this statutory protection to investors does not apply below the level of an Iberclear participant’s account holder.⁵⁸ Account holders that do not hold securities directly through an Iberclear participant do not have clearly defined rights against their intermediary’s creditors. An investor’s rights in the securities will only be protected from the claims of the intermediary’s creditors where it is fully evidenced before the court or insolvency authority that the securities in question were acquired on its behalf by the intermediary in a fiduciary capacity.

⁵³ Co-proprietary rights are not recognised under French law.

⁵⁴ Under Article 101(10) of the Civil Code an account holder is the owner of securities held with an intermediary. Provided that the account holder’s securities are segregated from the intermediary’s assets pursuant to Article 24(1)(3) of the Law on Securities Market, the account holder’s securities are protected from the claims of the intermediary’s creditors in the event of its insolvency.

⁵⁵ The requirement for segregation applies to securities held in the System for Monitoring Transactions in Book-Entry Securities.

⁵⁶ Eg Estonia which grants protection only to account holders holding through nominee accounts opened with the Central Registry (s 6(3) of the [ECRSA]).

⁵⁷ See paras 1.204-1.209 below.

⁵⁸ See also the Portuguese Securities Code which grants ownership rights to account holders that hold accounts directly with the issuer or indirectly through an intermediary within a centralised securities system. If the account holder is acting on behalf of another person, that person does not acquire ownership rights because such ‘sub-accounts’ are not within the centralised system.

Approach taken by the FMLC

1.74 In 2004, the Financial Markets Law Committee published a report (“the FMLC Report”) in which it identified uncertainties in English law arising in the context of the intermediated securities market. The FMLC Report proposed principles that could be used as a framework for the drafting of securities legislation in the UK (the “FMLC Principles”).

1.75 On the question of protection against creditors’ claims, FMLC Principle 3 asserts simply that:

Securities held by the customer through the intermediary are not available to the creditors of the intermediary.

1.76 As to the question of whether account holders have a valid property interest in a pool of securities, Principle 2(b) states that:

Each customer holding securities of a particular type through an intermediary has proportionate property rights in the pool to the extent of its entitlement.

1.77 These Principles are not intended to give an account holder a new form of property right in English law but continue to rely instead upon the protection afforded to beneficiaries under trust law. As has been shown above, English law gives account holders ample protection against an intermediary’s insolvency. The Principles do act, however, to remove any doubt as to the validity of a trust over a pool of intermediated securities held for account holders.

Approach taken by the US Uniform Commercial Code

1.78 By contrast, UCC Revised Article 8 creates a *sui generis* property right in intermediated securities in the form of a ‘security entitlement’. A security entitlement is both a package of personal rights against the securities intermediary and an interest in the property held by the securities intermediary.⁵⁹ The intermediary holds these security entitlements for account holders (called ‘entitlement holders’) only “to the extent necessary” for it to meet its obligations to entitlement holders.⁶⁰ This formulation is necessary to account for the fact that intermediaries (in US markets) do not generally segregate securities in such a fashion that one could identify particular securities as the ones held for customers.⁶¹ The entitlement holder is given a pro rata property interest in all interests in that financial asset held by the intermediary⁶² and is expressly protected under Section 8-503(a) from the intermediary’s general creditors.

Approach taken by UNIDROIT Convention

1.79 Investor protection from intermediary insolvency is one of the core concepts of the Convention. Article 11 of the Convention provides that:

⁵⁹ Official Comment 17 to §8-102.

⁶⁰ §8-503(a). See also para 1.271 below regarding the intermediary’s duty to maintain sufficient securities.

⁶¹ Official Comment 1 to §8-503.

⁶² §8-503(b).

the rights of an account holder...are effective against the insolvency administrator and creditors in any insolvency proceeding in respect of the relevant intermediary”.

- 1.80 The Article should be read together with Article 19 which states that securities held by an intermediary and credited to an account holder,

...shall not form part of the property of the intermediary available for distribution among or realisation for the benefit of its unsecured creditors in the event of an insolvency proceeding in respect of the intermediary or be otherwise subject to claims of unsecured creditors of the intermediary.”⁶³

Commentary on the Convention

- 1.81 The Articles illustrate the functional approach of the Convention. The language is neutral in consideration of the different legal traditions of the contracting states and the rules are formulated by reference to the desired result in order to accommodate different legal concepts in the different jurisdictions.⁶⁴

- 1.82 The rights of an account holder arise under the Convention from the simple act of crediting an account. The Convention makes these rights effective against third parties (such as an intermediary’s creditors) without need for further formality. For example, an account holder whose securities are credited to an account governed by English law would be protected under the Convention from the claims of its intermediary’s creditors irrespective of whether the account had satisfied the requirements necessary to establish a valid trust under English law. Commingling of customer and intermediary securities of the same description will not affect an account holder’s protection under the Convention provided that the intermediary holds sufficient securities to satisfy its account holders’ entitlements. If it does not and a shortfall exists, segregation may or may not affect the account holders’ ability to recover their securities. We deal with this issue in more detail in the next section.

PROTECTION EFFECTIVE UPON A CREDIT TO ACCOUNT HOLDER’S ACCOUNT

- 1.83 Under the Convention, a credit creates the account holder’s rights and constitutes the moment at which an account holder is protected from the claims of the intermediary’s creditors. Establishing this point in time is critical in determining the priorities between competing claims, whether they are the claims of an intermediary, an account holder, transferee, collateral taker or any of their respective creditors.

⁶³ Article 19(2).

⁶⁴ See UNIDROIT Preliminary Draft Convention on Harmonised Substantive Rules regarding Securities Held with an Intermediary, Explanatory Notes, December 2004, p 18.

- 1.84 The domestic laws and settlement system rules of the various Member States currently present a range of events that represent the point in time at which an account holder obtains rights. These include the date of the trade agreement, the moment at which a trust is created over the intermediated securities and the moment at which the securities are credited to the account holder's account by its intermediary. By adopting the last of these approaches, the Convention has chosen a temporally finite, factual event that is not subject to complex formalities and is universal in its application to computerised custody and settlement of intermediated securities.
- 1.85 We can see the merits in choosing the book-entry as the point in time at which the rights in a harmonised legal framework arise. It best satisfies the functional, neutral approach necessary to achieve harmonisation amongst different Member States by avoiding the need to characterise the legal relationship between intermediary and account holder. It does, however, represent a departure from English law, which recognises the credit as merely evidencing the proprietary equitable interest that arises upon the creation of a trust. The moment at which a trust comes into existence will typically occur when the assets are identifiably in the possession of the trustee and the necessary certainties are satisfied. In the context of intangible book-entry securities, this will occur when the securities are credited to the *intermediary's* account and not when the intermediary credits its own account holder. Accordingly, under English law, if the intermediary fails for whatever reason to credit its account holder's account, the account holder may still have an equitable interest in the securities which it can enforce against creditors and other third parties if the securities are misappropriated or the intermediary falls insolvent. This protection would not be afforded to the account holder under the Convention.
- 1.86 While acknowledging the importance of the book-entry within a harmonised legal framework, we must consider whether the rights that are enjoyed by an account holder upon a credit to an account can exist alongside other rights that arise under domestic law.⁶⁵ Permitting these rights to co-exist would represent the least intrusive means of implementing a common system. Rights arising under a harmonised legal framework would operate as a minimum standard ensuring that account holders in every Member State had at least these rights at the moment that their account was credited. However, in permitting earlier and additional rights to arise under domestic law, one must be careful not to compromise the legal certainty created by a harmonised legal framework in relation to limitations on participant's liability. Delineating the liabilities and duties of participants in cross-border custody and settlement is no less important than establishing certainty as to their respective rights. To the extent that domestic law rights and duties conflict with the limitations on liability set out within the harmonised legal framework, the harmonised rules should prevail. In our opinion, the Convention is currently unclear in a number of areas as to the interplay between Convention rules and the rights and obligations that may arise under the domestic laws of contracting states.

⁶⁵ Article 9(1)(d) permits other rights under domestic law to arise upon a credit.

Preliminary Conclusions

- 1.87 The protection of an account holder's interest in securities from the claims of its intermediary's creditors is at the core of the relationship between account holder and intermediary. To permit creditors to have an equal claim to securities that the intermediary holds on behalf of its customers would distort the economic realities of this relationship. Accordingly, once intermediated securities have been credited to an account maintained by an intermediary for its account holders, the securities should not be subject to claims of the intermediary's creditors.
- 1.88 The different legal systems have developed various means of ensuring that the commingling of customer securities in a pooled account does not affect the availability of this protection against creditors. While many systems prohibit the commingling of customer and intermediary assets, this segregation should not be a prerequisite for protection against creditors in a harmonised legal framework.
- 1.89 The protection granted by the legal framework rules should take effect upon the crediting of the account holder's account. This protection is without prejudice to earlier and additional rights that an account holder may have under domestic law to the extent that such rights do not conflict with the legal framework rules.

LOSS-SHARING IN SECURITIES ACCOUNTS

- 1.90 Despite the protection afforded to securities accounts in the event of an intermediary's insolvency, an account holder can still suffer a loss for a variety of reasons. A potential loss can arise if the securities are fraudulently or mistakenly disposed of by an intermediary and the transaction cannot be unwound either because the transferee has a valid defence or is untraceable. A potential loss can also arise if the account holder has purchased securities but a settlement failure results in them not being delivered into its account.⁶⁶
- 1.91 The loss is only potential because the intermediary will ordinarily be required to replace the missing securities or pay damages, or both, in order to satisfy its duty to maintain sufficient securities in its account.⁶⁷ If, however, the intermediary is insolvent or under no obligation to replace the intermediated securities (for example, because the improper transaction was the fault of an insolvent upper tier intermediary for which it is not responsible) the potential loss will crystallise into a real loss.⁶⁸
- 1.92 The manner in which systems account for potential losses and allocate real losses to account holders differs from system to system. The difference in how systems account for potential losses is a function of how systems track dispositions across accounts. The way in which they then allocate real losses appears simply to have followed on from this distinction. Broadly speaking the systems fall into two groups: matching systems and non-matching systems.

Non-matching systems: shortfalls

- 1.93 In non-matching systems the effectiveness of a disposition is not dependent upon corresponding debits and credits being matched. The net settlement of trades and the volume of trades in and out of accounts across one or more intermediaries can make matching a virtual impossibility in practice. An intermediary that receives a credit into its account may have no way of verifying in a multi-tiered holding system whether there have been corresponding debits in the books of the one or more of the intermediaries through which the selling investor held the securities. In most cases, the transferee will not even know the identity of the selling investor. Matching can therefore only operate effectively in circumstances where the transfer occurs exclusively on the books of a CSD or in transparent systems where the investor's interest is not only recorded in its direct intermediary's account.

⁶⁶ Settlement based on a delivery versus payment system should significantly reduce this risk.

⁶⁷ See paras 1.261-1.280 below.

⁶⁸ The account holder may have further remedies against third parties (eg for knowing assistance in English law).

- 1.94 Non-matching can lead to shortfalls in accounts. A shortfall occurs where the number of securities credited to account holders in the records of an intermediary exceeds the number of securities to which the intermediary is entitled (through its account with its intermediary or issuer above). A shortfall can either arise automatically as a result of failure to reconcile debits and credits within the system or can be deliberately manufactured upon discovery of an unauthorised transaction in order to reflect the account holders' continuing entitlement against its intermediary.
- 1.95 Let us take the following examples. An intermediary (A) fraudulently or mistakenly instructs the intermediary above it (B) to transfer some of the securities that B holds for A. B debits A's account. If A does not also debit the account of one of its customers (X) to reflect the transfer, a shortfall will arise in A's account. The account imbalance therefore arises automatically from a failure to match book-entries.
- 1.96 Alternatively, if A does debit X's account to correspond with the debit in its account with B, a non-matching system should manufacture a shortfall upon discovery of the unauthorised transaction by re-crediting X's account (but not A's account with B).
- 1.97 In both cases, the potential loss caused by the unauthorised transaction is reflected by a shortfall in the account rather than by allocating it to a specific account holder (such as X). If A becomes insolvent, the potential loss becomes a real loss and is only then allocated amongst A's customers in accordance with loss sharing rules in order to reconcile the account balances.

Matching systems

- 1.98 In some systems, it is theoretically impossible for shortfalls to arise. This does not mean that failed or improper transactions cannot occur in such systems but rather that the account imbalances that result in shortfalls are not permitted to exist.

- 1.99 Account imbalances are avoided in these ‘matching’ systems by ensuring that a credit in a transferee’s account cannot take effect unless it is matched with a corresponding debit in the transferor’s account.⁶⁹ If the credit is found to have been ineffective (for example, as a result of fraud or mistake) and the transferee has no defence, the transaction is unwound and no shortfall arises in either account. If the transferee has a defence (such as a bona fide purchaser defence) the credit and debit will stand. The account holder whose account has been wrongly debited will be left with a personal claim against the intermediary. Its account is not re-credited unless and until the intermediary has purchased additional securities to discharge this claim. If the intermediary falls insolvent before it can purchase the securities, the account holder is left with a claim against the intermediary as an unsecured creditor but no shortfall exists as such in the account. In matching systems, account balances are therefore always reconciled by allocating the potential loss to the account holder whose account is debited (or not credited in the case of a failed settlement).
- 1.100 If the intermediary becomes insolvent and the account holder’s personal claim as an unsecured creditor is worthless, the potential loss becomes a real loss for the account holder without further consideration of whether the loss should be shared with others.

The effect of ‘inflation’

- 1.101 In legal systems that give investors at the bottom of the holding chain a direct right against the issuer,⁷⁰ matching is virtually a necessity. This is because matching greatly reduces the threat of ‘inflation’. Inflation is caused by the number of securities credited to investors’ accounts exceeding the number of securities actually issued. If credits are not matched with corresponding debits, the issuer could be faced with direct claims from investors who may purport to have more securities than were originally issued. The issuer will not be in a position to easily verify which investors have legitimate claims and which do not. Inflation does not have this effect on indirect enforcement systems (such as in the United Kingdom) as investors cannot make a direct claim against the issuer. If the securities credited to an account holder’s account exceed the number held by its intermediary, it is for the intermediary to determine whether it must buy additional securities to remedy the imbalance.

⁶⁹ Examples of Member States with ‘matching’ systems include Germany, Spain, Cyprus, Austria and Portugal. In the case of Austria and Portugal the matching requirement applies only to transfers recorded on the register of the CSD. Finland and Sweden also have systems in which every transfer can be traced thereby minimising the likelihood of a shortfall arising.

⁷⁰ See paras 1.188-1.209 for a discussion of direct enforcement systems.

The potential application of risk allocation rules to matching systems

- 1.102 As mentioned above, while shortfalls are theoretically impossible in matching systems, the risk of loss caused by an improper or failed transaction is not. Member States that operate matching systems do not generally apply a risk allocation approach to these losses.⁷¹ If the intermediary does not replace the missing securities, it is the investor whose account was debited that will bear the loss. While the investor may possibly have recourse to a compensation fund, this allocation of the entire loss to a specific account holder in a pooled account may not represent the best method of risk management.
- 1.103 There seems no good reason why a pro rata sharing method could not be adopted in these circumstances. No inflation would occur if the debited account was readjusted simultaneously with the redistribution of the loss among the other account holders in the pool.

Possible ways of dealing with losses

- 1.104 Before dealing with specific issues regarding the treatment of losses, it is helpful to consider the different methods available for dealing with failed or improper transactions. One of the advisors to the committee that drafted Revised Article 8 of the US Uniform Commercial Code examined in depth the priorities between claimants in the event of a shortfall. A variety of pre-existing approaches were identified.⁷² These included:
- (1) A regulatory approach. This seeks to subject financial institutions to broad regulation and supervision so as to ensure that intermediaries maintain sufficient securities to cover the claims of their customers. Rules that require matching or segregation or which restrict intermediary's from using their customers' securities are examples of a regulatory approach. The approach does not however address the issue of allocating loss in the event that a shortfall does arise.
 - (2) The insurance approach. This approach provides the customer protection through insurance obtained privately or through the settlement system.⁷³ The study noted that the insurance approach and the regulatory approach are related. If the regulatory approach were abandoned, the insurance approach might become prohibitively expensive.

⁷¹ In some circumstances, matching systems may apply a pro rata sharing method in allocating loss. For example, if more than one account holder is affected by the same failed settlement into an omnibus account, the affected account holders will share any loss pro rata.

⁷² See C W Mooney, 'Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities controlled by Intermediaries', *Cardozo L Rev* (1990), 305, pp 326-330.

⁷³ By way of example, Germany has a mandatory deposit protection scheme (under the Deposit Guarantee and Investor Compensation Act) and a voluntary scheme (the Deposit Protection Fund of the Association of German Banks. Hungary has a scheme funded by mandatory contributions from investment services providers. The United Kingdom has the Financial Services Compensation Scheme funded by levies on authorised firms.

(3) The property law approach. This involves the application of property law rules to protect purchasers against prior and subsequent competing interests. The study considered property law to be ill-suited to dealing with priorities in relation to pooled securities of the same description. In addition, it noted that distributional rules of insolvency law could take precedence over property law rules intended to protect the purchaser.

(4) The risk allocation approach. In the words of the study, this

contemplates legal rules that distribute assets to claimants based on objective classifications of the claimants' status and relationship to the failed firm. In contrast to the property law approach, a risk allocation approach would not be grounded on determinations of discrete property interests in particular assets.⁷⁴

1.105 A functional approach to the treatment of shortfalls would lead us towards the risk allocation analysis of the issues thereby avoiding the potential incompatibility issues raised by adopting an approach based on a property law construct. Regulation and insurance are areas that fall outside the scope of a harmonised legal framework and the extent to which they are used by Member States is likely to be left to their discretion.

Specific issues

1.106 As we have noted, the allocation of losses to more than one account holder has generally only been a matter for consideration in systems that allow shortfalls to occur (that is to say, non-matching systems). In summary, the treatment of shortfalls raises three central issues for consideration:

- (1) Should an account holder be able to segregate, or otherwise ring fence, itself from having to share in a shortfall that is traced to transactions connected to another account?
- (2) Where the interests in securities of more than one account holder are pooled in an omnibus account or segregation is ineffective, 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 any, 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?

⁷⁴ C W Mooney, 'Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities controlled by Intermediaries', *Cardozo L Rev* (1990), 305, p 329.

Segregation of Intermediated Securities

- 1.107 We have already discussed segregation of intermediated securities in the context of protecting account holders' assets from the claims of an intermediary's creditors. Under the rules of some legal systems,⁷⁵ the proper segregation of customer assets from the assets of its intermediary may currently be a prerequisite to the availability of this protection. We provisionally propose to follow UNIDROIT's example by dropping this requirement so as to afford account holders protection against creditors irrespective of whether or not their assets have been segregated by their intermediary.
- 1.108 Segregation can play an equally important role in determining how shortfalls are allocated between account holders. An account that is effectively segregated from other customer accounts may, in some legal systems, be protected from shortfalls that appear in another customer account of equivalent securities held by the same intermediary.
- 1.109 What constitutes 'effective segregation' may itself vary from legal system to legal system. It is possible to state generally that if one or more pooled accounts exist between the tier at which a shortfall arises and the account holder's segregated account, the segregation will fail. The securities in the higher, pooled account are likely to be reduced pro rata which will result in some of the shortfall being passed down to the segregated account holder below. Where a shortfall originates in the books of the account holder's own intermediary, the analysis may vary.
- 1.110 Under English law, if an intermediary segregates accounts it must do so not only in its own books, but must open separate accounts with the issuer or intermediary above. Only in this way will a segregated account holder be protected from transfers that occur in other accounts held by its intermediary. This is because the credit in its account merely evidences the account holder's right to the trust assets that are held by its intermediary in an account with the intermediary or issuer above it.

Should customers be permitted to segregate accounts?

- 1.111 By permitting an account holder to segregate its account and thereby avoid shortfalls in other customer accounts, the account holder is given the choice of opting out of the 'shared risk' provided by pooled accounts. If an investor has no intention of carrying out frequent trades in its account, it may not want to participate in a pooled account where a large volume of trades is likely to increase the risk of operational error.⁷⁶

⁷⁵ Eg in Hungary, Italy, Lithuania, Malta and Greece. English law also requires segregation if a co-tenancy analysis is adopted.

⁷⁶ An account holder may also wish to ring fence itself from accounts that operate by way of contractual settlement (ie the intermediary credits account holders before the securities have been actually delivered into the account).

- 1.112 Segregation can also reduce the risk of accidental transfers within the system generally. Let us assume Custodian B opens two accounts with Custodian A. Account 1 is credited with 300 securities, which Custodian B holds for Investor 1. Account 2 is credited with 100 securities, which it holds for Investor 2. If Custodian B subsequently attempts, by mistake, to transfer 400 securities out of Account 1 (that is to say 100 more than it has in the account), Custodian A would be required to reject or only partially execute the instruction. If, however, Custodian B held its customers' securities in a pooled account, Custodian A would be unable to spot this error.
- 1.113 The alternative is to render segregation between account holders ineffective, at least in relation to the allocation of shortfalls. An investor wishing to hold securities through an intermediary would always be obliged to share in the general risk of a shortfall with other account holders (assuming the pro rata distribution method is applied).

Shortfalls in a pool

- 1.114 Where a shortfall arises in a pooled account and is not remedied by the intermediary, there are generally two alternative methods of allocating the loss.

Identify the underlying transaction that led to the shortfall

- 1.115 The first is to attempt to identify the account holder whose securities have been misappropriated from the pooled account and to allocate the full amount of the loss to that person. This approach attempts to reflect the reality of what has occurred and replicates the allocation of loss in matching systems. One could argue that the fact that the transfer of an account holder's entitlement was unauthorised should not change the fact that it was their entitlement rather than someone else's that was misappropriated. The account holder would in these circumstances be left with claims against the transferee (subject to any defence the transferee may have) and against the intermediary (to purchase additional securities or pay damages). The account holder would not however be left with any interest in the remaining assets of the pool if the securities were not replaced.
- 1.116 This method suffers, however, from a number of deficiencies. First, while it may be possible in theory to trace the problematic transaction to a debit or credit of a specific account holder's entitlement, this may prove very difficult in practice for non-matching systems. In many cases, it will be impossible to attribute a transaction to a debit or credit in an account that handles hundreds or thousands of trades each day or which nets trades between counterparties. Even if it was possible, the exercise is likely to be time-consuming and could lead to transfers in and out of the account being frozen until the claim was resolved.
- 1.117 Secondly, if the shortfall originates from an improper transfer in an upper tier account, there is likely to be no corresponding debits or credits in the lower tier pooled account that could be attributed to it. This method cannot therefore be a universal solution to allocating shortfalls.

- 1.118 Thirdly, the fact that the intermediary chose to debit a specific account holder's account may be entirely arbitrary. Attributing the loss to a particular account holder may not fit conceptually with the notion of unallocated rights in a common pool or commercially if the account holders intended to share the risk.
- 1.119 Finally, by the time the shortfall is discovered and the loss attributed to a specific account holder, the account holder may have already withdrawn or sold its securities in the account. If, for example, an intermediary credits 50 bonds to an account holder but fails to purchase the bonds to add to the pooled account, the innocent account holder may have subsequently sold its 50 bonds from the pooled account and closed its position before the shortfall is discovered. It may be impractical or impossible to attempt to recover the bonds or their sale proceeds from the account holder in these circumstances.

Rely upon presumptions as to the allocation of loss

- 1.120 Instead of attempting to trace a transaction to a specific account holder within a pool, non-matching legal systems generally impose a set of rules as to how transfers in and out of the account are presumed to occur. A presumption allows the intermediary to allocate a shortfall without need to trace the underlying transaction.
- 1.121 In English law, the rule established in *Clayton's Case*⁷⁷ has traditionally been applied to resolve competing claims to assets in a pooled fund. Under this rule, the first assets into a fund are deemed to have been the first assets out. However, the Court of Appeal in *Barlow Clowes International Ltd (in liquidation) v Vaughan*⁷⁸ has held that alternative methods of distribution should be used if the rule would be impractical, unjust or run contrary to the investors' express or implied intentions. It is unlikely therefore that the rule in *Clayton's Case* would be applied to an actively traded omnibus account.

PRO RATA DISTRIBUTION OF THE LOSS

- 1.122 A common method adopted for allocating a shortfall within an account is to allocate the losses in proportion to the size of each account holder's holding within the account. Accordingly, if one account holder is entitled to a quarter of the pooled account, it will bear a quarter of the shortfall.
- 1.123 In light of the arbitrary way in which administrative errors or frauds can affect individual accounts, the pro rata formula allows account holders to share the risk and therefore provides them with 'a higher likelihood of a lower potential loss'.⁷⁹ It reflects the common venture of holding securities in a pooled account and the common risk taken by the account holders as to their intermediary's integrity and solvency.
- 1.124 The English courts have considered at least three alternative methods of allocating a pro rata distribution of losses in a pooled account.

⁷⁷ (1816) 1 Mer 572.

⁷⁸ [1992] 4 All ER 22.

⁷⁹ C W Mooney, 'Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities controlled by Intermediaries', *Cardozo L Rev* (1990), 305, p 358.

The Rolling Charge Method

- 1.125 Under the 'rolling charge' method, each debit to the account, unless unequivocally attributable to one account holder, is attributed pro rata to all the account holders in the pool at that point in time.⁸⁰ The effect is to allocate a shortfall only among those persons that were account holders at the time that the improper transaction occurred. Subsequent deposits into the account (whether by new or existing account holders) would be unaffected.
- 1.126 By way of an example, A, B and C each deposit 10 Bonds into an account with their intermediary. The intermediary misappropriates 27 Bonds and the balance falls to 3 Bonds. D and E subsequently deposit 10 Bonds and 5 Bonds respectively into the account. The intermediary falls insolvent and the shortfall of 27 Bonds is discovered. Under the rolling charge method, A, B, and C will share the shortfall pro rata. Each of their entitlements will be reduced by 9 Bonds leaving them with 1 Bond each. D and E became account holders after the shortfall occurred and so their entitlements are unaffected.

Basic Pro Rata Sharing Method

- 1.127 A simpler alternative to the rolling charge is to treat all the account holders in the pool as suffering from one single loss. This approach disregards the order of prior dealings in the account and allocates the loss based on the size of each holding on a particular date.⁸¹ The Court of Appeal adopted this approach in *Barlow Clowes v Vaughan*.
- 1.128 Applying the example above, the shortfall of 27 Bonds would be allocated amongst A, B, C, D and E in proportion to the size of their entitlements.

The Lowest Intermediate Balance Rule Method

- 1.129 The third alternative applies the 'lowest intermediate balance rule' to the basic pro rata sharing method. This rule states that an account holder cannot claim in excess of the lowest amount that was held in the account during the period in which it was an account holder.⁸²
- 1.130 Taking again the same example, A, B and C each deposit 10 Bonds into an account with their intermediary. The intermediary misappropriates 27 Bonds and the balance falls to 3 Bonds. D and E subsequently deposit 10 Bonds and 5 Bonds respectively into the account. The intermediary falls insolvent and the shortfall of 27 Bonds is discovered. Under the lowest intermediate balance rule, although 18 Bonds remain in the account neither A, B or C can claim more than 3 Bonds each. This reflects the fact that while it cannot be ascertained whose 3 Bonds remained following the misappropriation, neither A, B, or C could have been left at that point with more than three. The remaining 9 of the 18 Bonds would be shared pro rata between D (who receives 6 Bonds) and E (who receives 3 Bonds).

⁸⁰ This method was applied by the Ontario Court of Appeal in *Re Ontario Securities Commission and Greymac Corp* (1986) 55 OR (2d) 673 and considered by the Court of Appeal in *Barlow Clowes International Ltd (in liquidation) v Vaughan* [1992] 4 All ER 22.

⁸¹ A similar approach has been taken in Ireland (*In the matter of W&R Murrough and in the matter of the Stock Exchange Act 1985* unreported 6 May 2003).

Commentary on these alternative methods

- 1.131 Clearly the basic pro rata sharing method is the most straightforward to implement. In order for the rolling charge and lowest intermediate balance methods to be applied, one must be able to track the order in which the transactions in and out of the account occurred. This should be possible if transactions are settled in real time, especially where records are computerised. If they are not and transactions are netted, the position is less clear. It has been suggested that a group of transactions that are subject to the same netting exercise should be treated as occurring simultaneously.⁸³
- 1.132 The rolling charge method could be considered the fairest of the pro rata formulae as it leaves untouched any deposits made after the improper transaction (or transactions). However, we consider that the basic pro sharing method best reflects the common risk that account holders undertake. It is not the shortfall itself but the intermediary's inability to remedy the shortfall that account holders must consider when choosing to hold securities through one or more intermediaries. As this credit risk may change over time it is the account holders that are assuming the credit risk at the moment of the intermediary's insolvency that should bear the loss.
- 1.133 As the composition of the account holders and the size of their respective holdings may alter significantly from day to day, the date on which the relative holdings of the account holders are measured is critical to the result. In this regard, the basic pro rata sharing method based on entitlements at the date of insolvency enjoys a considerable practical advantage over the other two alternatives. Methods that allocate losses based upon account holders' entitlements at the date of the improper transaction or some other prior date could prove unworkable if the composition of the account holders has changed dramatically by the time that the intermediary or its liquidator confirm that a shortfall has arisen. To return once more to the example, if A has sold its 10 Bonds prior to the shortfall being discovered, it may be impossible to make it share in the shortfall. In light of these entirely arbitrary variables, a basic pro rata sharing method based on the date of the insolvency order appears to be the easiest both to implement and to justify.

Approach taken by Member States

Pro rata sharing

- 1.134 As noted above, English law is likely to apply a basic pro rata sharing method in the case of an actively traded securities account. The account holders' entitlements will be measured at the date of the winding-up order.⁸⁴

⁸² *Roscoe v Winder* [1915] 1 Ch 62.

⁸³ AO Austen-Peters *Custody of Investments Law and Practice* (2000) at p 140.

⁸⁴ In *Sinclair v Brougham* [1914] AC 398 the calculation was based on claims as at the date of the commencement of the winding-up. The Insolvency Act 1986 defines the commencement of winding-up as the date of the winding-up resolution (in the case of a voluntary winding up) or the date of the winding-up order by the court: see Insolvency Act 1986, s 129.

- 1.135 A basic pro rata sharing method is also applied in Germany,⁸⁵ Ireland, Malta, the Netherlands, Austria (below the level of the CSD) and the Czech Republic⁸⁶ although there is no clear consensus among them as to the point in time that the entitlement is measured.
- 1.136 The settlement system rules in Germany apply pro rata sharing according to the collective custody credit balance in the ratio of the interests in the collective holding at the time when the loss occurred. If it is not possible to determine such time, the close of the books on the day immediately preceding the day on which the loss was discovered is deemed conclusive.⁸⁷
- 1.137 In the Netherlands, shortfalls in the accounts of the Securities Depository Company are allocated pro rata among customers who held such rights against the depository on the day of the discovery of the deficiency.

Other methods of allocating shortfalls

- 1.138 In the unusual event that a shortfall arises in the Danish system, it will most probably be allocated amongst the account holders on a first-in-time basis so that the shortfall will be borne first by the most recent account holders to join the account.
- 1.139 Some systems in which shortfalls can arise do not stipulate how they should be treated. For example, Member States such as Belgium and Luxembourg rely instead upon the contractual arrangements specified by the parties.

Account holders' claims in respect of securities of the same description belonging to the intermediary

- 1.140 The allocation of shortfalls is further complicated where an intermediary holds securities of the same description for its own account. We will refer to these as 'house securities'. Let us assume an intermediary holds 100 Vodafone shares as house securities and 200 for its customers. If the intermediary is responsible for a shortfall of 50 Vodafone shares but falls insolvent before it can remedy the shortfall, how should the shortfall be allocated as between the intermediary and its account holders?⁸⁸

⁸⁵ Germany has a matching system so no shortfalls should arise. The pro rata sharing method may apply however where bearer securities have been destroyed or lost.

⁸⁶ The law does not stipulate specific rules for the allocation of shortfalls. However, as holders are treated as owners of common property under section 34 of the Securities Act, the shortfall should be reduced proportionately.

⁸⁷ No 22 of the General Terms and Conditions of the German CSD.

⁸⁸ If the intermediary is not liable to make up the shortfall (eg because the shortfall was the fault of a higher tier intermediary) the account holders should not be able to make a claim in respect of the insolvent intermediary's own shares. They would be unable to do so if the intermediary remained solvent and its insolvency should not change this.

- 1.141 The answer may depend upon whether the intermediary's Vodafone shares are held in the same pooled account as its customers or are segregated in a segregated house account. If commingled in the same account, two alternatives exist: The shortfall can be allocated either pro rata as between all the account holders in the account (including the intermediary) or allocated first to the intermediary's house securities.
- 1.142 In our opinion, the second of these alternatives is the most sensible. If the intermediary is responsible for the loss, there should be a presumption that the improper transaction involved its own house securities.⁸⁹
- 1.143 If the intermediary's Vodafone shares are held in a separate house account and the shortfall occurs in the customer account, the result is more questionable. Permitting the account holders to recover 50 Vodafone shares from the intermediary's own account could be seen as a more equitable means of allocating loss to the party at fault. Why should the account holders suffer if the Vodafone shares held by the intermediary for its own account are indistinguishable from the ones that it has misappropriated?
- 1.144 However, in the context of insolvency, the allocation of loss is not between intermediary and account holders but between creditors and account holders, both of whom are innocent parties. If an account holder's assets are protected from creditors on the basis that they do not form part of the intermediary's estate, it should follow that the account holder does not also enjoy a priority over creditors where the assets belong to the intermediary and are reflected as such on the intermediary's balance sheet. While it may be entirely arbitrary that the shortfall arose in the customers' account and not the intermediary's account that is simply bad luck on the part of the account holders.⁹⁰ The account holders would therefore have to join the ranks of the general creditors in making their claim.
- 1.145 A further complication arises if the intermediary is not responsible for the shortfall in the customer account. If the shortfall is caused by the insolvency of a fraudulent intermediary higher in the chain, should the lower tier intermediary bear the loss out of its house securities? Should this again depend upon whether the house securities are segregated or commingled with the customer's securities? Arguably, in these circumstances, the intermediary's house securities should only be reduced pro rata if commingled with its customer's securities and not at all if they are segregated from the shortfall.

⁸⁹ This is also consistent with English law equitable tracing rules. It assumes that the intermediary disposes of its own interest first so as to preserve the customers' rights and to prevent it from unnecessarily being presumed liable for breach of trust (see *In re Hallett's Estate* (1880) 13 Ch D 696).

⁹⁰ See Rogers 'Negotiability, property and identity' 12 *Cardozo L Rev.* (1990-1991) 471 for a discussion of rights in commingled fungible goods.

How should the fault of an account holder affect the treatment of shortfalls?

- 1.146 The treatment of shortfalls in the different scenarios described above has in each case assumed that the account holders are innocent parties. If an account holder is in some way fully or partly responsible for the shortfall, it will be a matter for the courts in the relevant jurisdiction to determine to what extent it must compensate the other account holders. This should not affect the formula for treating the shortfall as between the account holders. The extent of the damages the account holder owes to other account holders or the intermediary would depend upon the extent to which the loss had already been shared out.

Ability to recover substitute assets from an insolvent intermediary

- 1.147 As we have shown above, the laws of Member States protect an account holder's intermediated securities from the claims of its intermediary's creditors. Similarly, we have noted that where a shortfall arises in the intermediary's customer account whether as a result of fraud, administrative error or otherwise, the account holder may suffer a loss if the intermediary is insolvent and unable to purchase securities of the same description to make up the shortfall.
- 1.148 Taking these principles together, it is clear that the account holder will rank ahead of general creditors with respect to the securities remaining in the account. Whether it ranks equal with, or ahead of, creditors as regards its claim for the shortfall amount may, however, depend upon whether its intermediated securities were 'converted' into new, identifiable assets (for example, sold in return for cash or some other asset).
- 1.149 Under English law, an intermediary that sells securities in breach of trust will hold the proceeds of sale on trust for the beneficiaries.⁹¹ Equitable rules of tracing can be applied to trace not only the sale proceeds but also subsequent new assets that may have been purchased with the sale proceeds. Where the sale proceeds have been mixed with the trustee's own funds to purchase substitute assets, the account holder is entitled to recover a proportionate share of the new assets or obtain a charge over the assets up to an amount equal to restore the shortfall.⁹² Only if the proceeds have been dissipated and cannot be traced will the account holder be left as an unsecured creditor.
- 1.150 The ability to recover sale proceeds or other substitute assets ahead of general creditors in its intermediary's insolvency offers a significant additional safeguard to account holders. Should this ability to recover substitute assets be available as part of a harmonised legal framework throughout the EU?
- 1.151 This question raises the larger question as to the extent, if at all, to which a harmonised legal framework should consider aspects of the law that touch upon remedies available to participants in a holding system. Both UNIDROIT and the FMLC are silent on the complex issue of remedies, albeit that they do consider the other side of this coin by defining the defences that are available to a claim (for example, the defence of an innocent transferee).

⁹¹ See *Underhill & Hayton, Law of Trusts and Trustees* (16th ed 2003) p 880.

⁹² *Re Diplock* [1948] Ch 465.

- 1.152 We agree that it is unrealistic to attempt to achieve a level of uniformity with respect to remedies arising from the misappropriation of intermediated securities. To do so would intrude significantly into the laws of individual Member States. In addition, the EU Commission's Legal Certainty Group has made no mention of the need to consider legal remedies. Accordingly, we do not intend to explore this issue further save to note that the varying nature and extent of remedies in different Member States will have a considerable bearing on the account holder's ability to recover the value of its securities in the event of a shortfall.

The approach taken by the FMLC

- 1.153 FMLC Principle 4 states that:

Any shortfalls in the pool will be borne by all participants in the pool in proportion to their entitlements. A shortfall does not arise where the customer's entitlement is contractual only or where pursuant to the agreement between the customer and the intermediary a credit is provisional only and is reversed or the intermediary disposes of an interest in securities in exercise of a power of re-use.

- 1.154 The Commentary on the FMLC Principles notes that the first sentence of Principle 4 reflects the better view of existing law as applied by *Barlow Clowes*. The Principle expressly excludes contractual settlement whereby intermediaries provisionally credit an account prior to the actual settlement of the securities. This arrangement assists certain customers with their accounting requirements pending settlement and is not intended to give rise to property rights.

The approach taken by US Uniform Commercial Code

- 1.155 Revised Article 8, section 8-503(b) provides that:

(b) An entitlement holder's property interest with respect to a particular financial asset under subsection (a) is a pro rata entitlement in all interests in that financial asset held by the securities intermediary, without regard to the time the entitlement holder acquired the security entitlement or the time the securities intermediary acquired the interest in that financial asset.

- 1.156 As the Official Comment to the section makes clear, temporal factors are irrelevant to determining the property interests of entitlement holders. All entitlement holders simply have a pro rata interest in that particular security held by the intermediary. Segregation consequently has no effect in attributing property interests in securities to particular accounts.

- 1.157 While the Section describes the property interest of entitlement holders, the Official Comment points out that this does not necessarily determine how property held by a failed intermediary will be distributed in insolvency proceedings. This will be governed by the distributional rules of the applicable insolvency law.

The approach taken by UNIDROIT Convention

1.158 The general rule dealing with the allocation of securities as between account holders and the intermediary is set out in Article 19(1) of the Convention, which states that:

– Securities of each description held by an intermediary or credited to securities accounts held by an intermediary with another intermediary shall be allocated to the rights of the account holders of that intermediary to the extent necessary to ensure that the aggregate number or amount of the securities of that description so allocated is equal to the aggregate number or amount of such securities credited to securities accounts maintained by the intermediary.

1.159 Article 19(4) permits a Contracting State to declare that the allocation required in Article 19(1) does not apply to securities that the intermediary has segregated for its own account by holding them through another intermediary.⁹³

1.160 Article 20 deals with the allocation of shortfalls as between account holders where the intermediary is insolvent. Article 20(1) states that:

1.- In any insolvency proceeding in respect of an intermediary, if the aggregate number or amount of securities and intermediated securities of any description held by an intermediary is less than the aggregate number or amount of securities of that description credited to securities accounts, the shortfall shall be allocated:

- (a) subject to paragraph (b), among the account holders to whose securities accounts securities of the relevant description are credited, in proportion to the respective numbers or amounts of securities so credited; or
- (b) where the intermediary is [the operator of] a securities settlement [or clearing]⁹⁴ system and the rules or agreements governing the operation of the system make provision for the allocation of the shortfall, in the manner so provided.

1.161 Article 20(2) makes clear that the origin or order of any past dealings and the order in which securities are credited or debited are irrelevant to the allocation. Finally, Article 20(3) makes the rule subject to any conflicting rule applicable to insolvency proceedings of the intermediary.

Comments on the UNIDROIT approach

1.162 The Convention makes a number of fundamental choices regarding the treatment of shortfalls while leaving others to the discretion of the Contracting States.

⁹³ The requirement that the securities be held through *another intermediary* is puzzling. Intermediaries that hold securities directly from the issuer should, subject to domestic law, be able to segregate them from their customers' securities of the same description by simply identifying them as separate holdings on the issuer's register.

⁹⁴ The square brackets are included in the text of the Draft Convention pending resolution.

THE APPLICATION OF LOSS SHARING RULES

- 1.163 Article 20 applies loss-sharing rules only where a shortfall arises in accounts maintained by an insolvent intermediary. If no shortfall arises because the settlement system operates a matching procedure, the loss resulting from a failed or improper transaction (which would give rise to a shortfall in a non-matching system) is not addressed by the Convention.

ALLOCATION OF SECURITIES BETWEEN INTERMEDIARY AND ACCOUNT HOLDERS

- 1.164 The Convention allows Contracting States to choose whether or not segregation is effective to prevent the allocation of house securities to account holders in circumstances where there is a shortfall in the customer account. The Convention is, however, categorical in requiring that where an intermediary holds house securities in the same account as its customers' securities of the same description, any shortfall will always be taken first out of the house securities.⁹⁵ This is irrespective of whether the intermediary was responsible for the shortfall in its customer account.

ALLOCATION OF SECURITIES BETWEEN ACCOUNT HOLDERS

- 1.165 The first point to make about the treatment of shortfalls between account holders is that the Convention sets out rules only in the event of the intermediary's insolvency. If the intermediary is not insolvent but is under no obligation to make up the shortfall (for example, because the fault originated higher in the chain), the Convention is silent as to how the shortfall would be allocated.
- 1.166 The second point is that the Convention does not appear to recognise the effectiveness of segregating customer accounts. A shortfall will be borne rateably among all account holders that own intermediated securities of the same description, irrespective of whether the securities are held in pooled or segregated accounts.

⁹⁵ This is consistent only up to a point with English law equitable tracing rules as it does not apply the lowest intermediate balance rule (see *Roscoe v Winder* [1915] 1 Ch 62).

- 1.167 The decision to render segregation ineffectual but to limit the risk-sharing pool of securities to those of the same description (rather than, say, to all customer securities) is a surprisingly definitive policy choice in light of the accommodating stance that is taken in the rest of the Convention. As we have discussed above, there are a number of benefits in permitting account holders to segregate their accounts.⁹⁶ On the other extreme, there are advantages to requiring account holders to share the risk of shortfalls with *all* other account holders irrespective of the type of security held. If one justifies the removal of segregation on the grounds that shortfalls affect investors on a largely arbitrary basis and that risk should be spread so as to minimise the likelihood of a higher loss, the type of securities that are subject to the shortfall are arguably irrelevant. The account holders are taking a risk based on the solvency and integrity of the same intermediary and not on the type of intermediated security that the intermediary holds.⁹⁷
- 1.168 While choosing one alternative over the others would offer uniformity, it is questionable whether, in this instance, absolute uniformity is required. A declaration mechanism allowing Contracting States to choose from these limited alternatives could offer the necessary degree of certainty whilst allowing states to make their own insolvency policy choice.
- 1.169 Finally, making the Article subject to any conflicting domestic rule applicable to the insolvency proceedings of the intermediary inevitably diminishes the legal certainty provided by the Convention. National insolvency rules may well cover the issues dealt with by the Convention in this area and consequently its harmonising effect may be minimal if it cannot prevail over conflicting national laws. Whether a national law ‘conflicts’ with the Convention or can operate alongside it may itself be a matter of uncertainty.

Preliminary Conclusions

- 1.170 Potential losses arising from fraud, operational error and settlement failure can occur in all systems. If the intermediary is unable or not obliged to remedy the potential loss, it becomes an actual loss borne by one or more account holders. How intermediated holding systems account for this potential loss tends to be a function of how they track dispositions in and out of accounts. Systems that match every corresponding debit and credit prevent account imbalances (shortfalls) from existing by allocating the potential loss automatically to a particular account holder. Non-matching systems permit shortfalls to exist and thereby only allocate a potential loss to account holders once it has become an actual loss. It is these non-matching systems that currently provide for the distribution of risk between account holders in a pooled account.
- 1.171 Subject to domestic law, an account holder should be able by arrangement with its intermediary to segregate its account and avoid sharing in shortfalls in other accounts.

⁹⁶ See paras 1.111-1.112 above.

⁹⁷ In the United States, the risk-sharing rules applied by SIPA and Subchapter III of Chapter 7 of the Bankruptcy Code to stockbrokers require any person with a claim on a securities account to share rateably in the entire pool of customer property. This is in contrast to securities held by banks where a claimant would share rateably only with the pool of customers holding securities of the same issue.

- 1.172 If an intermediary is unable or not obliged to replace securities or otherwise compensate an account holder as a result of an unauthorised transaction, the loss should be allocated between account holders in the same account. We see no reason why this risk sharing should apply only to non-matching systems.
- 1.173 Where losses must be allocated between account holders, the loss should be shared in proportion to the size of each account holder's entitlement at the date of the commencement of insolvency of its intermediary (or of the relevant upper tier intermediary as the case may be). This method best reflects the common risk undertaken by account holders.
- 1.174 Where an intermediary has commingled its own securities with those of its account holders, a loss arising from the intermediary's insolvency or breach of duty should first be allocated to reduce those securities held for the intermediary's own account. If the intermediary is not responsible for the shortfall, it is arguable that it should only share the loss pro rata.
- 1.175 Where an intermediary has segregated its house securities, a loss in its customer account should first be allocated to the intermediary's house account provided that the shortfall arises from the intermediary's own breach of duty. If the intermediary is not responsible for the shortfall, it is difficult to justify the allocation of the loss to its house securities.

THE CREATION AND ENFORCEABILITY OF AN ACCOUNT HOLDER'S RIGHTS.

Different categories of account holders' rights

- 1.176 In the first seminar paper we made a distinction between two categories of rights that can be enforced by an account holder in relation to intermediated securities.

Terms of the securities

- 1.177 The first category concerns rights 'attached' to the securities. These are personal obligations that an issuer owes to owners of its securities. The obligations are governed by the terms of the issue and by the law under which the securities are constituted. We refer to them as the 'terms' of the securities. The terms reflect the financial bargain offered to the investor. Any restrictions on the investor's ability to realise this bargain will affect the value of the securities.

- 1.178 Subject to domestic law and regulation, an issuer is free to set any terms it sees fit to reflect the financial deal represented by the securities. Accordingly, the terms of the securities may encompass a wide range of obligations. These may typically 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.

- 1.179 This is by no means an exhaustive list. We see no good reason to limit the scope of a common framework dealing with the rights of account holders only to specific terms as all are likely to have some affect on the value of the securities. Furthermore, any attempt to set out a definitive list would soon become outdated as a result of innovations and developments in market practice.

The right to transfer or withdraw securities

- 1.180 The second category of rights relates to the investor's ability to deal with securities (or intermediated securities) as transferable assets by causing its intermediary to transfer or pledge them to a transferee or collateral taker. This may involve the intermediary simply making the transfer (by way of credit and debit) on its own books or may require a series of instructions from one intermediary to another up the chain until an intermediary common to both transferor and transferee is identified.⁹⁸
- 1.181 The right to transfer intermediated securities is fundamental to the investor's ability to realise their value. The relative ease with which publicly traded securities can be bought, sold and pledged compared to other asset classes is one of their principle attractions as investments. Any limitations on this right arising from the intermediation of the securities would affect their liquidity and consequently their value.
- 1.182 A further subset of this second category of rights is the investor's ability to withdraw the intermediated securities from the account of its intermediary and hold them either directly from the issuer or indirectly through a different intermediary.

The nature of these rights

- 1.183 In any Member State, an investor that chooses to purchase and hold securities directly from an issuer does so in the knowledge that it can enforce these terms directly against the issuer. These are personal rights against the issuer arising from the holder's proprietary interest in transferable assets, namely the securities.
- 1.184 Where an investor holds securities through an intermediary, the nature of its rights and the method and extent to which the investor can enforce the terms of the securities will necessarily differ in certain respects from directly held securities. If these differences represent material limitations in relation to the types of rights that can be enforced or the persons against whom they can be enforced, investors may choose to hold their securities outside of the intermediated holding system.
- 1.185 Differences in the effective enforcement of account holder's rights also currently exist as between Member States. These largely stem from the way in which account holders' rights are characterised by national law.
- 1.186 In keeping with the functional approach, we are not concerned with characterising the legal nature of an account holder's rights. However, in order for a harmonised legal framework to provide an adequate level of legal certainty in cross-border ownership and settlement, the creation and enforcement of account holder's rights must be sufficiently uniform in their effect. Unless an investor has the undisputed ability to exercise both categories of rights consistently within the EU, the confidence of participants to enter into cross-border settlement of securities can be affected.

⁹⁸ This may be the central securities depository or the issuer (if the transferee wishes to hold the securities directly).

- 1.187 Simply put, an account holder's needs in relation to the enforcement of rights are two-fold. First, it requires sufficient legal rights and remedies to require both the issuer to fulfil its obligations and to require the intermediaries to pass the benefits derived from the securities down the chain. Secondly, where the fruits of these rights (for example, dividends and interest) are passed on from the issuer into the possession of the intermediaries, it will need these economic benefits to be protected from claims of the intermediary's creditors.

The enforcement of rights in intermediated securities

Direct and indirect enforcement systems

- 1.188 The differences in the enforcement of securities are most clearly pronounced between direct and indirect enforcement systems for intermediated securities.
- 1.189 The words 'direct' and 'indirect' are used in this context to describe whether the account holder can *enforce* its rights in the intermediated securities directly against the issuer (a 'direct enforcement system') or whether it must exercise them indirectly through its intermediary (an 'indirect enforcement system'). The words are not intended to describe the manner in which securities are *held*; intermediated securities will necessarily be held indirectly through an intermediary.
- 1.190 In jurisdictions such as the United Kingdom, the two meanings coincide and are therefore used interchangeably. Only securities that are held directly can be enforced directly; indirectly held securities are only enforceable indirectly. However, in many other jurisdictions an investor will have a direct right to enforce the terms of the securities against the issuer despite the existence of one or more intermediaries between it and the issuer. Such a settlement system can therefore be described as a direct enforcement system.⁹⁹
- 1.191 A further complication arises in determining whether or not securities are 'held through an intermediary'. In our opinion, the correct legal analysis is that any account provider whose account represents the primary register of ownership of the securities does not hold the securities as an intermediary. The account provider in these circumstances does not act as a link in the chain but as a record keeper and has neither ownership nor possession of the securities.¹⁰⁰ It cannot be said to be standing between the issuer and the account holder in the chain of ownership and the securities that the account holder owns are therefore not intermediated securities.

⁹⁹ The title of this project was changed from 'indirectly held securities' to 'intermediated securities' to avoid any confusion arising from the dual use of the phrase.

¹⁰⁰ We appreciate that the distinction is subtle when an intermediary is holding book-entry securities as the deposit is simply a record entry.

- 1.192 In the United Kingdom, CREST is an example of a securities settlement operator that maintains a register of account holders (called CREST participants) but does not constitute an intermediary in relation to the settlement of UK-listed securities. Participants in the CREST system in the UK hold dematerialised securities directly from the issuer rather than indirectly through CREST. CREST is not registered as legal owner of the securities in the issuer's register. Instead the name of the CREST participant is entered on both CREST and the issuer's register as legal owner.¹⁰¹
- 1.193 Similarly, investors who wish to hold directly through CREST but who do not themselves have electronic access to the computerised system may ask another CREST member to sponsor their membership and maintain a link with CREST on their behalf. The CREST sponsor maintains an electronic link with CREST and operates a CREST account on its client's behalf. It is not, however, an intermediary in the sense used in this paper. The sponsored party, not the sponsor, appears on the CREST register as the legal owner of the securities.

INDIRECT ENFORCEMENT SYSTEMS – THE UK MODEL

- 1.194 In the United Kingdom, the holding of securities by way of book-entries in an intermediary's account is an example of an indirect enforcement system. Legal title to the securities is vested in the upper tier intermediary in whose name the securities are registered (in the case of registered securities) or in whose possession the securities are kept (in the case of bearer securities). The upper tier intermediary may typically be a CREST member holding the securities directly from the issuer through an account operated with CREST.
- 1.195 The issuer may or may not have knowledge of whether the upper tier intermediary is holding the securities on behalf of others or for its own account¹⁰² and is unlikely to know the identities of the intermediary's own account holders. The issuer's relationship is solely with the intermediary named on the register or in possession of bearer certificates.

¹⁰¹ For UK companies it is the entry in the CREST register that confers legal title on the owner: Uncertificated Securities Regulations 2001, SI 2001 No 3755 (USR), reg 24(6). For Irish, Manx, Guernsey and Jersey securities, the pre-2001 system still operates. Settlement is through CREST but legal title is transferred when the entry is made in the issuer's register.

¹⁰² In the case of equities, Companies Act 1985, s. 360 prohibits notice of any trust being entered on the register of members.

- 1.196 Generally speaking, the upper tier intermediary will hold securities for its account holders on trust.¹⁰³ Under English trust law, an account holder as beneficiary will not have the right to enforce the terms of the securities against the issuer directly.¹⁰⁴ The account holder's ability to receive the benefit of the terms of the trust assets (that is to say, the securities) is set out in the trust instrument (which will invariably be the account agreement). The trust instrument will ordinarily require the intermediary to collect and distribute to its account holders the economic benefits that it receives such as dividends or interest. It may also, but not always, require the intermediary to exercise voting and other discretionary rights in accordance with the express wishes of the account holder.
- 1.197 In the absence of express provisions in a trust instrument, the account holder must rely upon the general fiduciary duties owed to it by the intermediary. Outside of its obligations to act in accordance with the trust instrument, a trustee must safeguard the trust assets, avoid conflicts of interest or unauthorised profits¹⁰⁵ and act with reasonable care and impartiality between beneficiaries. If necessary, the account holder can apply to the courts to give directions in relation to the administration of the trust.¹⁰⁶ The account holder's rights in these circumstances depend on trust law and on the terms of the trust instrument. They cannot therefore be said to be exactly equivalent to the corporate and property law rights vested in an investor that holds its securities directly from the issuer.¹⁰⁷
- 1.198 If the issuer defaults in its obligations in respect of the securities, the intermediary is not liable to the account holder for the default. The intermediary must, however, take such actions as are required of it to enforce the terms of the securities in accordance with the intermediary's fiduciary duties and the terms of its account agreement. This could involve suing the issuer or participating as a creditor in the issuer's insolvency. If the intermediary does not hold directly from the issuer but through a higher tier intermediary, it can enforce its rights on behalf of the investor only by enforcing its rights against the intermediary above it.

¹⁰³ See para 1.43 above.

¹⁰⁴ See *Hayim v Citibank NA* [1987] AC 730. Lack of privity of contract should also prevent the account holder as a matter of contract law, from enforcing any contractual terms entered into by the issuer under the terms of the securities, although the Contract (Rights of Third Parties) Act 1999 could give an account holder contractual rights against the issuer if certain conditions are met.

¹⁰⁵ *Bristol and West Building Society v Mothew* [1998] Ch1, p 18.

¹⁰⁶ *Re Buckton* [1907] 2 Ch 406, 414.

¹⁰⁷ See A O Austen-Peters, *Custody of Investments Law and Practice* (2000) p31 in which the author states, "thus, whilst investors in non-intermediary custody retain the same direct ownership rights as any owner of securities would enjoy, an investor with assets in intermediary custody would effectively have exchanged his rights in the relevant securities against the issuer for a new set of rights against the custodian through whom he claims.

DIRECT ENFORCEMENT SYSTEM – THE GERMAN MODEL

- 1.199 The German system for holding domestically issued securities through intermediaries is an example of a direct enforcement system.¹⁰⁸ Investment securities (both equity and debt) are issued in the form of negotiable instruments. As a matter of practice, all securities of the same issue are normally represented by one global certificate, which is deposited with Clearstream as central securities depository (Wertpapiersammelbank).¹⁰⁹
- 1.200 Clearstream only keeps accounts of the entitlement of intermediaries immediately connected with it. They, in turn, only keep accounts of the entitlement of providers or ultimate investors connected with them. Thus the issuer does not normally know the identity of the intermediary or intermediaries in the chain below Clearstream or of the ultimate investor of the securities. The German direct system, like indirect enforcement systems, is not transparent.
- 1.201 Despite holding the certificate through one or more intermediaries, the ultimate investor is considered the legal owner with title to the certificate through indirect possession (mittelbarer Eigenbesitzer). Clearstream acts as a direct bailee for the investor (unmittelbarer Fremdbesitzer). Intermediaries below it in the chain also have 'indirect possession' of the share certificate as indirect bailees (mittelbarer Fremdbesitzer) for the investor.
- 1.202 The investor as legal owner enjoys both the right to transfer its entitlement as well as the right to exercise the terms of the securities. The investor can sue the issuer and obtain a judgement directly enforceable against it should the issuer fail to honour its obligations under the terms. The investor does, however, need to prove that it is entitled to bring a claim as legal owner. Because the system is not transparent, this may require it to present confirmation of its legal ownership from the intermediaries in the chain above it.
- 1.203 As in the case of indirect enforcement systems, intermediaries will receive dividends and interest payments from the issuer and will be required to pass them down the chain to the investor. Unless expressly stated otherwise, the intermediary exercises the rights of the investor as its authorised attorney.¹¹⁰ Neither Clearstream nor the intermediaries below it have any legal ownership interest in the securities.

¹⁰⁸ The legal analysis for the holding of foreign securities in Germany is different and operates on the basis of a contractual fiduciary trust relationship (*Treuhund*) between the intermediary and account holder.

¹⁰⁹ At present only Clearstream Banking Frankfurt AG is licenced as a Wertpapiersammelbank.

¹¹⁰ [Special Conditions for Securities Dealings, s 14.]

DIRECT ENFORCEMENT SYSTEM – THE SPANISH MODEL¹¹¹

- 1.204 The Spanish holding system for listed securities¹¹² is a slightly different example of direct enforcement. At the level of the central securities depository, the system is a direct enforcement system based on a two-tier registry. The first tier of the registry is a 'central register' managed by Iberclear. This register contains the aggregate balances of securities held in the client account and house account of each system 'participant'. These participants are financial institutions that have entered into contractual arrangements with Iberclear.
- 1.205 The participants operate the second tier of the register, in which each maintains in its own books the balances held by its customers. This 'detailed register' records the names and details of each customer.
- 1.206 Spanish law treats the central register and the detailed registers as one registry.¹¹³ The two tiers are linked by a common register reference ('RR') for each account entry. Each time there is a change of ownership of securities (including a transfer by way of collateral), the RR of the original ownership is cancelled and a new RR is generated. An entry in the detailed register can only be made once an RR has been generated and assigned at the central register. A new RR cannot be created without a corresponding cancellation. Iberclear notes,
- ...the aim is to strengthen the synchronisation between the central and the individual registers. This will avoid authorising the settlement of a sale trade against the overall balance of a participant whilst the participant is unable to identify the securities trade and their original owner.¹¹⁴
- 1.207 The corresponding RR in each tier of the registry allows securities to be traced to the participant's customers. Unlike the German system, the Spanish direct enforcement system is transparent as regards the ownership of securities by the participant's customers. The legal effect is to give these customers direct rights to enforce the terms of the securities against the issuer as well as the right to dispose of, or withdraw, the securities. The customer can sue the issuer directly if the issuer fails to fulfil its obligations. The customer is the legal owner of the securities; neither Iberclear nor the participant has any proprietary or personal right or interest in the securities. They act merely as record-keepers. As the record they keep is the primary register of entitlement, it is questionable whether Iberclear and the financial participants can fall within the definition of intermediaries.
- 1.208 If the participant's customer is not the ultimate investor but is, itself, an intermediary, the legal analysis of its relationship with the investor is less clear. Professor Garcimartin Alferez explains:

¹¹¹ Much of the description of the Spanish system is taken from a paper given to the Bern seminar of the UNIDROIT project by Prof. Francisco J. Garcimartin Alferez.

¹¹² Securities listed in Spanish Regulated Markets.

¹¹³ Royal Decree 119/1996.

¹¹⁴ See www.iberclear.es/iberclear/home/home.hatm.

It may be the case that *de facto, and* contrary to the foresights of the Spanish lawmaker, an intermediary, places himself between the participant in Iberclear and the final investor. The position of the investor in this situation is not expressly contemplated in Spanish law. It could be argued that he only has a contractual right *vis a vis* his intermediary, or it could also be argued that under general rules of civil law he has a proprietary right to the extent that he can offer fully evidence that [the intermediary] was a mere fiduciary owner. The second understanding seems to be *prima facie*, more sensible.

- 1.209 While it is unlikely that a Spanish investor would choose to expose itself to this legal uncertainty by holding domestically-listed securities through an intermediary that is not an Iberclear participant, the investor may have little option if it wishes to hold foreign securities through a Spanish custodian. In these circumstances, the two-tier registry system may be by-passed altogether. The lack of uncertainty as to its legal position *vis a vis* its intermediary has implications not only in relation to its ability to enforce the securities but also with regard to the protection of its entitlement in the event of the intermediary's insolvency.

Approach taken by the FMLC

- 1.210 FMLC Principle 2(d) states that

Customers (and persons claiming through them, including attachment creditors) can enforce their interests in securities only against the intermediary, and not against the issuer or any other intermediary. However, this subject to any direct rights of action against the issuer or other intermediary provided under the terms of issue of the securities or of a deed poll or contract arising under general law against persons not acting in good faith.

- 1.211 The Principle reflects the current position under English trust law.

Approach taken by US Uniform Commercial Code

- 1.212 Article 8 gives the entitlement holder a number of specific rights in relation to its securities entitlement.¹¹⁵ These rights are essentially limited to enforcement of certain obligations owed to it by its intermediary. The obligations relate to the intermediary's duty to ensure that the entitlement holder receives all of the economic and corporate rights that comprise the securities.¹¹⁶ The intermediary must also comply with an order to transfer the securities given by an 'appropriate person'¹¹⁷ and must allow the entitlement holder to change its holding into any other form for which it is eligible or to transfer it to another intermediary.

¹¹⁵ UCC §8-503(c).

¹¹⁶ UCC §8-505(a) and §8-506. Once it has received these economic benefits, the intermediary is under an absolute obligation to pass them, an obligation that cannot be limited by agreement (UCC §8-505(b)). An intermediary need not exercise voting and other rights unless directed to do so.

¹¹⁷ UCC §8-507. 'Appropriate person' is defined in Section 8-107.

Approach taken by UNIDROIT Convention

1.213 The Convention deals with the enforcement of rights by an account holder in both direct and indirect enforcement systems.

1.214 Article 9(1) and (2) of the Convention states as follows:

1. – The credit of securities to a securities account confers on the account holder:

- (a) the right to receive and exercise rights attached to the securities, including in particular dividends, other distributions and voting rights
 - (i) where the account holder is not an intermediary or is an intermediary acting for its own account; and
 - (ii) in any other case, if the domestic non-Convention law so provides.
- (b) the right, by instruction to the relevant intermediary, to dispose of securities in accordance with Articles 4 and 5;¹¹⁸
- (c) the right, by instructions to the relevant intermediary, to cause the securities to be held otherwise than through a securities account, to the extent permitted under the law under which the securities are constituted, the terms of the securities and the account agreement;
- (d) subject to the Convention, such other rights as may be conferred by the domestic non-Convention law.

2. – Unless otherwise provided in the Convention,

- (a) the rights referred to in paragraph 1 are effective against third parties;
- (b) the rights referred to in paragraph 1(a) may be exercised against the relevant intermediary or the issuer of the securities, or both, in accordance with this Convention, the terms of the securities and the law under which the securities are constituted;
- (c) the rights referred to in paragraph 1(b) and (c) may be exercised only against the relevant intermediary....

1.215 The Article is perhaps the most important in the Convention as it establishes the book-entry as the event that creates the account holder's rights under the Convention. As we have explained above, this analysis is at odds with English law which considers a book entry as merely evidencing a trust.¹¹⁹

¹¹⁸ These articles deal with transfers of intermediated securities (Art 4) and the creation of security interests in intermediated securities (Art 5).

¹¹⁹ See para XXX above.

- 1.216 Article 9(1) gives a general right to the account holder to receive and exercise the rights represented by the terms of the securities and to dispose of the securities or withdraw them from an account.
- 1.217 Article 9(2)(a) is concerned with enforcement of these rights. Article 9(2)(a) has the effect of giving the rights what we would consider in English law to be proprietary effect by protecting the account holder's rights from the claims of third parties. For example, the account holder's right to dividends or other distributions received by an intermediary would be protected against claims by the intermediary's creditors in insolvency.
- 1.218 Article 9(2)(b) addresses the issue of enforcement of the terms of securities in direct and indirect enforcement systems. In keeping with a functional approach, the Article does not opt for one method of enforcement over another but permits enforcement of the terms against the issuer or the relevant intermediary or both depending upon the law under which the securities are constituted,¹²⁰ the terms of the securities and the account agreement. The account holder has no right under the Convention in either system to enforce the terms against an intermediary higher in the chain of holding.
- 1.219 Article 9(2)(c) makes clear that the account holder's rights to cause the securities to be transferred or withdrawn from an account are rights that are enforceable only against its immediate intermediary. The Convention does not give the account holder in either a direct or indirect enforcement system the right to cause the issuer or an upper tier intermediary to transfer securities credited in their accounts. This clearly makes sense - to permit such a right would risk enabling an investor to dispose of securities by circumventing security interests attached to the intermediated securities in an account higher up the chain and would be contrary to the prohibition on upper tier priority.¹²¹

Limitations on the account holder's ability to enforce rights against its intermediary.

- 1.220 As described above, the Convention establishes a number of rights in Article 9(1) that automatically arise upon a valid credit in an account and which can be enforced against an intermediary in accordance with Article 9(2). The Convention goes on to qualify the ability to enforce these rights in two ways. First, Article 10 states that while intermediaries must take 'appropriate measures' to enable the account holder to exercise its rights in Article 9(1),

...this obligation does not require the relevant intermediary to take any action that is not within its power or to establish a securities account with another intermediary.¹²²

¹²⁰ If the 'law under which the securities are constituted' permits direct enforcement against the issuer, an investor located in an indirect enforcement jurisdiction will presumably be able to bring an action directly against the issuer.

¹²¹ Discussed in [para XXX].

¹²² Article 10(1).

- 1.221 The Article addresses the obvious concern that circumstances may conspire to prevent an intermediary from discharging its obligations. For example, an intermediary may be unable to dispose of securities if the transferee's intermediary refuses to accept them into its account for whatever reason. In particular, unless the parties agree, an intermediary should not be required to incur the time and expense of opening an account with another intermediary in order to cause the transfer of securities.
- 1.222 Secondly, Article 18 of the Convention provides that,
- The obligations and duties of an intermediary under this Convention and the extent of the liability of an intermediary are subject to any applicable provision of the domestic non-Convention law and, to the extent permitted by that law, the account agreement.
- 1.223 Making the obligations, duties and liabilities subject to domestic law diminishes the legal certainty that the Convention aims to promote. If the current domestic law prevents an account holder from enforcing certain rights against an intermediary or issuer or adds further formalities to doing so, does the Convention simply permit this state of affairs to continue?
- 1.224 The risk that domestic law could impede an account holder's ability to enforce the terms of the securities under Article 9(1)(a) is, at least, reduced by the absolute requirement in Article 12 that:
- 1.- The law of a Contracting State shall permit the holding through intermediaries of securities that are permitted to be traded on an exchange or regulated market, and the effective exercise of the rights attached to such securities which are so held.
- 1.225 Article 12 does not appear to apply to the right to cause an intermediary to dispose of securities (this being a right that is not "attached" to the securities). As a result, domestic law could act to qualify an account holder's rights in this regard beyond the limits set by Article 10.
- 1.226 The Convention allows the parties to vary the intermediary's obligations, duties and liabilities in their account agreement. This is entirely sensible as the parties should be free to specify the terms of their commercial relationship. It is also more understandable that their ability to do so should be subject to domestic law. The terms of a financial intermediary's account agreement will raise issues of financial regulation and consumer protection policy that are beyond the bounds of the Convention.

- 1.227 As a final point, it should be noted that the exercise of the terms of the securities in Article 9 is phrased in terms of exercisable rights of the account holder rather than obligations of the intermediary. An intermediary would presumably not automatically be obliged under the Convention to pass on dividends or enquire as to the account holder's voting instructions unless and until the account holder chose to enforce these rights or as otherwise agreed in the account agreement. Domestic law could no doubt affect this analysis.¹²³

Preliminary conclusions

- 1.228 As the Convention demonstrates, there is no reason why direct and indirect enforcement systems cannot operate alongside each other within a harmonised legal framework. This is just as well as the differences between them in relation to the enforcement of account holders' rights are derived from fundamental distinctions in the legal traditions of the Member States. It would be unrealistic to expect to achieve consensus by favouring one over the other. Both systems provide an effective mechanism for the enforcement of an investor's rights in underlying securities. Accordingly we provisionally propose that:
- 1.229 The valid credit of securities to an account should grant the account holder with a right to instruct its intermediary to transfer the intermediated securities or withdraw them from its account. The right is effective against third parties and enforceable only against its own intermediary.
- 1.230 The valid credit of securities to an account should grant the account holder with a right to receive any corporate and economic rights in the underlying securities. This right is effective against third parties and is enforceable against its own intermediary.¹²⁴ Subject to national law, the right may also be enforceable against the issuer.
- 1.231 Subject to the terms agreed with its account holder, an intermediary must take reasonable actions to obtain the corporate and economic benefits generated by the underlying securities and to comply with the account holder's instructions for the transfer or withdrawal of securities credited to its account.

¹²³ In contrast, UCC§8-505(b) makes an intermediary obligated to its entitlement holder for a payment or distribution once the intermediary *receives* the distribution or payment. This obligation cannot be excluded by contract.

¹²⁴ This would remove any possibility that bare sub-trusts can be collapsed under English law so as to enable the investor to enforce its rights directly against the upper tier intermediary. See footnote 45 above.

THE APPLICATION OF THE 'NO-LOOK-THROUGH' PRINCIPLE

- 1.232 The 'no-look-through' principle forms part of the larger discussion concerning the enforceability of account holder's rights. The principle prohibits an account holder from 'looking through' its immediate intermediary to make a claim in its own name against another intermediary higher in the chain. The prohibition is likely in practice to be reinforced by express provisions in the account agreements entered into between each account holder and its intermediary within a holding chain.
- 1.233 The prohibition has the effect of enhancing market efficiency by limiting the persons able to make a claim against an intermediary. This relieves an intermediary from having to substantiate and respond to a claim made by a person that may or may not have an indirect interest in the intermediated securities held by it. Attempting to trace the chain of title through to an upper tier intermediary can be difficult if not impossible. Other than in the case of certain 'transparent' systems, the upper tier intermediary is unlikely to have any record of the lower tier account holder and so may be unable to verify the substance and validity of the claim without incurring expense and delay. If the account holder's immediate intermediary has acquired its own holding through more than one source, it may be impossible to match the account holder's holding to a particular upper tier intermediary's account.¹²⁵
- 1.234 By limiting claims in this way, the principle allows an intermediary to quantify and manage its risk by reducing most of its system risks to bilateral risk assessments. The intermediary is able to undertake voluntary responsibilities only to identified parties, with whom it can make specific arrangements and not to an indefinite number of unidentified persons.¹²⁶
- 1.235 A rule preventing an account holder from making a claim against an intermediary other than its own also acts to simplify the conflicts of law issues that would arise if no such rule existed. Different laws may often govern transactions at different levels of a chain of holdings. The domestic legal system governing an investor's rights against its intermediary can therefore differ from the law governing its intermediary's relationship with the intermediary above it.
- 1.236 While the no-look-through principle is appealing both in logic and practice, we must nevertheless consider whether to apply it in every circumstance. What should happen if the investor's own intermediary is in breach, insolvent or simply chooses not to sue? What if the upper tier intermediary has dishonestly assisted in a fraud perpetrated on the investor or is owes a duty of care in tort or statute to the investor?

¹²⁵ See FMLC *Issue 3 - Property Interests in Investment Securities* (July 2004) p 12.

¹²⁶ See N Paspaspyrou, 'Immobilisation of Securities – Part 1 – Proprietary Rights of Indirect Holders' (1996) *JIBL* 430 at 431.

Possible exceptions under English law

- 1.237 English law has tended to reject the view that third parties acting to the detriment of trust assets should owe a duty of care to the trust's beneficiaries.¹²⁷ This analysis generally extends to beneficiaries under a sub-trust wishing to bring an action against a head trustee (that is to say, an upper tier intermediary), subject to certain statutory exceptions.¹²⁸ The courts have also been generally unwilling to allow beneficiaries to step into the shoes of trustees so as to prosecute the trustees' action against third parties, even where the trustees have consented to such a move.¹²⁹ That said, there is contrary authority to support the view that a third party may owe a duty of care to its counter-party's beneficiaries where it has assumed a special responsibility towards them.¹³⁰ It also seems likely that a court will permit beneficiaries to sue where the trustee has acted in bad faith or has acted unreasonably in refusing to sue in clear cases of actionable wrong against the trust assets.¹³¹

Approach taken by other Member States

- 1.238 The general rule in both common law and civil law systems appears to be that an investor cannot make a claim against an upper tier intermediary. The investor has no direct contractual or trust relationship with the upper tier intermediary and must therefore enforce its claim through its immediate intermediary. That said, if an upper-tier intermediary has violated the property rights of the investor, the investor may have a direct claim in some jurisdictions provided that this right has not been limited by contract.¹³²
- 1.239 An investor may be granted a right to enforce its claim against an upper tier intermediary in circumstances where its own intermediary has acted in breach of duty or is insolvent. This is the case in Denmark and Germany¹³³ and possibly also in the Netherlands.¹³⁴

¹²⁷ *Parker-Tweedale v Dunbar Bank plc (No1)* [1990] 2 All ER 577, pp 586-587

¹²⁸ If the upper tier intermediary is an authorised person under the Financial Services and Markets Act 2000 and is in breach of certain FSA rules (including the CASS rules), an investor can bring a claim against it under FSMA, s150. It is likely however, that this claim will be brought on its behalf by its intermediary or some other representative of the account holders.

¹²⁹ *Bradstock Trustee Services Ltd v Nabarro Nathanson* [1995] 1 WLR 1405.

¹³⁰ *White v Jones* [1995] 2 AC 207; *Smith v Eric Bush* [1990] 1 AC 831; *Henderson v Merrett Syndicates Ltd* [1995] 2 AC 145.

¹³¹ Under Trustee Act 1925, s 41 the courts do have the power to appoint an additional or substitute trustee, particularly where the current trustee is unable or unwilling to perform its duties

¹³² Austria and Portugal are examples of legal systems that permit an account holder to enforce its property rights in these circumstances 'erga omnes' (towards all).

¹³³ If an intermediary refuses to enforce a claim against the intermediary above for the return of securities, German law permits the investor to bring a direct action for return against the upper tier intermediary under the Securities Deposit Act, sections 7-8.

¹³⁴ Sections 7:420 and 421 of the Netherlands Civil Code which relate to agency contracts could give the investor a right against an upper tier intermediary in the event of a breach of duty or insolvency of its own intermediary.

- 1.240 If an upper tier intermediary has committed a tort it may be subject to a civil action by the investor in a number of Member States. These include Italy, Lithuania and Poland.

Approach taken by the FMLC

- 1.241 The FMLC Report endorses the no-look-through principle incorporated into FMLC Principle 2(d), which states that:

Customers (and persons claiming through them, including attachment creditors) can enforce their interests in securities only against the intermediary, and not against the issuer or any other intermediary. However, this subject to any direct rights of action against the issuer or other intermediary provided under the terms of issue of the securities or of a deed poll or contract or arising under general law against persons not acting in good faith.

- 1.242 The final sentence of the Principle reflects current law by indicating that a direct right of action may still arise under general law against intermediaries that do not act in good faith. Accordingly, if such a right of action did exist, the investor could bring it even if it could also enforce its rights through an action brought by its intermediary. Qualifying the principle in this way would seem to place an upper tier intermediary in a position of uncertainty whenever a lower tier account holder makes a claim against it alleging bad faith. Presumably, in these circumstances, the upper tier intermediary would need to assess the substance of the claim and verify that the investor has a right to make it in relation to the particular securities that the intermediary holds.

Approach taken by the US Uniform Commercial Code

- 1.243 The no-look-through principle is central to the indirect enforcement system rules established by Article 8. Section 8-503 makes clear that an entitlement holder's rights are rights against its intermediary. It cannot assert these rights against upper tier intermediaries.¹³⁵
- 1.244 The no-look-through principle reflects the rationale expressed in the Official Comment that the concept of tracing used for physical chattels does not work in indirect enforcement systems. A person's entitlement is not in relation to a specific identifiable thing that can be traced through the hands of different persons but is a package of rights and interests that a person has against an intermediary and the property held by the intermediary.¹³⁶

Approach taken by UNIDROIT Convention

- 1.245 Articles 9(2)(b) and (c) apply the no-look-through principle in respect of claims arising from an upper tier intermediary's violation of the account holder's rights under the Convention.

¹³⁵ §8-503(d) goes further still by preventing the entitlement holder from asserting its rights against third parties to whom the intermediary may have wrongfully transferred interests other than in exceptional circumstances where the intermediary is insolvent and the third party colluded in the wrongdoing. This extension of the concept will be considered further in the seminar on Transferees.

¹³⁶ See above.

1.246 As we have already seen, Article 18 of the Convention provides that the obligations and duties of an intermediary under the Convention and the extent of the liability of an intermediary are subject to any applicable provision of the domestic non-Convention law. This suggests that obligations and duties owed by the intermediary under domestic law could result in a claim being made by a lower tier account holder if the domestic law permitted look-through. If such an analysis is correct, the legal certainty created by the no-look-through principle adopted by the Convention is significantly diminished.

Preliminary conclusions

1.247 The best answer may be that the prohibition should be absolute, so long as the investor's intermediary is able to prosecute the action effectively. Accordingly, even where the investor does have a direct action itself it should not be permitted to bring a claim if it also has the option of directing its intermediary to sue instead. This has the advantage of avoiding multiple suits from investors. It also maintains the general principle that an intermediary need not concern itself with claims from lower tier account holders which may be based on interests in securities that cannot easily be traced back to the securities that the intermediary holds. If, however, the investor can demonstrate that its rights cannot be exercised through its intermediary (due, for example, to its insolvency, complicity in the wrongdoing or unreasonable refusal to sue), an upper tier intermediary should not be shielded from such a claim.¹³⁷

¹³⁷ See G McCormack, 'Suing external fund managers: redress for disgruntled trust beneficiaries' *Trust Law International*, Vol. 11, No. 3 (1997) 60-67, 65 in which the author states that 'beneficiaries should be allowed to step into the name of the trustee and sue, speaking for the trust as a whole, where the trustees are in some way disabled from instituting proceedings. Action by them against external fund managers should not otherwise be permitted.'

A PROHIBITION ON UPPER TIER ATTACHMENT

- 1.248 As the phrase suggests, upper tier attachment refers to the ability of a lower tier account holder or its creditors to assert rights in respect of securities or intermediated securities held by an intermediary in a higher account. The prohibition on upper tier attachment could be viewed as a subset of the no-look-through principle in so much that it applies only to claims against assets and not also to personal claims against the intermediary itself. Needless to say, the practical implications of upper tier attachment are closely related to those discussed in connection with the no-look-through principle.
- 1.249 Upper tier attachment in non-transparent holding systems (that is to say, systems in which the investor's interest is not recorded in upper tier accounts) can lead to market inefficiencies. If the intermediary is unsure whether the creditor has a valid claim and is unable to identify which securities in its customer account are subject to the claim, the intermediary may end up freezing all transfers out of the account to avoid the risk of liability for an improper transfer. Such an action would clearly prejudice the intermediary's other account holders.
- 1.250 More fundamentally, upper tier attachment may be inconsistent with the order of priorities between claims at different levels of a multi-tiered holding system. As we have described above, in some jurisdictions, the intermediaries in a holding chain retain a legal position in the intermediated securities at their respective tiers. In these circumstances, the intermediary or a third party can take a security interest over the intermediated securities at that tier of the holding chain. These interests in intermediated securities all relate economically to the same underlying securities. If no clear order of priorities exists as between different tiers in the chain (which may be subject to the laws of different jurisdictions), collateral takers and purchasers can have no certainty as to where they stand in relation to other claimants.
- 1.251 Attempts to apply the first-in-time or bona fide purchaser priority rules across a number of different tiers have been described as "confusing, awkward and unprincipled".¹³⁸ As C W Mooney observes, the emphasis on timing is questionable considering that participants at different tiers have little or no way to control or find out about transactions above or below them. Furthermore, there may be no certainty that two competing claimants are asserting rights in the same securities.

¹³⁸ See C W Mooney, 'Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities controlled by Intermediaries', *Cardozo L Rev* (1990), 305, p 378. See generally pp 365-415 upon which much of this discussion is based.

- 1.252 A solution in legal systems where legal interests are retained by persons at higher tiers is to adopt the principle of upper tier priority. This principle provides that claimants with a legal position in a higher tier will always prevail over claimants in lower tiers.¹³⁹ As a result a creditor should not be granted an attachment order against securities held in an upper tier intermediary's account, as to do so would prejudice the rights of higher tier collateral takers and purchasers and run contrary to upper tier priority.

Approach taken by the FMLC and the US Uniform Commercial Code

- 1.253 Both the FMLC Principle and the US Uniform Commercial Code apply the prohibition on upper tier attachment and deal with it in their limitations on the ability of account holders to enforce rights other than against their own intermediary.¹⁴⁰

Approach taken by UNIDROIT Convention

- 1.254 Article 15(1) of the Convention sets out a straightforward prohibition against the granting of an 'attachment'¹⁴¹ against the issuer or a higher tier intermediary.

Preliminary conclusions

- 1.255 An account holder (and persons claiming through it, including creditors) should be prohibited from bringing an attachment order in relation to securities that are not credited to an account held by the account holder's intermediary.

¹³⁹ The effect of upper tier priority will be explored in more depth in our seminar on Collateral Takers.

¹⁴⁰ See paras 1.241-1.244 above.

¹⁴¹ Article 15(2) defines an attachment as "any judicial, administrative or other act or process for enforcing or satisfying a judgment, award or other judicial, arbitral, administrative or other decision against or in respect of the account holder or for freezing, restricting or impounding property of the account holder in order to ensure the availability to enforce or satisfy any future judgment, award or decision."

THE SCOPE AND LEVEL OF DUTIES OWED BY AN INTERMEDIARY WHERE NOT CONTRACTUALLY SPECIFIED.

The need for a minimum set of default duties

- 1.256 The obligations owed by an intermediary to an account holder should, for the most part, be set out in the account agreement entered into between the two parties.
- 1.257 Beyond this, the intermediary's duties arise through general principles of domestic law as well as national and EU legislation and regulation. The scope and extent of these duties will depend largely upon the characterisation of the relationship between intermediary and account holder. The duties may be relatively light if the arrangement is characterised as merely a commercial relationship between two business entities or more substantial if the intermediary is subject to consumer protection policies, financial regulation or fiduciary responsibilities. To the extent permitted by law, these duties may themselves be modified or limited by the terms of the account agreement. Furthermore, the same characterisation is not likely to apply to all aspects of the relationship; fiduciary duties, if applicable, will not necessarily apply to every action undertaken by the intermediary on its investor's behalf.¹⁴²
- 1.258 It is our provisional view that an EU-wide legal framework should not seek to harmonise the scope and level of duties owed by an intermediary to the exclusion of duties that currently exist under national law and regulation. Attempts to limit the financial regulation and protection owed to account holders in particular Member States for the sake of establishing uniformity within the EU is neither desirable nor within the ambit of this project.
- 1.259 A harmonised legal framework can, however, enhance both market confidence and efficiency by providing a minimum standard of duties that could operate in default of contractual provisions. An account holder would benefit from knowing that its intermediary owed to it these duties (unless modified or excluded with its consent) whether its account is located in its own jurisdiction or elsewhere in the EU.
- 1.260 We have already discussed at length many of the fundamental duties of the intermediary from the perspective of an account holder's enforceable rights against its intermediary. These duties are triggered by crediting the account holder's account and include:
- (1) the duty to comply with its account holders' instructions to exercise or pass on corporate and economic benefits; and
 - (2) the duty to comply with its account holders' instructions to transfer the securities or otherwise withdraw them from its account.

¹⁴² AO Austen-Peters, *Custody of Investments Law and Practice* (2000) p 108.

- 1.261 One fundamental duty that we have considered only incidentally in the context of shortfalls is the intermediary's obligation to maintain a sufficient quantity of securities to satisfy its account holders' entitlements. This obligation is central to minimising the account holders' financial risks and is one of the core elements of the intermediary/account holder relationship.
- 1.262 A custodian of non-fungible physical assets may be under a duty simply to retain these assets in safe custody and return the exact same assets to its customer upon request. An intermediary that holds fungible securities need only return equivalent securities. Depending on how this duty is formulated, the intermediary may have considerable liberty to do as it wishes with fungible securities that are deposited with it provided that it maintains a direct correspondence between positions that it holds and the claims of its customers.

Duties under English law to maintain sufficient securities

- 1.263 Under English law, an intermediary as trustee must take all reasonable steps to safeguard trust assets. This includes ensuring that assets deposited in a fund are not exposed to any unnecessary risk.¹⁴³ More generally, the trustee owes a duty to take such care and exercise such skill as it professes to possess.¹⁴⁴ A higher standard will therefore apply to a paid financial intermediary than to an unpaid non-professional.
- 1.264 Trustees are now subject to a statutory duty under the Trustee Act 2000 to exercise reasonable care in the exercise of powers conferred on him by the trust instrument or the general law. Section 1 of the Act provides that:

Whenever the duty under this subsection applies to a trustee, he must exercise such care and skill as is reasonable in the circumstances, having regard, in particular –

- (1) to any special knowledge or experience that he has or holds himself out as having, and
- (2) if he acts as a trustee in the course of a business or profession, to any special knowledge or experience that it is reasonable to expect of a person acting in that kind of business or profession.

- 1.265 Schedule 1 lists the circumstances in which the duty of care in section 1 applies.¹⁴⁵ In particular, a trustee must comply with the duty of care when exercising and reviewing investment powers,¹⁴⁶ and when appointing agents, nominees and custodians.¹⁴⁷

¹⁴³ *Wyman v Paterson* [1900] AC 271.

¹⁴⁴ *Bartlett v Barclays Bank Trust Co Ltd* [1980] Ch 515, 534.

¹⁴⁵ See s 2.

¹⁴⁶ Sch 1 para 1.

¹⁴⁷ Sch 1 para 3.

- 1.266 Segregated accounts are held on separate trusts. Consequently, an intermediary cannot count securities of the same description that it holds in its house account (or other customer accounts) towards satisfying its duty to maintain the entitlements in a customer account. Securities held in a house account are subject to the claims of the intermediary's creditors and cannot be treated as falling inside the trust unless they have been misappropriated from the customer account.
- 1.267 This analysis differs from that adopted in other Member States. In Belgium, if an intermediary holds securities for the same description for its account holders and for its own account, it is only entitled to whatever securities remain once the entitlements of its account holders have been satisfied.¹⁴⁸

Ability to use securities as collateral or for stock lending

- 1.268 A trustee must not use or deal with trust property for his own personal benefit or advantage.¹⁴⁹ When coupled with its duty to safeguard trust property and not expose it to unnecessary risks it is clear that an intermediary would be in breach of trust if it grants a security interest over trust assets or lends them without the consent of the account holders.

Approach taken by the FMLC

- 1.269 FMLC Principle 2(c)(iii) states that an intermediary must ensure that securities held in a pool¹⁵⁰ are sufficient to satisfy all customers' interests in securities. The duty is satisfied as regards any investor if the intermediary has acted in accordance with its agreement with that investor and, subject to that agreement, has exercised such care to ensure the avoidance of a shortfall 'as accords with reasonable market standards'.
- 1.270 We presume that the 'reasonable market standards' duty of care supplements rather than supplants any fiduciary duty of care that an intermediary owes its customers.

Approach taken by the US Uniform Commercial Code

- 1.271 In the words of Section 8-504(a):

A securities intermediary shall promptly obtain and thereafter maintain a financial asset in a quantity corresponding to the aggregate of all security entitlements it has established in favor of its entitlement holders with respect to that financial asset. The securities intermediary may maintain those financial assets directly or through one or more securities intermediaries.

¹⁴⁸ Royal Decree 62, Article 12.

¹⁴⁹ *A-G for Hong Kong v Reid* [1994] 1 AC 324.

¹⁵⁰ Although not stated here, the Principles also apply to maintaining sufficient securities in segregated customer accounts and not just to pooled customer accounts (see FMLC Report p 20).

- 1.272 Unlike English law, the general duty in Article 8 makes no distinction between securities of the same description owned by the intermediary or by customers in segregated accounts.¹⁵¹ Instead all interests in securities of the same description held by the intermediary are allocated to its entitlement holders to the extent necessary to satisfy their entitlements. The obligation is subject to the terms of any agreement. In the absence of any agreement, the intermediary satisfies its duty if it ‘exercised due care with reasonable commercial standards to obtain and maintain the financial asset’.¹⁵²
- 1.273 Section 8-504(b) explicitly provides that an intermediary may not grant any security interest in financial assets that it is obligated to maintain for its customers without their consent.

Approach taken by UNIDROIT

- 1.274 The requirement to hold sufficient securities is set out in Article 17 of the Convention, which states:
1. – An intermediary must, for each description of securities, hold securities and intermediated securities of an aggregate number and amount at least equal to the aggregate number and amount of securities of that description credited to securities accounts which it maintains.
 2. -- If at any time an intermediary does not hold sufficient securities and intermediated securities of any description in accordance with paragraph 1, it must [immediately][promptly]¹⁵³ take such action as is required to ensure that it holds sufficient securities and intermediated securities of that description.
- 1.275 The Convention follows the US approach by allowing the intermediary to satisfy its duty without distinguishing between its house and customer accounts in relation to securities of the same description. Article 17(2) imposes an obligation on the intermediary to take such action (for example, by purchase or stock lending) to ensure that it redresses any insufficiency.
- 1.276 Unlike the Uniform Commercial Code or the FMLC Principles which apply a market reasonableness standard in the absence of express contract terms, the obligation in the Convention is absolute. The duty does not, however, affect:

¹⁵¹ UCC §8-504(a). Note 1 of the Official Comment states that this “recognises the reality that as the securities business is conducted today, it is not possible to identify particular securities as belonging to customers as distinguished from other particular securities that are the firm’s own property.”

¹⁵² UCC §8-504(c)(2).

¹⁵³ These square bracketed alternatives currently exist in the draft Convention.

...any provisions of the domestic non-Convention law, or, subject to the domestic non-Convention law, any provision of the rules of a securities settlement [or clearing] system or of an account agreement, relating to the allocation of the cost of ensuring compliance with the requirements [to maintain sufficient securities].¹⁵⁴

- 1.277 We are currently uncertain as to the intended effect of this Article 17(3). It seems to suggest that if there is a shortfall, the intermediary is under an absolute obligation to purchase securities to remedy the shortfall albeit that the cost of doing so may be allocated to others in accordance with domestic law, settlement system rules and the terms of the account agreement. If an intermediary is not at fault for the shortfall it is not clear who should bear this cost nor is it clear why the intermediary cannot simply allocate the shortfall to account holders by reducing their entitlements and thereby reconcile the account balances.

Preliminary conclusions

- 1.278 Most of the key duties owed by an intermediary are established in the context of account holder's rights enforceable against the intermediary. In addition, an intermediary is obliged to maintain a number and amount of securities that at least equals the aggregate number and amount of securities of the same description that are credited to securities accounts that it holds for account holders. This would permit the intermediary to count house securities towards satisfying the duty on the basis that any shortfalls arising from the intermediary's breach of duty would be allocated first to these house securities.
- 1.279 If at any time an intermediary does not maintain sufficient securities to satisfy this duty, it should be obliged to promptly obtain additional securities.
- 1.280 Subject to the terms of the account agreement, the intermediary should be able to satisfy these obligations if it has acted with such care as is required by reasonable market standards.

¹⁵⁴ Article 17(3).

INTERMEDIARIES ACTING ON INSTRUCTIONS FROM PERSONS OTHER THAN THEIR ACCOUNT HOLDER

- 1.281 An intermediary may receive instructions from a range of persons other than an account holder. The account holder's authorised agent may contact the intermediary with instructions. Third parties may claim to have an interest in the securities that the intermediary holds on behalf of the account holder. The intermediary may be presented with a court order containing instructions in respect of the securities.
- 1.282 In order for an intermediary to be able to manage its accounts effectively, it needs clear rules as to whether it can act on instructions from persons other than an account holder without incurring any liability. Similarly, it needs to know if it can ignore instructions from persons other than its account holder without exposing itself to a claim. A lack of certainty could result in operational delays and will complicate the intermediary's ability to manage its risk. In many respects the issue of how intermediaries should respond to the instructions of third parties is interrelated with upper tier attachment and the no-look-through principle discussed above.¹⁵⁵
- 1.283 A number of legal sources regulate an intermediary's actions in relation to instructions. First and foremost, the account agreement entered into with account holders will specify who can and cannot instruct the intermediary and the method by which they should do so. Yet while the agreement is effective in governing the intermediary's liability in relation to its account holders, it has little ability to restrict the intermediary's liability to third parties that are not privy to the contract. In this regard, the intermediary must comply with national laws and settlement system rules.
- 1.284 A harmonised legal framework should, nevertheless, be able to provide some consistency in relation to an intermediary's response to instructions in certain specific circumstances. It can also provide default arrangements as between the account holders and the intermediary in the event that the account agreement is silent on these issues.

Approach taken by the US Uniform Commercial Code

- 1.285 In the United States, instructions to transfer or redeem intermediated securities are known as 'entitlement orders' and are treated separately in Article 8 from other instructions. An intermediary is protected from liability if it acts upon an entitlement order given by either an 'appropriate person' or a person who has the power to transfer the security under agency (including a person with control).¹⁵⁶

¹⁵⁵ See paras 1.232-1.255 above.

¹⁵⁶ See UCC§8-115. 'Appropriate person' is defined in §8-107(a) as the entitlement holder (ie the account holder) or its successor or legal representative if that person has died or lacks capacity.

- 1.286 An intermediary is also protected if the appropriate person has ratified the order or is otherwise precluded from asserting its ineffectiveness.¹⁵⁷ An intermediary is only *bound* to comply with an entitlement order if it originates from an ‘appropriate person’.¹⁵⁸
- 1.287 An intermediary has a general duty to exercise rights with respect to intermediated securities if directed to do so by the entitlement holder. It can satisfy this duty by acting as agreed upon with the entitlement holder or, in the absence of an agreement, if it acts in a commercially reasonable manner.¹⁵⁹
- 1.288 In the case of both entitlement orders and other instructions, the intermediary’s duty is always subject to applicable statutes, regulations or rules.¹⁶⁰ The Article 8 guidance is not a comprehensive statement of the relationship between the entitlement holder and intermediary. This relationship is largely governed by contract and agency law, supplemented or supplanted by regulatory law.¹⁶¹

Approach taken by UNIDROIT Convention

- 1.289 Article 16 of the Convention deals with instructions to the intermediary. It provides that:

...an intermediary is neither bound nor entitled to give effect to any instructions with respect to intermediated securities of an account holder given by any person other than that account holder.¹⁶²

- 1.290 This general rule is made subject to:
- (1) the provisions of any contractual arrangements agreed to by the account holder;
 - (2) the rights of collateral takers who hold a security interest created in accordance with the Convention;
 - (3) any order or decision of a court or similar authority of competent jurisdiction;
 - (4) any mandatory rule of domestic non-Convention law; and
 - (5) where the intermediary is the operator of securities settlement system, the rules of that system.¹⁶³

¹⁵⁷ UCC§8-107(b)(3). This would presumably cover persons authorised by agreement with the entitlement holder.

¹⁵⁸ UCC§8-507(a).

¹⁵⁹ UCC§8-506.

¹⁶⁰ UCC§8-509(a).

¹⁶¹ UCC§8-509, Official Comment.

¹⁶² Article 16(1).

¹⁶³ Article 16(2)(a)-(e).

1.291 Making the general rule subject to any mandatory national laws inevitably diminishes legal certainty. That said, it is unrealistic to expect the Convention to attempt to specify all the circumstances where an intermediary that acts on the instruction of its account holder could nevertheless be liable to a third party. In English law, agency, corporate law and tort are just some of the branches of law that may come into play.

1.292 The Convention rule might be of greater worth, however, if it did override mandatory domestic law in certain limited circumstances. In particular, intermediaries would benefit from a general rule dealing with an intermediary's ability to act on authorised instructions despite its knowledge of a third party claim.¹⁶⁴ In addressing customer instructions in English law, the FMLC proposed that:

The intermediary acting honestly may rely on such instructions [of its customer and/or the customer's duly authorised agent], notwithstanding any notice it may have of third party claims.¹⁶⁵

1.293 What constitutes 'honesty' is a difficult question and could be left to domestic law to determine.¹⁶⁶ While there would not be complete uniformity between legal systems, a similar rule if included in a harmonised legal framework would give an intermediary greater assurance to ignore third party claims if it was confident that it had acted honestly.

Forged instructions and fraudulent representatives

1.294 Two further important issues arise in this area. The first relates to forged instructions from unauthorised persons. Should an intermediary be liable for misapplying custody assets if it can show that it acted on forged instructions in the honest belief that they were issued by the account holder or its duly authorised agent?¹⁶⁷

¹⁶⁴ Under English law, the intermediary could potentially be liable as a constructive trustee for dealing with property in which a third party has a proprietary interest: *Soar v Ashwell* [1893] 2 QB 390.

¹⁶⁵ FMLC, *Issue 3- Property Interests in Investment Securities* (July 2004), Principle 2(e).

¹⁶⁶ The Privy Council in *Barlow Clowes v Eurotrust International Ltd* [2005] UKPC 37 recently confirmed that in an action for dishonest assistance the test from honesty is an objective one. According to this test, an intermediary will have acted dishonestly if a reasonable and honest person would think that it had acted dishonestly.

¹⁶⁷ Under English law, the intermediary would be in breach of trust for acting on forged instructions and would be personally liable to reconstitute the account holder's account as it would have been but for the breach, unless the account agreement exempted the intermediary from liability for breach of trust: *Clough v Bond* (1838) 3 M&C 490.

- 1.295 In its proposals for English law, the FMLC considered that “forged instructions, which do not in fact come from the customer or its duly authorised agent, will not be effective.”¹⁶⁸ An intermediary would therefore be unable to rely on a defence that it acted on unauthorised instructions in the honest belief that they were issued by the account holder or its duly authorised agent. Although the Convention does not expressly refer to the effect of forged instructions, Article 16 also appears to preclude any such defence as it provides that an intermediary is not entitled to give effect to instructions given by any person other than that account holder. That said, as the matter relates to the intermediary’s liability, Article 18 would operate to make it subject to domestic non-Convention law in each Member State.
- 1.296 The second issue relates to instructions given by authorised persons acting in violation of their duties to the account holder. The FMLC Report and the Convention are silent on this point. Section 8-107(c) of the US Uniform Commercial Code provides that an intermediary will be able to treat an entitlement order as effective, notwithstanding the authorised person’s violation.

Preliminary Conclusions

- 1.297 The intermediary should act, and act only, on the instructions of its account holder in relation to securities that it holds for that account holder.
- 1.298 This duty should be subject to:
- (1) the provisions of any contractual arrangements agreed to by the account holder;
 - (2) the rights of collateral takers in relation to the securities;
 - (3) any order or decision of a court or similar authority of competent jurisdiction;
 - (4) any mandatory rule of domestic law; and
 - (5) where the intermediary is the operator of securities settlement system, the rules of that system.
- 1.299 Notwithstanding any mandatory rule of domestic law, an intermediary acting honestly may rely on authorised instructions despite any notice it may have of third party claims.
- 1.300 Subject to domestic law, an intermediary may be liable if it acts on forged instructions but not if it acts on authorised instructions given by a person in violation of its duties provided that the intermediary acts honestly.

¹⁶⁸ FMLC, *Issue- 3 Property Interests in Investment Securities* (July 2004) p 22.

APPENDIX A

ISSUES TO BE ADDRESSED

A.1 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 harmonised 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 harmonised legal framework?
- (2) As we have already stated, the harmonised legal framework will be limited to intermediated securities. We will need to distinguish operators in systems in which securities are directly held (such as CREST) from intermediaries in an intermediated holding system. This may not always be straightforward especially in direct systems where the system operator's books are not the definitive register of entitlement against the issuer.¹
- (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.

¹ 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.

- (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.
- (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 harmonised 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 harmonised 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?