



**Law
Commission**
Reforming the law

**The UNIDROIT Convention on Substantive
Rules regarding Intermediated Securities
Updated Advice to HM Treasury**

May 2007

LAW COMMISSION

THE UNIDROIT CONVENTION ON SUBSTANTIVE RULES REGARDING INTERMEDIATED SECURITIES

UPDATED ADVICE TO HM TREASURY

CONTENTS

PART 1:INTRODUCTION	6
Introduction	6
Background to the Law Commission project	7
The EU Legal Certainty Group	7
The UNIDROIT project	8
Our project	10
International approach to our project	10
The progress of our project	11
Plan of this report	13
PART 2: HISTORICAL DEVELOPMENT OF INTERMEDIATED SECURITIES HOLDING	14
Investment securities	14
Dematerialization and immobilisation	15
The benefits of intermediation	17
Pooled Accounts	19
Central Securities Depositories in Indirect Holding Systems	19
The United Kingdom Settlement System	20
Legal analysis of intermediated securities	20
National law reform	21
The differences between holding systems	22
The analysis of intermediated securities holding under English law	28
PART 3: OUR GENERAL CONCLUSIONS	33
PART 4: THE CONVENTION: COMPARATIVE ANALYSIS AND COMMENTARY	40

Scope and sphere of application	40
The Convention	40
The advice of the Legal Certainty Group (the “LCG Advice”)	40
Law Commission Comments	41
The role of CSDs	42
The Convention	42
The LCG Advice	43
Law Commission comments	43
Rights of the account holder	48
The Convention	48
LCG Advice and Law Commission comment	49
Transfer of intermediated securities	50
The Convention	50
Law Commission comments	50
Security interests and limited interests in intermediated securities	53
The Convention	53
Law Commission comments	56
Settlement finality	60
The Convention	60
LCG Advice	61
Law Commission comments	61
Acquisition by an innocent purchaser	63
The Convention	63
LCG Advice	64
Law Commission comments	64
Insolvency protection	70
The Convention	70
LCG Advice	70

Law Commission comments	71
Prohibition on upper tier attachment	72
The Convention	72
LCG Advice	72
Law Commission comments	72
Instructions	72
The Convention	73
LCG Advice	73
Law Commission comments	73
Requirement of the intermediary to hold sufficient securities	73
The Convention	73
LCG Advice	73
Law Commission comments	76
Limitations on obligations and liabilities of an intermediary	74
The Convention	74
LCG Advice	75
Law Commission comments	76
Allocation of the securities held by an intermediary	77
The Convention	77
LCG Advice	78
Law Commission comments	78
Legal recognition of intermediated securities	82
The Convention	82
Law Commission comments	83
Set-off	83
The Convention	83
LCG Advice	83
Law Commission comments	83

Provisions in relation to collateral transactions	84
The Convention	84
LCG Advice	85
Law Commission comments	85
PART 5: INNOCENT PURCHASERS OF INTERMEDIATED SECURITIES	87
Summary of conclusions	87
Introduction	88
Terminology	89
The legal protection available to a purchaser of directly held securities	90
Negotiability	91
Good faith purchaser of the legal estate without notice	92
The legal protection available to a purchaser of intermediated securities	96
Unavailability of negotiable status for intermediated securities	97
Unavailability of the good faith purchaser defence for intermediated securities	97
Availability of legal protection where the legal estate is subsequently acquired	98
Priority of good faith purchaser of equitable interest over 'mere equities'	99
Loss of priority as a result of the actions of the original owner	99
De facto protection from fault-based personal claims	100
Example of current lack of protection for purchasers of intermediated securities	101
Example – Transfer of securities without the consent of the original owner	101
The need for protection of purchasers of intermediated securities	103
The case against extending legal protection to innocent purchasers of intermediated securities	103
The case for giving legal protection to innocent purchasers of intermediated securities	103
Options to remedy the disparity in purchaser protection	110
Adopt the Convention defence for innocent purchasers	110
Establish intermediated securities as legal interests.	111
Extend one or more of the defences to encompass intermediated securities.	113

Transfers from a pooled account	115
Scope and application of legislative protection	120

PART 1

INTRODUCTION

- 1.1 It has become commonplace in modern securities markets for investors to hold bonds, shares and other investment securities not directly from the issuer of the securities but indirectly through financial intermediaries. In 2004, it was estimated that securities worth approximately 50 trillion euros were held in this way worldwide.¹
- 1.2 The bundle of rights and interests that an investor has in the securities that it holds through an intermediary are often referred to as “intermediated securities” or “book-entry securities”. This project has been concerned with how the law treats these intermediated securities and the custodial relationship through which they are given effect. In particular, the project has concentrated on the effect that holding securities through an intermediary has on the exercise of the proprietary rights of ownership, transfer and pledge of intermediated securities.
- 1.3 The principal purpose of the analysis has been twofold. First, our aim has been to identify areas of legal risk. While legal risk is a phrase with no universally shared meaning,² we use it in this Report to describe circumstances in financial markets where the rules applicable to market practice are incomplete, ambiguous or otherwise difficult to understand or access.
- 1.4 The financial markets are particularly prone to legal risk as market practice constantly evolves to accommodate financial and technological innovations. If the law is unable to keep pace with these developments, legal uncertainty³ can increase to the point where counter-parties become unwilling to carry out transactions or must incur burdensome costs and delay in obtaining the necessary assurances to limit their risk. More dangerous still is the risk that an institution fails to quantify or even appreciate its exposure to potentially damaging outcomes, and consequently finds itself liable for a sum that causes it to fail in its financial obligations to third parties. The knock-on effect of this failure on interdependent institutions could potentially trigger a systemic crisis in a financial system.
- 1.5 An obvious means of reducing legal and systemic risk is to establish clear, reliable and readily accessible rules that provide for consistent and predictable outcomes to particular fact situations. The second aim of the project has been to consider how best to do this in relation to the ownership and disposition of intermediated securities.

¹ Explanatory Notes to the Preliminary Draft of the UNIDROIT Convention, para 1.2.3.

² See generally, R McCormick, *Legal Risk in the Financial Markets* (2006) Ch 4. UNIDROIT state that ‘Legal risk commonly refers to a situation where the applicable law does not provide for a predictable or sound solution’. The Explanatory Notes to the Preliminary Draft of the UNIDROIT Convention, para 1.2.1.

³ Legal uncertainty has been described as the ‘travelling companion’ of legal risk: see R McCormick, *Legal Risk in the Financial Markets* (2006) p 96.

BACKGROUND TO THE LAW COMMISSION PROJECT

- 1.6 Normally, the Law Commission would be concerned only in exploring the legal issues concerning intermediated securities within the parameters of English law and with a view to proposing English legislation. Indeed, the project's origins lie in a recommendation for domestic legislation made in a report published by the Financial Markets Law Committee (the "FMLC") in July 2004 (the "FMLC Report").⁴ Legal initiatives outside of the UK would be of interest to us only to the extent that they offered useful ideas and examples of how to tackle particular issues in English law.
- 1.7 The scope of our project is, however, much broader and reflects the fact that legislative reform in this area will most likely be implemented at an international level. In order to understand this better, we set out below a summary of the existing legislative initiatives that form the background to the Law Commission's project.

The EU Legal Certainty Group

- 1.8 In 2001, a consultative group appointed by the European Commission (the "Giovannini Group") published a report on cross-border clearing and settlement arrangements within the European Union.⁵ The report identified 15 important barriers to efficient cross-border clearing and settlement. One of the legal barriers reported by the Giovannini Group was the absence of an EU-wide framework for the treatment of interests in securities (including procedures for the creation, perfection and enforcement of security). The report concluded that the absence of a common legal framework represented the most important source of legal risk in cross border transactions.⁶

⁴ FMLC, *Issue 3 – Property Interests in Investment Securities, Analysis of the need for and the nature of legislation relating to property interests in indirectly held investment securities, with a statement of principles for an investment securities statute*. The report found that although English law in this area was basically sound, the relevant legal principles and rules governing the treatment of intermediated securities were not readily accessible. In addition, some anomalies in the law needed to be removed to accommodate market practice. The FMLC Report recommended that legislation be passed to remedy these deficiencies and set out a series of principles for the drafting of an investment securities statute. The report is available on the FMLC website http://www.fmlc.org/papers/fmlc3apr_2005.pdf. See para 2.71 below.

⁵ The Giovannini Group, *Cross-Border Clearing and Settlement Arrangements within the European Union* (November 2001).

⁶ The Giovannini Group, *Cross-Border Clearing and Settlement Arrangements within the European Union* (November 2001) p 56.

- 1.9 In its second report, published in April 2003, the Giovannini Group proposed that the European Commission should establish a project to look at how the legal nature of ownership of intermediated securities could be harmonised across the EU.⁷ As a result, in early 2005 the European Commission appointed a Legal Certainty Group of experts to consider the need for legislation to establish a common legal framework for the ownership and transfer of intermediated securities in the European Union.⁸
- 1.10 The Legal Certainty Group has since reported back to the European Commission with a formal advice (the “LCG Advice”) in which it recommends legislation.⁹ In addition to recommending legislation, the LCG Advice sets out, in fairly general terms, a number of core propositions that the new legislation should contain.

The UNIDROIT project

- 1.11 In recent years the European project has run concurrently with a legislative initiative undertaken by UNIDROIT. The UNIDROIT project shares markedly similar aims to our project and to the work of the Legal Certainty Group. It has as its purpose,

to promote legal certainty and economic efficiency with respect to the cross-border holding and disposition of securities held with an intermediary, by harmonising certain legal aspects in this regard.¹⁰

- 1.12 It proposes to achieve this by creating a convention that will be ratified and incorporated into the domestic law of each of the UNIDROIT contracting states (the “Contracting States”).¹¹ Through the nature of its work generally, UNIDROIT has considerable experience of analysing different legal systems and traditions in order to establish a common set of rules that can be implemented universally. As one commentator has recently stated:

⁷ The Giovannini Group, *Second Report on EU Clearing and Settlement Arrangements* (April 2003) p 16.

⁸ See EU Commission, *Communication from the Commission to the Council and the European Parliament: Clearing and Settlement in the European Union- The way forward* (COM (2004) 312), p 22.

⁹ The Legal Certainty Group formally communicated to the European Commission its written advice on 28 July 2006. In response to the three issues it had been asked to consider, it concluded that: (1) legislation was necessary to provide a minimum level of harmonisation of Member States’ laws in relation to the legal effect of book entries made on securities accounts; (2) a proposed solution regarding the differences in national laws affecting corporate actions should wait until the conclusion of other EU investigations and the finalisation of proposals for the directive on shareholders’ voting rights; and (3) restrictions did exist in relation to an issuer’s ability to choose the location of its securities but that the matter required further study before specific proposals could be made

¹⁰ UNIDROIT Preliminary Draft Convention on Harmonised Substantive Rules regarding Securities Held with an Intermediary, Explanatory Notes (December 2004), p 4.

¹¹ UNIDROIT membership comprises 60 states, including every Member State of the European Union except Lithuania and all of the G10 states.

The UNIDROIT draft Convention represents the most advanced work, at international level, that has been done in relation to the analysis of potential legal problems caused by indirect holding systems, and the best solutions to those problems.¹²

- 1.13 The UNIDROIT Committee of Governmental Experts has held three plenary sessions and the Convention is now at an advanced stage of drafting. A final plenary session is scheduled for 21-25 May 2007 to finalise the draft Convention in readiness for a diplomatic conference at the end of 2007 or the beginning of 2008. Thereafter, the Convention will be put forward for ratification by the member states of UNIDROIT.

Possible ratification of the Convention by the European Union

- 1.14 Ratification of the Convention has been mooted by a number of members of the Legal Certainty Group as offering the best route for establishing a minimum level of harmonisation of the laws of EU member states ("Member States") in relation to intermediated securities. While the LCG Advice held back from formally recommending what legislative form should be adopted to implement a common legal framework, it noted that:

...if the draft UNIDROIT Convention, when it has been negotiated, matches the new legislation described here, its ratification will be preferable to any parallel but separate Community instrument.

- 1.15 Ratifying the Convention would of course create a legal framework applicable not only to Member States but also internationally in relation to all other contracting states to the Convention. The global reach of the Convention would be of considerable benefit in light of the international nature of capital markets and the huge volume of cross-border settlement between Member States and states outside the EU.

- 1.16 In the run-up to the next UNIDROIT plenary session and in the period after it, the EU Commission and EU Member States will need to determine whether or not to ratify the Convention. The scope of the Convention covers virtually all of the legal issues that the Legal Certainty Group has been asked to address.¹³ Accordingly, if the decision is made at a European level that Member States should ratify the Convention, the need for additional European and domestic legislation to address these issues will be greatly reduced or removed altogether.

¹² R McCormick, *Legal Risk in the Financial Markets* (2006) p 183.

¹³ The Convention does not deal with two of the Legal Certainty Group's mandated objectives, namely to find solutions regarding (i) the differences in national laws affecting corporate actions and (ii) the restrictions on an issuer's ability to choose the location of its securities.

OUR PROJECT

International approach to our project

- 1.17 As already mentioned, the FMLC have recommended that domestic legislation be passed to rectify various legal uncertainties and deficiencies concerning the ownership, transfer and pledge of intermediated securities under English law. We believe, however, that, subject to one exception concerning purchasers of intermediated securities,¹⁴ it would make little sense for us to propose a range of changes to English law at this point, while the work of the Legal Certainty Group is still on-going. A number of consultees have expressed the concern that we avoid a situation in which domestic legislation is passed only for it to be modified shortly thereafter as a result of new European measures. The Treasury also shares this view and accordingly instructed us as part of the Law Commission's Ninth Programme of Law Reform to examine the issue initially with the aim of:

providing information and recommendations to influence the work of the European Commission on intermediated investment securities, and which might be used in any response to proposals made by the European Commission. In the event that little or no progress is made at the European level, we will consider producing a Report with draft legislation for England and Wales.¹⁵

- 1.18 During the course of our project, the work of the European Commission has increasingly focussed upon the Convention. Accordingly, with the agreement of the Treasury, we have followed the lead of the Legal Certainty Group and have concentrated much our attention in the last year on an analysis of the work being carried out by UNIDROIT. This has included sending a member of the Law Commission as part of the UK delegation to the UNIDROIT plenary sessions as well as advising the Treasury on whether the draft Convention meets the UK's commercial interests and legal requirements.

Internal soundness and compatibility

- 1.19 We agree with the approach taken by UNIDROIT that the modernisation and harmonisation of substantive law in this area should be viewed from two angles. It should be considered first from the point of view of promoting 'internal soundness' within each domestic legal framework.¹⁶ The modernisation should have the effect of ensuring that each system is robust and meets the general needs of the system participants through clear and simple rules and procedures. When reviewing and commenting on the Convention we have therefore kept in mind the issues of legal uncertainty or anomaly that were identified by the FMLC Report.

¹⁴ See Part 5 below.

¹⁵ Law Commission Ninth Programme of Law Reform (March 2005) p 24.

¹⁶ UNIDROIT Preliminary Draft Convention on Harmonised Substantive Rules regarding Securities Held with an Intermediary, Explanatory Notes (December 2004), p 18.

- 1.20 Secondly, the harmonisation of the substantive law must ensure the 'compatibility' of different legal systems so as to provide for consistent and predictable outcomes where the laws of one or other legal system are applied to securities settled or pledged cross-border. A common legal framework should be able to assure account holders or purchasers of intermediated securities that they will have at least a minimum level of rights under the law of a Contracting State provided that they act in accordance with the Convention. The application of these minimum legal rights may be of comfort to an investor both in respect of its own direct intermediary and also in relation to any intermediaries higher in the chain that operate their securities account under the laws of another Contracting State.
- 1.21 If the twin goals of internal soundness and cross-border compatibility can be achieved by the Convention, the effect will be to reduce legal risk both for domestic participants and for investors that settle securities cross-border. In light of the huge volume of securities that are held and traded through intermediaries this can only have a very positive effect in facilitating the flow of capital in today's globalised economy.

The progress of our project

- 1.22 We announced our intention to undertake a project on property interests in indirectly held securities in our Ninth Programme of Law Reform.¹⁷ The project was launched in December 2005.

Seminar Papers

- 1.23 During the Summer of 2006, we published three seminar papers. The seminar papers were each the subject of public seminars attended by lawyers, academics and securities industry professionals. The purpose of these papers and meetings was to identify the legal and policy issues that should fall within the scope of our project and to reach preliminary views for further discussion. These preliminary views formed the basis of the general conclusions set out in Part 3. Our seminar papers borrowed from the comparative study undertaken by the Legal Certainty Group of the law on intermediated securities in each Member State.¹⁸ This study proved of great assistance in our attempt to ensure that our own conclusions were sufficiently compatible with the laws of other EU jurisdictions.
- 1.24 The first seminar paper sets out the Law Commission's initial view of the general policy issues and market needs of participants that hold, transfer and pledge indirectly held securities in settlement systems.
- 1.25 The second seminar paper contains a discussion of:

- (a) the scope and enforceability of account holders' rights;

¹⁷ www.lawcom.gov.uk/docs/9th_Prog_Final.pdf

¹⁸ The comparative study took the form of a legal questionnaire completed by the members of the Legal Certainty Group. The questionnaire is available on the Legal Certainty Group's website www.ec.europa.eu/internal_market/financial-markets/clearing/certainty_en.htm

- (b) the protection of account holders' securities from the claims of an insolvent intermediary's creditors;
- (c) the application of the 'no look through' principle in relation to claims against intermediaries as well as the related issue of upper tier attachment; and
- (d) the treatment of shortfalls in an intermediary's account.

1.26 The third seminar paper considers:

- (a) the formalities of transferring intermediated securities;
- (b) the moment at which intermediated securities are deemed to have been transferred;
- (c) the finality of transfer; and
- (d) the defences available to a transferee against adverse claims.

1.27 A fourth and final seminar paper covering the use of intermediated securities as collateral was planned for later in 2006 but was postponed following our decision to concentrate on an analysis of the Convention in preparation for the upcoming UNIDROIT plenary sessions.

1.28 While the seminar papers constituted work in progress at the time of their publication, they set out in detail the legal issues that are discussed or referred to in this Updated Advice. Each of the seminar papers can be accessed from the project web-page on the Law Commission web site.¹⁹

Interim advice to the Treasury

1.29 In September 2006 we submitted to the Treasury our interim advice in relation to the Convention. The Interim Advice was prepared to assist the Treasury in determining the position that the UK Government should take in negotiations at the third drafting session of the Convention in November 2006. The Interim Advice was published on the project's web-page in October 2006 inviting comments from consultees. We received a small number of comments that were taken into consideration when producing this Updated Advice.

Report and Updated advice to HM Treasury

1.30 The purpose of the Updated Advice is to advise the Treasury in relation to the fourth and final drafting session of the Convention prior to its submission to a diplomatic conference.

1.31 The Updated Advice restates the Interim Advice given by the Law Commission to the Treasury in October 2006 and updates it to take into account revisions made to the draft Convention by the third plenary session of the UNIDROIT Committee of Governmental Experts held in November 2006. The Updated Advice contains a detailed commentary and comparative review of:

¹⁹ www.lawcom.gov.uk/investment_securities.htm

- (1) The LCG Advice;²⁰ and
 - (2) The latest draft of the Convention.
- 1.32 We intend to update this advice again following the fourth session of UNIDROIT and prior to the diplomatic conference in order to take into account changes made to the Convention in May 2007. If the Treasury requires, we may follow this with a final advice after the diplomatic conference giving our comments on the final draft of the Convention.
- 1.33 The Updated Advice is being placed on our web site and circulated to consultees so that interested parties can submit further reflections, which will be passed on to the Treasury.

Advice on innocent purchasers of intermediated securities

- 1.34 In addition to our advice on the Convention we have set out in Part 5 our proposals for domestic legislation to increase the legal protection afforded to purchasers of intermediated securities. For the reasons set out in our proposals, we believe that there are sufficient grounds for passing domestic legislation in relation to this discrete aspect of intermediated securities law notwithstanding the likelihood of European legislation at some stage in the future.

PLAN OF THIS REPORT

- 1.35 Part 2 of this Report describes the historical development of intermediated securities holding. Part 3 contains a list of general conclusions reached by the Law Commission over the course of the project. Part 4 sets out our Updated Advice on the Convention. Part 5 contains our advice in relation to innocent purchasers of intermediated securities. Finally, the Appendix contains a marked-up version of the Convention showing the Law Commission's proposed changes to the latest draft.

²⁰ This advice is available at http://ec.europa.eu/internal_market/financial-markets/docs/certainty/advice_final_en.pdf.

PART 2

HISTORICAL DEVELOPMENT OF INTERMEDIATED SECURITIES HOLDING

INVESTMENT SECURITIES

- 2.1 The term 'investment securities', when used generally, encompasses a wide range of transferable financial assets issued to raise funds on the capital markets. Investment securities are effectively pseudo-property rights which give the owner a personal claim directly enforceable against the issuer but which themselves constitute items of property that can be traded by investors. Broadly speaking, investment securities can be split into two categories: debt securities, embodying an obligation by the issuer to repay a debt to the holder (such as bonds and money market instruments) and equities that give the owner economic and corporate rights in relation to the issuer (for example, shares).
- 2.2 Investment securities have traditionally been represented in paper form. In the case of 'registered' securities, paper certificates act as prima facie evidence of the ownership of the securities¹; title is conferred not by the certificate but by entry in the register of the issuer. In the case of 'bearer' securities, the paper document legally constitutes the securities and the rights that they embody. Delivery of the document is sufficient to transfer ownership of the bearer securities.² In each case, the transfer of registered and bearer securities has required the use of paper either by way of delivery of transfer forms and the issuance of certificates for registered securities or else by delivery of bearer securities.
- 2.3 Historically, the commercial developments in the ownership and transfer of investment securities have followed slowly but steadily behind similar developments in the holding and transfer of money. Principal among these developments has been the depositing of financial assets into the custody of financial institutions. This development sprung originally from the public's growing confidence in the financial stability of these institutions and in their desire to reduce the costs and risks associated with holding and transferring securities.³

¹ Companies Act 1985, s186 in the case of shares constituted under English law.

² The possessor of the bearer instrument must have acquired it from someone who intended to transfer ownership. A thief will not have good title although it can convey good title to an innocent purchaser if it is a holder in due course (see paras 5.18-5.21 below).

³ See R Guynn, *Modernizing Securities Ownership, Transfer and Pledging Laws* (Capital Markets Forum of the International Bar Association, 1996) pp 16-24.

2.4 The trend towards the intermediation of securities has been driven in recent decades by a number of developments in modern securities markets. Foremost among the forces for change was a need to overcome the disadvantages of a paper-based settlement system. Not only are paper certificates expensive to produce - they must be security printed in order to reduce the risk of forgery - but, in the form of bearer securities, they are more vulnerable to theft or loss. The decline of paper-based settlement was precipitated by the increasing administrative burden of using paper as the volume of transactions rose in the second half of the twentieth century. In the US, the labour-intensive process of delivering bearer physical certificates or surrendering registered securities certificates for registration reached crisis proportions by the late 1960s.⁴ The UK was to experience a similar 'paper crunch' in the 1980s following the privatisation of nationalised industries and the 'Big Bang' restructuring of the London equity markets.

2.5 By this time, technology was able to relieve the problem by replacing a system based on paper certificates and transfer forms with an electronic settlement system. The Group of Thirty in its 1989 Report⁵ identified two principal measures that could be adopted in a computerised settlement regime to accommodate the replacement of paper, namely dematerialization and immobilisation.

Dematerialization and immobilisation

2.6 'Dematerialisation' involves the issuance of securities without a paper certificate to constitute or evidence them.⁶ A dematerialised security (also known as an 'uncertificated security') is represented instead by an electronic record and is transferable by amendment of an electronic register. Securities that are 'dematerialised' therefore exist only as intangible assets. Securities can be issued in dematerialised form from the very outset or can be dematerialised by cancelling the existing certificates.

⁴ See UCC Revised Article 8 (1994 Revision), Prefatory Note, 1B.

⁵ The Group of Thirty Report *Clearance and Settlement in the World's Securities Markets*. The Group of Thirty is a leading consultative group on international economic and monetary affairs.

⁶ The Group of Thirty Report *Clearance and Settlement in the World's Securities Markets* defines dematerialisation as "the elimination of physical certificates or documents of title which represent ownership of securities so that securities exist only as computer records."

- 2.7 While dematerialisation has been embraced over recent decades by a number of countries it is still far from universal in securities markets.⁷ One of the principal reasons for this has been the trend towards ‘immobilisation’ of securities. While dematerialization offers a means of creating a completely paperless settlement system without affecting the direct relationship between investor and issuer, immobilisation entails depositing securities in paper form with a depository linked to a settlement system so that they are held indirectly. Where a new issue of securities is immobilised from the outset, the entire issue will be typically constituted by a single ‘global’ or ‘jumbo’ certificate which remains in the vaults of the depository.⁸ The depository (or its nominee) becomes the owner of the securities either by registering the securities in its name with the issuer (in the case of registered securities) or by physical possession of the global certificate (in the case of bearer securities).
- 2.8 Participants in the settlement system keep interests in the immobilised securities by holding an account with the securities depository. These account holders are able to transfer and pledge their interests in the securities through book entries on the depository’s books rather than by re-registration or by delivery of the underlying securities. Following the computerisation of settlement systems in the late twentieth century, the depository’s ‘books’ that record ownership are now electronic records.

⁷ As a result of the ‘paper crunch’, amendments had already been made to Article 8 of the US Uniform Commercial Code in 1978 to permit for the evolution of a parallel system in which issuers would no longer have to issue certificates. In France, dematerialization became compulsory for securities in 1984. In the United Kingdom, section 185 of the Companies Act 1985 places a duty upon companies to produce and deliver certificates for all shares and debentures that it has issued. Dematerialisation was, however, given statutory authority in respect of securities issued in CREST in 1995: the statutory basis is now the Uncertificated Securities Regulations SI 2001/3755.

⁸ Interests in the global note may be exchangeable for definitive certificates, so that the investor can acquire a direct relationship with the issuer. Usually, however, the global note is intended to be permanently immobilised and cannot be split into definitive certificates other than in extreme circumstances, such as the failure of a bond trustee to act on the instructions of the investors upon a default.

- 2.9 Immobilisation was the securities industry's practical solution to the paper-crunch. While dematerialisation required legislation to give it effect, immobilisation required a change in market practice and was therefore able to evolve first. One of its consequences was to slow the impetus towards the complete removal of physical certificates. By removing the need to issue paper certificates to each investor and virtually eliminating the risk of loss or destruction of certificates immobilisation effectively cured the problems that dematerialization was intended to solve. Immobilisation also had the support of vested interests in the indirect holding system. For as long as securities are immobilised in the form of a global certificate, investors are obliged to settle through the securities depository or an account holder of the depository.⁹ The use of immobilisation as a technique to reduce the need for paper has contributed significantly to the intermediation of investment securities

The benefits of intermediation

- 2.10 The trend towards holding investment securities through an intermediary is by no means simply a function of the need to immobilise paper securities. Indeed, dematerialised securities are very often held through an intermediary. This is because intermediation offers a number of practical advantages to the investor and issuer. Some of these benefits are listed below.

Transferability

- 2.11 Recording investors' interests in securities as electronic bytes of information enables these interests to be transferred with ease from one account holder to another simply by a credit and debit in the computerised accounts of an intermediary. As long as the legal system recognises this as a valid transfer of an interest in securities, traditional formalities associated with the transfer of underlying securities (for example, the execution of stock transfer forms and the issuance of new certificates) can be avoided. Greater transferability of securities enhances liquidity and consequently their value.

Enabling market sophistication

- 2.12 In order for settlement systems to benefit from technological innovation and efficiency, they are reliant upon their participants being sufficiently equipped to interconnect with them. They also rely upon their participants understanding the often-complex rules of the system. Holding securities through a financial intermediary allows investors to access the system without the need for them to acquire this financial and technological sophistication.

⁹ As Russell Hakes observes in connection with the US securities markets: "With indirect holding, an investor does not make a trade without coming back to the broker through whom it indirectly holds the security." See R Hakes 'UCC Article 8: Will the indirect holding of securities survive the light of day' (2002) 35 *Loy LA Rev* p 669.

Access to custodial services

- 2.13 The growth in the custody of assets has enjoyed a symbiotic relationship with the development of other financial services associated with custody. These services include prime brokerage,¹⁰ stock lending, dividend monitoring, collateral management and investment management. Investors will often choose to hold securities through a financial institution that offers these services.

Efficient division of labour

- 2.14 It is not uncommon for an investor to hold its investment through multiple tiers of intermediaries. Multi-tiered holding structures of this kind produce an efficient division of labour, removing the need for each transfer to be centrally recorded in the register of the issuer or settlement system operator. The pyramidal structure of indirect holding systems can also reduce the burden on an issuer or central securities depository of processing corporate actions such as dividend payments and voting rights by reducing the number of shareholders on the issuer's register.

Administrative convenience

- 2.15 The internationalisation of the capital markets has made it common for investors to hold securities of issuers located in many different jurisdictions. Intermediation enables the investor to hold its international portfolio in a single account with an intermediary. The investor's intermediary may hold intermediated securities within the portfolio through a complex structure of links with issuers and other intermediaries in different settlement systems. The investor can avoid the administrative burden of establishing and maintaining these links itself.
- 2.16 The concentration of the investor's interests into one account with a single *situs* can also greatly simplify conflicts of laws issues. This is of particular benefit to lenders wishing to take security over a portfolio of securities. Provided that the choice of law rules applied to the different intermediated securities are clear, the lender need only concern itself with the perfection requirements of the jurisdiction in which the account is located rather than the requirements of each of the jurisdictions applicable to the various underlying securities.¹¹

¹⁰ In general terms, prime brokerage involves the intermediary lending funds to its account holder to purchase the securities. The securities are held by the intermediary as custodian and are used by it as collateral for its account holder's debt.

¹¹ Both the Financial Collateral Directive and the Settlement Finality Directive have sought to provide legal certainty as to the applicable law by incorporating a conflicts rule in relation to book-entry securities.

Pooled Accounts

- 2.17 Before we move on to consider the way in which legal systems have addressed the legal needs of account holders, we should first briefly describe the most common method used by intermediaries to hold their customers' securities. Where an intermediary holds fungible securities¹² for more than one investor it will typically pool these securities in a single client account. To do so, the intermediary opens an account with the issuer or intermediary above it in its own name and records in its own books each individual investor's allocation in the pooled account. In most legal systems, the only reference to an investor's specific allocation is made in its intermediary's accounts and not in the accounts of any higher-tier intermediary or in the register of the issuer.
- 2.18 These 'omnibus' or 'pooled' customer accounts are generally easier and cheaper for an intermediary to operate than opening 'segregated' accounts for each customer.¹³ The effect of commingling securities in this way can, however, present problems for legal systems faced with the need to protect account holders' property interests. We shall return to this problem later in this Part.

Central Securities Depositories in Indirect Holding Systems

- 2.19 The efficiencies generated by intermediation led the Group of Thirty to recommend in 1989 that each domestic market should establish a central securities depository (CSD) to hold both physical and dematerialised securities in the relevant market.¹⁴ Immobilisation of securities is therefore centralised in a single depository (or through a nominee of the CSD). An indirect holding system based on the immobilisation of securities in a domestic CSD is the most common model in advanced countries¹⁵ and there are about thirty systems operating in this manner in Europe alone. As we explain below, the UK does not operate a centralised depository for domestic securities in this way.
- 2.20 In addition to national CSDs, Euroclear in Brussels and Clearstream in Luxembourg operate as international central securities depositories (ICSDs). ICSDs were originally established to manage clearing and settlement of Eurobonds for which there was no supporting market infrastructure. Since their creation over thirty years ago, the business of ICSDs has expanded to also cover most domestic and internationally traded securities. Euroclear and Clearstream maintain links to CSD counterparts in all the significant domestic financial markets, facilitating cross-border securities trading, clearing and settlement.

¹² Fungible securities are securities that are interchangeable with each other, typically as a result of having the same terms and conditions and belonging to the same series of issue.

¹³ Segregated accounts require the intermediary to open a separate account or make a separate register entry with the intermediary or issuer above it in which are credited the specific number of intermediated securities to which the client is entitled.

¹⁴ The Group of Thirty, *Clearance and Settlement in the World's Securities Markets*, Recommendation 3 (March 1989) p 7.

¹⁵ In America, the Depository Trust Corporation (DTC) has custody, through its nominee Cede & Co, of between 60% to 80% of all publicly traded securities in the US. In 1999, this amounted to securities worth \$23 trillion.

The United Kingdom Settlement System

- 2.21 Investment securities constituted under English, Scots and Northern Irish law can take either certificated or dematerialised ('uncertificated') form. CREST is the main securities settlement system in the UK and settles securities in uncertificated form.¹⁶ Unlike system operators in most national settlement systems, CREST does not hold domestically issued securities¹⁷ as a central securities depository for account holders. CREST has no proprietary rights in the securities and is not treated as 'holding' these securities from the issuer on behalf of its participants. Rather, the CREST member is treated as holding directly from the issuer. This CREST member alone is entitled to exercise voting, dividend and other rights attaching to the shares and may do so directly against the issuer.
- 2.22 Instead, it is the register operated by CREST which, in the case of UK securities, is actually constituted by statute¹⁸ as the sole legal record of entitlement to the securities. Although the issuer will maintain a regularly reconciled record of what is held in CREST for corporate events purposes, it is the CREST register that confers legal title and which determines the person or entity named in the register as the shareholder for company law purposes
- 2.23 The CREST member may be holding the securities for its own investment purposes or may be an intermediary holding the securities on behalf of its client. As we shall see when we come to examine the Convention,¹⁹ CREST may fall within the definition of an intermediary in the Convention even though it does not hold the securities or disturb the direct legal relationship between CREST member and issuer. If so, even CREST members holding securities for their own account may fall within the scope of the Convention and the European project generally.

LEGAL ANALYSIS OF INTERMEDIATED SECURITIES

- 2.24 Intermediation has had a substantial effect in transforming the legal nature of investor's rights in securities. In the UK and elsewhere, the traditional analysis of an investor's rights arising from its direct relationship with an issuer and based on its physical possession of securities or by an entry in the issuer's register no longer reflects the reality of the market place.

¹⁶ On average CREST handles in excess of 300,000 transactions and moves £650 billion in cash and £1 trillion in stock each day: See FSA, *Assessment of CREST Against the CPSS-IOSCO recommendations for Securities Settlement Systems* (June 2006) p 6. Certificated securities can be settled outside CREST by transfer of certificates and stock transfer forms but settlement may be subject of the delays inherent in the handling and processing of documents..

¹⁷ That is, in the UK, Republic of Ireland, Isle of Man, Guernsey and Jersey.

¹⁸ 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. 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.

¹⁹ See paras 4.18-4.20 below.

- 2.25 In order for indirect holding systems to remain attractive to an investor, they must not leave the investor in a significantly weaker position than if it held the securities directly. The attendant advantages of intermediation must not come at the expense of the investor's basic legal needs.
- 2.26 In simple terms, an investor's needs are twofold. First, the law must be able to protect the account holder's interests in securities (including any economic benefits derived from the securities) from the claims of its intermediary's creditors. 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.²⁰
- 2.27 Secondly, the law must provide the account holder with sufficient legal rights and remedies to enable it to exercise the rights and enjoy the economic benefits derived from the securities.
- 2.28 As will be explained later in this Part, English law generally achieves these needs by way of a trust arrangement.

National law reform

- 2.29 In some countries, the significant market developments in the holding of investment securities have already prompted them to revise their legal frameworks to address the realities and needs of the marketplace.
- 2.30 Perhaps the most substantial legislative reform was undertaken by the United States in its revision of Article 8 of the Uniform Commercial Code ("UCC Article 8") in 1994. The revision involved the creation of new legal regime for intermediated securities based around the concept of a 'security entitlement'.²¹ A security entitlement constitutes a bundle of property rights and contractual rights belonging to an account holder that arise upon a credit of securities to its account. The package of rights arising from a security entitlement are almost exclusively enforceable only against the account holder's intermediary. UCC Article 8 contains detailed rules and commentary to address such matters as the duties of an intermediary and the rights of account holders and purchasers. Canada has recently modelled the proposed revision to its securities transfer legislation on UCC Article 8.²²

²⁰ 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.

²¹ UCC Article 8-103(a)(14). . The legal regime was developed under the presupposition that: "Modern securities markets have moved so far beyond the movement of pieces of negotiable paper that the property law construct is inadequate and unworkable." C W Mooney 'Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries' (1990) 12 *Cardozo Law Review* 305 at p 313

²² The Canadian Securities Transfer Act became effective in Ontario and Alberta on 1 January 2007. Other territories and provinces are expected to follow suit.

- 2.31 Belgium²³ and Luxembourg²⁴ are each home to major ICSDs (Euroclear and Clearstream respectively) and both have recently clarified their respective securities laws. Investors that hold securities through an intermediary in an omnibus account²⁵ are treated as having a co-ownership right in the pool of fungible securities, exercisable only against the intermediary. Should the intermediary fall insolvent, the investor is given a right of *revendication*, that is to say, a claim for the return of property enforceable against the intermediary and its creditors.
- 2.32 Japan and Switzerland are further examples of countries that have undergone reviews of their laws in relation to indirectly held investment securities.

The differences between holding systems

- 2.33 Unsurprisingly, there are a number of significant differences in the way multi-tiered holding systems have developed in various jurisdictions. We have identified four categories within which most of these differences can be placed. These are:
- (1) differences in the way an investor's rights in the underlying securities are enforced against the issuer;
 - (2) differences in the manner in which an account holder's interest in securities is recorded within a chain of intermediaries; this is commonly referred to in terms of the 'transparency' of the system;
 - (3) differences as to whether or not a credit to an account must be matched with a corresponding debit in order for a transfer to be valid; and
 - (4) differences in the manner in which legal systems address the effect of commingling securities in a pooled account.
- 2.34 We explain these basic differences between holding systems in the EU below before describing in more detail the legal analysis of intermediated securities under English law.

²³ Belgian Royal Decree No. 62, as co-ordinated by Royal Decree of 27 January 2004.

²⁴ Luxembourg Law of 1 August 2001 on the circulation of securities and other fungible instruments, Articles 6.7 and 15.

²⁵ See para 2.17 above for a description of pooled accounts.

Direct enforcement versus indirect enforcement

- 2.35 In all common law jurisdictions (such as the UK and the US) and a number of civil law countries (for example Belgium and Luxembourg), an investor that holds through an intermediary is unable to exercise the rights it may have in the underlying securities directly against the issuer of those securities.²⁶ The investor can only enjoy the fruits of its investment by enforcing its rights against its intermediary. Furthermore, the investor will be generally prohibited from making a claim against securities held in the account of a higher tier intermediary but must rely on the contractual and fiduciary obligations of its own intermediary to pursue such claims.
- 2.36 This indirect approach contrasts with some other legal systems. The German system for holding domestically issued securities through intermediaries is an example of a direct enforcement system.²⁷ Investment securities (both equity and debt) are issued in the form of negotiable instruments, normally represented by one global certificate, which is deposited with the CSD (*Wertpapiersammelbank*).²⁸
- 2.37 However, 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*). The CSD 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.
- 2.38 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. This may require it to present confirmation of its legal ownership from the intermediaries in the chain above it.
- 2.39 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. Neither the CSD nor the intermediaries below it have any legal ownership interest in the securities.

²⁶ Unless the issuer permits otherwise by contract or provisions in a deed poll or trust deed.

²⁷ 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. The French system is another example of a direct enforcement system.

²⁸ At present only Clearstream Banking Frankfurt AG is licenced as a *Wertpapiersammelbank*.

- 2.40 The Spanish holding system for listed securities²⁹ 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, the Spanish CSD. 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.
- 2.41 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.
- 2.42 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.

Transparent versus non-transparent systems

- 2.43 A further distinction between securities holding systems in different jurisdictions can arise as a result of the law treating certain entities within the holding chain as 'transparent'. The transparency of the entity within the chain will result in the names of its account holders being recorded not only in its books but also in the books of the intermediary above it, typically the CSD. The legal effect of this is usually to permit a lower tier claimant to make an attachment order against the securities at the level of the CSD.³⁰
- 2.44 The Spanish system offers an extreme version of transparency inasmuch that it treats the central register (operated by the CSD) and the detailed registers (operated by financial intermediaries) as one registry.³¹ 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. The corresponding RR in each tier of the registry allows securities to be traced to the participant's customers.

²⁹ Securities listed in Spanish Regulated Markets.

³⁰ The issue of transparency is independent from the issue of direct relationship between issuer and investor and there is no causal link between the two. Jurisdictions such as France and Germany provide a direct relationship between issuer and investor but are not transparent as the investor's name is recorded only in its own intermediary's accounts. Unlike the German system, the Spanish direct enforcement system is transparent as regards the ownership of securities by the participant's customers.

³¹ Royal Decree 119/1996.

- 2.45 As will be considered in the analysis of the Convention below, the ability to ‘look-through’ an intermediary is a significant breach of the prohibition against upper-tier attachment adopted by non-transparent systems and espoused as one of the central tenets of the Convention.³² UNIDROIT has established a working group to consider issues relating to transparent systems in more detail prior to the fourth plenary session in order to propose solutions to this potential conflict.

Matching versus non-matching systems

- 2.46 Normally where a credit is made as a result of a transfer of securities there will be a corresponding debit in another account. However, in the UK as well as other jurisdictions it is not a legal requirement for the account holder to identify a corresponding debit in order for its proprietary rights to be effective. Processes such as multi-lateral netting and clearing through a central counter-party can make it virtually impossible to trace the credit back to a specific debit. If the credit is later found to have been the result of a defective trade, the account holder will not necessarily lose its proprietary claim to the pool of securities that are in its intermediary’s account.
- 2.47 In a number of jurisdictions including many European settlement systems, a credit of securities to an account holder is not treated as having effect unless the credit can be matched with a corresponding debit. Failure to match the trade will result in reversal or invalidation of the credit. The settlement systems in such jurisdictions will generally have procedures in place to limit the possibility of a mismatch.
- 2.48 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. This is of particular concern to direct enforcement systems. If credits are not matched with corresponding debits in such systems, the issuer could be faced with direct claims from investors who together 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 holding intermediated securities 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.

³² See para 4.35 below.

Legal methods of protecting rights in commingled securities within the EU

- 2.49 The effect of commingling securities in a pooled account is generally to preclude the continuing existence of direct property rights of individual owners in the specific securities held prior to commingling.³³ Put simply, the client is unable to identify which of the fungible assets in the pool belong to it. In the absence of direct property rights, there is a risk that 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. A significant challenge faced by both common law and civil law traditions in protecting account holders arises where interests are commingled within the same account in this way.
- 2.50 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. These methods can be split into three general categories.

LEGAL PROTECTION BASED ON CO-OWNERSHIP

- 2.51 In a number of EU 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.
- 2.52 In Belgium³⁴ and Luxembourg,³⁵ 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.
- 2.53 In Germany, an account holder in a pooled account is the co-owner of a pool of fungible securities held in collective safe custody (typically in bearer form) with the CSD.

LEGAL SYSTEMS REQUIRING SEGREGATION OF CUSTOMER AND INTERMEDIARY ASSETS

- 2.54 In some EU Member States, 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 is described in detail below, 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.³⁶

³³ R Potok, *Cross Border Collateral: Legal Risk and the Conflict of Laws*, (2002) p 21.

³⁴ Belgium Royal Decree No 62, Article 2.

³⁵ Securities Act 2001, Article 7.

³⁶ See para 2.64.

- 2.55 French law, for example, 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*”).³⁷ 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.
- 2.56 Other Member States requiring segregation include Hungary, Italy,³⁸ Lithuania,³⁹ Malta and Greece⁴⁰.

STATUTORY PROTECTION LIMITED TO SETTLEMENT SYSTEM PARTICIPANTS

- 2.57 In some EU Member States statutory protection for intermediated securities is limited to accounts opened with the CSD or the CSD’s participants (or nominees).⁴¹
- 2.58 An account holder that holds dematerialised Spanish listed securities through a participant in the Spanish CSD 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 the CSD participant’s account holder.⁴² Account holders that do not hold securities directly through a CSD participant do not have clearly defined rights against their intermediary’s creditors.⁴³

³⁷ Co-proprietary rights are not recognised under French law.

³⁸ The Financial Law Consolidated Act 1998 and Legislative Decree 213 of 1998. The intermediary or its representatives are criminally liable for the breach of the segregation rules.

³⁹ 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.

⁴⁰ The requirement for segregation applies to securities held in the System for Monitoring Transactions in Book-Entry Securities.

⁴¹ Eg Estonia which grants protection only to account holders holding through nominee accounts opened with the Central Registry (s 6(3) of the [ECRSA]).

⁴² 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.

⁴³ Under Spanish law, an investor’s rights in these circumstances 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.

The analysis of intermediated securities holding under English law

The use of a trust

- 2.59 English law has come to recognise a deposit of cash as giving the depositor only a personal contractual claim against the bank or custodian to deliver to it an equivalent amount of cash. By contrast, an intermediary that acquires investment securities for its client will invariably hold them either under a bailment or a trust arrangement.
- 2.60 In the case of a bailment, the intermediary acquires actual possession but not ownership of the securities. Legal title remains with the investor as bailor. In order for the bailee to have possession, the securities must be tangible assets capable of transfer by delivery (namely, bearer securities).⁴⁴ The need for possession rules out the use of bailment for securities that are registered in the register of the issuer or are evidenced by a credit to the account of an intermediary.
- 2.61 The trust has emerged as by far the most common arrangement for the custody of both bearer and registered securities.⁴⁵ It enables the investor, as beneficiary under the trust, to retain an equitable proprietary interest in the specific pool of securities held for it by its intermediary and so protect these assets from the claims of the intermediary's creditors.
- 2.62 Trust law imposes upon the intermediary a series of fiduciary duties owed to its account holders. These include a duty to obey the terms of the trust, to safeguard the trust assets and to account for any profits arising from the securities held on trust. The terms of the trust instrument will modify and add to the package of fiduciary obligations arising under general law.

⁴⁴ The effect of delivery can be varied by the intention of the parties. Delivery for the purposes of safekeeping creates a bailment whereas delivery by way of security interest creates a pledge: see J Benjamin *Interests in Securities* (2000), p 39 fn 42.

⁴⁵ Parties are deemed at law to intend the legal consequences of their actions [*Swiss Bank Corporation v Lloyds Bank*, [1980] 2 All ER 419, by Buckley LJ p 426]. Therefore the probable result of a custodian agreeing to hold intangible securities for clients on the basis that the client continues to have a proprietary interest in them, is to create a trust. 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.

Commingling of securities under English law⁴⁶

- 2.63 In English law, 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.⁴⁷ 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.⁴⁸
- 2.64 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. 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.⁴⁹
- 2.65 It may seem to be 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 which securities are held on trust for account holders and which belong to the intermediary.⁵⁰ Segregation of customer and intermediary assets would seem to be a prerequisite to the creation of a valid trust and therefore to protection from the intermediary's creditors.⁵¹

⁴⁶ For further explanation of this legal issue, see Law Commission Seminar Paper 2 'Legal Issues Affecting Intermediaries', paras 1.45-1.60.

⁴⁷ *Re London Wine Company (Shippers) Limited* [1986] PCC 121, 137, by Oliver J.

⁴⁸ AO Austen-Peters *Custody of Investments Law and Practice* (2000) p 42.

⁴⁹ 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.

⁵⁰ See *Stapylton Fletcher Ltd* [1995] 1 All ER 192.

⁵¹ 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."

- 2.66 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*,⁵² the Court of Appeal affirmed the decision at first instance that Moss had declared a valid trust.⁵³ 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.
- 2.67 *Hunter v Moss* has been the subject of much academic criticism but has nevertheless been followed in *Re Harvard Securities*⁵⁴ and *Re CA Pacific Finance Ltd*⁵⁵ and stands as the current law.⁵⁶
- 2.68 Professor Sir Roy Goode puts forward a third analysis based both upon co-ownership and upon a distinction between tangible and intangible assets.⁵⁷ 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 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.
- 2.69 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.

The current deficiencies in English law

- 2.70 The trust offers a flexible arrangement for the custody of securities based upon long developed principles of English law. The investor has a beneficial, equitable interest in securities enforceable against its intermediary and protected against the claims of its intermediary's creditors.
- 2.71 Despite the basic soundness of English law in relation to the holding, transfer and pledge of intermediated securities, uncertainties and deficiencies do exist. IN summary, the FMLC Report identifies them as follows:

⁵² [1993] 1 WLR 934; [1994] 3 All ER 215, CA.

⁵³ [1994] 3 All ER 215.

⁵⁴ [1997] 2 BCLC 369.

⁵⁵ [2000] 1 BCLC 494.

⁵⁶ 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.

- (1) Nature of the account holder's rights: While a trust is by far the most common custody arrangement for investment securities, English law lacks a clear rule specifying the bundle of personal and proprietary rights that an account holder is presumed to enjoy in the absence of contrary agreement.
- (2) The allocation of shortfalls in an account: Where fungible securities are pooled in a single account by an intermediary for its account holders, there is a lack of clarity in English law as to how shortfalls in that account should be allocated to the account holders.
- (3) Third party claims and instructions: While an intermediary acting as trustee is entitled to act on the instructions of its account holder, circumstances may arise where an intermediary is uncertain whether it can act without exposing itself to liability. This may occur where it becomes aware of an adverse claim from a third party or where it is given instructions from another person claiming to act for the account holder.
- (4) Perfection and priority of security interests: Further clarity is needed as to the circumstances in which a security interest over intermediated securities in an account can be perfected (so as to be effective against third parties) as well as the priority of competing claims in the same asset.
- (5) Look-through and upper tier attachment: English law generally prevents a beneficiary under a sub-trust from looking through its intermediary in order to exercise rights against a higher tier intermediary. There are, however, exceptions to this general rule. The practicalities of fast moving settlement systems and the need for market efficiency require a clear prohibition against looking through to higher tier intermediaries as well as against making attachment orders against securities located in a higher tier account.
- (6) Protection of good faith purchasers: Purchasers of the legal title to securities can generally rely either upon the negotiable status of bearer securities or upon the defence of bona fide purchase of a *legal* estate to protect them from any adverse claims of which they were unaware. Intermediated securities are not negotiable and are equitable, not legal, interests. Consequently, purchasers who acquire intermediated securities by way of a transfer across the books of an intermediary cannot rely on either of these protections. The FMLC considers that the distinction between legal and equitable interests should be irrelevant in this context.

⁵⁷ R Goode 'Are intangible assets fungible' *LMCLQ* [2003] 379.

- (7) Disposition of equitable interests: Under section 53(1)(c) of the Law of Property Act 1925, a transfer of an equitable interest requires a written instrument. While this section is disapplied for settlement through CREST, transfers across the books of intermediaries do fall within its scope. It is unclear whether current market practice involving computerised accounts satisfies this requirement.
- (8) Set-off: The presence of an intermediary may result in the investor having no direct relationship with the issuer. This may result in the investor having no right of set-off.
- (9) The legal validity of a trust of pooled securities: While the validity of a trust of pooled securities seems to be now settled following the Court of Appeal decision in *Hunter v Moss*, it would be helpful to express this position in legislation.

2.72 We agree with the FMLC's legal analysis of current English law. In our opinion, the Convention, if adopted in its current form, would satisfactorily address each of these deficiencies.

PART 3

OUR GENERAL CONCLUSIONS

- 3.1 The conclusions set out below address legal issues that were identified in the early stages of the project as being fundamental to the creation of a common legal framework for the ownership and transfer of intermediated securities. We have borne these conclusions in mind when evaluating the suitability of the Convention and have used them as an aid to compiling our comments and proposals for amendment to successive drafts of the Convention. They are listed in the order that they were discussed in the public seminars.

Protection from an Intermediary's creditors¹

- 3.2 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 other 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 other creditors.
- 3.3 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, the segregation of customer and intermediary assets should not be a prerequisite for protection against creditors in a harmonised legal framework.
- 3.4 The protection granted by the legal framework should take effect, at the latest, 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.

¹ See paras 4.119-4.125 below for an analysis of the Convention's handling of this issue.

The allocation of losses²

- 3.5 Potential losses arising from settlement failure, operational error and fraud 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 can reduce the risk of account imbalances (shortfalls) existing by automatically allocating the potential loss 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.
- 3.6 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 pooled account. We see no reason why this risk sharing should apply only to non-matching systems and not also to matching systems.³
- 3.7 Subject to domestic law and with the consent of the intermediary, an account holder should be able by arrangement with its intermediary to segregate its account and avoid sharing in shortfalls in other customer accounts. Segregation is effected by the intermediary opening a separate account with the issuer above or the upper tier intermediary in which the intermediary holds securities on behalf of the particular customer.
- 3.8 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.
- 3.9 Where an intermediary has commingled its own securities with those of its account holders, a loss arising from the intermediary's 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 subject to the terms of the contract.

² See paras 4.160-4.171 below.

³ The Convention currently leaves it for domestic law to determine the validity and reversal of debits and credits. As a result, matching systems would not need to apply loss-sharing in this way. While we would clearly prefer it to apply to both matching and non-matching systems we do not view this as essential.

- 3.10 Where an intermediary has segregated its house securities in a separate account with an upper tier intermediary or issuer, a loss in its customer account should first be allocated to the intermediary's house account only if the customer has a proprietary right to trace and claim the house securities under domestic law.. If the intermediary is not responsible, it is difficult to justify the allocation of any of the loss to its segregated house securities.

Scope and enforceability of account holders' rights⁴

- 3.11 The valid credit of securities to an account should give the account holder a right to instruct its intermediary to transfer the securities or withdraw them from the account. The right is effective against third parties and enforceable against the account holder's own intermediary (subject to any security interest the intermediary may have).
- 3.12 The valid credit of securities to an account should give the account holder 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 the account holder's own intermediary. Subject to national law, the right may also be enforceable against the issuer.
- 3.13 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.
- 3.14 A common legal framework should ensure that national law permits the effective exercise of rights enjoyed by account holders. Accordingly, rules that prevent split voting or that otherwise restrict an intermediary from exercising the corporate rights that attach to securities held in a pool should be prohibited in the case of publicly held securities.
- 3.15 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 the account holder's account.

No-look-through principle⁵

- 3.16 An account holder may enforce its rights in relation to the intermediated securities against its own intermediary. If national law permits, the rights are also enforceable directly against the issuer. An account holder cannot enforce its rights against a higher tier intermediary. 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.

⁴ See paras 4.34-4.38 below.

⁵ See para 4.35 below.

- 3.17 An account holder should however be able to bring a claim against the issuer or an upper tier intermediary in certain limited circumstances such as, for example, where domestic law gives the account holder the ability to step into the position of its intermediary and bring a claim.

Upper tier attachment⁶

- 3.18 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 ensure that omnibus accounts are not frozen due to the insolvency of one of the account holders. Ensuring the lower tier account holders cannot acquire securities higher in the chain also ensures a clear order of priorities between different tiers in a holding chain.

The scope and level of duties owed by an intermediary

- 3.19 Most of the key duties owed by an intermediary arise as a result of the rights that its account holder receives upon a credit to its account. 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.
- 3.20 If at any time an intermediary does not maintain sufficient securities to satisfy this duty, it should be obliged to promptly obtain additional securities.
- 3.21 The intermediary's duties should be subject to the terms of the account agreement with the exception of two obligations that cannot be contractually modified. These are the obligation to maintain sufficient securities (even if liability for breach of this duty can be limited) and the obligation to pass on economic distributions that it receives.

Instructions⁷

- 3.22 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.
- 3.23 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.

⁶ See paras 4.126-4.128 below.

⁷ See paras 4.129-4.131 below.

Formalities of transfer⁸

- 3.24 Rights arising under a harmonised legal framework should be acquired by a credit to the account holder's account. No other formalities should be necessary. Ideally a harmonised legal framework should enable a participant to determine clearly whether or not a credit has been made.
- 3.25 A harmonised rule on transfers should not prevent a transfer being effected by other means under domestic law. The rule is intended to provide a certain means of transfer, not the only means of transfer.

The moment at which interests in securities are acquired

- 3.26 By establishing the credit to an account as the constitutive act that creates rights in intermediated securities, it follows that an account holder should acquire rights in securities upon credit of the securities to its account.

Settlement finality⁹

- 3.27 A harmonised legal framework cannot attempt to provide an exhaustive list of circumstances in which transfers may be reversed or treated as ineffective. A sufficient level of settlement finality can nevertheless be achieved by (1) disapplying insolvency rules that void transfers and netting retroactively; (2) preventing a transferor from revoking a transfer order after a certain point in the settlement cycle; and (3) protecting the finality of transfers to innocent purchasers.
- 3.28 The Settlement Finality Directive fulfils the first two of these objectives in relation to certain designated clearing and settlement systems. The question remains as to whether harmonised rules should deal with the effect of insolvency and the revocation of transfer orders in the case of transfers outside of designated settlement systems. Our conclusion is that they should not.

⁸ See paras 4.39-4.53 below.

⁹ See paras 4.78-4.91 below.

Protection of an innocent purchaser¹⁰

- 3.29 It is important for the operation of securities markets that innocent purchasers are protected from competing claims to the intermediated securities that they acquire. In most cases this is not a problem. Defective trades are uncommon and a loss should occur only where the responsible intermediary is insolvent. Furthermore, the difficulty in tracing securities through omnibus accounts and in systems that net transactions will often provide an effective shield against most claimants. As a result of the difficulties in tracing pre-existing interests, as well as for reasons of efficiency, a person that holds securities through an intermediary should not expect the purchaser of the securities to investigate title to them. Accordingly, if an account holder's intermediary wrongfully transfers securities to a purchaser, the purchaser should take good title unless it has notice or knowledge of a violation of another's rights to those securities can be attributed to it by constructive notice. This should be a minimum protection to purchasers without prejudice to additional defences and rights that they may have under domestic law or the rules of a settlement system (such as CREST).

Collateral¹¹

- 3.30 We did not hold a seminar to discuss legal issues affecting the use of intermediated securities as collateral. However, we are able to identify some basic requirements that we consider a harmonised legal framework should satisfy.
- 3.31 A harmonised legal framework should prescribe one or more steps which, if followed, will render a security interest or limited interest over intermediated securities effective against third parties. These methods of perfection should include both title transfer collateral arrangements (whereby the intermediated securities are transferred to another account) as well as security interest collateral arrangements (where an interest is taken over the collateral giver's account),
- 3.32 The harmonised methods of perfection should be based around a clear concept of 'control' by the interest taker over the intermediated securities being used as collateral.
- 3.33 A harmonised legal framework should have a clear order of priorities as between competing interests made in accordance with the harmonised methods and as between such interests and interests that arise under domestic law.
- 3.34 The rules of a harmonised legal framework should extend to issues of substitution and top-up of collateral as well as the right to use collateral by the collateral taker.

¹⁰ See paras 4.92-4.118 below.

¹¹ See paras 4.54-4.77 and 4.183-4.191 below.

- 3.35 We generally support the approach taken by the Convention in relation to the methods necessary to perfect security. We also note that the Convention has replicated to a large degree the provisions of the Financial Collateral Directive¹² in relation to the enforcement and re-use of book-entry financial collateral.

Potential adoption of the Convention to address the issues faced by the European project

- 3.36 The comparative analysis in the next section of this Advice will show that there are only relatively few issues on which the Convention, the LCG Advice and the Law Commission's own proposals are not generally aligned. Assuming that these differences can be resolved satisfactorily, we share the view of many LCG members that ratification of the Convention will offer the best legislative means of removing the legal barriers to cross-border clearing and settlement systems within the EU. We also note that the Convention satisfactorily addresses the areas of legal uncertainty identified in English law by the FMLC Report. We believe that a shared legal framework with the United States, Japan and other significant capital markets jurisdictions is both achievable and greatly preferable to the existence of two (or more) parallel frameworks operating upon slightly different rules.

¹² Financial Collateral Directive 2002/47/EC (OJL 168/43 27.06.2002).

PART 4

THE CONVENTION: COMPARATIVE ANALYSIS AND COMMENTARY

SCOPE AND SPHERE OF APPLICATION

The Convention

Application to both domestic and cross-border ownership and transfer

- 4.1 The scope of the Convention is broad. Crucially, the Convention makes no distinction between domestic and cross-border ownership and transfer of securities but applies equally to both, provided that the applicable law is the law of a state that has adopted the Convention.¹

Scope of ‘securities’ definition

- 4.2 The Convention applies to all shares, bonds or other financial instruments or financial assets (other than cash), which are capable of being credited to a securities account and of being acquired and disposed in accordance with the Convention.²

Non-business arrangements

- 4.3 The securities account is an account maintained by an “intermediary”,³ being a person who operates securities accounts in the course of a business or other regular activity for others.⁴ In many legal systems such intermediaries will be subject to regulation. The Convention is not, however, limited only to regulated financial intermediaries although non-business situations fall outside its scope.

The advice of the Legal Certainty Group (the “LCG Advice”)

- 4.4 The LCG’s position is generally consistent with the Convention on matters of scope.

Application to both domestic and cross-border ownership and transfer

- 4.5 All book-entries are covered, whether or not they relate to a transaction with a cross-border element.

¹ Article 2.

² Article 1(a). The requirement that the securities be capable of acquisition and disposal is intended to exclude exchange-traded and over-the-counter derivatives. These derivatives represent rights and obligations that are typically settled by off-setting rather than by transfer. Accordingly, it is not appropriate that they fall within the scope of the Convention.

³ Article 1(c).

⁴ Article 1(d). We note that there is a circularity in the definitions of “securities account” and “intermediary”. The two definitions mirror those used in the Hague Convention on the Law Applicable to Securities Held with an Intermediary.

Scope of ‘securities’ definition

- 4.6 The LCG Advice adopts the wide meaning of securities attributed to that concept by EU law. It proposes that scope should not be restricted to ISIN⁵ bearing securities or to listed securities but remain open-ended.

Non-business arrangements

- 4.7 The LCG also shares the view that the new legislation should apply to all intermediaries and not just to those that are subject to financial regulation. It does, however, propose the exclusion not only of non-business arrangements but also of business situations that are not intended to constitute intermediary relationships (for example, some inter-group relationships).

Law Commission Comments

Application to both domestic and cross-border ownership and transfer

- 4.8 We fully support the approach taken by the Convention to include within its scope both purely domestic and cross-border ownership and transfer of intermediated securities. It would not be in the interests of legal certainty to attempt to create two parallel regimes, nor would it always be easy to confirm from one moment to the next whether or not a transaction had a cross-border element.

Definition of securities

- 4.9 We agree that the scope of the legislation should apply to all financial instruments or financial assets (other than cash) that can be credited to an account maintained by an intermediary. The definition must be capable of accommodating changing market practice and financial innovation and we see no benefit in including some book-entry securities and excluding others. We note that the definitions either replicate or very closely resemble the definitions used by the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary (the “Hague Convention”). It is clearly desirable that the scope of the Convention fits within the conflicts of laws regime established by the Hague Convention.
- 4.10 The Convention does not define the terms “financial instruments” or “financial assets”.⁶ Nor does it specify what characteristics a financial instrument or asset must possess in order for it to be capable of credit to an account. It is conceivable that the law in some states may prohibit certain financial assets from being credited to a securities account or may not recognise the credit for legal or policy reasons. Under the Hague Convention, the law governing the recipient’s account will prevail to determine whether or not it is legally possible to record a financial asset as a book-entry. While this raises the potential risk of cross-border incompatibility, we suspect the risk in practice is small.

⁵ International Securities Identification Number. A unique international code which identifies a securities issue.

⁶ “Financial instruments” are defined in the Financial Collateral Directive, Article 2(1)(e).

Non-business arrangements

- 4.11 We consider the exclusion of non-business relationships from the scope of EU legislation to be entirely appropriate. The principal grounds for imposing a harmonised framework within the EU is to enhance market confidence and efficiency in cross-border clearing and settlement. Securities that are held in a non-business arrangement are unlikely to require, or benefit from, the changes needed to achieve this. Rules intended to accommodate computerised settlement and the administration of omnibus accounts will be of little relevance to securities held in a non-business arrangement such as a family trust. It would be overly invasive to require Member States to harmonise their laws in respect of non-business relationships that, by their nature, do not require conformity across the EU.
- 4.12 We agree that the credit of securities to an account in a business situation should not necessarily give rise to an intermediary relationship. However, there should be a presumption that it does. This presumption could be rebutted by particular facts showing, for example, that the parties intend the custodian to have only a contractual duty of redelivery. We would recommend that this presumption should be made explicit in the Convention or, at the very least, included in the explanatory notes.
- 4.13 In the alternative, or in addition, to a rebuttable presumption, the Convention could set out more clearly the circumstances in which an intermediary relationship arises. While difficult to encapsulate within a definition, UCC Article 8 of the US Uniform Commercial Code manages to reach a satisfactory result by focusing on the intentions of the intermediary. It defines a securities account as one for which the person maintaining the account undertakes to treat the account holder as entitled to exercise the rights that comprise the financial asset credited to the account.⁷
- 4.14 A similar result could be achieved in the Convention by incorporating the notion of an intermediary's undertaking into a definition of what is meant by "maintaining" a securities account for others.

THE ROLE OF CSDS

The Convention

- 4.15 The Convention does not apply to the 'issuer-facing' functions of a central securities depository (CSD). These are described in Article 3 as:

the activity of creation, recording or reconciliation of securities conducted by central securities depositories or other persons *vis-à-vis* the issuer of those securities.⁸

⁷ UCC, §8-501(a).

⁸ Article 3.

The LCG Advice

- 4.16 The LCG envisages that the new legislation should apply to all accounts that intermediate between an issuer and investor, This would encompass CSDs when acting in their capacity as account providers. The LCG Advice goes on to state that accounts operated by the CSDs for the sole purpose of establishing securities in book-entry form (sometimes referred to as 'issue accounts') should not be covered by the legislation.

Law Commission comments

- 4.17 The application of the Convention to CSDs raises three main issues in relation to the UK settlement system. The first is the question of whether CREST is an 'intermediary' under the Convention bearing in mind that it does not hold securities. This feeds into the second issue concerning the application of Article 3 concerning CSDs and the eligibility of CRESTco to fall within the scope of the provision. The third issue concerns the difficulties faced by the Convention in accommodating the ownership and settlement of depositary instruments representing foreign issued securities in CREST.

The definition of 'intermediary' and its implications for CREST

- 4.18 The definition of an 'intermediary' is of particular importance to the UK settlement system as it determines whether operators such as CRESTco fall within the ambit of the Convention rules. Unlike CSDs, CRESTco is not recorded in the register of the issuer as holding securities on behalf of account holders but instead operates a register in which CRESTco's participants are named as direct holders.⁹
- 4.19 The Convention defines an intermediary as a person that "maintains securities accounts". The definition is silent on whether the intermediary must hold the securities (or intermediated securities) in a proprietary sense rather than simply operating as record-keeper. In the absence of further qualification, the definition can easily be construed to include CREST. The Explanatory Report on the Hague Convention (which is to be compatible with the Convention and from which many of the Convention's definitions are derived) provides further evidence that operators such as CREST are intended to fall within the definition. It states that:

In the context of a statutory operator of a securities transfer and settlement system, such as the United Kingdom CREST system..., the term 'securities account' is to be interpreted broadly to include any form of entitlements and transfers, whether or not denominated as an account by the operator.¹⁰

⁹ See paras 2.21-2.23 below.

¹⁰ R Goode, H Kanda and K Kreuzer, *Hague Securities Convention, Explanatory Report* (2005), p 32.

- 4.20 The LCG, however, clearly supports the view that such operations should be outside of the scope of the legislation and the definition in the Convention. One option to clarify this issue would be to adopt a declaration mechanism of the kind included in the Hague Convention.¹¹ Another would be to permit direct holding systems to opt-in to specific provisions of the Convention that applied equally to direct and indirect holding systems. This is a matter for discussion between CRESTco and the Treasury.

Application of Article 3 to CREST

- 4.21 It is not altogether clear whether the purpose of Article 3 is to exclude activities that would otherwise fall within the Convention's scope or to clarify that the Convention does not cover these activities at all. Nor is it clear how the provision interacts with the rest of the Convention. If, for example, a reconciliation results in the number of securities in a CSD account being reduced is it only the legal effect of this *vis a vis* the issuer that is excluded from determination in accordance with the terms of the Convention? Or is the legal effect of reducing the securities accounts *vis a vis* the account holders in the CSD also treated as outside the scope of the Convention? We presume the former particularly as the rules of a settlement system (in which CSDs will operate) are already given precedence over a number of specific provisions of the Convention. To permit CSDs to operate entirely outside the scope of the Convention would greatly diminish the harmonising effect of the Convention.
- 4.22 We note that while CRESTco does not act as a central depository for UK issued securities it has issuer-facing functions that it may want to exclude from the scope of the Convention. As we read Article 3, it should be able to do so by falling under the category of "other persons" referred to in the provision.

Depository Interests in CREST

- 4.23 In addition to domestic securities, it is also possible to hold certain international securities through CREST. A CRESTco nominee company (or a nominee company set up by a securities registrar) will hold the securities on trust for the account holder in CREST. This intermediary will be entered as holder of the underlying securities in the register maintained by or behalf of the issuer or in the overseas CSD.

¹¹ Article 1(5) of the Hague Convention states: "In relation to securities that are credited to securities accounts maintained by a person in the capacity of operator of a system for the holding and transfer of such securities on records of the issuer or other records which constitute the primary record of entitlement to them as against the issuer, the Contracting State under whose law those securities are constituted may, at any time, make a declaration that the person which operates that system shall not be an intermediary for the purposes of this Convention."

- 4.24 The foreign securities are not admitted into the CREST system. Instead, the interest of the account holders in CREST (the “underlying clients”) in the non-UK securities held by the intermediary is constituted as a separate securitised “depository interest” issued by the intermediary under English law. The securitised depository interest is credited to an account maintained by CREST in the name of the underlying client. The accounts of CREST are the sole legal record of entitlement as between the underlying client and the intermediary. It is CREST (and not the intermediary) that maintains these accounts as ‘operator registers’ under statutory obligations imposed upon it and, in the same way to domestic securities, responds to instructions in relation to the depository interests sent by, or on behalf of, the underlying client (as account holder).
- 4.25 Under this holding pattern, while it is CREST that maintains the sole legal record of the depository interests, it is the intermediary that actually holds the underlying foreign securities in its securities account in CREST. The intermediary is alone able to exercise voting, dividend and other rights attaching to the international securities. There is therefore a division in the respective identities of the persons who perform the relevant intermediary functions:
- (a) the “securities holding” function is performed by the intermediary;¹² but
 - (b) the “account maintenance function” is performed by CREST.¹³
- 4.26 While the intermediary issues the depository interests rather than holds them on behalf of the account holder, the fact that the depository interests represent underlying securities held by the intermediary makes them likely to fall within the scope of the Convention. The split function arrangement for CREST and the intermediary described above is not envisaged by the Convention. Where a provision of the Convention refers to an obligation of the “relevant intermediary”, it may be unclear whether CREST, the intermediary or both are liable to discharge it.

¹² The “securities holding functions” are specifically those contained in Articles 5(1)(a), 5(2)(b), 6, 15, 17, 19, 21, 22 and 25.

¹³ The “account maintenance functions” are specifically those contained in Articles 5(1)(b), 5(1)(c), 5(2)(c), 13(3)(c), 18.

4.27 We understand that the delegations of other states participating in the UNIDROIT plenary sessions are reluctant to include specific wording in the Convention to address this potential source of uncertainty as the scenario does not arise in other holding systems. New wording included in Article 20 (*Limitations on obligations and liabilities of intermediaries*) permits the rules of a settlement system to prevail over the Convention in relation to the obligations and extent of liability of intermediaries. Accordingly, it should be open to CREST to specify in its rules which of CREST and the intermediary are obliged to carry out a particular obligation specified in the Convention (and additionally exclude the liability of the other for failure to do so). The explanatory notes of the Convention can also refer to the existence of these split-function arrangements. This should help to reduce the potential for uncertainty. The UK delegation has also used its membership of the UNIDROIT inter-sessional working group on transparent systems to advocate that the Convention recognises the possibility of a split in the functions of an intermediary.

Precedence of settlement system rules

4.28 Settlement systems that fall within the Convention definition (for example, systems operated by central banks or regulated by a governmental authority) are typically governed by detailed rules. These rules cover a wide range of issues concerning the operation of the system and, to some degree, the liability of its participants. The extent to which the rules of a securities settlement system (and in some limited cases, a securities clearing system)¹⁴ will prevail over conflicting provisions of the Convention has been clarified by changes to the latest draft of the Convention.¹⁵ The relevant provisions over which system rules take precedence are as follows:

- (1) Article 5 (*Intermediated Securities*): the right to cause securities to be held otherwise than through a securities account;
- (2) Article 11 (*Invalidity and reversal*): rules determining the validity, reversal and conditional effect of credits and the consequences of reversal of credits (but subject to the Convention's rules on innocent purchasers and competing priorities).
- (3) Article 12 (*Acquisition by an innocent person of intermediated securities*): the effect of an onward transfer to an innocent purchaser.
- (4) Article 18 (*Instructions to the intermediary*): where the intermediary is the operator of a securities settlement system, its rules regarding instructions.
- (5) Article 20 (*Limitations on obligations and liabilities of intermediaries*): an intermediary's obligations and the extent of its liabilities under the Convention.

¹⁴ The carve-out for securities clearing systems is limited to Articles 20 and 22.

¹⁵ These settlement and clearing systems must be (i) operated by a central bank or subject to regulation, supervision or oversight by a governmental or public authority in respect of their rules and (ii) be notified, on the ground of reduction of risk to the stability of the financial system, in a declaration by the Contracting State.

- (6) Article 22 (*Loss sharing in case of the insolvency of the intermediary*): shortfalls in the accounts of a settlement system operator.
- (7) Article 23 (*Effectiveness of debits, credits etc. and instructions on insolvency of operator or participant in securities settlement system*): rules of a settlement system or a clearing system that preclude the revocation of transfer or payment instructions or the invalidation or reversal of credits as a result of insolvency.

LAW COMMISSION COMMENT

- 4.29 We support the decision to make only specific Articles of the Convention subject to system rules. A general carve-out for system rules would significantly reduce the level of harmonisation within the EU by restricting the application of the Convention to the ownership and transfer of intermediated securities on the books of intermediaries not covered by CSD and ICSD rules. While it may be appropriate for the financial stability of a system for certain aspects of securities holding to be subject to the particular rules of the system, the core features of the Convention must apply generally to all systems.
- 4.30 Even the limited number of specific carve-outs in the current draft could lead to potentially significant discrepancies in the treatment of intermediated securities between securities settlement systems. We note, in particular, the precedence of system rules in determining the invalidity and reversal of credits (Article 11), the effect of an onward transfer to an innocent purchaser (Article 12(5)),¹⁶ and the obligations and liabilities of intermediaries (Article 18). The overriding effect of system rules in these provisions will have a knock-on effect into other parts of the Convention. For example, the ability of system rules to determine an intermediary's obligations and liabilities under Article 18 will, in practice, affect the core rights of an account holder set out in Article 5.¹⁷
- 4.31 We note that most of the provisions in the Convention that are subject to system rules are also subject to domestic law. Only Articles 12 (in relation to onward transferees) and Article 23 (in relation to loss sharing) create carve-outs from the Convention in relation to system rules but not for domestic law generally.
- 4.32 We have two further comments regarding definitions. We advise that the definition of "uniform rules" should make clear that system rules created by legislation (for example, the Uncertificated Securities Regulations 2001) are rules for the purposes of the Convention and do not fall exclusively within the definition of non-Convention law.

¹⁶ The purpose of this carve-out is to ensure that if a shortfall occurs at a higher level in the chain of holdings, a credit made further down the chain can be reversed if the intermediary is not at fault for the shortfall. If not, all intermediaries could be held strictly liable under the Convention to account for the securities credited to an account even if they were blameless under general law and/or the terms of the account agreement.

¹⁷ See paras 4.34-4.38 below.

4.33 Secondly, it has been drawn to our attention that the definition of ‘securities settlement system’ may require slight amendment in two ways to bring it in line with the Settlement Finality Directive. The definition currently requires that the Contracting State “the law of which governs the rules of the system” should notify the system as a securities settlement system for the purposes of the Convention.¹⁸ The Settlement Finality Directive on the other hand specifies that “the Member State whose law is applicable to the system” shall designate it as a system for the purposes of the Directive.¹⁹ CRESTco have indicated to us that this subtle difference may be problematic in the case of the Irish securities settlement system which is a system governed by Irish law but whose rules (namely, the CREST Rules) are governed by English law. We therefore believe that the Convention definition should be altered to refer to the law of applicable to the system rather than the law governing the system’s rules. Finally, we note that the current definition requires that any notification of a system must be made on grounds of financial stability. In the Settlement Finality Directive, while designation of a system is permissible on the grounds of financial stability it is not a precondition to designation.

RIGHTS OF THE ACCOUNT HOLDER

The Convention

4.34 The Convention sets out the package of rights that an account holder acquires upon a valid credit. A credit gives the account holder:

- (1) if acting for its own account (rather than as an intermediary), the right to receive and exercise the rights attached to the securities.²⁰
- (2) the right by instruction to its intermediary to transfer or grant an interest over the securities;²¹ and
- (3) the right by instruction to its intermediary to withdraw the intermediated securities credited to its account.²²

¹⁸ Article 1(n)(iii).

¹⁹ Settlement Finality Directive, Article 2(a).

²⁰ Article 5(1)(a)(i).

²¹ Article 5(1)(a)(ii).

²² Article 5(1)(b). This right is subject to the law under which the securities are constituted, the terms of the securities, the non-Convention law and, to the extent permitted by non-Convention law, the account agreement or the uniform rules of the securities settlement system.

- 4.35 In each case these rights are effective against third parties and enforceable against the account holder's intermediary (subject to any security interest the intermediary or a third party may have over the securities). In the case of rights to enforce the economic and corporate terms of the securities, these may also be enforceable directly against the issuer of the securities in many civil law systems.²³ The Convention allows the domestic law of the issuer to determine whether an investor has a direct right to enforce these terms against the issuer or only an indirect right enforceable through its intermediary.²⁴ Under no circumstances is the account holder able to enforce its rights directly against an upper-tier intermediary (the "no-look-through" principle).
- 4.36 In addition to the package of rights provided by the Convention, an account holder may have additional rights under the domestic law of the jurisdiction in which its securities account is located.²⁵ The Convention therefore operates as a minimum set of basic rights that account holders will enjoy throughout the EU. In the case of account holders that acquire security interests or other limited interests by way of a credit, the domestic law can impose limits on the account holder's ability to enforce these Convention rights.²⁶
- 4.37 An intermediary must take appropriate measures to enable its account holder to exercise these rights. The obligation does not, however, require the intermediary to take any action not within its powers or to establish a securities account with another intermediary.²⁷ These limitations are intended to protect an intermediary from having to incur unreasonable expense or risk in carrying out its account holders' instructions.

LCG Advice and Law Commission comment

- 4.38 The rights that are listed in the LCG Advice as arising upon a book-entry are broadly equivalent to those set out in Article 5 of the Convention. One slight variation is contained in the LCG's reference to the right to instruct the account provider to dispose of, pledge or charge the rights and "to limit the rights in any other way, to change the account on which the securities are held". We are not entirely sure what the last part of this sentence is intended to cover. However we do not necessarily agree that (in the absence of contract terms) an account holder should have an unqualified right to cause the account provider to limit its rights or change the account if this goes beyond disposing of, pledging or withdrawing the securities in accordance with the Convention. An intermediary offering a basic service to its account holders may not be able to accommodate particular instructions from them as to the partial or conditional limiting of its rights in the securities without incurring unreasonable administrative costs.

²³ Article 5(2)(b).

²⁴ See paras 2.35-2.42 above for a description of direct enforcement versus indirect enforcement systems.

²⁵ Article 5(1)(d).

²⁶ Article 5(3).

²⁷ Article 6(1).

TRANSFER OF INTERMEDIATED SECURITIES

The Convention

- 4.39 Intermediated securities are created by a credit to a securities account.²⁸ The Convention prescribes that no other steps are necessary to acquire these rights and for them to be effective against third parties.²⁹ A debit, if authorised by the account holder, has the opposite effect of disposing of intermediated securities from an account.³⁰
- 4.40 Debiting an account and crediting another with an equivalent amount of securities has the economic effect of transferring securities from one person to another. Some legal systems (or settlement system rules) require the matching of credits and debits in order for a transfer to be effective. Others do not. The Convention leaves it to domestic law and settlement system rules to determine whether or not matching is necessary.
- 4.41 Finally, the Convention does not preclude other methods of acquisition and disposition from taking effect under domestic law.³¹

Law Commission comments

- 4.42 Credits and debits present a simple and relatively certain mechanism for transferring securities between securities accounts. It must be noted, however, that the simplicity of this method of 'transferring' intermediated securities belies the more complex issue of what constitutes an *effective* credit.

Credit to an account

- 4.43 An account holder receives the rights set out in the Convention only once its intermediary has credited its account. A credit also confers upon the account holder such other rights, including rights and interests in securities, as may be conferred by the applicable domestic law.³²

²⁸ Article 1(b)

²⁹ Article 7(1) and (2).

³⁰ Article 7(3).

³¹ Article 9.

³² Article 5(1).

- 4.44 We note that the Convention does not attempt to specify what steps must be taken to 'credit' an account. Article 11(2)(a) does however state that the validity of a credit is subject to domestic law, the rules of a settlement system and, if permitted by law, the terms of an account agreement. National legal systems as well as settlement system operators will each have their own rules on what constitutes a credit to an account. For example, CREST rule 14 contains very detailed provisions to determine when a securities account is credited. In light of the importance placed upon a credit by the Convention, we would ideally want a common, functional test to grant account holders legal certainty in determining whether or not a credit has been made in any given Contracting State. We acknowledge however that Contracting States, and in particular settlement system operators, are unlikely to want a common test if the test fails to reflect their settlement operations or does not fit with the specific business, legal and regulatory requirements in that system. We accept that, regrettably, the likelihood of devising a common test that is workable in all Contracting States is very small.
- 4.45 'Credit' suggests some record-keeping action taken by the intermediary in relation to its customer's account. However, in some legal systems an account holder may acquire rights against its intermediary even where the intermediary has failed to make a record in its accounts. Under English law, an account holder will acquire a proprietary interest in securities transferred to its intermediary on trust as soon as the securities are identifiable in the hands of the intermediary. This will most likely occur once the securities are:
- (1) transferred to the intermediary by an executed transfer agreement or delivered into its possession (in the case of bearer securities); or
 - (2) credited to the intermediary's account by the intermediary above (where the intermediary does not hold directly from the issuer).
- 4.46 Thus under English law, the credit to the account holder's account by the intermediary is not the constitutive act of transfer. Failure to credit the securities to the account holder's account should not affect its proprietary rights provided that the account holder can demonstrate that it is entitled to the trust assets.

- 4.47 The need for an action by the intermediary to effect a credit also differs from the approach taken by UCC Article 8. It specifies three circumstances in which a security entitlement arises. The first of these is a credit to the securities account. The second circumstance arises once the securities have been ‘accepted for credit’.³³ Accordingly, a customer can, for example, enforce its security entitlement against an intermediary as soon as the intermediary takes receipt of bearer certificates on the customer’s behalf. In addition, UCC Article 8 contains a third residual test that gives the customer the package of rights once its intermediary becomes ‘obligated under other law, regulation, or rule’ to credit the customer’s account.³⁴ This final test is intended to avoid any implication that a failure of an intermediary to make an appropriate credit would prevent the customer from acquiring a security entitlement. The UCC approach is based on the idea that a customer’s rights are not solely dependent upon a ‘transfer’ but rather on the intermediary undertaking to treat the customer as entitled to the financial asset represented by a credit. If a credit is made before the securities are actually transferred (for example, due to an operational delay in settlement) the customer will still have rights against the intermediary.³⁵
- 4.48 In jurisdictions and settlement systems in which a credit (in the form of some record-keeping action) to the account holder’s account is already required to give account holders rights, we presume that domestic law will simply apply the same legal meaning of the term ‘credit’ to credits under the Convention. Where, however, the domestic law gives rights to account holders where without the need for any credit in the account holder’s account it is unclear to us how the Convention is intended to operate. Must such Contracting States apply a natural meaning to the term ‘credit’ and treat the rights under the Convention as arising only once a record has been made in the account holder’s account? Or can they choose to treat a credit as having a much wider meaning in order to reconcile it with existing domestic law?
- 4.49 We believe that the second of these alternatives is the correct one particularly in light of Article 5(1)(d). It provides that a credit confers to an account holder not only the rights under the Convention but also “such other rights, including rights and interests in securities, as may be conferred by non-convention law”. The effect of this provision is to coincide the point in time at which rights under the Convention and rights under domestic law arise. This suggests to us that it is the domestic law that determines the point at which a credit is treated as arising under the Convention. If it did not, Article 5(1)(d) could have the effect of revising the point in time at which domestic law rights arise. We do not believe that this is the intention of the Convention and that the Article should be redrafted to make this clear.

³³ UCC, §8-501(b)(2).

³⁴ UCC, §8-501(b)(3).

³⁵ UCC, §8-501(c) and Official Comment, Note 2.

- 4.50 Finally, we note that by stating in Article 7(2) that no further step other than a credit is necessary to render an acquisition effective against third parties, the Convention addresses the uncertainty created by section 53(1)(c) of the Law of Property Act 1925. As was mentioned earlier, section 53(1)(c) requires a disposition of an equitable interest to be made by written instrument.

Matching credits and debits

- 4.51 As was mentioned in Part 2,³⁶ in a number of Continental systems (for example, Germany and France) matching of a credit with a corresponding debit is needed to effect transfer of intermediated securities. Matching reduces the risk of inflation, that is to say, the risk that there may be more credits to investors' accounts than there are underlying securities issued by the issuer.
- 4.52 The need to match transfers presents an additional step to attaining settlement finality and as such is a potential drag on the efficiency of settlement. Matching credits and debits can become difficult in clearing and settlement systems that operate multi-lateral netting.³⁷ English law does not require matching. It is important for the efficiency of settlement in the UK that we retain the current provision in the Convention that allows transfers to be effected without matching corresponding debits and credits.
- 4.53 We saw earlier that the Convention permits Contracting States to retain a matching requirement. Thus, in the case of cross-border settlement, transfers into an account governed by a legal system that requires matching will continue to be subject to reversal or invalidation if there is no corresponding debit. While this is, in our opinion, a deficiency in the Convention we acknowledge that it is an unavoidable one in light of the importance placed by some legal systems on matching. Some comfort can be taken from the fact that the settlement systems in these jurisdictions have procedures in place to reduce the chance of a mismatch arising.

SECURITY INTERESTS AND LIMITED INTERESTS IN INTERMEDIATED SECURITIES

The Convention

- 4.54 The Convention treats security interests and limited interests that are created by transfer of the securities to another account ('title-transfer arrangements') differently from those interests that are created over securities that remain in the account of the person granting the interest ('non-title transfer arrangements').

³⁶ See paras 2.46-2.48 above

³⁷ Where the transfers of more than two counter-parties are netted.

Title transfer arrangements

- 4.55 It is possible to create a security interest or limited interest by way of a transfer of the securities into an account controlled by the party acquiring the interest (the “interest taker”). A mortgage (whereby the giver of the security interest retains some proprietary interest in the securities) is an example of such an arrangement under English law.³⁸ Securities are also commonly collateralised by outright transfers of title made subject to a contractual obligation (and close-out netting provision) to redeliver equivalent securities.³⁹ The UK Financial Collateral Arrangement (No 2) Regulations 2003 groups title transfers by way of security (that is to say, mortgages) with non-title transfer arrangements (such as pledges and fixed charges).⁴⁰ However, the Convention does not do this and groups title transfers by way of security and outright title transfers together.⁴¹

Non-title transfer arrangements

- 4.56 The Convention sets out a two-step process for creating and perfecting an interest in intermediated securities where the securities are retained in the grantor’s securities account. The first step requires the grantor to enter into an agreement with the interest taker.⁴² The second step is to satisfy one of the three conditions set out in Article 8, provided that the applicable Contracting States has declared the condition to be effective.⁴³ The three conditions are that:

- (1) the person to whom the interest is granted is the intermediary of the account holder;⁴⁴
- (2) a ‘designating entry’ in the securities account in favour of that person has been made, the effect of which is to giving the interest taker ‘control’⁴⁵ over the account or specific securities in it.⁴⁶
- (3) the parties have entered into a control agreement giving control of the securities to the interest taker.⁴⁷

- 4.57 The Convention permits Contracting States to retain national differences in the granting of security by means of a declaration mechanism. A Contracting State may declare:

³⁸ The mortgagor will retain an equity of redemption in the securities.

³⁹ For example, a sale and repurchase transaction.

⁴⁰ The UK Financial Collateral Arrangements (No 2) 2003, Reg 3.

⁴¹ Article 7(1) and 7(4).

⁴² We note that the Convention does not specify the need for an agreement if a security interest or limited interest is created by way of a title-transfer arrangement under Article 7(4). However, the need for an agreement will be a matter for domestic law (see Article 11(2)(a)).

⁴³ Article 8(1)(a).

⁴⁴ Article 8(2)(a)

⁴⁵ For the meaning of ‘control’, see paras 4.68-4.73 below.

⁴⁶ Article 8(2)(b).

⁴⁷ Article 8(2)(c).

- (1) which of the conditions are sufficient to render an interest effective against third parties;
 - (2) that the ability to create a security or other limited interest under the Convention shall not apply to certain categories of person;
 - (3) that the security or other limited interest shall be effective in respect of all securities credited to an account or to a specified category, quantity, proportion or value of securities credited to a securities account from time to time.⁴⁸
- 4.58 Outside of the declaration mechanism, domestic law also determines (1) the circumstances in which non-consensual security interests (such as statutory liens) arise⁴⁹ and (2) the evidential requirements needed to satisfy the two-step process under the Convention.⁵⁰

Priority among competing interests

- 4.59 Where a party acquires a security interest or other limited interest in securities by way of a credit to its account, the interest taker falls within the scope of the protection granted to outright purchasers of intermediated securities under Article 12. As is discussed in greater detail below, the interest taker takes free of any other interest that it did not know of at the time of the credit.
- 4.60 Where an interest taker acquires an interest by way of one of the non-title transfer methods prescribed by the Convention (for example, a designating entry or control agreement), its interest will take priority over any security interests created and perfected under domestic law.⁵¹ As between themselves, security interests created under the Convention rank in order of the time in which they become effective.⁵²

Priority of interests granted by intermediary

- 4.61 The Convention does not determine the priority or the relative rights and interests between the rights of account holders of an intermediary and the interests granted by way of a non-title transfer arrangement by that intermediary over the intermediated securities credited its account holders' accounts.⁵³
- 4.62 Consequently, if an intermediary acts in breach of its account agreement and creates a security interest over its account holder's securities account without its consent, domestic law is left to determine the competing priorities.

⁴⁸ Article 8(3)(a) and (b).

⁴⁹ Article 8(5).

⁵⁰ Article 10.

⁵¹ Article 13(2).

⁵² Article 13(3).

⁵³ Article 14.

Law Commission comments

- 4.63 Generally speaking, we consider the creation of common methods for creating and perfecting security interests over intermediated securities to be one of most valuable benefits provided by the Convention. Again, we consider it unfortunate that a clear definition cannot be given to ‘credits’, ‘designating entries’ and ‘control agreements’ to ensure that additional requirements are not introduced by domestic law but we accept that this may be unavoidable. Furthermore, we would advocate that EU Member States take this opportunity to conform the practice of taking security within the EU by declaring that all three of the non-title transfer methods are effective under their national law.
- 4.64 The LCG Advice makes no comment on the creation, perfection or enforcement of security interests over intermediated securities. This may be because the issues are dealt with, at least in general terms, by the Financial Collateral Directive⁵⁴ (“FCD”). The FCD confers advantages, for example in insolvency, to financial collateral arrangements between certain categories of collateral taker and provider. It has been implemented in the UK by the Financial Collateral Arrangements (No 2) Regulations 2003 (FCAR).⁵⁵ The European Commission has exclusive competence to negotiate on behalf of the EU Member States in relation to matters affecting the FCD. We understand that one of its principal aims is to ensure that the Convention is compatible with the FCD.

Comparison of the scope of the Convention and the FCD

- 4.65 While the Convention covers much of the territory already legislated by the FCD in relation to intermediated securities collateral, the scope of the Convention’s rules is potentially wider both in terms of the persons and the kinds of intermediated securities collateral to which the rules apply. The FCD does not extend the application of the rules to natural persons⁵⁶ and gives Member States the further option of excluding companies if they are not public bodies or regulated financial institutions.⁵⁷ The Convention on the other hand does not expressly limit the application of the rules to non-natural persons but does permit contracting states to exclude certain categories of person from the rules governing security interests through a declaration mechanism. It seems likely that Member States may choose to make declarations that replicate the choices they have made with respect to the domestic application of the FCD. While Contracting States should be permitted to exclude certain categories of person for policy reasons, we hope this option is used sparingly. In our opinion, such a decision would greatly diminish the legal certainty generated by the Convention’s creation of universal methods for granting security and limited interests.
- 4.66 The FCD’s definition of book entry securities is narrower than that of the Convention. The FCD’s defines “book entry securities collateral” as:

⁵⁴ Directive 2002/47/EC of the European Parliament and Council of 6 June 2002, OJ L 168/43.

⁵⁵ SI 2003 No 3226.

⁵⁶ FCD, Article 1(2)(e).

⁵⁷ FCD, Article 1(3).

Financial collateral provided under a financial collateral arrangement which consists of financial instruments, title to which is evidenced by entries in a register or account maintained by or on behalf of an intermediary.⁵⁸

- 4.67 Unlike the FCD, which covers only financial instruments,⁵⁹ the Convention's definition of securities covers both financial assets (other than cash) and financial instruments which are capable of being credited to a securities account.⁶⁰ Consequently, even if a Member State chooses to limit the application of the Convention rules to those persons covered by the FCD it must note that the Convention rules will nevertheless extend to kinds of financial collateral not already within the scope of the directive.

Control

- 4.68 The FCD dictates that the creation, validity, perfection and enforceability or admissibility in evidence of a financial collateral arrangement should not require any formal act such as execution of a document, filing or registration.⁶¹ The only perfection requirement which national law may impose in respect of financial collateral should be that the financial collateral is:

...delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker...⁶²

- 4.69 Neither the FCD nor the FCAR provide a precise definition of what amounts to 'possession and control' of financial collateral. Control could have a number of possible meanings. Control can be 'positive', that is to say, it can confer on the collateral taker the ability to realise the collateral without the consent of the collateral provider. Positive control is necessary to perfect a security interest over uncertificated securities under the UCC.⁶³ This type of control does not, by itself, prevent the collateral provider from dealing with the collateral assets. On the other hand, control could be 'negative' in effect by conferring on the collateral taker the right to prevent the collateral provider from disposing of the collateral. Often the interest taker will acquire both negative and positive control or will agree under the terms of the collateral arrangement to acquire negative control only in certain limited circumstances. It is unclear whether one or both of these positive and negative elements of control are required to satisfy the meaning in the FCD.

⁵⁸ FCD Article 2(g). The definition is replicated in Regulation 3 of the FCAR.

⁵⁹ Furthermore, the FCD's definition of financial instruments does not apply to debt securities that are not negotiable on capital markets: see FCD, Article 2(1)(e).

⁶⁰ Article 1(a). See also para 4.10 above.

⁶¹ FCD, Recital 10 and Article 3.

⁶² FCD, Recital 9.

⁶³ UCC, §9-106 and §8-106(c).

4.70 The Law Commission in its recent report on Company Security Interests concluded that 'negative control' was the sole requirement under the Directive. Positive control without negative control would not suffice. This conclusion was based upon references in the FCD to control requiring 'dispossession'.⁶⁴ However, this conclusion was reached only by interpreting the relevant article of the Directive in light of its recitals.⁶⁵ Without further legislation or a ruling by the European Court of Justice, the definition remains uncertain.

4.71 The Convention accommodates both negative and positive tests of 'control' within its definitions of control agreement⁶⁶ and designating entry⁶⁷. Each definition prescribes that the agreement or entry must have *either or both* of the following effects:

- (i) that the relevant intermediary is not permitted to comply with any instructions given by the account holder in respect of the intermediated securities to which the agreement or entry relates without having received the consent of that other person;⁶⁸
- (ii) that the relevant intermediary is obliged to comply with any instructions given by that other person in respect of the intermediated securities in respect of which the agreement or entry is made in such circumstances and as to such matters as may be provided by the account agreement, a control agreement, the uniform rules of a securities settlement system or the non-Convention law, without any further consent of the account holder.⁶⁹

⁶⁴ See FCD, Recital 10 which states: 'This Directive must...provide a balance between market efficiency and the safety of the parties to the arrangement and third parties, thereby avoiding inter alia the risk of fraud. This balance should be achieved through the scope of this Directive covering only those financial arrangements which provide for some form of dispossession...'.

⁶⁵ For further discussion of the meaning of control see Law Commission, Company Security Interests (2005) Law Com No 296, pp 137-138.

⁶⁶ Defined in Article 1(k).

⁶⁷ Defined in Article 1(l).

⁶⁸ ie negative control.

⁶⁹ ie positive control.

4.72 The 'positive control' test in sub-paragraph (ii) above differs slightly from the equivalent test in the UCC inasmuch that it does not expressly state that the collateral giver can deal freely with the intermediated securities.⁷⁰ In our opinion, the collateral giver's ability to deal is necessarily implied. If control under sub-paragraph (ii) did require the collateral giver not to deal without the consent of the collateral taker, one would never be able to satisfy sub-paragraph (ii) without also satisfying sub-paragraph (i). Consequently, the positive control test set out in the Convention would become superfluous. A holder of a floating charge under English law should be able to satisfy the test in sub-paragraph (ii). It should be able to show that in certain circumstances (namely the crystallisation of the floating charge) it will be able to instruct the intermediary to hand over the intermediated securities without the collateral giver's consent.

4.73 As we read it, the current phrasing of the definitions makes it sufficient that a collateral taker obtains either positive or negative control *or* that it obtains both positive and negative control. The Convention does not provide domestic law and system rules with the power to restrict this choice. This could lead to possible incompatibility with European legislation if it is finally decided that the positive control test set out in the Convention is not sufficient to constitute control under the FCD.

Protection from competing claims

4.74 We note that a non-title transfer arrangement made in accordance with Article 8 of the Convention takes priority over any security interest or limited interest created under domestic law whether created before or after it. This is subject only to non-consensual security interests whose priority against interests created by the Convention remains a matter for domestic law.⁷¹

4.75 Knowledge of an existing security interest created under domestic law (but created not in accordance with the Convention) does not appear to affect a person's ability to take priority if its security is by way of a non-title transfer arrangement created under the Convention. This is in contrast to a collateral taker who acquires a security interest by way of a transfer of the securities into its account. In order for this collateral taker to take priority over existing security interests created by domestic law it must rely upon the innocent purchaser defence. The defence requires a purchaser to have no knowledge of pre-existing rights of other persons irrespective of whether those rights arise under the Convention or under domestic law. This places a buyer (for its own account) and a collateral taker in a title transfer arrangement (including a mortgagee) at a disadvantage to a collateral taker that relies upon a non-title transfer arrangement.

⁷⁰ UCC, §8-106(f).

⁷¹ Article 13(2) and (5).

- 4.76 We query whether this disparity is intentional. We acknowledge that it is almost analogous to the position under English law which gives priority to chargees and mortgagees over earlier unregistered charges of which they have notice but not to buyers.⁷² However, we see no obvious justification for the disparity⁷³ and we note that it differs from UCC Article 8, which grants priority over earlier unperfected security interests to any subsequent buyer or interest taker as long as it takes control.⁷⁴
- 4.77 Finally, we note that a Contracting State may declare that the right to create a security interest under the Convention does not extend to certain categories of person. If a Contracting State were to exclude a specific category, this would leave persons in that category with no means of protecting their security interest from subsequent interest takers under the Convention other than by transferring the securities into an account under their control. This is a different and more drastic prospect than the one faced by persons that are excluded from the FCD as the FCD does not generally affect the competing priorities of security interests created within or outside of its scope.

SETTLEMENT FINALITY

The Convention

- 4.78 The Convention makes only a limited attempt to harmonise rules that deal with settlement finality. The following legal issues remain outside the scope of the rules:
- (1) the validity of a debit, credit or designating entry;
 - (2) whether a debit, credit or designating entry is liable to be reversed;
 - (3) where a debit, credit or designating entry is liable to be reversed, its effect (if any) against third parties and the consequence of reversal;
 - (4) whether and in what circumstances a debit, credit or designating entry maybe made subject to a condition; and
 - (5) where a debit, credit or designating entry is made subject to a condition, its effect (if any) against third parties before the condition is fulfilled and the consequences of the fulfilment or non-fulfilment of the condition.⁷⁵

⁷² Under English law a buyer with notice of an unregistered charge will take subject to it, whereas the charge is void as against a subsequent interest taker even if it has actual notice of the unregistered charge. That said, the Convention differs from English law as regards mortgagees. Under English law a mortgagee with notice of an unregistered charge will take free of it whereas, under the Convention, the mortgagee is treated as a purchaser and therefore would not take free if it cannot establish a defence of innocent purchaser.

⁷³ Professor Sir Roy Goode describes this as 'curious' and also suggests that a bank or financier taking security should in fact be under a greater obligation to investigate the existence of prior interests in the asset than a purchaser acquiring the asset in the ordinary course of business. See R Goode *Commercial Law* (3rd ed) p 666-668.

⁷⁴ UCC, §8-106(d)(i).

⁷⁵ Article 11(2)(a)-(e).

- 4.79 These issues are left to the domestic laws of each Member State and (to the extent permitted by domestic law) to the terms of the account agreement and any applicable rules of a securities settlement system. The innocent purchaser defence does act however to prevent a reversal or invalidity under domestic law if the purchaser (or interest taker) is able to show that the reversal or invalidity is based upon an invalidation of any previous debit or credit.⁷⁶ In so doing, the Convention protects the finality of onward transfers.
- 4.80 The Convention also ensures that transfer orders, credits and debits that are treated as irrevocable by settlement system rules take precedence over national insolvency rules.⁷⁷

LCG Advice

- 4.81 The LCG Advice states that:

...rules will be needed within the new legislation as to the circumstances under which a book-entry is liable to be invalidated, and whether the invalidity should be as from the moment the book-entry was made, or only as from a later moment, and whether the invalidity should be achieved by the making of a fresh reverse entry or by treating the initial book-entry as legally void.

Law Commission comments

- 4.82 Settlement finality is another area that has already been the subject of EU legislation. In 1998, the Settlement Finality Directive⁷⁸ (the 'SFD') was passed to reduce systemic and legal risk in payment and securities settlement systems in the EU. The SFD ensures the finality of transfer orders and netting, as well as the enforceability of collateral security within designated systems throughout the EU.
- 4.83 The SFD is narrow in scope. The 'systems' to which it applies are defined as formal arrangements between (usually) three or more participants with common rules and standardised arrangements for the execution of payment or securities transfer orders between the participants. Member States may designate systems as qualifying. Participants in a system are limited to supervised financial institutions, public authorities, central counter-parties, settlement agents and clearing houses.
- 4.84 While the SFD does not cover settlement finality outside of designated systems, it does provide invaluable guidance as to how the issues raised by the LCG should be dealt with, if at all, by the Convention. Adopting an approach at variance with the SFD is unlikely to be acceptable within the EU, even if the SFD continued to take precedence over the Convention in relation to designated systems.

⁷⁶ See Article 12(1) and (2). The credit does remain subject to any applicable settlement system rules and the terms of the account agreement.

⁷⁷ Article 23.

⁷⁸ Directive 98/26/EC of 19 May 1998 on settlement finality in payment and securities settlement systems.

- 4.85 Finality in respect of securities transfers is achieved by a combination of three provisions in the SFD. Article 3 of the SFD ensures that transfer orders and netting made before the commencement of insolvency proceedings remain legally enforceable against a participant. Transfer orders are made irrevocable by Article 5 from the moment defined by the rules of the system. Finally, Article 7 abolishes the 'zero hour rule'⁷⁹ applied by some Member States to determine the moment at which insolvency proceedings are deemed to take effect.
- 4.86 The first two of these provisions are closely reflected by Article 23(1) of the Convention. The Convention also implicitly abolishes the 'zero hour rule' in relation to transfers that have become irrevocable under the rules of a securities settlement systems and securities clearing systems. We note however that the Convention goes beyond the SFD by preventing the application of insolvency law to revoke a transfer order even in circumstances where insolvency proceedings have commenced. The SFD in contrast protects only transfer orders that are entered into a system prior to the opening of insolvency proceedings..
- 4.87 Recital 13 of the SFD states that nothing should prevent a participant or a third party from exercising any right or claim resulting from the underlying transaction which they may have in law to recovery or restitution in respect of a transfer order provided that this does not lead to a revocation of the transfer order. An account holder's remedies for fraud, negligence or other wrongdoings in relation to misappropriated securities are therefore unchanged by the SFD and will depend upon the domestic law of the relevant Member State. The Convention again mirrors this light-handed approach by leaving domestic law to determine the circumstances in which credits may be reversed.
- 4.88 We agree with this approach. It would be unrealistic to attempt to harmonise the laws of each Member State in relation to the variety of different circumstances in which a credit may be liable for reversal. A purchaser may be assured to some extent that, in most legal systems, transfers that are reversible (for example, on grounds of fraud) often prevent reversal where the transfer is to an innocent purchaser.
- 4.89 The Convention also leaves the question of validity of credits, debits and designating entries to domestic law. While an attempt to list the grounds on which credits and debits can be deemed invalid might again be unrealistic in light of the range of legal systems involved, the absence of certainty is nevertheless a large hole in the Convention. Matching of credits and debits has already been raised as a requirement for validity in some legal systems. Settlement finality could be seriously impaired if domestic law imposed a range of additional requirements for the valid transfer of securities. Furthermore, laws that deem a transfer invalid are less likely to offer protection to an innocent purchaser.

⁷⁹ Under the 'zero hour rule' the commencement of insolvency proceedings is treated as taking effect retroactively from the first minute of the day on which the proceedings were initiated. Under Article 6(1) of the Directive, the moment of opening of insolvency proceedings shall be the moment when the relevant judicial or administrative authority handed down its decision.

- 4.90 The carve-out for domestic law does at least recognise the paramount importance of upholding onward transfers where the transfer has been made before the defective nature of an earlier entry has been discovered. Without an assurance that these onward transfers are free of the risk of reversal or invalidation a securities settlement system would be subject to considerable uncertainty. Any attempt to unwind subsequent transfers due to the discovery of an earlier invalid or reversible transfer would be in many cases unworkable and could cause significant problems at the higher levels of a clearing and settlement system. Restricting the risk of invalidity to the parties involved in the relevant transfer at least places participants in a far better position to identify and control this risk.
- 4.91 The final issue raised by the LCG relates to the point in time at which credits should be treated as invalid. Should the invalidity take retrospective effect or should it only take effect from the moment that the credit is reversed? This point is left to domestic law by the Convention.

ACQUISITION BY AN INNOCENT PURCHASER

The Convention

Transfers where there is a pre-existing interest

- 4.92 An account holder that has securities credited to its account (otherwise by way of gift or gratuitously) at a time when it does not know that the credit violates the rights of another person is not subject to that other person's interest nor liable to the other person.⁸⁰

Onward transfers of securities subject to an earlier defective entry

- 4.93 If securities are transferred in violation of another person's interest in them, the purchaser must look to rely upon the protection referred to in the paragraph above. If the securities are then transferred on by credit to another purchaser or an interest is created over the securities, this subsequent credit or interest is not rendered invalid, ineffective or liable to be reversed as a result of the defective earlier transfer. In addition, the purchaser or interest taker is not liable to anyone that would benefit from the invalidity or reversal of that defective entry.⁸¹

⁸⁰ Article 12(1)(a) and (b).

⁸¹ Article 12(2)(a) and (b).

- 4.94 The protection given to subsequent account holders and interest takers from the reversal of an earlier credit is subject to the rules of a securities settlement system and to the terms of the subsequent account holder's account agreement.⁸² The reason for qualifying the protection in this way is to enable intermediaries in certain circumstances to pass down losses arising as a result of a shortfall at a higher tier. If an intermediary could not pass on these losses, it would become strictly liable for breaches made by higher tier intermediaries. Unless the intermediary has undertaken to accept liability for these losses (under the rules of the system or its account agreement), it is the account holder that should bear this risk not its intermediary.

Knowledge

- 4.95 A person 'knows' of an interest or fact for the purposes of the Convention if it has actual knowledge or has "knowledge of facts sufficient to indicate that there is a significant probability that the interest or fact exists and deliberately avoids information that would establish that this is the case".⁸³

LCG Advice

- 4.96 The LCG Advice briefly states that:

An account holder who has a book-entry made in his favour, may rely on that book-entry against the account provider and against any third party unless he knew or ought to have known that the book-entry should not have been made.

Law Commission comments

- 4.97 While we generally agree with the approach taken by the Convention in protecting innocent purchasers from adverse claims, we have a number of specific observations regarding the current formulation of the defence.

A defence to claims rather than a procedural bar against claims

- 4.98 There are two preliminary points to make about UNIDROIT's decision to create a harmonised defence for account holders. The first is that the Convention does not seek to prevent a claimant from bringing a domestic law action against the purchaser; instead it creates a guaranteed minimum level of protection for purchasers in Contracting States within the context of litigation proceedings. This contrasts with the approach taken by UCC Article 8 which requires the account holder to bring an action first against its own intermediary other than in exceptional circumstances.⁸⁴

⁸² Article 12(5).

⁸³ Article 12(4)(b). The test is virtually identical to the test for notice of an adverse claim in UCC§8-105(a)(2).

⁸⁴ UCC §8-503(d) and (e). The account holder may only bring an action if (i) its intermediary is insolvent; (ii) the insolvent intermediary does not have sufficient assets to satisfy the account holder's claim; (iii) the intermediary violated its obligation to maintain sufficient securities; and (iv) the purchaser colluded with the intermediary in violating this obligation.

- 4.99 The second point is that the defence is made available only to purchasers that hold the securities through an intermediary following purchase. Innocent purchasers that directly acquire the legal title to the underlying securities by receiving bearer certificates or by being entered on the issuer's register cannot rely on the Convention defence. They must rely instead on the domestic law applicable to the transfer of directly held securities.
- 4.100 Casting the protection under the Convention as a defence rather than a bar against actions means that purchasers are not insulated from adverse claims under the Convention to the extent that they are in the US markets. Under the Convention, an account holder whose securities have been misappropriated by its intermediary may choose whether or not to pursue the intermediary or the purchaser or both. In the US, the account holder must look first to its intermediary. Only if its intermediary is insolvent and is unable to remedy the account holder's loss can the account holder succeed in an action against the purchaser in the US. Even then it must show that the purchaser has actively colluded in the violation of the intermediary's duty to maintain sufficient securities. This collusion test not only switches the burden of proof to the claimant, but also requires a greater level of fault on the part of the purchaser than the standard of knowledge in the Convention.⁸⁵
- 4.101 While the collusion test may arguably swing the balance too far in favour of the purchaser, the requirement that an account holder must look initially to its intermediary does enhance the finality of settlement by reducing the number of transactions that are at risk of reversal.⁸⁶ As long as the intermediary can restore the account holder's securities, the transfer made to a purchaser will remain intact irrespective of whether the purchaser was aware of any violation. By contrast, a purchaser under the Convention must generally ensure that it can adequately establish an innocent purchaser defence.

⁸⁵ Note 3 of the Official Comment to UCC §8-503 states that the effect of the choice of the collusion standard is that: "customers of a failed intermediary must show the transferee from whom they seek to recover was affirmatively engaged in wrongful conduct rather than casting on the transferee the burden of showing that the transferee had no awareness of wrongful conduct by the failed intermediary".

⁸⁶ Note 3 of the Official Comment to UCC §8-503 justifies the limitations on claimants to bring claims against transferees as follows: "The limitations...on the ability of a customer of a failed intermediary to recover securities or other financial assets from the transferee are consistent with the fundamental policies of investor protection that underlie this Article and other bodies of law governing the securities business. The commercial law rules for the securities holding and transfer system must be assessed from the forward-looking perspective of their impact on the vast number of transactions in which no wrongful conduct occurred or will occur, rather than on the post hoc perspective of what rule might be most advantageous to a particular class of persons in litigation that might arise out of the occasional case in which someone has acted wrongfully. Although one can devise hypothetical scenarios where particular customers might find it advantageous to be able to assert rights against someone other than the customer's own intermediary, commercial law rules that permitted customers to do so would impair rather than promote the interest of investors and the safe and efficient operation of the clearance and settlement system."

4.102 Despite this attraction, the option of following the US approach was not met with great enthusiasm in our preliminary seminars. Nor, realistically, is such a radical step likely to be acceptable to UNIDROIT delegates at this late stage in drafting process. Accordingly, we concede that protecting the innocent purchaser by way of a harmonised defence is the most practical solution, although we should point out that adopting the US approach at a domestic level is an option that would still be compatible with the Convention. We also note the concern raised by one consultee that the more limited solution offered by the Convention may leave industry with the misimpression that their protection from claimants is greater than it actually is.

Knowledge of adverse claims

4.103 The standard of knowledge adopted in the Convention is a close but not exact match of the test applied by the English courts in relation to transactions in stocks and shares. Like the Convention, English law requires the purchaser to demonstrate that it has no actual or constructive notice of an earlier right.

4.104 The application of the doctrine of constructive notice to securities transactions was considered in *Macmillan Inc. v Bishopsgate Trust (No 3)*.⁸⁷ At first instance, Millet J cited Lord Browne-Wilkinson's formulation of the doctrine of constructive notice in *Barclays Bank plc v O'Brien*⁸⁸ as being of general application. In that case Lord Browne-Wilkinson said:

...if the party asserting that he takes free of the earlier rights of another knows of certain facts which put him on inquiry as to the possible existence of the rights of that other and he fails to make such inquiry or take such steps as are reasonable to verify whether such earlier right does or does not exist, he will have constructive notice of the earlier right and take subject to it.⁸⁹

4.105 The test requires a purchaser under English law to investigate if it has knowledge of facts putting it on inquiry. In the absence of such facts there would appear to be no duty to investigate. In this respect English law is consistent with the Convention. However, according to *O'Brien* facts need only give rise to the *possible* existence of an earlier right rather than a *significant probability* in the case of the Convention test. Furthermore, once put on notice, the decision in *O'Brien* requires the purchaser to take such steps as are reasonable to verify whereas under the Convention the purchaser need do nothing provided it does not deliberately avoid information that would establish that the existence of an adverse claim.

4.106 In an epilogue to his judgment (criticising the conduct of the plaintiff in the litigation), Millet J threw further light on the duty of the purchaser (or, in that case, its account officers responsible for the transaction) to investigate title:

⁸⁷ [1995] 1 WLR 978.

⁸⁸ [1994] 1 AC 180.

⁸⁹ [1994] 1 AC 180 at pp 195-196.

Account officers are not detectives. Unless and until they are alerted to the possibility of wrongdoing, they proceed, and are entitled to proceed, on the assumption that they are dealing with honest men. In order to establish constructive notice it is necessary to prove that the facts known to the defendant made it imperative for him to seek than an explanation, because in the absence of an explanation it was obvious that the transaction was probably improper.⁹⁰

- 4.107 The last sentence indicates the reluctance of the court to attribute constructive notice in securities trades and suggests a test that is closer to the Convention than the line taken in *O'Brien*. Furthermore, the doctrine of constructive notice laid down in *O'Brien* has since been described by Lord Nicholls in *Royal Bank of Scotland v Etridge (No 2)* as:

...not a conventional use of the equitable doctrine of constructive notice.⁹¹

- 4.108 The application of the doctrine in *O'Brien* has been limited by the House of Lords decision in *Etridge (No 2)* to specific class of cases involving suretyship.⁹² We speculate that the English courts would take a narrower view of constructive notice when applying it to the settlement of securities across the books of a financial intermediary. That said, we acknowledge that removing any obligation to investigate suspicious facts and attributing constructive notice only to purchasers that deliberately avoid information is probably a step beyond where the courts have reached.

- 4.109 While any discrepancy between the English law defence and the Convention defence would be unfortunate, on balance we would not object to the standard of knowledge adopted by the Convention. The formulation of the standard is helpful in making it clear to purchasers that they are not required to make any form of inquiries other than in relation to information already known. This best meets the needs and operational realities of a fast-moving settlement system and reflects market practice. While in theory this leads to a disparity in the level of knowledge required of purchasers of directly held securities (under English law) as against purchasers of intermediated securities (under the Convention), the difference should be insignificant in practice. Transactions in securities markets are swift and largely anonymous. A buyer will rarely know the identity of the seller and will not be expected to carry out a thorough investigation of title in order to satisfy its obligations to make inquiries as an honest and reasonable person. We therefore consider the test in the Convention to be satisfactory, particularly in light of the difficulty in finding a formulation that is acceptable to a large number of different legal systems. For clarity we should add that the protection given by the Convention to purchasers is intended to act as a minimum level of protection. If CREST falls within the scope of the Convention, purchasers in CREST should still be able to rely upon the higher level of protection (based on actual notice) set out in the Regulation 35 of the Uncertificated Securities Regulations 2001

⁹⁰ [1994] 1 AC 180 at pp 1014.

⁹¹ *Royal Bank of Scotland v Etridge (No. 2)* [2001] UKHL 44

⁹² See also Chitty on Contracts (29th ed) 7-096.

Knowledge attributed to an organisation

- 4.110 The level of knowledge necessary to prevent an account holder from relying on the Convention defence is the same whether the account holder is an individual or an organisation. If the account holder is an organisation, the question arises as to the appropriate point in time at which the organisation should be treated as being aware of a fact. The Convention states that in the case of organisations, knowledge is attributed to it “from the time when the interest or fact is or ought reasonably to have been brought to the attention of the individual responsible for the matter to which the interest or fact is relevant”.⁹³ The time of knowledge is important in determining the availability of the defence as an organisation or individual can still rely on the defence if it only became aware of the fact or interest after the time that the securities are credited.⁹⁴
- 4.111 The formulation of this rule for an organisation raises two connected issues. The first concerns the meaning of the term ‘organisation’. The lack of a definition in the Convention makes it unclear how widely the term should be construed. For example, should it cover organisations that are not corporate entities or which lack legal personality (such as partnerships)? In addition, should the term covers separate legal entities within a corporate group?⁹⁵
- 4.112 It is commonplace in the securities industry for large institutions to operate from a single location, in relation to the global activity of numerous subsidiaries acting as nominees. The nominee subsidiaries into whose accounts the securities are credited may have no knowledge of the underlying transaction and of any potential violation of a third party’s claim. Fairness suggests that where relevant knowledge is obtained by the legal entity within the group managing a trade, it ought reasonably to be attributed to the nominee account holder within the corporate group in whose name the securities are credited.
- 4.113 Instead of widening the meaning of organisation to include more than one legal entity, the Convention could recognise the possibility of imputing the knowledge of certain specified categories of person to the account holder. These categories could include not only affiliates of the account holder but also agents acting on its behalf.

⁹³ Article 12(4).

⁹⁴ We note again that the lack of a definition of what constitutes a credit in the Convention is a deficiency that may prevent uniformity between Contracting States on this point.

⁹⁵ We are grateful to Colin Bamford of 3 / 4 South Square for drawing our attention to this point.

4.114 The Convention currently makes no provision for imputing knowledge to a purchaser. We accept that the various exceptions and nuances to the concept of imputed knowledge may mean that it is necessary to make any Convention rule on imputed knowledge subject to domestic law.⁹⁶ Nevertheless, we are concerned that if the possibility of imputing knowledge is not recognised by the Convention the innocent purchaser defence could be manipulated through the use of an agent or by corporate structuring to give a defence to purchasers where none should exist.

Interplay between the Convention defence and domestic law actions

4.115 The Convention does not seek to harmonise the legal substance or procedure of actions that can be brought against a purchaser of securities. This is left to domestic law. Instead, the Convention sets out a defence that can be applied under the laws of a contracting state in response to actions based on the violation of a claimant's alleged interest in the securities.⁹⁷

4.116 Although not unequivocally stated in the Convention, an acquirer of securities can rely upon other defences (for example, change of position or ministerial receipt under English law) to adverse claims under domestic law. The purchaser should also presumably be allowed to rely upon the domestic law version of the innocent purchaser rule if it grants the purchaser wider protection (for example, if it excludes constructive knowledge from the defence).⁹⁸ The Convention defence is therefore intended to provide no more than a minimum level of protection for purchasers.⁹⁹ The Convention would benefit from a statement in the text clarifying that the defence is without prejudice to any other defences available to the purchaser under domestic law.

⁹⁶ For example, English law does not impute notice acquired by an agent in a previous transaction to the purchaser nor even notice acquired in the same transaction unless it is so material to the transaction that the agent is under a duty to inform the purchaser (see J Mc Ghee, *Snell's Equity* (13th ed 2000) para 4-27). An agent's knowledge will also not be imputed to the purchaser if the agent was concealing information from the purchaser in order to defraud him (*Kennedy v Green* (1834) 3 My & K 699; *Houghton & Co v Nothard, Lowe & Willis Ltd* [1928] AC 1).

⁹⁷ Claims for the recovery of securities from an innocent purchaser can be made in the UK under the Proceeds of Crime Act 2002 (POCA) if the assets were obtained through unlawful conduct and sold onto the purchaser. POCA provides good faith purchasers with a defence against recovery of these assets although the defence differs slightly from that of the Convention (see POCA ss. 266, 308). We do not think that claims brought by the Asset Recovery Agency under POCA constitute "adverse claims" as defined in the Convention as they are not claims brought by a person claiming a violation of its interest in the securities. Accordingly POCA's interrelationship with the Convention would not need to be considered in these circumstances.

⁹⁸ For example, purchasers of securities and depositary instruments settled in CREST need only show they had no *actual* notice: Uncertificated Securities Regulations 2001, Reg 35(5)(a).

⁹⁹ This position was asserted by the UK delegation in the third UNIDROIT plenary session without contradiction by other delegations.

- 4.117 Any uncertainty arising from a minimum harmonisation rather than a uniform standard will be felt most keenly by claimants. Under the Hague Convention it is the law of the purchaser's account that determines competing priorities between purchaser and original account holder.¹⁰⁰ Accordingly, an account holder bears the risk that its securities will be misappropriated into a securities account governed by a law that gives greater protection to the purchaser than is provided by the Convention. That said, the uncertainty for claimants under the Convention would be no worse than under current law and is seldom likely to be a problem.
- 4.118 Finally, we note that incorporating the Convention's innocent purchaser defence into English law would address the concern expressed in the FMLC Report regarding the absence of protection for purchasers of intermediated securities. In Part 5, however, we explain why we feel that domestic legislation should be passed now to rectify this deficiency rather than relying upon the possible adoption of the Convention.

INSOLVENCY PROTECTION

The Convention

- 4.119 The Convention protects the rights of account holders and interest takers from the insolvency administrator and creditors of an insolvent intermediary.¹⁰¹ It also gives precedence over domestic insolvency rules to system rules that adjudge a transfer or transfer order to have become irrevocable¹⁰² or which permit top-up or substitution of collateral prior to the commencement of insolvency.¹⁰³
- 4.120 Article 16 of the Convention expressly states that nothing in the Convention's affects any rules of domestic law relating to the avoidance of transactions as a preference or a fraud of creditors.¹⁰⁴ Nor does the Convention affect any rules of insolvency procedure relating to the enforcement of rights to property under the control or supervision of an insolvency administrator.¹⁰⁵

LCG Advice

- 4.121 The LCG Advice states the insolvency of the account holder's immediate account provider shall not affect the book-entry rights. Book-entry rights do not form part of the insolvent account provider's estate.

¹⁰⁰ The question of which law should govern in these circumstances is not expressly dealt with in the Hague Convention. The European Commission Staff Working Document, *Legal assessment of certain aspect of the Hague Convention* (3 July 2006) notes at p10 that it is an unfortunate lapse of drafting that the Hague Convention does not have a normative provision expressly addressing this crucial issue. It does note, however, that the Explanatory Report to the Hague Convention makes it clear that if the law of the purchaser's account awards priority to the purchaser, this law will prevail.

¹⁰¹ Article 15.

¹⁰² Article 23

¹⁰³ Article 31.

¹⁰⁴ Article 16(a).

¹⁰⁵ Article 16(b).

Law Commission comments

- 4.122 The protection of an account holder's rights from an insolvent intermediary's creditors is at the core of the intermediary/account holder relationship. The Convention is neutral in its characterisation of this protection, describing the account holder's rights simply as being 'effective' against the insolvency administrator and creditors.¹⁰⁶ Article 21(2) is more revealing. It states that securities allocated to an intermediary's account holders "shall not form part of the property of the intermediary available for distribution among or realisation for the benefit of creditors of the intermediary".
- 4.123 As mentioned above, the Article provides that the Convention does not affect certain domestic rules applicable to insolvency proceedings (namely the avoidance of transactions as a preference or fraud) and all procedural rules relating to enforcement of property rights, subject to the two specific exceptions.¹⁰⁷
- 4.124 We are unclear why it is necessary to state that domestic insolvency law will take precedence in relation to the avoidance of transactions for preference or fraud. Article 11 leaves all issues relating to the invalidity or reversal of credits, debits and designating entries to domestic law (which includes insolvency law) and so presumably, this is already covered. If, however, this is not the case and there is a need to expressly carve-out these avoidance rules, we do not see why only preferences and frauds on creditors should be left unaffected by the Convention. English insolvency law lays down a number of other circumstances in which transactions may be avoided. These include:
- (1) transactions at an undervalue;¹⁰⁸
 - (2) extortionate credit transactions;¹⁰⁹
 - (3) floating charges given otherwise than for specified forms of new value;¹¹⁰
and
 - (4) dispositions of the company's property made without leave of the court after presentation of a winding up petition.

¹⁰⁶ In our opinion, this general insolvency protection should not prevent an English court from exercising its discretion to award costs out of an account holder's assets in circumstances where the law recognises that the assets belong to the account holder and not to the intermediary. An example is where the assets of the insolvent intermediary are insufficient to meet the liquidator's costs in administering property held on trust by the intermediary for its clients. See *Re Berkeley Applegate (Investment Consultants) Ltd (No 2)* [1989] Ch 32; *Re Berkeley Applegate (Investment Consultants) Ltd (No 3)*. (1989) 5 BCC 803. See J Benjamin, "Cross Border Proprietary Rights", *Butterworths Journal of International Banking and Financial Law*, January (1997), 16

¹⁰⁷ We presume that the Article applies irrespective of whether the insolvency proceedings are those of the intermediary or of the account holder.

¹⁰⁸ Insolvency Act 1986, s 238.

¹⁰⁹ Insolvency Act 1986, s 244.

¹¹⁰ Insolvency Act 1986, s 245. This will only be relevant if floating charges fall within the scope of the Convention.

- 4.125 The implication of Article 16 seems to be that any domestic insolvency rule not covered by it will be overridden by the Convention to the extent that the rule and the Convention conflict. Yet we see no clear justification for permitting avoidance of transactions for preference and fraud but not, for example, of transactions at an undervalue carried out by an intermediary at the request of an insolvent account holder. Rather than attempt to set out an exhaustive list of insolvency law rules, we propose that the carve-out be reversed and that national insolvency law rules should generally take precedence over the Convention unless the Convention specifically states otherwise. It should also be remembered that national insolvency laws within the EU have already been amended to accommodate the Financial Collateral Directive and the Settlement Finality Directive. Both these directives disapply insolvency laws in certain circumstances in relation to intermediated securities.

PROHIBITION ON UPPER TIER ATTACHMENT

The Convention

- 4.126 The Convention prevents an attachment order in relation to intermediated securities being granted against the issuer or an upper tier intermediary.¹¹¹

LCG Advice

- 4.127 The LCG Advice states that book-entry rights are not enforceable, nor is attachment in respect of such rights allowed, against any upper tier intermediary.

Law Commission comments

- 4.128 The prohibition on upper tier attachment is critical to removing legal uncertainty associated with asserting rights in securities above the level of an account holder's own intermediary. The prohibition also maintains the principle of upper-tier priority in relation to claims between different tiers of account holders. We have no comments on the Article as currently drafted and note that it addresses the concern raised in the FMCL Report regarding clarity on this matter.

INSTRUCTIONS

The Convention

- 4.129 An intermediary is neither bound nor entitled to give effect to instructions with respect to intermediated securities given by any person other than the account holder. This general rule is subject to (1) the provisions of the account agreement, (2) the rights of interest takers in respect of the securities, (3) any court order, (4) any mandatory rule of domestic law, and (4) where the intermediary is a system operator, the rules of the system.¹¹²

LCG Advice

- 4.130 The LCG Advice makes no comment regarding instructions given to intermediaries.

¹¹¹ Article 17.

¹¹² Article 18.

Law Commission comments

- 4.131 We agree with the approach taken by the Convention. The carve-out for mandatory rules of domestic law are for court orders should be of assistance to a lower tier account holder in circumstances where its intermediary is incapable of giving instructions on its behalf (for example, due to insolvency or because the intermediary has absconded or is otherwise acting fraudulently). Requirement of the intermediary to hold sufficient securities

THE REQUIREMENT OF THE INTERMEDIARY TO HOLD SUFFICIENT SECURITIES

The Convention

- 4.132 An intermediary is required to hold the number of securities equal to the aggregate number and amount of securities credited to the accounts that it maintains. If it does not, it must within the time required by domestic law, take action to ensure that it satisfies the duty.¹¹³ The method and cost allocation of complying with this obligation (and the consequences of breaching it) are subject to domestic law, the account agreement and any applicable rules of the system.¹¹⁴

LCG Advice

- 4.133 The LCG sets out a list of minimum duties that an intermediary owes to its account holders. This includes a duty to maintain holdings that match the balance of credits on its account holders' accounts.

Law Commission comments

- 4.134 An intermediary's duty to hold sufficient securities to satisfy its account holders' entitlements is critical to minimising custody risk. The duty is drafted in general terms in the Convention and does not distinguish between the intermediary's house account and the accounts it holds for customers.¹¹⁵ This could result in an intermediary technically being in breach of the obligation in the event that a shortfall arises in its own house account but not in its customer accounts.
- 4.135 We would prefer that the Article is reformulated so that the intermediary cannot be in breach of a duty owed to itself. The intermediary should be required instead to maintain sufficient securities to meet the entitlements of its account holders but not also to satisfy the credits in its own accounts. This would tie in better with Article 21 (*Allocation of securities to account holders' rights*) which permits domestic law to determine to what extent securities credited to an intermediary's house account can be allocated to its account holders.¹¹⁶

¹¹³ Article 19(1) and (2).

¹¹⁴ Article 19(3).

¹¹⁵ See UCC §8-504.

¹¹⁶ The interplay between these two Articles is discussed in further detail below. See para X.

- 4.136 It is a corollary of the intermediary's duty to hold sufficient securities that the intermediary must obtain the consent of its account holders if it wishes to grant a security interest over their securities. It is not enough for an intermediary to hold securities of an equivalent number if it has charged some or all of these securities to a collateral taker (by means of a designating entry or some other non-possessory security interest) without the account holders' consent. We believe that Article 19(1) would benefit from greater clarity on this point.

LIMITATIONS ON OBLIGATIONS AND LIABILITIES OF AN INTERMEDIARY

The Convention

Precedence of domestic law

- 4.137 Article 20(1) of the Convention states that:

The obligations of an intermediary under this Convention and the extent of the liability of an intermediary in respect of those obligations are subject to any applicable provision of the non-Convention law and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system.

Additional protection from third party claims

- 4.138 The Article has been revised since the last draft to include provisions that give certain categories of intermediary additional protection from the claims of third parties whose rights in intermediated securities have been violated. Article 20(2) protects the operator of a settlement system from liability to such third parties if the liability arises as a result of the operator making debits, credits or designating entries to its account holder's accounts.¹¹⁷ This protection does not affect the operator's liability to its own account holders and interest takers nor does it protect it in relation to entries made other than in accordance with the Convention's rules on instructions.¹¹⁸ It has not yet been decided whether to extend this protection to all intermediaries and not just to settlement system operators.
- 4.139 In addition, settlement system and clearing system operators who act as central counter-parties by matching credits and debits to their own accounts are protected from liability to third party claimants arising from this exercise.¹¹⁹ Neither of these defences is available if the operator makes the entry despite having had reasonable time to act in response to a legal process restraining it from doing so or if the operator acts wrongfully and in concert with another person to violate the rights of the third party.

¹¹⁷ Article 20(2).

¹¹⁸ Article 20(3).

¹¹⁹ Article 20(4).

LCG Advice

Precedence of domestic law

- 4.140 While the LCG Advice does not comment directly on this Article, it does propose that where national laws are incompatible with the aim of the legislation, which is to recognise the legal effects of a book-entry, the national laws must be brought into conformity.

Absolute obligations

- 4.141 The LCG Advice further states that certain duties of an intermediary should be absolute and therefore immune to alteration by contract. These include the duty to comply with instructions in relation to disposing, pledging and withdrawing securities from an account. The duty to maintain sufficient securities is also considered absolute although the duty to replace missing assets or reimburse the account holder in the case of shortfalls can be contractually limited or excluded. The LCG leaves for further consideration the question of whether other duties should also be immune from contractual variation.

Law Commission comments

Precedence of domestic law

- 4.142 The Convention operates in large part as a minimum set of rights that an account holder can rely upon as a result of a credit to its account.¹²⁰ In addition, the Convention sets out the obligations of intermediaries that maintain accounts for account holders. An account holder's rights will typically correspond to its intermediary's obligations and vice versa.¹²¹ Rights, obligations and liabilities that exist under domestic law continue to exist alongside those created under the Convention.
- 4.143 We support the general approach that the parties should be able to modify an intermediary's obligations by contract (to the extent permitted by law). We also acknowledge that settlement systems may need to prescribe their own rules on these matters. However, we are concerned that if domestic law is simply permitted to prevail over all obligations and liabilities created by the Convention to the extent that the two conflict, any legal certainty created by the Convention would be significantly diminished. The legal framework would simply permit the inconsistencies that currently exist between Contracting States to continue. We note that some of the intermediary's obligations prescribed by the Convention are already made subject to domestic law in certain respects and are also limited by Article 6.¹²² We believe that a general carve-out is therefore inappropriate.

¹²⁰ See Article 5(1)(d).

¹²¹ In a direct enforcement system, the account holder may also have rights against the issuer if the account holder is acting for its own account.

¹²² For example, Article 19(3), Article 18(d).

4.144 Furthermore, by making an intermediary's obligations subject to domestic law, the Convention effectively makes the package of account holder's rights under the Convention also subject to domestic law. If, as in the case of the English law, an account holder is able to enforce the Convention rights only against its intermediary, domestic law should not always be left to determine the extent to which the intermediary is obliged to give effect to these rights. Again, we would prefer to rely on specific references to domestic law in each Article.

Absolute obligations

4.145 Leading on from this, we also agree with the LCG's proposal that certain of the intermediary's obligations should be absolute. While we view it as a somewhat puzzling distinction, we do not object to there being an unalterable duty to maintain sufficient securities to satisfy account holders' entitlements as long as the duty to remedy a shortfall in the account can be limited or excluded by contract. The obligation to pass on payments or distributions made by the issuer of the securities once they have been received by the intermediary should also be absolute and not subject to alteration by contract or domestic law.¹²³

4.146 On the other hand, contrary to the LCG position, we believe an intermediary should have the contractual flexibility to provide for the manner in which it complies with instructions to dispose of securities and to withdraw them from an account. It is more appropriate that domestic law govern whether the contractual variation of these duties and liabilities are legally effective.

Protection from third party claims

4.147 The latest draft of the Convention has introduced a high level of protection for certain classes of intermediary against claims made by third parties. It has yet to be determined whether or not this protection should be extended to all intermediaries or only to clearing and settlement system operators. As currently drafted, settlement system operators enjoy the higher protection when settling securities across the accounts of their participants.¹²⁴ A similar protection extends to both securities settlement system operator and clearing system operators in relation to the clearing of securities as a central counter-party.¹²⁵ The motive behind increasing this protection is to promote systemic efficiency by removing the potential liability of a system operator where it is put on notice of a conflicting claim to securities. Without an assurance that it will not be liable should the claim be valid, the system operator may be forced to freeze an account holder's account pending confirmation.

4.148 The solution proposed by the Convention would make the system operator liable only where it has acted in violation of a legal process (such as an injunction) or where "it acts wrongfully and in concert with another person" in the violation of a third party's rights. Formulating so robust a defence is a sensitive policy issue as it lessens investor protection in favour of systemic efficiency.

¹²³ See for example UCC, Article §8-505(b).

¹²⁴ Article 20(2).

¹²⁵ Article 20(3).

- 4.149 In English law, intermediaries that receive and deal with securities in violation of a third party's rights may be protected from liability if they have acted in a ministerial capacity – that is to say, if the intermediary upon receipt of the securities owes an immediate duty to account for them to its account holder.¹²⁶ Cases of 'ministerial receipt' have typically involved the receipt of misappropriated trust property by banks but we see no reason why the principle would not apply to intermediaries receiving securities on trust for their account holder. In these circumstances, the intermediary may still be liable for dishonest assistance if it has dealt with the property in accordance with its account holder's instructions, knowing that it is facilitating a breach of trust, and knowing that its actions would be regarded as dishonest by right-thinking people.¹²⁷ Facilitating a breach of trust in a way that the intermediary knows would be considered dishonest does not seem to us to be far removed from the Convention test of wrongfully acting in concert.
- 4.150 Nevertheless we question whether it is necessary to harmonise the treatment of third party claims either against intermediaries generally or system operators specifically in the way proposed by the Convention. While we recognise the benefit to systemic efficiency, we believe that Contracting States should be free to establish their own national policies and clearing and securities settlement system rules. CREST, for example, is subject to the Uncertificated Securities Regulations 2001 which restrict its liability when acting on 'properly authenticated dematerialised instructions'.¹²⁸

ALLOCATION OF THE SECURITIES HELD BY AN INTERMEDIARY

The Convention

- 4.151 Securities held by an intermediary or credited to its account with an upper tier intermediary are allocated first to its own account holders to the extent necessary to satisfy their entitlements.¹²⁹ This allocation can be effected by arrangements made by the intermediary in accordance with domestic law. The arrangements can include pooled accounts as well as segregated accounts holding securities for one or more designated account holders.¹³⁰
- 4.152 Contracting states can opt to allow an intermediary to segregate the securities it holds for its own account from those of its account holders so that, in the event of a shortfall in the customer account, the intermediary's own securities are not automatically allocated to its account holders but remain part of its estate.¹³¹

¹²⁶ See D Hayton, *Underhill & Hayton Law of Trusts and Trustees*, (16th ed) pp 970-973.

¹²⁷ *British North American Elevator Co v Bank of British North America* [1919] AC 658.

¹²⁸ Uncertificated Securities Regulations 2001, Reg 35.

¹²⁹ Article 21(1).

¹³⁰ See paras 2.17-2.18 above for an explanation of segregated and pooled accounts.

¹³¹ Article 21(5). The opt-out is effected by means of declaration mechanism.

- 4.153 In the event of an intermediary's insolvency, any shortfall in the number of securities that it holds is allocated in accordance with the rules of the insolvency proceedings.¹³² Where the intermediary is the operator of a securities settlement system, any system rules that deal with the allocation of shortfalls will take precedence over the Convention.¹³³ In the absence of conflicting insolvency rules and settlement system rules, the Convention provides that a shortfall shall be borne pro rata amongst those account holders to whom the relevant securities had been allocated. The allocation of losses will therefore recognise any arrangements made by the intermediary for the segregation of customer accounts.

LCG Advice

- 4.154 The LCG Advice refers to the allocation of losses only briefly. It states that a rule will be needed within the new legislation as to how insufficient assets held by the account provider are shared among its account holders, if there is an incurable shortfall. The LCG notes that the formulation of this rule is a matter for policy makers.

Law Commission comments

Allocation between intermediary and customers

- 4.155 The Convention's general rule for allocating securities to an intermediary's account holders makes no distinction between securities that are credited to customer accounts and those held by the intermediary for its own account. If a shortfall arises in the customer account, securities held by the intermediary for its own account would be treated as belonging to its account holders in the event of its insolvency.¹³⁴
- 4.156 The Convention permits Member States to opt out of this arrangement and give legal effect to the segregation of intermediary and customer assets. In order for segregation to be effective under English law, the intermediary must open separate accounts (or entries in the issuer's register if the intermediary holds directly from the issuer) with the intermediary or issuer above it. Securities held by the intermediary in its own name and for its own account in a segregated securities account are treated as belonging to the intermediary. Should the intermediary fall insolvent leaving a shortfall in its customers' securities accounts, its customers will have no priority claim over these house securities but will rank equally with its other creditors. This is subject, however, to any remedy the account holders may have under English law to trace securities that have been misappropriated from the customer accounts into the intermediary's own house account.

¹³² Article 22(1).

¹³³ Article 22(3).

¹³⁴ While this allocation out of the house securities could remedy the shortfall in the customer account, it would nevertheless result in a technical breach of the intermediary's duty to maintain sufficient securities as this applies both to its customer and house accounts. We have proposed that this be revised.

- 4.157 The Convention offers greater clarity than English law currently does regarding the treatment of account holders' rights where both house securities and customer securities are held in the same account. Many legal commentators would argue that, under English law, the mixing of house and customer securities in a single account precludes the creation of a valid trust. In these circumstances it becomes impossible to identify whether particular securities in the account belong to customers or to the intermediary and consequently the trust fails for certainty of subject matter.¹³⁵ If so, the account holder is left with only a personal claim and would rank equally with unsecured creditors in the intermediary's insolvency. While this view is at odds with the approach taken by the courts, it is nevertheless a source of uncertainty.¹³⁶
- 4.158 Under the Convention, segregation is no longer necessary to protect account holders from the credit risk of their intermediary. House and customer securities mixed in a single account are allocated first to account holders. Any shortfall in a mixed account will therefore be borne first by the intermediary's house securities of the same description. Segregation of house and customer accounts will still serve the purpose of ensuring that account holders do not take priority over the intermediary's other creditors in relation to the intermediary's own house securities.¹³⁷
- 4.159 We note that the Convention does not specify what steps need to be taken to segregate accounts. As mentioned above, segregation under English law requires separate accounts to be opened up by the intermediary with the issuer or intermediary above it. It is not enough for the intermediary simply to hold securities in single account but record that they are segregated in its own accounts. We believe that the Convention would benefit from an explanation of what constitutes segregation. For example, an intermediary should not be able to claim that a loss in a pooled account above it should be borne only by its customers on the grounds that it has debited its customer's accounts and not its own house account.

Allocation of losses between account holders

- 4.160 We turn next to the allocation of losses amongst account holders in the event of their intermediary's insolvency.

¹³⁵ For a fuller discussion of this 'allocation problem' see Law Commission Seminar Paper 2 at paras 1.43-1.60. Whereas an omnibus account holding only customer securities can be viewed as conveying upon each account holder an interest as an equitable tenant in common in the entire pool of securities, a mixed account cannot.

¹³⁶ See *Hunter v Moss* [1993] 1 WLR 934 (followed by *Re Havard Securities* [1997] 2 BCLC 369 and *Re CA Pacific Finance Ltd* [2000] 1 BCLC 494) in which the judge at first instance concluded that specific identification of fungible assets was "unnecessary and irrelevant". See also Seminar Paper 2 paras 1.37 –1.60 for further discussion of this issue.

¹³⁷ It is entirely appropriate that account holders should not rank ahead of the intermediary's other creditors in relation to securities that belong to the intermediary. This is of course subject to any tracing remedy the account holders may have to claim that the house securities belong to them. If account holders were automatically able to take priority over segregated house securities of the same description as those missing in a customer account, the intermediary's other creditors would have no way of assessing the credit risk of the intermediary. The intermediary would be forced into a costly restructuring in order to ring-fence their custodial business to avoid this result.

LOSS ATTRIBUTED TO SPECIFIC ACCOUNT HOLDERS

- 4.161 Loss allocation rules generally follow one of two paths. One approach is to simply attribute the loss to the account holder whose account was wrongfully or mistakenly debited. The loss of its proprietary entitlement is borne by the account holder unless and until the credit is restored by reversing or invalidating the transfer (as a result of domestic law)¹³⁸ or by its intermediary purchasing additional securities. If the intermediary falls insolvent before it can do so, the account holder is left as an unsecured creditor with a personal claim against the intermediary.
- 4.162 This method of allocating losses confronts practical problems if no debit has been made in the account of a particular account holder. This scenario could occur in a non-matching system where a credit does not have to be matched with a corresponding debit for a transfer to be effective. It can also occur in both matching and non-matching systems where the account holder whose account has been debited without its knowledge holds the securities on behalf of a pool of customers. In such cases, it will not know which of its customers it should debit to reflect the shortfall in its account with the intermediary above. In both circumstances the system must fall back on a loss distribution method to reconcile the account imbalance (known as a shortfall) between the intermediary's account and the accounts of its customers.

LOSS DISTRIBUTION RULE

- 4.163 The second approach to loss allocation is to formulate a loss distribution rule and apply it to all losses affecting innocent account holders irrespective of whether the loss can be attributed to a specific account. In these circumstances, an improper debit to an account is re-credited even if the intermediary has yet to purchase securities to satisfy its duty to maintain sufficient securities. Accordingly, an improper transfer will ultimately result in a shortfall in every case. If the intermediary cannot remedy it by buying more securities, the shortfall must be allocated by the loss distribution rules.
- 4.164 English law has developed rules for apportioning losses between claimants to a pooled fund. The rule established in *Clayton's Case*¹³⁹ whereby the first assets into a fund are deemed to have been the first assets out has traditionally been applied to resolve competing claims. However, the Court of Appeal in *Barlow Clowes International Ltd (in liquidation) v Vaughan*¹⁴⁰ has held that alternative methods of distribution should be used if the 'first in first out' 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 pooled account. The Convention's approach of pro rata apportionment therefore reflects the method most likely to be adopted by the English courts.

¹³⁸ This will not be possible if the transferee has a defence, e.g. it is an innocent purchaser.

¹³⁹ (1816) 1 Mer 572.

¹⁴⁰ [1992] 4 All ER 22.

PRO RATA ALLOCATION OF LOSS

- 4.165 How the method of loss distribution is formulated is effectively a question of risk management. The Convention's approach of allocating the loss pro rata amongst account holders in proportion to the size of their entitlements offers an equitable way of sharing the risk. We believe that, in the absence of domestic insolvency law rules, contractual terms or system settlement rules to the contrary, this method should be universally applied. Consequently, we welcome the revision in the last draft of the Convention that removes the need to take into account past dealings or the order or time at which securities were debited or credited.

Identifying the pool of account holders

- 4.166 Identifying the pool of account holders that should share in the allocation of loss and fixing the moment at which the entitlements of this pool should be measured are critical to ensuring that the loss allocation method is consistently employed in different Contracting States.
- 4.167 The Convention is silent as to the time at which this pool should be measured. As the composition of an intermediary's pool of account holders can fluctuate significantly from day to day, the lack of a common approach on this point could lead to significant differences in the outcome of loss allocations in different Contracting States.
- 4.168 Generally speaking, it is the combination of a shortfall in an account with the insolvency of the intermediary that will result in an account holder failing to receive full recovery of its securities. Accordingly, account holders must not only assess the risk that their intermediary may act negligently or fraudulently (that is to say, custody risk) but also the risk that the intermediary will be unable to remedy the shortfall (namely credit risk). . 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. At the last UNIDROIT session, the UK delegation proposed that the pool of account holders should be measured at the moment of the intermediary's insolvency. This proposal was rejected by the plenary on grounds that there may be circumstances where changes in the size of account holders' entitlements made after the commencement of insolvency proceedings should be taken into consideration.
- 4.169 The plenary did accept the UK delegation's proposal that the allocation of losses should take into account arrangements that have been made to segregate customer accounts from each other. As has already been mentioned, effective segregation requires the intermediary to open separate accounts with the issuer or intermediary above it which, while in its own name, are recorded as being held for the specific account holders. Under English law, each segregated account represents a separate trust of assets held for the particular beneficiaries of that trust. Allocating losses across segregated accounts would represent a fundamental break from this traditional trust analysis.

- 4.170 The revision to the draft to recognise the legal effect of segregation as between customer accounts retains a customer's options as regards risk management. Although pro rata sharing of risk is an attractive means of managing risk, account holders who actively choose (and pay for) the segregation of their account should be able to opt out of this method. Some may have good reason to do so. For example, 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 errors.¹⁴¹

Circumstances in which loss allocation method is applied

- 4.171 The loss sharing rules set out in the Convention apply to “any insolvency proceeding in respect of an intermediary”.¹⁴² In our opinion, limiting the application of the rule to insolvency situations is too narrow if the correct interpretation of the provision is to restrict the application of the loss sharing rules to situations where the account holders' own intermediary is insolvent. In longer chains of ownership, where a shortfall arises as a result of the insolvency of a higher tier intermediary, the lower tier intermediaries may not be obliged under the terms of their account agreements to remedy the loss themselves. Instead these solvent intermediaries will pass on the loss to their own account holders. In the absence of insolvency law, settlement system rules or contractual terms dealing with the allocation of losses, they too should be able to rely on the Convention's loss allocation rules as the default regime.

LEGAL RECOGNITION OF INTERMEDIATED SECURITIES

The Convention

- 4.172 The Convention imposes on legal systems the requirement that they permit the effective exercise of an account holder's rights in publicly-traded securities where the securities are held through an intermediary.¹⁴³ The Convention does not, however, require that all securities must be issued on terms that permit them to be held through an intermediary. Accordingly, where an issuer wishes to effectively restrict the holding of its securities through an intermediary it may do so in the terms of the securities.
- 4.173 The Convention further states that domestic law must recognise an intermediary's ability to exercise voting and other rights in different ways for its account holders in circumstances where the intermediary is acting in its own name on behalf of them.¹⁴⁴ The Convention does not however determine the conditions under which an intermediary is authorised to exercise these rights nor does it determine whom an issuer is required to recognise as the holder of securities.¹⁴⁵

¹⁴¹ An account holder may also wish to ring fence itself from accounts that operate by way of contractual settlement (i.e. the intermediary credits account holders before the securities have been actually delivered into the account).

¹⁴² Article 22(1).

¹⁴³ Article 24(1).

¹⁴⁴ Article 24(2).

¹⁴⁵ Article 24(3).

Law Commission comments

- 4.174 While the LCG Advice does not expressly mention the need for legal recognition of intermediated holding, it is fair to say that it is implicit in its Advice. We agree that ensuring the effective exercise of rights in publicly-traded securities is a necessary prerequisite to establishing a harmonised framework for their treatment within the EU. Limiting the rule to publicly traded securities is a satisfactory concession to those Contracting States wishing to retain certain legal restrictions on the exercise of indirectly held rights in closely-held companies.
- 4.175 Laws that prevent the rights attaching to a block of securities from being voted or exercised in different ways is perhaps the most obvious example of a restriction on the effective exercise of rights through an intermediary. Perhaps for this reason, the Convention makes specific reference to them. The fact that domestic law can impose conditions upon the authority of a person to exercise these rights could be seen as a way of reintroducing restrictions. However, in our opinion, these conditions must remain subject to the general requirement that the law must allow the effective exercise of rights.

SET-OFF

The Convention

- 4.176 The Convention states that the existence of an intermediary or intermediaries between account holder and issuer does not, of itself, prevent the exercise of any right of set-off that would exist if the securities were held directly from the issuer.¹⁴⁶

LCG Advice

- 4.177 The LCG Advice makes no comment regarding set-off between account holder and issuer.

Law Commission comments

- 4.178 Ensuring that an account holder can set-off a debt against an insolvent issuer is a welcome assurance to investors holding securities indirectly through an intermediary. Set-off can facilitate structures in which a customer holding debt securities can manage the risk of an issuer default. The FMLC Report explains the arrangement as follows:

The customer arranges for the issuer to have a credit exposure to the customer (for example by entering into a swap with the issuer, and running up an uncollateralised out of the money position). In the event of the issuer defaulting on the bonds, the customer would ensure that it is in effect paid in full by setting its obligation to pay under the swap against its right to be paid under the bonds.¹⁴⁷

¹⁴⁶ Article 25.

¹⁴⁷ FMLC Report, p 25.

- 4.179 While the FMLC Report advocates the availability of set-off between issuer and account holder, it makes the right subject to an important qualification. In order for an account holder to assert set-off it must have good title to the securities, free from any defences or rights of set-off of its intermediary and any third party interests.¹⁴⁸ The qualification is necessary to avoid rendering worthless an intermediary's lien, charge or right of set-off against its account holder (for example in relation to the intermediary's fees). If the qualification did not exist, an account holder could circumvent the intermediary's encumbrance by setting-off the whole amount of its encumbered interest in securities against a debt it owes to the issuer without first discharging the obligation it owes to its intermediary.
- 4.180 We note that the Article is expressed in negative terms and does not seek to state the conditions necessary for set-off to be available. Instead, it simply ensures that the existence of an intermediary does not, of itself, preclude a right of set-off. Domestic law is left to determine whether other requirements for set-off are satisfied. Therefore, on balance, we now think that this qualification could simply be referred to in the explanatory notes to the Convention rather than in the text.
- 4.181 The existence of an intermediary is likely to be an impediment to set-off in legal systems, such as in England, that require mutuality of obligations between the parties but which give the investor direct rights only against its own intermediary and not against the issuer. We presume that, in disregarding the existence of an intermediary, the Article also acts to remove this need for mutuality of obligations. If it does not, it is arguable what benefit the Article provides in these legal systems.¹⁴⁹
- 4.182 We are pleased that the Article has been revised to clarify that the right of set-off is potentially available when more than one intermediary exists between the issuer and the ultimate investor. We acknowledge that giving a right of set-off to an investor that holds through one or more intermediaries is a violation of the no-look through principle. We note, however, that this occurs only in very limited circumstances, namely the insolvency of the issuer and the benefits of extending the right of set-off in these circumstances outweigh the disadvantages of creating this exception.

PROVISIONS IN RELATION TO COLLATERAL TRANSACTIONS

The Convention

- 4.183 The Convention sets rules for the enforcement of a security interest over intermediated securities. In addition to giving effect to the enforcement of collateral by means of sale or appropriation, the Convention recognises the effectiveness of contractual provisions that allow for close-out netting, top-up or substitution of collateral.

¹⁴⁸ FMLC Report, p 18.

¹⁴⁹ Regulation 12 of the UK Financial Collateral Arrangements (No 2) Regulations 2003 appears to remove the need for mutuality in relation to close-out netting for financial collateral although this remains a matter of debate. See A Fawcett, 'The Financial Collateral Directive: An examination of some practical problems following its implementation in the UK' JIBLR 2005, 20(6), 296.

- 4.184 The rules are set out in a separate Chapter of the Convention.¹⁵⁰ Contracting States are entitled to declare that the Chapter does not apply under its domestic law or may choose to declare that the Chapter shall not apply in relation to (1) collateral agreements entered into by natural persons, or (2) intermediated securities that are not listed, or (3) certain types of secured obligations.
- 4.185 The Chapter was substantially revised during the last drafting session largely as a result of amendments proposed by the International Swaps and Derivatives Association.¹⁵¹

LCG Advice

- 4.186 The LCG Advice contains no reference to the enforcement and use of collateral.

Law Commission comments

- 4.187 We note that the Chapter no longer refers specifically to security interests granted in accordance with the Convention.¹⁵² We do not believe that the purpose of the Convention is to apply the rules set out in the Chapter to all security interests over intermediated securities irrespective of whether they are created in accordance with the Convention or under domestic law. If we are correct in this belief, the qualification should be reinserted into the Chapter.

Title transfer arrangements

- 4.188 The new definitions in the Chapter make it clear that the rules apply not only to collateral arrangements involving a security interest (such as a charge or mortgage) but also to title transfer collateral arrangements in which full ownership of the securities is transferred to the collateral taker.
- 4.189 Title transfer collateral agreements typically rely upon the operation of a close-out netting which converts each party's obligations into monetary sums which are then set-off against each other. The Chapter now includes provisions dealing with the legal recognition and operation of close-out netting. These provisions are closely modelled on the FCD.

Comparison with the FCD

- 4.190 As in the case of the creation of security interests, the rules set out in the Convention should be compatible with the FCD. To a large extent the provisions of the Convention replicate exactly the relevant provision in the FCD.
- 4.191 A comparison of the Convention rules and the FCD does throw up the following discrepancies:
- (1) Member States that do not allow appropriation on 27 June 2002 are not obliged to recognise it under the FCD whereas under the Convention they must do so.

¹⁵⁰ Chapter VI.

¹⁵¹ A letter, dated 6 October 2006, sent by ISDA to UNIDROIT explaining its proposed amendments is available on ISDA's website www.isda.org.

¹⁵² Note the deletion in Article 26(1).

- (2) Recital 15 of the FCD permits domestic law to prevent the netting or set-off of obligations in circumstances where the collateral taker knew, or ought to have known, of the commencement of insolvency proceedings at the time that the netting arrangement was entered into. This need for an absence of notice is incorporated into the UK Financial Collateral Regulations.¹⁵³ The Convention imposes no such requirement nor does it appear to permit domestic law to impose one. We propose that the Convention is amended to bring it into conformity with the FCD by allowing Contracting States to require that the collateral taker had no notice of insolvency proceedings.
- (3) The circumstances in which collateral can be topped-up without falling foul of insolvency rules go beyond those permitted in the FCD. In addition to top-ups in response to a change in value of collateral or in the amount of the relevant secured obligations (both of which are permitted by the FCD), Article 31(1)(a)(ii) permits top-up:

in order to take account of any circumstances giving rise to an increase in the credit risk incurred by the collateral taker as determined by reference to objective criteria relating to the creditworthiness, financial performance or financial condition of the collateral provider or other person by whom the relevant obligations are owed.
- (4) Contracting States are able to opt-out of this additional circumstance should they so wish. Article 27(1) states that the law of a contracting state shall permit a title transfer collateral agreement to take effect in accordance with its terms. While this mirrors the language in the FCD, it has been pointed out to us that, without the benefit of the explanatory recitals in the FCD, such wording would appear to permit *each and every* term of the title transfer financial collateral arrangement to be effective. The FCD provision was concerned only with preventing 'recharacterisation risk'. The Convention should clarify that this Article refers only to terms in a collateral agreement that could be reinterpreted by domestic law to recharacterise the title transfer collateral arrangement as a security interest.
- (5) The recitals in the FCD make it clear that references to netting are to bilateral netting arrangements and not to multilateral netting or cross affiliate netting. The Convention makes no such qualification.

¹⁵³ Financial Collateral (No 2) Regulations 2003, Reg 12(2).

PART 5

INNOCENT PURCHASERS OF INTERMEDIATED SECURITIES

SUMMARY OF CONCLUSIONS

- 5.1 A disparity exists in the level of protection against proprietary claims afforded by English law to purchasers of intermediated securities when compared to purchasers of the legal title to securities. This disparity cannot be justified on legal or commercial grounds and potentially gives rise to arbitrary and anomalous results. It does not reflect market expectations and should be removed.
- 5.2 Incorporating the UNIDROIT Convention (as currently drafted) into English law would adequately rectify this disparity by granting purchasers of intermediated securities a level of protection that closely matches that of purchasers of directly held securities under English law.
- 5.3 There can be no guarantee that the EU Member States will ratify the UNIDROIT Convention within the next couple of years or at all.
- 5.4 There is a risk that the absence of legal protection for purchasers could lead to a loss of confidence by investors and collateral takers in the settlement of securities across the books of an intermediary under English law. This loss of confidence could, for example, be triggered by litigation or by a revaluation of legal risk following a financial crisis. In a worst-case scenario, it could have a significant adverse affect on securities markets in the UK and on the choice of English law to govern property rights in intermediated securities.
- 5.5 The risk is relatively small for a number of reasons.
- 5.6 Experience shows that the settlement of securities across the books of intermediaries has grown despite the appreciation of this absence of protection by some legal experts and despite discussion of the issue in previous case-law¹ and public reports.²
- 5.7 Financial regulation reduces the risk of loss by reducing both the chances of impropriety and the possibility that the intermediary at fault will be insolvent and consequently unable to remedy the loss in full.
- 5.8 Netting in clearing and settlement systems makes it difficult for claimants to trace securities (or their proceeds) into the hands of a purchaser.
- 5.9 Litigation concerning the availability of legal protection to purchasers of intermediated securities is rare.

¹ ie . *Macmillan Inc.v Bishopsgate Trust (No 3)* [1995] 1 WLR 978.

² See FMLC Report, *Issue 3: Property Interests in Investment Securities* (July 2004), p 13; Law Commission Seminar Paper 3 - Issues affecting Transferees of Intermediated Securities, p 34: www.lawcom.gov.uk/docs/investment_securities_seminar_paper_3.pdf.

- 5.10 On balance, we nevertheless recommend that domestic legislation should be passed to bring the law into line with market practice. We propose that this be effected by treating a good faith purchaser of intermediated securities as being unaffected by equitable interests or equities of which it had no notice at the time of the transfer.
- 5.11 Subject to the views of parliamentary draftsmen, we believe that the disparity could be removed relatively easily and without need for long and complex legislation. Particular consideration would need to be given to the scope of application of the legislation and in particular the definitions of 'securities' and 'intermediated securities'. Current legislation (such as the Financial Collateral Arrangements (No2) Regulations 2003) and the draft Convention offer a starting point.

INTRODUCTION

- 5.12 In this part of the Report we examine the level of protection currently granted by English law to innocent purchasers of intermediated securities. At the end of our analysis, we make recommendations for the creation of a legal defence in English law for purchasers of intermediated securities against the adverse claims of third parties.
- 5.13 The extent to which the law should protect a transferee from pre-existing interests in property that it acquires is a complex and far reaching question. At the heart of the matter lies a conflict between two fundamental principles of English commercial law; namely security of transfer and security of title.³
- 5.14 Security of title provides that a person should be deprived of his proprietary rights only in exceptional circumstances. Consequently, a person should not be able to convey title to goods belonging to another unless it possesses the authority or title to do so. Opposing this position is the principle of security of transfer. It protects the purchaser of property rather than the vested rights of the original owner and provides that a transfer of assets in good faith should not be reversed.

³ See generally J Benjamin *Interests in Securities* (2000) pp 75-78.

- 5.15 The conventional wisdom and commercial expectation of participants in modern securities settlement systems is that the innocent purchaser of securities should prevail. This expectation is one that is generally fulfilled by law in most jurisdictions within the European Union⁴ and worldwide. The protection of an innocent purchaser has developed into a central plank of settlement finality within securities settlement systems.⁵
- 5.16 There is uncertainty in English law whether, and to what degree, a purchaser that acquires intermediated securities by way of a transfer on the books of an intermediary is protected. Such purchasers appear unable to rely upon the most common defences and exceptions to security of title available to purchasers of securities held directly from the issuer. The underlying legal cause of this disparity lies in the fact that intermediated securities are equitable not legal interests. Generally speaking, there are sound reasons why holders of equitable interests in property should receive a lesser right than holders of legal interests. However, it is our view that these justifications do not extend to purchasers of equitable interests in intermediated securities. Furthermore, we consider that the absence of an equal level of protection is particularly unjustified when applied to the commercial realities of intermediated holding systems and that the continuing disparity could damage market confidence.

Terminology

- 5.17 In order to understand better the legal position of purchasers of intermediated securities, it is helpful first to consider the defences available to a purchaser of directly held securities. Before we do so, we must explain in more detail what we mean by a 'purchaser of directly held securities' as distinct from a 'purchaser of intermediated securities'.

⁴ In a number of EU Member States it is uncertain whether general principles on good faith purchase can be applied to the transfer of intangibles. For example, there are no specific rules under French law which protect the good faith purchaser of securities. There is similar uncertainty surrounding the law in Belgium, Poland and Lithuania. German law has conceptual difficulties with according good faith acquisition to securities that are held in the form of a permanent global certificate. Several Member States do not protect innocent transferees. In Denmark the original owner of securities can always recover them from a transferee acting in good faith, provided he can identify his securities in the transferee's account. However, the transferee can claim compensation from the CSD, regardless of whether the CSD has been negligent. (Danish Securities Trading Act, Article 69 and 80(2). The position is similar in Latvia

⁵ eg see Uncertificated Securities Regulations 2001, Reg 35. See the Convention, Article 12.

- 5.18 We use the phrase ‘purchaser of directly held securities’ here to mean a person that acquires (for value) the legal title to securities from another person or has the legal estate transferred to an intermediary acting as a trustee or nominee for him. The legal title to securities is held by the person in possession of bearer securities⁶ or by the person named in the issuer’s or, in the case of dematerialised securities, CREST’s register of title. Legal title is transferred by delivery of the bearer document or by alteration of the issuer or CREST register, as the case may be.
- 5.19 A purchaser of intermediated securities by contrast acquires its intermediated securities by a debit and credit on the books of an intermediary and without any transfer of legal title in the underlying securities.

THE LEGAL PROTECTION AVAILABLE TO A PURCHASER OF DIRECTLY HELD SECURITIES

- 5.20 The common law has always favoured the principle of security of title.⁷ The common law rule of *nemo dat quod non habet* (no-one can give what they do not have) represents the default rule for sale of goods in English law. Applying this rule, a person whose securities are transferred without its consent can recover them if the person purporting to sell them did not have authority or title to do so. It is irrelevant that the transferee purchased the securities in good faith. The purchaser can seek only to reduce this risk by investigating the title to securities and ensuring that the transferor has the authority to transfer them free of any pre-existing interests.
- 5.21 The rule is not absolute and there are number of common law and statutory exceptions to it.⁸ Nevertheless, in the context of securities dealing, a purchaser will generally look to displace the *nemo dat* rule by relying on one of the following two legal doctrines.

⁶ A person who steals bearer securities or who otherwise acquires them from someone that does not intend to transfer them does not acquire legal ownership. However, such person is able to confer good title to a holder in due course (see para 5.18 below). In addition, where bearer securities are held under bailment, it is the bailee who has deposited the securities that retains the legal title.

⁷ See R Goode, *Commercial Law* (3rd ed 2004) p 416.

⁸ See R Goode, *Commercial Law* (3rd ed 2004) pp 417-446.

Negotiability

- 5.22 The first of these is the doctrine of negotiability. The legal attributes of negotiability were developed by the law merchant during the nineteenth century and applied to certain financial instruments through statute or customary usage. Negotiability converts the instrument from mere evidence of ownership into an instrument that is legally deemed to constitute the securities and the rights attaching to them. Ownership of the negotiable instrument is transferred by physical delivery (or, in some cases, by endorsement and delivery) of the paper certificate or document of title, provided that the transferor has the necessary intention to transfer. Theft of the negotiable instrument does not vest good title in a thief but, crucially in relation to the security of transfer, the acquisition of a negotiable instrument from a thief does confer good title free of any prior defects or adverse claims upon a 'holder in due course'. Only in the case of forgery are the holder's rights defeated.
- 5.23 The Bills of Exchange Act 1882 defines a 'holder in due course' as one who provides value, acts in good faith and has no notice of any defects in the title of the transferor. The holder includes a pledgee that holds the securities by way of security⁹ and there is a presumption that a holder has given value for the instrument.¹⁰ It is generally established that traditional bearer investment securities in the secondary securities markets are negotiable instruments¹¹ although it is also considered 'reasonably clear' that this status is conferred on them by mercantile usage rather than by the Bills of Exchange Act.¹²
- 5.24 Registered securities do not have negotiable status. Some doubts have also been expressed about the negotiability of permanent global bearer certificates in view of the fact that they are rarely, if ever, delivered.¹³

⁹ *London Joint Stock Bank v Simmons* [1892] AC 201.

¹⁰ Bills of Exchange Act 1882, s 27(2).

¹¹ See J Benjamin & M Yates *The Law of Global Custody* (2nd ed) p 16 fn 6 which quotes Ewart 'Negotiability and Estoppel' (1900) 14 *LQR* 135 at 136 in listing the following negotiable instruments: (1) Domestic corporate bonds (*Re General Estates* (1868) 3 Ch 758; *Higgs v Northern Assam Tea Co Ltd* (1869) LR 4 Exch 387; *Re Imperial Land Co of Marseilles* (1870) LR 11 Eq 478; *Bechuanaland Exploration Co v London Trading Bank* [1898] 2 QB 658; (2) Foreign government and corporate bonds (*Gorgier v Mieville* (1824) 3 B & C 45; *Simmons v London Joint Stock Bank* [1891] 1 Ch 270; *Bentinck v London Joint Stock Bank* [1893] 2 Ch 120; *Venables v Baring* [1892] 3 Ch 527; (3) Scrips for Bonds (*Goodwin v Roberts* (1875) LR 10 Exch 337; (4) Secured bearer bonds (*Webb v Herne Bay* (1870) LR 5 QB 642. Also (5) Bearer bonds (*Edelstein v Schuler* [1900-3] All ER Rep 884; and (6) Certificates of deposit (*Customs and Excise Comrs v Guy Butler (International) Ltd* [1977] QB 377 at 382; *Libyan Arab Foreign Bank v Bankers Trust Co* [1988] 1 Lloyd's Rep 259 at 276. Benjamin & Yates states that the general consensus in the legal community is that Euro-notes and Euro-commercial paper has also obtained negotiable status through customary usage.

¹² R Goode *Commercial Law* (3rd ed) p 572.

¹³ R Goode *Commercial Law* (3rd ed) p 574.

- 5.25 A holder is deemed to be in good faith if it has acted honestly.¹⁴ However, the good faith requirement appears to have largely been subsumed within the doctrine of notice. A holder in due course must have no actual or imputed notice of a defect in the transferor's title.¹⁵ However, constructive notice of a defect in the transferor's title does *not* preclude a holder from taking an instrument as a holder in due course. So it does not matter if the holder was negligent and would have discovered the defect in the transferor's title if he had taken more care. However, if the holder has deliberately turned a blind eye to the possibility of a defective title, the court may interpret this as bad faith.¹⁶

Good faith purchaser of the legal estate without notice

- 5.26 A purchaser that acquires securities that do not enjoy negotiable status may still be protected from adverse claims if it is a good faith purchaser of the legal title to the securities without notice (a 'good faith purchaser').¹⁷

Good faith purchaser protection limited to equitable claims

- 5.27 Unlike a holder in due course, the good faith purchaser is protected by the rule only against existing equitable claims. If the securities have been registered in the purchaser's name, the legal owner can sue to have the register rectified. The owner of the legal title to securities will, however, lose its rights if it authorises the transfer,¹⁸ waives its rights or is estopped from proving its entitlement.¹⁹ In the case of uncertificated securities in CREST, the legal owner will be bound by a 'properly authenticated dematerialised instruction' sent from its computerised link with CREST without its consent if the purchaser had no actual knowledge of this lack of authority.²⁰

¹⁴ See, for example, Bills of Exchange Act 1882, s 90(1).

¹⁵ Knowledge of the equitable interest amounts to actual notice. The definition is the same in the context of good faith purchase: see para 1.120 below. Imputed notice is actual notice which a holder's counsel, solicitor or agent, acquires, provided that the notice was obtained in the same transaction in which the question of notice arises. An agent's constructive notice will not be imputed to the holder: see R Goode, *Commercial Law* (3rd ed, 2004) p 524.

¹⁶ *Jones v Gordon* (1887) 2 App Cas 616, 628 – 629 by Lord Blackburn.

¹⁷ *Pilcher v Rawlins* (1872) L R Ch 259. Historically the plea of bona fide purchase is a plea to the jurisdiction of the court to dismiss the plaintiff's bill for no equity and therefore cause of action: see *Ind Coope & Co. v Emmerson* (1887) 12 App. Cas. 300 at 305.

¹⁸ *Barton v London and North Western Railway Co* (1889) 24 QBD 77.

¹⁹ *Re Bahia and San Francisco Rly Co* (1868) LR 3 QB 584. See E Micheler 'Farewell Quasi-Negotiability? Legal title and transfer of shares in a paperless world' [2002] *JBL* 358 at p 366.

²⁰ Uncertificated Securities Regulations 2001, Reg 35(3). E Micheler 'Farewell Quasi-Negotiability?: Legal title and transfer of shares in a paperless world' [2002] *JBL* 358 at p 372.

Additional protection for purchasers of certificated registered shares

- 5.28 Where the original owner retains legal title, a transferee may nevertheless have a remedy against the issuer instead. At least in the case of certificated shares, if the transferee acquires shares by relying on genuine certificates issued by the company, it will be able to sue the company.²¹ The company will be prevented from denying the purchaser's title on grounds of estoppel but will have a claim against whoever instructed the company to act on the forged transfer documents that caused it to issue the certificates.²² So long as this person is not the transferee itself (but is, for example, its broker), the transferee is effectively protected.
- 5.29 In the case of dematerialised securities in CREST, this additional protection for purchasers does not exist as no certificates are issued. While there is no authority as to whether an entry in the company's register amounts to a representation that could give rise to an estoppel, it has been persuasively argued that a buyer of uncertificated securities is unlikely to have a claim against the company for an unauthorised transfer.²³ CRESTco, as system operator, may be statutorily liable in some limited circumstances but only up to a statutory limit.²⁴

Test for good faith purchaser

- 5.30 Generally speaking, there is little to distinguish between the conditions necessary to satisfy the respective tests of a holder in due course and a good faith purchaser. A good faith purchaser must acquire the legal title to the securities and act in good faith. It must demonstrate that it gave sufficient value for the property as nominal consideration is not sufficient. A good faith purchaser must also have had no notice of equitable interests at the time when it gave value for the property and when it was transferred to him. There is conflicting authority as to whether the burden is on the defendant to demonstrate that it gave value and had no notice²⁵ or on the plaintiff to show that the test is not satisfied.²⁶ A number of academics have written in favour of the authorities that impose the burden on the defendant.²⁷

²¹ *Balkis Consolidated v Tomkinson* (1893) AC 396.

²² *Sheffield Corporation v Barclays* [1905] AC 392.

²³ Uncertificated Securities Regulations 2001, Reg 35(3). E Micheler 'Farewell Quasi-Negotiability?: Legal title and transfer of shares in a paperless world' [2002] *JBL* 358 at p 374-375.

²⁴ CRESTco may, for example, be liable for transfers arising from a forged transfer instruction provided that it cannot identify the forger: Uncertificated Securities Regulations 2001, Reg 36.

²⁵ *Thomson v Clydesdale Bank Limited* [1893] AC 282, 289 by Lord Herschell LC; *Polly Peck International plc v Nadir (No 2)* [1992] 4 All ER 769 by Scott LJ.

²⁶ *Attorney-General v Biphosphated Guano Company* (1898) 11 ChD 327, 337 by Thesiger LJ; *Lipkin Gorman v Karpnale* [1991] 2 AC 548, pp 574-577.

²⁷ See AO Austen-Peters, *Custody of Investments* (2000), p 154 note 211 which refers to K Barker, 'After Change of Position: Good Faith Exchange in the Modern Law of Restitution' in PBH Birks (ed), *Laundering and Tracing* (1995) 206; RP Meagher, WMC Gummow and JRF Lehand, *Equity, Doctrines and Remedies* (3rd ed 1992) 257-259, PBH Birks, 'Overview: Tracing, Claiming and Defences' in PBH Birks (ed), *Laundering and Tracing* (1995) 334.

5.31 Under Section 199 of the Law of Property Act 1925 a purchaser is not prejudicially affected by notice of any instrument, matter, fact or thing, unless it has:

- (1) actual notice: where the equitable interest is within his own notice;
- (2) constructive notice: where the equitable interest would have come to his own knowledge if he had made proper inquiries; and
- (3) imputed notice: where his agent has actual or constructive notice of the equitable interest in the course of the same transaction.

5.32 Each of these forms of notice is dealt with in turn below.

Actual notice

5.33 Knowledge of an equitable interest amounts to actual notice. A purchaser has actual notice if he has knowledge of information from any source which is of such a nature that a reasonable man or a man of business would act upon the information.²⁸ It is immaterial whether he acquired the notice before or at the time of the purchase and whether he acquired the information from an interested party.²⁹

Constructive notice

5.34 Under the Law of Property Act 1925, a purchaser has constructive notice of matters that would have come to his knowledge if such inquiries had been made as ought reasonably to have been made by him.³⁰

5.35 The law has developed a significant distinction in relation to constructive notice between transactions involving land and other transactions. Hayton points out that in the purchase of land “there are elaborate inquiries and inspections that have to be made.”³¹ However, for property other than land, the purchaser is under no duty to make inquiries as to title in the absence of suspicious circumstances since “the courts are most reluctant to import a duty of inquiry as to title which would restrict the flow of commerce.”³²

²⁸ *Lloyd v Banks* (1868) 3 Ch App 488.

²⁹ *Lloyd v Banks* (1868) 3 Ch App 488. The concept of “actual notice” is specifically defined for the purposes of CREST settlement in regulation 44 of the Uncertificated Securities Regulations and is different from the general law concept of “actual notice”.

³⁰ Law of Property Act 1925, s199(1)(ii)(a).

³¹ D J Hayton, *Underhill and Hayton’s Law of Trusts and Trustees* (2003, 16th ed) p 989. See J McGhee, *Snell’s Equity* (2000, 13th ed) paras 4-20 – 4-26.

³² D J Hayton, *Underhill and Hayton’s Law of Trusts and Trustees* (2003, 16th ed) p 989. See, for example: *Baden v Société Générale pour Favoriser le Développement du Commerce et de l’Industrie en France SA* [1992] 4 All ER 161; *Manchester Trust v Furness* [1895] 2 QB 539; *Eagle Trust plc v SBC Securities Ltd* [1992] 4 All ER 488, 507-508.

5.36 Thus, the Court of Appeal in *Polly Peck (No 2)* held that, in the context of commercial transactions not involving land, a purchaser will not have constructive notice unless suspicious circumstances existed but he deliberately or recklessly failed to make the inquiries that an honest and reasonable man would have made.³³

5.37 The application of the doctrine of constructive notice to transactions in stocks and shares was later considered in *Macmillan Inc.v Bishopsgate Trust (No 3)*.³⁴ At first instance, Millet J cited Lord Browne-Wilkinson's formulation of the doctrine of constructive notice in *Barclays Bank plc v O'Brien*³⁵ as being of general application. In that case Lord Browne-Wilkinson said:

The doctrine of notice lies at the heart of equity. Given that there are two innocent parties each enjoying rights, the earlier right prevails against the later right if the acquirer of the later right knows of the earlier right (actual notice) or would have discovered it had he taken proper steps (constructive notice). In particular, if the party asserting that he takes free of the earlier rights of another knows of certain facts which put him on inquiry as to the possible existence of the rights of that other and he fails to make such inquiry or take such steps as are reasonable to verify whether such earlier right does or does not exist, he will have constructive notice of the earlier right and take subject to it.³⁶

5.38 As has been discussed earlier in this Report,³⁷ the doctrine of constructive notice laid down in *Barclays Bank plc v O'Brien* has since been described by Lord Nicholls in *Royal Bank of Scotland v Etridge (No 2)* as:

...not a conventional use of the equitable doctrine of constructive notice.³⁸

5.39 The application of the doctrine in *O'Brien* has been limited by the House of Lords decision to a specific class of cases involving suretyship.³⁹ We believe that the courts would take a narrower view of constructive notice when applying it to the settlement of securities across the books of a financial intermediary.

³³ *Polly Peck International plc v Nadir (No 2)* [1992] 4 All ER 769. Scott LJ held that the requisite degree of knowledge corresponded to category (iii) of the five categories of mental state identified by Peter Gibson J in the *Baden* case above at p 235. The *Baden* case concerned the requisite degree of knowledge for constructive trusteeship.

³⁴ [1995] 1 WLR 978.

³⁵ [1994] 1 AC 180.

³⁶ [1994] 1 AC 180 at pp 195-196.

³⁷ See paras 4.104-4.110 above.

³⁸ *Royal Bank of Scotland v Etridge (No. 2)* [2001] UKHL 44

³⁹ See also Chitty on Contracts (29th ed) 7-096.

Imputed notice

- 5.40 Any actual or constructive notice which a purchaser's counsel, solicitor or agent, acquires will be imputed to the purchaser provided that the notice was obtained in the same transaction in which the question of notice arises.⁴⁰ Notice acquired in a previous transaction will not be imputed to the purchaser and even notice acquired in the same transaction will only be imputed if it is so material to the transaction that the agent has a duty to inform the purchaser.⁴¹ The agent's knowledge will not be imputed to the purchaser if the agent was concealing information from the purchaser in order to defraud him.⁴²

THE LEGAL PROTECTION AVAILABLE TO A PURCHASER OF INTERMEDIATED SECURITIES

- 5.41 As we have shown above, a purchaser of the legal title to securities is generally able to defeat claims to those securities if it has no knowledge of them. The precise level of knowledge necessary to deprive the purchaser of this protection will depend upon whether or not the securities are negotiable.
- 5.42 Innocent purchasers of negotiable securities can defeat all claims including those of the original holder of legal title. Innocent purchasers of non-negotiable securities can defeat existing equities and equitable interests. Consequently, the purchaser will have a defence to a claim by an account holder from whose account the intermediated securities were transferred. It will also take free of any security interest over the intermediated securities. The same cannot be said of purchasers of intermediated securities.

⁴⁰ Law of Property Act 1925, s199 1(ii)(b). See also *Merry v Abney* (1663) 1 Cas in Ch 38; *Le Neve v Le Neve* (1747) 2 Amb 436; *Kemmis v Kemmis* [1988] 1 WLR 1308, 1333 by Nourse LJ.

⁴¹ J McGhee, *Snell's Equity* (2000, 13th ed) para 4-27.

⁴² *Kennedy v Green* (1834) 3 My & K 699; *Cave v Cave* (1880) 15 Ch D 639; *Houghton & Co v Nothard, Lowe & Willis Ltd* [1928] AC 1.

Unavailability of negotiable status for intermediated securities

- 5.43 Most commentators take the view that registered securities and bearer securities held through an intermediary in electronic form have not yet acquired (or cannot acquire) negotiable status.⁴³ One of the main arguments against their negotiability is the inability of intermediated securities to be transferred by physical delivery; delivery requires the transfer of possession and intermediated securities, as intangibles, are incapable of possession. It is arguably fundamental to negotiability that a transferee should be able to present a physical certificate as representing an original promise to the bearer without further need to demonstrate its title. Therefore, an innocent transferee of intermediated securities cannot presently rely on the benefits of negotiability to protect itself from the claims of a defrauded account holder.

Unavailability of the good faith purchaser defence for intermediated securities

- 5.44 The good faith purchaser rule protects a person who in good faith acquires *legal* title without notice of any prior equitable interests in the property. The plea operates by ensuring that equity will not intervene to deprive a purchaser of a legal advantage that it may have acquired if it can show that it satisfies the good faith purchaser test.⁴⁴
- 5.45 Under English law, intermediaries typically hold securities for their clients by way of an express trust.⁴⁵ A trust involves the separation of legal and equitable title. Accordingly, if an intermediary holds title to the securities directly from the issuer on trust for its client, it follows that the client's interest in the underlying securities will be equitable in nature. If, as may often be the case, the securities are held through a chain of intermediaries, the highest tier intermediary will hold the legal title to the underlying securities with the intermediary directly below it holding an equitable interest in them. The conclusion generally drawn from this analysis is that each lower tier intermediary will hold its equitable interest as sub-trustee on sub-trust for the intermediary below it and so on down to the investor at the bottom of the chain. Consequently, the bundle of rights and interests held by the investor (and by each lower tier intermediary) represent equitable rights and interests that are derived through a series of sub-trusts from the underlying securities.

⁴³ See above pp 17 to 19 and the FMLC report, *Issue 3, Property Interests in Investment Securities* (July 2004) p 13. But see E Micheler, 'Farewell Quasi-Negotiability? Legal Title and Transfer of Shares in a Paperless World' (2002) *Journal of Business Law* 358. J S Rogers described his objection to negotiability for dematerialised securities as follows: "What negotiability does is enable us to use physical objects as tokens of abstract rights without applying the legal concepts that ordinarily govern rights in physical objects. Saying that one takes the token free from prior adverse claims to "it", really means that one takes the abstract right, and that what may once have happened to the physical token is irrelevant. It would, then, be ironic to attempt to preserve the concept of negotiability once we dispense with the physical tokens". J S Rogers, 'Negotiability, Property and Identity' (1990) 12 *Cardozo L Rev* 471, 508.

⁴⁴ See D O'Sullivan, 'The Rule in Phillips v Phillips' (2002) 118 *LQR* 296, 296-323. See *Wallyn v Lee* (1803) 9 *Ves.* Jun 24 at p 34: "the principle of the Court is, that against a purchaser for valuable consideration this Court gives no assistance".

⁴⁵ See para 2.59-2.62 above.

- 5.46 As intermediated securities are equitable in nature, the transfer of indirectly held securities made by way of a credit and debit on the books of an intermediary will necessarily constitute a disposition of an equitable interest. No legal title in relation to an acquisition of intermediated securities will pass unless the underlying securities are also delivered to, or re-registered in the name of, the purchaser (or an intermediary through whom the purchaser holds its investment).
- 5.47 Accordingly, unless a purchaser of intermediated securities separately acquires some legal right or advantage, the good faith purchaser rule does not apply. The law must instead determine the competing equitable claims of the vested interest and the purchaser in accordance with equitable priority rules. The general equitable rule states that priority goes to the claimant with the better equity. Where the equities are otherwise equal, the first in time prevails and therefore the original owner takes precedence over the subsequent purchaser.

Availability of legal protection where the legal estate is subsequently acquired

- 5.48 A doctrine of “quasi-tacking” can assist purchasers of equitable interests who are subsequently able to acquire the legal estate. According to *Snell's Equity*⁴⁶:

A purchaser without notice who at the time of the purchase fails to obtain either a legal estate or the better right to one will nevertheless prevail over a prior equity if, without being party to a breach of trust, he subsequently gets in a legal estate, even if he then has notice of the equity.

- 5.49 Millet J considered the doctrine of “quasi-tacking” in *Macmillan Inc. v Bishopsgate Trust (No 3)*.⁴⁷ He concluded that a purchaser could not make use of the doctrine if to do so involved acquiring the legal estate from a person who commits a breach of trust by conveying it to him.⁴⁸ Millet J noted that a purchaser of securities that acquired share certificates and a share transfer form executed by the holder would not fall foul of the restriction. This is because it could simply acquire the legal title by submitting these documents without further recourse to the legal owner. The company would not be in breach of trust for subsequently registering the transferee as it is not a trustee of the shares for the registered holder. It can therefore register the securities even if it has knowledge of the prior interest.⁴⁹
- 5.50 Again, this doctrine may be of little assistance to a purchaser within an intermediated holding system. A transfer across the books of an intermediary will not put the purchaser in a position to obtain the legal estate without further action on the part of the upper tier intermediary that holds legal title.

⁴⁶ McGhee, *Snell's Equity*, (30th ed 2000) p 51.

⁴⁷ [1995] 1 WLR 978.

⁴⁸ See [1995] 1 WLR 978 at p 1003 in which Millet J cited Sir George Jessel MR in *Harpham v Shacklock* (1881) 19 Ch D 207 at 214.

⁴⁹ See *Dodds v Hills* (1865) 2 H & M 424.

Priority of good faith purchaser of equitable interest over 'mere equities'

- 5.51 The fact that the purchaser of an equitable interest has no notice of a prior adverse equitable claim may still be of assistance to it in some circumstances. According to the orthodox interpretation of the rule in *Phillips v Phillips*⁵⁰ a good faith purchaser of an equitable interest takes priority over a claimant that asserts a 'mere equity' as opposed to an equitable proprietary interest. A 'mere equity' includes, for example, an equity to rectify a deed in order to recover property or an equity to rescind an assignment. This interpretation of the rule in *Phillips v Phillips* has been disputed.⁵¹ However, even if correct, it does not assist the purchaser against a holder of a proprietary interest (such as the original account holder or holder of a security interest) nor, crucially, does it appear to extend to interests in choses in action (which include intermediated securities).⁵²

Loss of priority as a result of the actions of the original owner

- 5.52 A person's pre-existing interest in property may be defeated "by conduct, by representations, by misstatements of a character which would operate and ensure to forfeit and take away the pre-existing title". In order for a purchaser of an equitable interest to defeat a pre-existing equitable interest in this way it must show these actions to "amount to something tangible and distinct, something which can have [this] grave and strong effect."⁵³ It has been suggested that the basis of this exception from the equitable priority rules, while unclear, may lie in estoppel.⁵⁴
- 5.53 Estoppel by negligence has in the past been considered an exception to the *nemo dat* rule although mere inactivity in regard to safeguarding property is not sufficient.⁵⁵ It seems to us highly unlikely that a purchaser could expect to rely on this defence in circumstances where securities have been transferred by an intermediary without the consent or knowledge of its account holder (or chargee) unless there had been a clear representation by the account holder (or chargee) of its intermediary's authority to transfer.

⁵⁰ eg see *Ernest v Vivian* (1864) 33 L J Ch (N S) 513; *Cave v Cave* (1880) 15 Ch D 639.

⁵¹ See D O'Sullivan, 'The Rule in *Phillips v Phillips*' (2002) 118 LQR, 296, 296-323 in which it is argued that Lord Westbury's decision in *Phillips v Phillips* demonstrates that the plea of bona fide purchase is simply not applicable where no legal advantage has been acquired and that consequently the rules of equitable priority apply. Purchase of an equitable interest will take priority over a mere equity on the grounds that it is a superior equity (see *Re Ffrench's Estate* (1887) 21 IR 283).

⁵² eg *Turton v Benson* (1718) 1 P Wms 496; *Southern British National Trust (in liq.) v Pither* (1936) 57 CLR 89 at 108, 112. See also D O'Sullivan 'The Rule in *Phillips v Phillips*' LQR 2002, 118(Apr), 296 at 316 which states that the general rule for choses in action is that they take subject to equities.

⁵³ *Shropshire Union Railways and Canal Co v The Queen* (1875) LR 7 HL 496, 507.

⁵⁴ Thomas & Hudson, *The Law of Trusts* (2004) p 180.

⁵⁵ *Moorgate Mercantile Co v Twitchings* [1977] AC 890. See R Goode *Commercial Law* (93rd ed) p 418.

De facto protection from fault-based personal claims

- 5.54 The level of protection available to a purchaser of intermediated securities can depend significantly upon whether the claimant chooses to bring a personal or a proprietary claim against the purchaser in respect of the securities.
- 5.55 If a person claiming an interest in misappropriated securities can identify their recipient, it may have a personal claim, a proprietary claim, or both against the recipient.⁵⁶ As only the upper tier intermediary has legal title to the securities, a claim by an account holder or other interest taker will be an equitable claim rather than a claim at law.⁵⁷
- 5.56 There are a variety of equitable personal claims that the account holder may be able to bring against the transferee to recover the value of his securities. The most important is the action for knowing receipt. In order to establish liability for knowing receipt there must be a disposal of the account holder's assets in breach of trust, beneficial receipt by the transferee of the claimant's traceable assets and knowledge on the part of the transferee that the assets were transferred in breach of trust.⁵⁸ Crucially, it is irrelevant whether the transferee retains the assets or not.⁵⁹ The fault requirement is satisfied where the transferee's state of knowledge makes it 'unconscionable' for him to retain the benefit of the receipt.⁶⁰ Importantly, as the liability is fault-based the burden of proof falls on the claimant to establish unconscionability.
- 5.57 A purchaser that acquires intermediated securities in good faith and without notice of the claimant's interest is unlikely to have acted 'unconscionably' for the purposes of a personal action in knowing receipt. Accordingly, the innocent purchaser need not rely upon the good faith purchaser defence but is protected by the claimant's inability to show fault.

⁵⁶ Where the claimant has both options, the election need not be made until judgment.

⁵⁷ There are a number of obstacles to bringing a strict liability claim at law through an upper tier intermediary. First, where intermediated securities have been transferred and the upper tier legal owner remains unchanged, we presume it is not possible for the upper tier legal owner to bring a claim at law to recover a misappropriated equitable interest. Secondly, only an equitable claim can trace securities into a mixed fund. Thirdly, if the upper tier intermediary was responsible for disposing of the property, it may be estopped from bringing an action at law by the principle of non-derogation from grant: see *Re Diplock* [1948] Ch 465.

⁵⁸ *El Ajou v Dollar Land Holdings plc* [1994] 2 All ER 685.

⁵⁹ A Burrows, *The Law of Restitution* (2nd ed 2002) p 196.

⁶⁰ *BCCI v Akindele* [2001] Ch 437, 455 by Nourse LJ. Whereas before conflicting case law favoured a dishonesty standard or a wider definition embracing constructive notice, the test of unconscionability was intended to provide a context-sensitive test that makes it unnecessary to distinguish between dishonesty and negligence.

5.58 In contrast to personal claims, equitable proprietary claims attach to the property itself and are good against anyone who has the property or who has interfered with it. Where the account holder can trace its equitable interest in securities (or assets substituted for them) into the transferee's hands, the account holder may bring an equitable proprietary claim to recover the securities from the transferee.⁶¹ As we have seen above, a good faith purchaser of intermediated securities has no defence against an equitable proprietary claim.

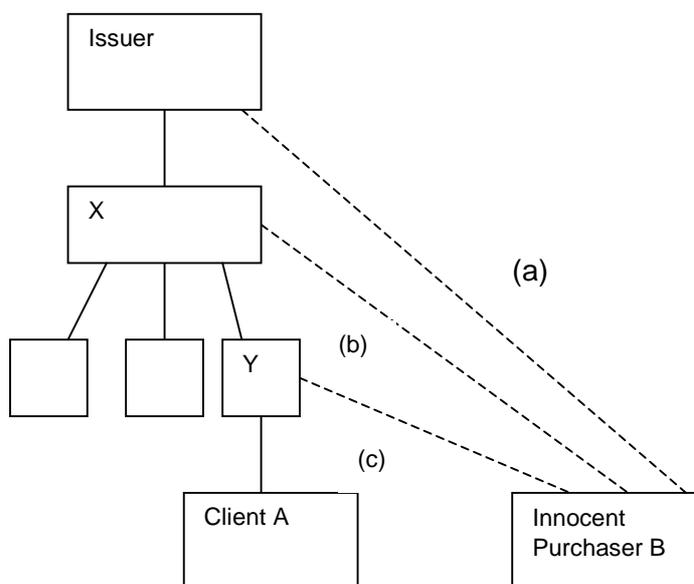
EXAMPLE OF CURRENT LACK OF PROTECTION FOR PURCHASERS OF INTERMEDIATED SECURITIES

5.59 The following example may help to illustrate the discrepancy between the purchaser of directly held securities and a purchaser of indirectly held securities.

Example – Transfer of securities without the consent of the original owner

5.60 An intermediary (X) holds registered securities in its own name on trust for a pool of clients, one of whom is Y. X credits Y's account to indicate the number of securities that it holds for Y.

5.61 Y is also an intermediary and holds these intermediated securities for its client A. Either negligently or fraudulently Y sells the securities to a purchaser B without the consent of A. B acts in good faith with no actual or constructive notice that the securities have been acquired in breach of A's proprietary rights.



5.62 There are three ways in which B could acquire the securities.

⁶¹ Unlike a personal claim, a proprietary claim enjoys priority over an insolvent defendant's unsecured creditors. It also entitles the claimant to recover any increase in the value of the property as well as any income derived from it.

- (1) Y could instruct X to transfer the underlying securities directly to B by having B's name entered onto the issuer's register (see (a) in diagram above). This would result in legal title passing to B. B is therefore able to rely upon the good faith purchaser defence against a claim by A. A is left with a personal claim against X for breach of trust. If the underlying securities are held in CREST, B can rely upon Regulation 35(4) of the Uncertificated Securities Regulations 2001⁶² as a defence against adverse claims other than in circumstances where it has actual notice that the transfer was made without the authority of A.⁶³
- (2) Y could instruct X to debit the account it holds for Y and credit an account opened by X for B (see (b) in diagram above). This is a transfer of only an equitable interest and therefore the good faith purchaser defence is not available to B. If A is able to trace the transfer of securities to B it should be able to bring a successful proprietary claim to recover the securities on the grounds of it having an earlier equitable interest. B is left with a contractual claim against Y for breach of the agreement to transfer the securities.
- (3) Y could effect the transfer on its own books by debiting A's account and crediting an account that Y will hold for B (see (c) in diagram above). Again this is a transfer of only an equitable interest and so the good faith purchaser rule does not apply to protect B. This should mean that B loses its proprietary interest in the indirectly held securities. However, because A and B are both account holders of Y, it is not entirely clear whether B would be left with merely a personal claim against Y or whether it remains a co-owner in the pool of assets held by Y for its customers. Whether B has a personal or proprietary claim becomes relevant if Y falls insolvent before it buys additional securities to satisfy its obligation to B. If A and B are both co-owners they are likely to share pro rata in any shortfall in the account.

5.63 In conclusion, the example demonstrates that where the transfer in breach of trust is effected:

- (1) by a transfer of the underlying securities, the innocent purchaser is protected from the claims of the original owner;
- (2) by a transfer on the books of an intermediary other than the original owner's direct intermediary, the original owner is protected from unauthorised transfers and, provided it can trace the securities (or their substitute) may bring an action to recover the securities.

⁶² SI 2001/3755.

⁶³ Uncertificated Securities Regulations 2001, Reg 35(5)(iii).

- (3) by a transfer on the books of the original owner's intermediary, English law protects the original owner's proprietary interest. It is less clear whether, the purchaser loses its co-ownership right in the pool of securities. In practice, the better solution would be that the purchaser remains a co-owner and any shortfall is borne by the account holders pro rata. Both the original owner and the purchaser have chosen to hold through the same intermediary and therefore both have undertaken the risk that it might act improperly. However, it is difficult to square this with the current law which leaves the purchaser only with a personal claim against the intermediary.

THE NEED FOR PROTECTION OF PURCHASERS OF INTERMEDIATED SECURITIES

The case against extending legal protection to innocent purchasers of intermediated securities

- 5.64 Some commentators have queried the assumption that the securities market could not function if innocent purchasers were not given complete protection from adverse claims. They argue that it is not the assurances provided by law that purchasers rely upon but the trustworthiness and creditworthiness of financial intermediaries, backed by governmental regulatory and insurance systems.⁶⁴ They also point out that in general property is not misappropriated. This fact assures purchasers that they need not investigate title each time to ensure that the property has not been stolen. Lawyers, they argue, often miss this explanation of human behaviour, it being an occupational hazard of their profession to focus on the "fortunately minuscule subset of transactions that have gone awry."⁶⁵
- 5.65 We agree that only a minuscule number of securities trades will require the transferee to invoke a defence against adverse claims. Generally, this will be due to the simple fact that the intermediary has transferred the securities with the express or implied authority of the account holder (together with any other party with an interest). Only in exceptional circumstances of fraud or error will securities be transferred without this authority.
- 5.66 Where securities have been transferred without the consent of an interested party, the transferee may still not need to rely on a defence. In systems that employ clearing and netting functions the claimant will face considerable practical difficulty in tracing the securities to their recipient. If it is not possible to identify the recipient, the claimant will be left with a claim against the party at fault for the transfer. Where the purchaser is identifiable, the claimant may choose in any event to pursue a claim against the intermediary at fault especially if it has deeper pockets than the purchaser.

⁶⁴ J S Rogers, "Negotiability, Property and Identity" (1990) 12 *Cardozo L Rev* 471, 478-484.

⁶⁵ J S Rogers, "Negotiability, Property and Identity" (1990) 12 *Cardozo L Rev* 471, 481.

- 5.67 It is also true that rules protecting purchasers in securities markets merely reallocate a risk within the system rather than reduce it. For every innocent purchaser that is able to invoke its legal protection against a claimant, there is an innocent claimant that may be harmed (if, for example, the claimant is left with a personal claim against an insolvent intermediary).
- 5.68 Further evidence that change is not required may be drawn from the paucity of litigation regarding the protection of innocent purchasers of intermediated securities. The first instance decision in *Macmillan Inc v Bishopsgate Investment Trust Inc* handed down over ten years ago remains, to our knowledge, the last time that these issues were considered in detail by the English courts in relation to securities trades.⁶⁶ We suspect that in the vast majority of cases any loss suffered by an owner or purchaser as a result of an improper transfer by an intermediary is compensated by the intermediary at fault or even by the purchaser's own intermediary. This may be done for reasons of maintaining reputation and client relations.
- 5.69 It cannot be ignored that the trend in the United Kingdom towards holding and settling securities through financial intermediaries has continued apace despite the disparity in protection afforded to purchasers of directly held and indirectly held securities. The absence of a good faith purchaser rule or its equivalent for purchasers of intermediated securities is not a recent development of case law but has existed ever since securities were transferred on the books of intermediaries. It is a fact understood by legal experts and practitioners in this area of financial law and has been reported upon publicly by the Financial Markets Law Committee.⁶⁷
- 5.70 Finally, even if one accepts that legal protection of purchasers of intermediated securities is important, it does not necessarily follow that domestic legislation should be passed to rectify the deficiency. As our analysis of the Convention demonstrates, ratifying the Convention and thereby incorporating the innocent purchaser provisions into English law would resolve this issue. Passing domestic law now could prove unnecessary or even confusing if it was shortly followed by further legislation on the same issue in the form of the Convention.

The case for giving legal protection to innocent purchasers of intermediated securities

- 5.71 Despite these arguments, we believe that innocent purchasers of intermediated securities should benefit from legal protection against adverse claims and that, on balance, this should be established by domestic legislation.

⁶⁶ [1993] IRLR 393.

⁶⁷ FMLC Report (July 2004), *Issue 3: Property Interests in Investment Securities*, p 13 which states: "Equity protects a person who in good faith acquires legal title without notice of any adverse claims, but this protection cannot apply if the purchaser only acquires an equitable interest in the securities. There should be a clear rule in favour of the bona fide purchaser for value without notice."

The application of equitable priority rules to innocent purchasers is anomalous and does not reflect modern market practice or expectation.

5.72 The unavailability of a good faith purchaser defence for purchasers of an equitable interest is not, in our opinion, a rational development of the law. Instead, it is the product of the incremental development of different causes of action resulting from the historical division of English law into the concurrent jurisdictions of common law and equity.⁶⁸ The continuing existence of differences in priority between legal and equitable interests in relation to transferred assets and security interest is, in the words of one expert:

...a nettle which was not grasped in the great reforms of the Judicature Acts of 1873-1875. Today, however, when the computerisation and intermediation of financial markets has diverted so much of our economic wealth out of the law and into equity, the time may be ripe.⁶⁹

5.73 Generally speaking, there are sound reasons why holders of equitable interests in property should receive a lesser right than holders of legal interests. A holder of the legal title to securities is ostensibly the owner either by virtue of its possession of a bearer certificate or by its registration in the issuer's register. As a result, a purchaser of the legal title can take steps to verify the seller's title. In addition, transfer of the securities generally requires the legal owner's participation either by delivery of the bearer securities or by execution of the transfer documents necessary for re-registration. If it transpires that the certificate is a forgery or the seller is a fraud, the purchaser must look to the fraudster (or, if the purchaser has relied on certificates issued by the company, to the company⁷⁰) for redress. Legal title remains with the innocent owner.

⁶⁸ See J Hackney *Understanding Equity and Trusts* (1987) who states at p 24: "The English explanation of this particular rule [of good faith purchaser] comes from constitutional law, from the relationship between law and Equity, and was clearly seen by at least one of the judges in *Picher v Rawlins*. It is a matter of jurisdiction, not a matter of policy."

⁶⁹ J Benjamin *Interests in Securities* (2000) p 329.

⁷⁰ See paras 5.28 above.

- 5.74 By contrast, the holder of an equitable interest in securities (for example, an account holder or chargee) will often be invisible to the purchaser. The purchaser cannot easily investigate the existence of equitable interests unless they are publicised by registration or by some other means. By voluntarily entrusting its assets in this way, an account holder or chargee takes the risk that its intermediary can fraudulently transfer the title from which its interest is derived to an innocent purchaser without its involvement. The onus is therefore on the holder of the equitable interest to take precautions to ensure that its interest is sufficiently visible to a purchaser. Where this is not possible it must rely upon the trustworthiness of the holder of the title from which its interest is carved. The owner of the equitable interest therefore has some control and choice over the level of risk it bears in relation to the protection of its property rights. While both the good faith purchaser without notice and the vested owner may be innocent, there are sensible and realistic grounds for selecting the latter as the victim.⁷¹
- 5.75 Having established that an innocent purchaser should be protected from prior equitable interests, we see no good reason why it should be denied this protection because the property rights it acquires are equitable and not legal.
- 5.76 This is particularly true in the case of intermediated holding systems. An investor may have little or no knowledge or control over whether the securities credited to its account have been acquired as a result of a transfer of legal title in the underlying securities or of equitable title across the books of an intermediary. The ostensible authority of the seller's intermediary to transfer securities is no less apparent because it chooses to effect the transfer across its books rather than cause the legal title to be transferred.
- 5.77 Nor can the absence of a good faith purchaser defence for purchasers of intermediated securities be said to provide account holders with any reliable security of title. In the event of an unauthorised transfer, an account holder has, by definition, no control over whether the unauthorised transfer by its intermediary results in the transfer of the legal or equitable title. Bearing in mind the legal and commercial arguments for protecting the account holder in these circumstances, we consider it wrong that the outcome of the priority dispute between owner and purchaser should depend on the arbitrary decision of the wrongdoer as to its method of effecting transfer.

⁷¹ See R Goode *Commercial Law* (3rd ed) p 416. [We believe that a distinction can be made between purchasers that take control of securities by having them transferred to themselves or their intermediary and subsequent chargees or other interest takers that do not. These subsequent interest takers are prepared to take the same risks as the earlier chargees and, in these circumstances, the equitable priority rule of first in time is more understandable in the absence of any other priority regime such as registration.]

5.78 Finally, we note that the market does not recognise any distinction between purchases of directly held securities or intermediated securities. The price an investor pays for intermediated securities is the same as it would pay to purchase the underlying securities; there is no reduction to reflect the absence of a defence against third party claims. One could argue that this reflects the fact that the market attributes no value to security of transfer. However, we would suggest that the reasons are more likely to lie in a combination of the market's failure to appreciate fully the legal issue and a realisation that it would be impractical and unappealing to attempt to reflect this disparity in the price of otherwise fungible securities.

Importance of transferability for investment securities

5.79 In addition to the legal arguments, there is arguably a stronger economic case for protecting purchasers of investment securities than purchasers of other forms of property. Transferability is a defining characteristic of investment securities and the ease with which investment securities can be bought and sold is one of their most valuable attributes. It is plain to see, at least in theory, that their transferability is enhanced by a legal system that protects the rights of an innocent purchaser over those of an innocent owner.

5.80 Some purchasers may have no choice but to purchase intermediated securities across the books of an intermediary (for example, because the underlying securities are held in a permanent global note in the vaults of depository). Even if the purchaser undertakes a costly and time-consuming investigation of title to the securities it cannot guarantee that no equitable interests exist. The purchaser is therefore left with the option of:

- (1) accepting the risk that no adverse claim exists or that any claim that does exist will not be pursued; or
- (2) choosing to purchase the securities by credit and debit in a securities account governed by a foreign law that grants adequate protection to innocent purchasers; or
- (3) not purchasing the securities.

5.81 A system that encourages transferability by protecting purchasers should not however simply be seen as benefiting participants that buy and sell securities on a regular basis. By increasing transferability and thus liquidity, the protection offered to purchasers should also benefit owners of securities by supporting the value of their securities from day-to-day.

Potential damage to intermediated holding systems

- 5.82 If investors decided that it was necessary or desirable to obtain the legal title to securities in order for them to have a defence from third party proprietary claims, this change in behaviour could deprive the securities market of some of the principal benefits of intermediation. As has been described earlier in this Advice , intermediation brings with it a number of systemic efficiencies. One of these is the division of labour created by allowing intermediaries to effect transfers by debits and credits in their accounts. This avoids the time and expense incurred by complying with the potentially more onerous formalities of transferring the underlying securities. It also removes the need to make debits or credits in the accounts of intermediaries in the holding chain above the level of the transfer.
- 5.83 In the case of securities immobilised in the form of a permanent global certificate, the global certificate would have to be split into definitive certificates in order to allow for transfers of the legal title to portions of the issue. Consequently, while intermediation would still offer investors certain advantages, the need to transfer the underlying securities could greatly increase the volume of transfers recorded by the issuer or CREST.

Importance of legal assurance to sophisticated participants in settlement systems

- 5.84 We acknowledge that the rarity of an improper sale can, in many commercial dealings, be sufficient to allay the concerns of a purchaser. We also appreciate that purchasers of some types of property (such as goods) will often be unconcerned about legal protections, some of which may not even be known to them. Again, we believe that these arguments have less application to securities settlement systems. The huge value of investment securities traded in securities settlement systems for investment or as collateral means that even a small chance of a purchaser or pledgee losing the priority to securities can be sufficient to cause concern. When measured by value of securities traded, the vast majority of participants in settlement systems are commercially sophisticated institutions for whom legal assurances are expected and keenly valued. The importance given by the financial industry to the eradication of legal risk in financial markets suggests to us that certainty of legal outcomes remains critical to settlement finality and that financial regulation and insurance cannot alone provide the necessary comfort.

Financial regulation can only reduce not solve the legal anomaly

- 5.85 Financial regulation plays an important role in reducing the occurrence of failed or improper transactions by regulating and overseeing the behaviour of institutions and by reducing the risk of their insolvency. Settlement system rules and financial regulation will of course only cover securities trades by intermediaries within a regulated environment. Nor will regulation always address the question of how losses should be allocated once fraud and insolvency combine. If one accepts that an innocent purchaser is more deserving of protection than an account holder, it seems perverse that under current law an account holder's interest should prevail against a purchaser in circumstances where the improper transfer results from its own intermediary's breach of financial regulation.

The risk of delay or abandonment of the Convention

- 5.86 While we accept that the Convention satisfactorily addresses this issue, we believe that it would be better to pass domestic legislation now rather than wait for the Convention to be incorporated into English law. While there has been conspicuous support for the Convention among some members of the Legal Certainty Group, there has also been reticence on the part of some European delegations. It is therefore far from certain that the European Commission will recommend that the Member States ratify the Convention. Nor can it be certain that the necessary majority in the European Council will pass the resolution to oblige Member States to ratify the Convention. If the Convention fails to address the EU's need for a common legal framework, any attempt to create separate European legislation is likely to take some considerable time. While it may still be open for the UK to choose to ratify the Convention (assuming the final draft was compatible with European law), this would bring with it the risk that the law may have to be revised again to accommodate any subsequent European legislation in this area.
- 5.87 Even if the Member States decide to ratify the Convention, based on the current timetable we think it unlikely that this will happen before the second half of 2008 at the earliest. This time frame may be optimistic in light of the continuing failure of the Member States to agree on ratification of the Hague Convention on the Law Applicable to Securities held by an Intermediary.
- 5.88 Consequently, there is a high chance that it will be several years before this issue is addressed by non-domestic legislation. In the meantime there is a risk that the disparity in legal protection could have an adverse affect on the UK securities markets. While we can only speculate, we accept that the likelihood of this happening is relatively small for the following reasons:
- (1) Experience shows that the settlement of securities across the books of intermediaries has grown despite the appreciation of this absence of protection by legal experts and despite discussion of the issue in previous case-law⁷² and public reports.⁷³
 - (2) Financial regulation reduces the risk of loss by reducing both the chances of impropriety and the possibility that the intermediary at fault will be insolvent and consequently unable to remedy the loss in full.
 - (3) Netting in clearing and settlement systems makes it difficult for claimants to trace securities (or their proceeds) into the hands of a purchaser.
 - (4) Litigation concerning the availability of legal protection to purchasers of intermediated securities is rare.

⁷² ie . *Macmillan Inc.v Bishopsgate Trust (No 3)* [1995] 1 WLR 978.

⁷³ See FMLC Report, *Issue 3: Property Interests in Investment Securities*, (July 2004) p 13; Law Commission Seminar Paper 3 - Issues affecting Transferees of Intermediated Securities p 34: www.lawcom.gov.uk/docs/investment_securities_seminar_paper_3.pdf.

- 5.89 These factors suggest that there is only a small chance that the disparity in legal protection could lead to a disruptive change in the way in which securities are held or that it could produce an inequitable result in litigation. However, such is the huge value of securities held through intermediaries for investment and collateral purposes we are concerned that, when multiplied by the possible scale of the adverse effect, the risk is sufficiently high that it should be addressed now.
- 5.90 Coupled with this is our belief that it would be relatively straightforward to fix the problem without need for extensive or complex legislation. The reform in the law would not require any material change in market practice or legal documentation but would bring the law into alignment with current expectations.

OPTIONS TO REMEDY THE DISPARITY IN PURCHASER PROTECTION

Adopt the Convention defence for innocent purchasers

- 5.91 One option would be to create a defence that replicates the defence for innocent purchasers of intermediated securities set out in Article 12 of the draft Convention. The Article provides that where securities are credited to a securities account of an account holder who, at the time of the credit, has no knowledge of another persons interest in the securities, the account holder is not liable and the securities are not subject to the prior interest.⁷⁴ A person is treated as having knowledge of an interest if it has actual knowledge or has knowledge of facts sufficient to indicate that the interest exists and deliberately avoids information that would establish that this is the case.⁷⁵ The defence closely, but not exactly, matches the good faith defence available under English law to purchasers of directly held securities.⁷⁶
- 5.92 In our opinion it would not be sensible to pass domestic legislation now based upon the defence as currently constituted by the draft Convention. Needless to say, there can be no guarantee that the defence will not be amended to some degree in the fourth plenary session or during the diplomatic session. Any subsequent amendment would require an additional change to domestic law if the final draft of the Convention were ratified.
- 5.93 Nor can it be guaranteed that the EU will adopt the Convention as the answer to the EU-wide legal framework for intermediated securities. If it is not, we will be left with a defence for purchasers of intermediated securities that does not precisely match the equivalent defences available to purchasers of directly held securities and which may develop separately from them. Furthermore, if the EU does subsequently pass legislation addressing this issue, we may be required to change domestic law again to incorporate it.

⁷⁴ Article 12(1). See paras 4.92-4.95 above.

⁷⁵ Article 12(4)(b).

⁷⁶ For clarity we should add that the protection given by the Convention to purchasers is intended to act as a minimum level of protection. If CREST falls within the scope of the Convention, purchasers in CREST should still be able to rely upon the higher level of protection (based on actual notice) set out in Regulation 35 of the Uncertificated Securities Regulations 2001.

Establish intermediated securities as legal interests.

- 5.94 Another approach to solving the problem posed by the lack of legal protection afforded to purchasers of equitable interests may be to reclassify intermediated securities as legal interests.

Create a new statutory property right

- 5.95 In the United States, the conceptual difficulties raised by the holding and transfer of securities held by intermediaries in omnibus accounts were addressed by the revisions made in 1994 to Article 8 of the Uniform Commercial Code.
- 5.96 Central to the legal solution was the creation of a new legal regime for intermediated securities based around the concept of a 'security entitlement'.⁷⁷ A security entitlement constitutes a sui generis property interest belonging to an account holder that arises upon a credit of securities to its account. The package of rights arising from a security entitlement and the ability to enforce these rights against an intermediary and third parties are the subject of detailed rules and commentary in the revised code. As part of this detailed framework, purchasers of securities entitlements or of the underlying securities are given a high degree of protection from adverse claims.⁷⁸
- 5.97 As has been examined at length in this Update Advice, the creation of a legal framework for intermediated securities is currently work in progress for UNIDROIT. Article 12 of the Convention addresses the needs of innocent purchasers by establishing a defence to adverse claims in respect of intermediated securities that are credited to its account. To propose the creation of domestic legislation now to create a legal framework dealing with all matters of ownership, disposition and pledge of intermediated securities based around a new statutory property right would pre-empt the work of UNIDROIT and go beyond the specific issue we are addressing.

⁷⁷ UCC Article 8-103(a)(14). . The legal regime was developed under the presupposition that: "Modern securities markets have moved so far beyond the movement of pieces of negotiable paper that the property law construct is inadequate and unworkable." C W Mooney 'Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries' (1990) 12 *Cardozo Law Review* 305, 313

⁷⁸ UCC, Articles 8-503 and 8-510.

Recharacterise intermediated securities as legal assets

- 5.98 Professor Sir Roy Goode and others have proposed that intermediated securities held by an intermediary in a pooled account for its clients are best viewed as bundles of personal and co-ownership rights that are detached from the underlying securities.⁷⁹ This is a similar concept to that of a ‘securities entitlement’ adopted by UCC Article 8. From this premise it can be argued that an account holder’s intermediary is the exclusive source of its rights. Any interest the investor may have in the underlying securities is derived only from its own intermediary, not from the issuer or a higher tier intermediary.⁸⁰ The account holder’s rights are therefore enforceable only against its own intermediary.
- 5.99 This refinement may be a helpful step towards a reconceptualisation of the traditional property law characterisation of intermediated securities. As Mohamed Khimji has pointed out, at a practical level the separation of the property rights (constituting the security entitlement) from the underlying asset achieved by UCC Article 8 is essentially the same as under the general principles of law established by trust or bailment.⁸¹ If we are able to redefine the assets of the account holder as being the intermediated securities credited to its account, the records of the account holder’s intermediary could be treated as constituting the root of legal title to the account holder’s property rights. These assets would be related to intermediated securities held in higher tiers in the sense that their value would depend upon the ability to enforce rights at each tier of the chain. However, the account holder’s property interest would be separate as it would be derived only from the securities credited to its own account.⁸²
- 5.100 The option of addressing the lack of legal protection by a more organic development of existing English law principles is an attractive one. In the absence of a UNIDROIT or European solution to these issues, it would certainly merit further examination. However, despite the attraction of these legal arguments, we believe that changing the proprietary nature of intermediated securities may represent too radical a solution for the specific issue at hand.

⁷⁹ R Goode, *Legal Problems of Credit and Security* (2003) pp 211-218. See also M Khimji ‘Intermediary Credit Risk – A comparative law analysis of property rights in indirectly held securities’ *JBL* (2005) 287-325.

⁸⁰ R Goode, *Legal Problems of Credit and Security* (2003) p 215.

⁸¹ M Khimji ‘Intermediary Credit Risk – A comparative law analysis of property rights in indirectly held securities’ (2005) *JBL* 287, 316.

⁸² Even if each intermediary was deemed to hold the legal title to its account holder’s intermediated securities, a transfer across its books might still only result in a disposition of an equitable interest if it held these securities under a trust arrangement. In order to overcome this hurdle, it has been further proposed that the law of bailment should be expanded to include intangible assets thereby ensuring that the account holder retains legal title to the intermediated securities held by its intermediary. If bailment of intangible assets (in the form of intermediated securities) was permitted, a purchaser of the intermediated securities would acquire a legal title and would consequently be able to rely on the good faith purchaser rule. Mohamed Khimji has argued that while delivery of possession is essential to bailment, it is the actual consequence of possession rather than the mechanics of it that is important. Possession can be constructive (for example, in the case of attornment) so that physical custody is not necessary provided that the bailee has control over the subject-matter: See M Khimji ‘Intermediary Credit Risk – A comparative law analysis of property rights in indirectly held securities’ (2005) *JBL* 287, 306-307

Extend one or more of the existing defences to encompass intermediated securities.

- 5.101 Rather than recharacterising the legal nature of intermediated securities, it may be simpler to expand one or more of the principal defences available to purchasers of directly held securities to cover purchasers of intermediated securities. This would have the effect of enhancing the legal rights of these purchasers with minimum disturbance to the legal rights of account holders holding under a trust.
- 5.102 As has been described above, the two principal exceptions to security of title are negotiability and the good faith purchaser rule.

Allow purchasers of intermediated securities to become 'holders in due course'

- 5.103 One option would be to replicate the benefits of negotiability by enabling a purchaser of intermediated securities to take free of any defects in title if it is able to satisfy the requirements of a 'holder in due course'.⁸³
- 5.104 A difficulty with this approach lies in the extent to which the parts of the current doctrine of negotiability are irrelevant or inapplicable to intermediated securities. The statutory basis of negotiability established in the Bills of Exchange Act 1882 anticipates written bills of exchange capable of transfer by delivery (or delivery and endorsement) and does not easily accommodate intermediated securities. Nor do all of the requirements of a holder in due course correlate with the factual circumstances of a purchaser of intangible, intermediated securities.⁸⁴
- 5.105 Similarly, the doctrine of negotiability formulated by case law and attributed by mercantile usage to certain financial instruments that fall outside of the Bills of Exchange Act assumes the existence of a tangible asset. We would be required to formulate a holder in due course test specifically for intermediated securities that took into account the absence of a tangible asset. This could lead to uncertainty in the application of existing case law to the new test.

Allow purchasers of intermediated securities to rely on the good faith purchaser rule

- 5.106 The alternative would be to permit purchasers of intermediated securities to rely upon the protection granted to good faith purchasers.
- 5.107 While the doctrine of negotiability applies only to a limited number of financial instruments, the good faith purchaser rule has the advantage of applying to all transfers of legal title to property, including intangible financial assets (such as registered securities). In extending the scope of the rule we would not be faced with reconciling the transfer of intangible assets with case-law based on possession of tangible assets.

⁸³ See J Benjamin *Interests in Securities* (2000), p 328 where this solution is suggested.

⁸⁴ For example, Bills of Exchange Act 1882, s 29(1) requires that a bill be "complete and regular" on its face and makes it a condition that a holder acquire it before it is overdue and without notice that it had been previously dishonoured.

- 5.108 Unlike a holder in due course, a good faith purchaser can be tainted with constructive notice and is unable to rely upon a presumption of good faith or value.⁸⁵ As has already been discussed,⁸⁶ a court's reluctance to attribute constructive knowledge to a good faith purchaser in commercial dealings may narrow this distinction. Nevertheless, these differences suggest that it may be more difficult for a purchaser to establish itself as a good faith purchaser than a holder in due course. In our opinion, this presents a further argument against conferring negotiable status on intermediated securities. We believe that a purchaser of intermediated securities should not enjoy a greater level of protection than a purchaser that acquires legal title to the underlying securities. Such a result could arise if negotiability were attributed to intermediated securities where the underlying securities were non-negotiable.
- 5.109 Extending the good faith purchaser rule to purchasers of intermediated securities offers an attractive symmetry to the defence available for purchasers of directly-held, non-negotiable securities. Purchasers of intermediated securities would be able to rely on the existing body of case law that has developed regarding the constituent parts of the good faith purchaser test, particularly in relation to the doctrine of constructive notice. We would favour this approach over establishing a new statutory test that attempted to codify the existing law. The latter approach could lead over time to the development of two parallel but slightly different defences and could recreate the discrepancy that we have been seeking to remove.

AMENDMENT TO THE EQUITABLE PRIORITY RULES

- 5.110 Unfortunately, simply stating that the good faith purchaser doctrine should extend to the purchase of equitable intermediated securities fails to recognise the way in which the current rule operates. The good faith purchaser rule is a plea of relief, allowing the purchaser to enjoy the benefit of whatever legal interest or advantage that it has innocently acquired without the intervention of equity.⁸⁷ It does not therefore involve the court in determining a contest between competing interests. As has been pointed out by one commentator, applying the good faith purchaser rule to purchasers of equitable interests would require a change in the basic structure of the doctrine from equitable non-intervention to intervention in favour of the purchaser by preferring one equitable claim over another.⁸⁸

⁸⁵ Bills of Exchange Act 1882, s 30(1) and (2).

⁸⁶ See paras 4.103-4.109 above.

⁸⁷ *Stanhope v Earl Verney* (1761) 2 Eden 81 at p 85: "a purchaser without notice for a valuable consideration is a bar to the jurisdiction of this court".

⁸⁸ See D O'Sullivan, 'The Rule in *Phillips v Phillips*' 2002 118 *LQR* 296, 302

- 5.111 Consequently, it would be more accurate to view the granting of protection to innocent purchasers not as an extension of the good faith purchaser rule but as an amendment to the equitable priority rules. One could argue that a purchaser of intermediated securities acting in good faith without notice of adverse claims should be treated as having an equity that is unaffected by earlier equities and equitable interests.⁸⁹ This could be justified on the grounds that, of the two innocent parties, it is the claimant that permitted the fraud or in some way allowed the fraudster to represent itself as the unencumbered owner. Accordingly, the equitable interest of the good faith purchaser without notice should prevail.
- 5.112 A similar reasoning was adopted in a number of nineteenth century cases on the grounds that the purchaser's equity was superior to earlier mere equities (such as the equity of rescission).⁹⁰ Our proposed amendment would go beyond this by protecting the good faith purchaser from all equities and equitable interests. It would also constitute a departure from the rule that choses in action are taken subject to all equities affecting them.⁹¹
- 5.113 In adjusting the equitable priority rules in this way, our intention would still be to apply the general law in determining whether or not the purchaser satisfied the test of 'good faith purchaser without notice'. In this way, developments in the doctrine would apply equally to purchasers of directly held and intermediated securities.

Transfers from a pooled account

- 5.114 In addition to removing the disparity between purchasers of directly-held and intermediated securities, the creation of a new defence does offer the opportunity to clarify what happens to the rights of account holders where an unauthorised transfer is made from a pooled account. We use the phrase 'unauthorised transfer' in this context to mean a transfer made by an intermediary which gives rise to a claim against it by its account holder for a breach arising under the account agreement, domestic law or any applicable settlement system rules.

⁸⁹ For the reasons explained in para 5.117 below, we propose that the new defence is based on the purchaser's equitable interest being unaffected by earlier equities and equitable interests of which it has no notice rather than superior to them.

⁹⁰ The rule was used in this way in two nineteenth century Irish cases but only in relation to defeat mere equities and not to defeat a pre-existing equitable interest: See *Re Ffrench's Estate* (1887) 21 IR 283 and *Scott v Scott* [1924] 1 IR 141.

⁹¹ *Turton v Benson* [1907] 2 Ch 104.

- 5.115 Let us assume that a broker (as intermediary) operates a pooled account for its customers. All of the securities held for its customers are credited to a single account which it holds with the intermediary above it (or are recorded in a single entry in the register of the issuer above it). The broker's accounts record the individual entitlements of all of its customers. It improperly debits a particular account holder's account and transfers the securities to an innocent purchaser. In these circumstances, should the debited account holder be left with only a personal claim against its intermediary or should it nevertheless retain a proprietary interest along with the other account holders in the pool of remaining securities?⁹²
- 5.116 The question arises both in the context of transfers to a purchaser outside of the pooled account and to transfers within a pooled account. As was mentioned in diagram example (c) above,⁹³ an unauthorised transfer within the same pooled account currently leaves the purchasing account holder with no defence against the original account holder. If the original account holder makes a proprietary claim to recover the securities, the corresponding credits and debits are reversed and the purchaser may be left with only a personal claim against the intermediary.
- 5.117 Extending the good faith purchaser rule to intermediated securities could simply reverse this outcome. On the face of it, the original account holder would be left with no proprietary claim to the securities in the pool. If the intermediary fell insolvent before it could buy additional securities to discharge its personal obligation to the account holder, the account holder would be left as an unsecured creditor. In each case the other account holders in the pool (including the purchaser if the transfer was made within the pool) would be left unaffected by any shortfall. It has been put to us that this analysis best replicates the effect of purchasing directly held securities and should therefore be adopted.
- 5.118 Both of these outcomes appear to us to be unduly harsh. Account holders that choose to hold through a pooled account accept the same custody risk, namely that their intermediary may act fraudulently or negligently in relation to the securities held in the pooled account. An unauthorised transfer of intermediated securities within a pooled account should not therefore result in the debited account holder losing its pro rata proprietary claim to what is left in the pool. While the innocent purchaser within the pool is protected from a claim made against it by the original account holder, the purchaser will not escape from sharing in any loss borne by the pool of account holders if the intermediary is unable to make good the shortfall. The innocent purchaser will share in any loss arising from its intermediary's insolvency because it has chosen to hold securities in a pool at the point in time at which the intermediary falls insolvent.

⁹² See also the discussion in paras 4.160-4.171 above.

⁹³ See para 5.62 above.

- 5.119 We believe that where a transfer is made to an innocent purchaser outside the pool, the debited account holder should likewise be able to retain its pro rata interest in what is left in the pool. The fact that the transfer is outside of the pool should be irrelevant. Just as in the case of a transfer within a pool, the other account holders are sharing the risk of improper dealings by the intermediary. By spreading the risk in this way, they are accepting a higher likelihood of a lower potential loss.⁹⁴ The securities held in the pooled account are fungible and are not allocated to any particular account holder. The credits evidence the size of the account holders' respective interests in the pooled account and should not be conflated with the intangible assets themselves. A transfer of the intermediated securities to an innocent purchaser should therefore not prevent the account holder from retaining its claim against the pool and having the credit to its account restored.⁹⁵
- 5.120 We note that the Convention does not address this issue directly as it leaves the question of the validity or reversal of debits to domestic law.⁹⁶ If, under domestic law, the credit is restored to the account holder, the effect under the Convention is to restore the account holder's proprietary claim to the securities in the account along with all the other account holders. This, in turn, creates a shortfall in the account (as the credits in the pooled account will now exceed the number of securities held by the intermediary or credited to its account with the intermediary above it). Should the intermediary fall insolvent without purchasing securities to remedy the shortfall, the allocation of losses within the pool is determined by the rules of insolvency law, the settlement system and the account agreement. In the case of legal systems that recognise the segregation of accounts, the loss will be limited to account holders holding in the pooled account. In legal systems that do not, the loss may be spread more widely to other accounts.
- 5.121 We believe that our proposal for sharing the risk of unauthorised transfers made from or within a pool could be achieved under English law by ensuring that the good faith purchaser rule for intermediated securities operates only to prevent claimants making a claim against the good faith purchaser. The rule would not, however, extinguish the original owner's own equitable interest in the pool. In other words, the good faith purchaser's interest in the intermediated securities would simply be *unaffected* by prior equitable interests or equities of which it had no notice. We have deliberately avoided reference to the purchaser as having a *superior* equity to the claimant, so as to ensure that where the transfer is within a pooled account, the purchaser cannot claim ahead of the original owner. The purchaser will instead share pro rata in any loss with the other account holders in the pool.

⁹⁴ See CW Mooney, 'Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities controlled by Intermediaries', (1990) *Cardozo L Rev* 305, 358.

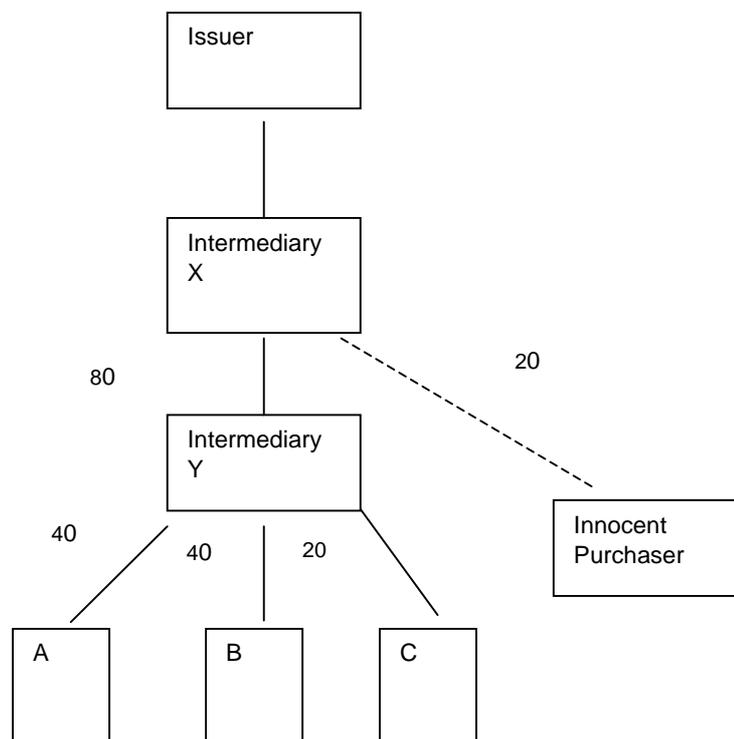
⁹⁵ In practice, this result is achievable under current law. If the record-keeping of the intermediary is so inadequate as to make it impossible to attribute the loss to particular purchasers or account holders, a court may opt instead to apply a loss distribution rule such as the pro rata method adopted by the court in *Barlow Clowes v Vaughan*. Where, however, a court is clearly able to attribute an unauthorised transfer to a particular account within the pool, this option may not be available to it.

⁹⁶ Article 11(2)(a) and (b).

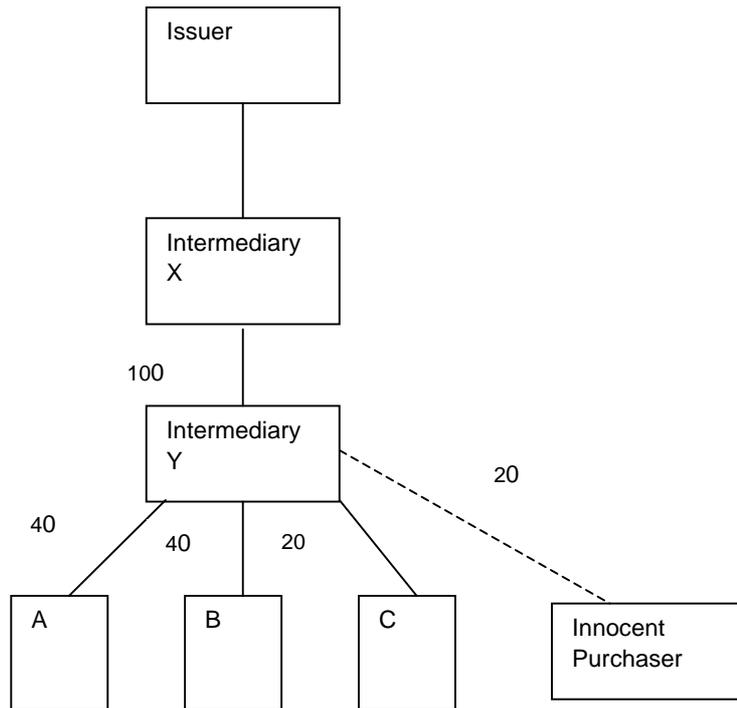
5.122 We acknowledge that this proposal would mark a departure from the conventional trust law analysis in relation to trust assets wrongfully transferred out of a pool of trust assets belonging to multiple beneficiaries. We should clarify that this proposal is intended to cover only intermediated securities and the particular legal and commercial circumstances of choosing to hold tangible securities in a pooled account.

5.123 The following examples may help to explain how the rule would operate:

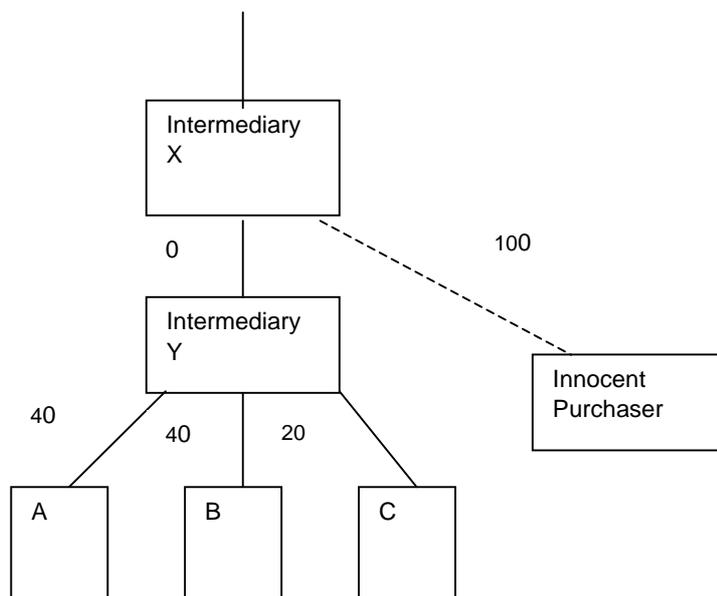
5.124



5.125 Intermediary Y instructs its own intermediary X to transfer 20 securities to a good faith purchaser. Y improperly debits the 20 securities from the account of C. The good faith purchaser is protected from a claim by C. C would, under our proposal, retain its proprietary claim to a pro rata share of the remaining securities in the account held by Y. Y's account holders would be entitled to 100 securities in aggregate despite Y now having only 80 in its account. If Y falls insolvent before the shortfall is remedied, the loss should be allocated pro rata in accordance with the decision in *Barlow Clowes*.



5.126 Where the transfer is within the same pooled account, all of the account holders (including the purchaser and the original owner C) would share in any loss caused by the resulting shortfall. While the purchaser would be protected from a claim made against it by C, its proprietary claim to the securities credited to the pooled account would still be subject to shortfalls in the pool just like any other account holder.



- 5.127 Where all of the securities in the pooled account have been transferred to a purchaser in a separate account, the original owners cannot make a successful claim against the purchaser of the securities. Their proprietary claim in relation to the pooled account continues but is of no practical benefit until the intermediary repurchases securities to remedy the shortfall.

Scope and application of legislative protection

Definition of intermediated securities

- 5.128 While there may be justification for a general reform of the law relating to innocent purchasers of equitable interests, our proposals are limited to protecting purchasers of interests in investment securities held through an intermediary. Accordingly, the definition of intermediated securities is critical to defining the scope of the new protection.
- 5.129 While it is ultimately a matter for Parliamentary Counsel to determine the form that the legislation should take we would advocate adopting the same or similar language to that used by current domestic legislation. Securities held through an intermediary were included within the scope of the Financial Collateral Arrangements (No 2) Regulations 2003⁹⁷ that implemented the Financial Collateral Directive.⁹⁸ “Book-entry securities collateral” is defined as:

Financial collateral subject to a financial collateral arrangement which consists of financial instruments, title to which is evidenced by entries in a register or account maintained by or on behalf of an intermediary;

“Financial instruments” means:

- (a) shares in companies and other securities equivalent to shares in companies;
- (b) bonds and other forms of instruments giving rise to or acknowledging indebtedness if these are tradeable on the capital market; and
- (c) any other securities which are normally dealt in and which give the right to acquire any such shares, bonds, instruments or other securities by subscription, purchase or exchange or which give rise to a cash settlement (excluding instruments of payment):

and includes units of a collective investment scheme within the meaning of the Financial Services and Markets Act 2000, eligible debt securities within the meaning of the Uncertificated Securities Regulations 2001, money market instruments, claims relating to or rights in or in respect of any of the financial instruments included in this definition and any rights, privileges or benefits attached to or arising from any such financial instruments;

⁹⁷ SI 2003/3226.

⁹⁸ Directive 2002/47/EC of the European Parliament and Council of 6 June 2002, OJ L 168/43.

- 5.130 As one would expect, the definitions closely follow the definitions used by the Financial Collateral Directive.
- 5.131 As noted elsewhere in this Advice, Regulation 35 of the Uncertificated Securities Regulations provides an effective ‘innocent purchaser’ rule for CREST securities (whether directly-held or in the form of depository interests) based on actual notice. Accordingly, CREST should be excluded from the scope of the proposed domestic rule. This could be done by ensuring that any definition of ‘intermediary’ used for the purposes of setting the scope of the ‘intermediated securities’ definition expressly excludes systems where the transfer of securities is across the primary record of entitlement to the securities (i.e. CREST) . An equivalent exclusion was used in regulation 3 of the Financial Collateral Arrangements (No. 2) Regulations to carve-out CREST securities.

Who constitutes a purchaser for purposes of the protection?

- 5.132 The question arises as to whether the protection should be available only to the person that acquires the equitable interest or whether the protection should extend to persons for whom the purchaser holds the interest on trust. For example, where an intermediary effects a transfer on its books by way of credit and debit and the purchasing account holder is itself an intermediary acting for its own account holder, should its lower tier account holder be able to rely on the protection if it can satisfy the good faith purchaser test? We propose that it should.
- 5.133 On the other hand, if an account holder acquires intermediated securities as a result of a purchase of the underlying securities by its own intermediary (or by a higher tier intermediary) it should not be able to rely upon the new protection. The account holder in these circumstances should be in a position to rely upon the good faith purchase of the intermediary that acquired the legal title in order to escape liability.⁹⁹ This is provided that the account holder has not acted dishonestly in connection with the breach of trust leading to the transfer, in which case it may still be personally liable for dishonest assistance.¹⁰⁰ Alternatively, the account holder’s knowledge could also conceivably be imputed to its own intermediary if it was aware of an adverse claim at the time of the transfer.

⁹⁹ *Harrison v Forth* (1675) Prec Ch 51; *Mertons v Joliffe* (1756) Amb 311.

¹⁰⁰ *Twinsectra v Yardley* [2002] 2 AC 164.

APPENDIX A

PRELIMINARY DRAFT CONVENTION ON SUBSTANTIVE RULES REGARDING

(Revised to show Law Commission's suggested underlined amendments)

UNIDROIT 2006 – Study LXXVIII – Doc. 57

PRELIMINARY DRAFT CONVENTION ON SUBSTANTIVE RULES REGARDING INTERMEDIATED SECURITIES CHAPTER I - DEFINITIONS, SCOPE OF APPLICATION AND INTERPRETATION

Article 1

[Definitions]

In this Convention:

- (a) “*securities*” means any shares, bonds or other financial instruments or financial assets (other than cash) which are capable of being credited to a securities account and of being acquired and disposed of in accordance with the provisions of this Convention;
- (b) “*intermediated securities*” means securities credited to a securities account or rights or interests in securities resulting from the credit of securities to a securities account;
- (c) “*securities account*” means an account maintained by an intermediary to which securities may be credited or debited;
- (d) “*intermediary*” means a person that in the course of a business or other regular activity maintains securities accounts for others or both for others and for its own account and is acting in that capacity;
- (e) “maintain” means, in the context of a securities account, to undertake or otherwise become obligated under non-Convention law to treat the person in whose name the securities are credited as entitled to exercise against it any or all of the rights set out in Article 5 in respect of them.
- (f) “*account holder*” means a person in whose name an intermediary maintains a securities account, whether that person is acting for its own account or for others (including in the capacity of intermediary);

(gf) “*account agreement*” means, in relation to a securities account, the agreement between the account holder and the relevant intermediary governing that securities account;

(hg) “*relevant intermediary*” means, with respect to a securities account, the intermediary that maintains the securities account for the account holder;

(ih) “*insolvency proceeding*” means a collective judicial or administrative proceeding, including an interim proceeding, in which the assets and affairs of the debtor are subject to control or supervision by a court or other competent authority for the purpose of reorganisation or liquidation;

(ji) “*insolvency administrator*” means a person (including a debtor in possession where applicable) authorised to administer an insolvency proceeding, including one authorised on an interim basis;

(kj) securities are “*of the same description*” as other securities if they are issued by the same issuer and:

- (i) they are of the same class of shares or stock; or
- (ii) in the case of securities other than shares or stock, they are of the same currency and denomination and are treated as forming part of the same issue;

(lk) “*control agreement*” means an agreement between an account holder, the relevant intermediary and another person, or, if so permitted by the non-Convention law, an agreement between an account holder and another person of which notice is given to the relevant intermediary, which relates to intermediated securities and includes either or both of the following provisions –

- (i) that the relevant intermediary is not permitted to comply with any instructions given by the account holder in respect of the intermediated securities to which the agreement relates without having received the consent of that other person;
- (ii) that the relevant intermediary is obliged to comply with any instructions given by that other person in respect of the intermediated securities to which the agreement relates in such circumstances and as to such matters as may be provided by the agreement or the non-Convention law, without any further consent of the account holder;

(ml) “*designating entry*” means an entry in a securities account made in favour of a person other than the account holder in respect of intermediated securities, which, under the account agreement, a control agreement, the uniform rules of a securities settlement system or the non-Convention law, has either or both of the following effects –

- (i) that the relevant intermediary is not permitted to comply with any instructions given by the account holder in respect of the intermediated securities in relation to which the entry is made without having received the consent of that other person;
- (ii) that the relevant intermediary is obliged to comply with any instructions given by that other person in respect of the intermediated securities in respect of which the entry is made in such circumstances and as to such matters as may be provided by the account agreement, a control agreement, the uniform rules of a securities settlement system or the non-Convention law, without any further consent of the account holder;

(~~nm~~) “*non-Convention law*” means the provisions of law in force in the State whose law is applicable under Article 2, other than those provided in this Convention;

(~~oa~~) “*securities settlement system*” means a system which-

- (i) settles, or clears and settles, securities transactions;
- (ii) is operated by a central bank or central banks or is subject to regulation, supervision or oversight by a governmental or public authority in respect of its rules; and
- (iii) has been notified, on the ground of the reduction of risk to the stability of the financial system, as a securities settlement system in a declaration by the Contracting State ~~whose the law of which governs the rules of~~ is applicable to the system;

(p) “segregation arrangement” means an arrangement whereby the relevant intermediary holds securities or holds an account with another intermediary to which are credited securities that are allocated only to a particular account holder or group of account holders of the relevant intermediary.

(~~oe~~) “*securities clearing system*” means a system which –

- (i) clears, but does not settle, securities transactions through a central counterparty or otherwise;
- (ii) is operated by a central bank or central banks or is subject to regulation, supervision or oversight by a governmental or public authority in respect of its rules; and
- (iii) has been notified, on the ground of the reduction of risk to the stability of the financial system, as a securities clearing system in a declaration by the Contracting State the law of which governs the rules of the system;

(~~re~~) “*uniform rules*” means, in relation to a securities settlement system or securities clearing system, rules of that system (including rules constituted by non-Convention law) which are common to the participants or to a class of participants and are publicly accessible.

Article 2

[Sphere of application]

This Convention applies where –

(a) the conflict of laws rules of the forum state designate the law in force in a Contracting State as the applicable law; or

(b) the circumstances do not involve a choice in favour of any law other than the law in force in the forum state and the forum state is a Contracting State.

Article 3

[Central Securities Depositories]

This Convention does not apply to the activity of creation, recording or reconciliation of securities conducted by central securities depositories or other persons *vis-à-vis* the issuer of those securities.

Article 4

[Principles of interpretation]

In the implementation, interpretation and application of this Convention, regard is to be had to its purposes, to the general principles on which it is based, to its international character and to the need to promote uniformity and predictability in its application.

CHAPTER II – RIGHTS OF THE ACCOUNT HOLDER

Article 5

[Intermediated securities]

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

- (a) the right to receive and exercise the 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 non-Convention law so provides;
- (b) the right, by instructions to the relevant intermediary, to effect a disposition under Article 7 or grant an interest under Article 8;
- (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, the non-Convention law and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system;
- ~~(d) unless otherwise provided in this Convention, such other rights, including rights and interests in securities, as may be conferred by the non-Convention law.~~

2. - Unless otherwise provided in this 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 1(c) may be exercised only against the relevant intermediary;

(d) the rights referred to in paragraph 1 are without prejudice to such other rights, including rights and interests in securities, conferred on the account holder by non-Convention law.

3. - Where an account holder has acquired a security interest, or a limited interest other than a security interest, by credit of securities to its securities account under Article 7(4), the non-Convention law determines any limits on the rights described in paragraph 1.

Article 6

[Measures to enable account holders to receive and exercise rights]

1. - An intermediary must take appropriate measures to enable its account holders to receive and exercise the rights specified in Article 5(1), but 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.

2. - This Article does not affect any right of the account holder against the issuer of the securities.

CHAPTER III – TRANSFER OF INTERMEDIATED SECURITIES

Article 7

[Acquisition and disposition by debit and credit]

1. - Subject to Article 11, intermediated securities are acquired by an account holder by the credit of securities to that account holder's securities account.

2. - No further step is necessary, or may be required by the non-Convention law, to render the acquisition of intermediated securities effective against third parties.

3. - Subject to Article 11, intermediated securities are disposed of by an account holder by the debit of securities to that account holder's securities account.

4. - A security interest, or a limited interest other than a security interest, in intermediated securities may be acquired and disposed of by debit and credit of securities to securities accounts under this Article.

5. - Debits and credits to securities accounts in respect of securities of the same description may be effected on a net basis.

Article 8

[Grant of interests in intermediated securities by other methods]

1. - An account holder grants an interest in intermediated securities, including a security interest or a limited interest other than a security interest, to another person so as to be effective against third parties if -

- (a) the account holder enters into an agreement with that person; and
- (b) one of the conditions specified in paragraph 2 applies and the relevant

Contracting State has made a declaration in respect of that condition under paragraph 4; and no further step is necessary, or may be required by the non-Convention law, to render the interest effective against third parties.

2. - The conditions referred to in paragraph 1(b) are as follows –

- (a) that the person to whom the interest is granted is the relevant intermediary;
- (b) that a designating entry in favour of that person has been made;
- (c) that a control agreement in favour of that person applies.

3. - An interest in intermediated securities may be granted under this Article so as to be effective against third parties –

- (a) in respect of a securities account (and such an interest extends to all intermediated securities from time to time standing to the credit of the relevant securities account);
- (b) in respect of a specified category, quantity, proportion or value of the intermediated securities from time to time standing to the credit of a securities account.

4. - A Contracting State may declare that under its non-Convention law –

- (a) the condition specified in any one or more of sub-paragraphs (a) to (c) of paragraph 2 is sufficient to render an interest effective against third parties;
- (b) this Article shall not apply in relation to interests in intermediated securities granted by or to parties falling within such categories as may be specified in the declaration;
- (c) paragraph 3, or either sub-paragraph of paragraph 3, does not apply;
- (d) paragraph 3(b) applies with such modifications as may be specified in the declaration.

5. - The non-Convention law determines in what circumstances a non-consensual security interest in intermediated securities may arise and become effective against third parties.

Article 9

[Other methods under non-Convention law]

This Convention does not preclude any method provided by the non-Convention law –

- (a) for the acquisition or disposition of intermediated securities or of an interest in intermediated securities;

(b) for the creation of an interest in intermediated securities and for making such an interest effective against third parties; other than the methods provided by Articles 7 and 8.

Article 10

[Evidential requirements]

The non-Convention law determines the evidential requirements in respect of the matters referred to in Articles 7 and 8.

Article 11

[Invalidity and reversal]

1. - A debit of securities to a securities account or a designating entry is invalid if the relevant intermediary is not authorised to make that debit or designating entry:

(a) by the account holder and, in the case of a debit or designating entry that relates to intermediated securities which are subject to an interest granted under Article 8, by the person to whom that interest is granted; or

(b) by the non-Convention law.

2. - Subject to Article[s] 12 [and 13], the non-Convention law and, to the extent permitted by the non-Convention law, an account agreement or the uniform rules of a securities settlement system determine –

(a) the validity of a debit, credit or designating entry;

(b) whether a debit, credit or designating entry is liable to be reversed;

(c) where a debit, credit or designating entry is liable to be reversed, its effect (if any) against third parties and the consequences of reversal;

(d) whether and in what circumstances a debit, credit or designating entry may be made subject to a condition; and

(e) where a debit, credit or designating entry is made subject to a condition, its effect (if any) against third parties before the condition is fulfilled and the consequences of the fulfilment or non-fulfilment of the condition.

Article 12

[Acquisition by an innocent person of intermediated securities]

1. - Where securities are credited to the securities account of an account holder at a time when the account holder does not know that another person has an interest in securities or intermediated securities and that the credit violates the rights of that other person with respect to that interest –

- (a) the account holder is not subject to the interest of that other person;
- (b) the account holder is not liable to that other person; and
- (c) the credit is not invalid or liable to be reversed on the ground that the interest or rights of that other person invalidate any previous debit or credit made to another securities account.

2. - Where securities are credited to the securities account of an account holder, or an interest becomes effective against third parties under Article 8, at a time when the account holder or the person to whom the interest is granted does not know of an earlier defective entry –

- (a) the credit or interest is not rendered invalid, ineffective against third parties or liable to be reversed as a result of that defective entry; and
- (b) the account holder, or the person to whom the interest is granted, is not liable to anyone who would benefit from the invalidity or reversal of that defective entry.

3. - Paragraphs 1 and 2 do not apply in respect of an acquisition of securities, other than the grant of a security interest, made by way of gift or otherwise gratuitously.

4. - For the purposes of this Article –

- (a) “*defective entry*” means a credit of securities or designating entry which is invalid or liable to be reversed, including a conditional credit or designating entry which becomes invalid or liable to be reversed by reason of the operation or non-fulfilment of the condition;
- (b) a person knows of an interest or fact if that person –
 - (i) has actual knowledge of the interest or fact; or
 - (ii) ~~(ii)~~ has knowledge of facts sufficient to indicate that there is a significant probability that the interest or fact exists and deliberately avoids information that would establish that this is the case; or
 - (iii) is deemed under non-Convention law to have the knowledge of another person who knows of an interest or fact; and
- (c) when the person referred to in (b) is an organisation, it knows of an interest or fact from the time when the interest or fact is or ought reasonably to have been brought to the attention of the individual responsible for the matter to which the interest or fact is relevant.

5. - To the extent permitted by the non-Convention law, paragraph 2 is subject to any provision of the uniform rules of a securities settlement system or of the account agreement.

6. – This Article is without prejudice to any rights or defences available to an account holder or intermediary under non-Convention law or the rules of a Securities Settlement System in relation to ~~the violation of~~ another person’s claim to an interest in securities or intermediated securities.

Article 13

[Priority among competing interests]

1. - This Article determines priority between interests in the same intermediated securities which become effective against third parties under Articles [7 and 8](#).
2. - Subject to paragraph 5 and Article 14, interests that become effective against third parties under Articles [7 and 8](#) have priority over any interest that becomes effective against third parties by any other method permitted by the non-Convention law.
3. - Interests that become effective against third parties under Article 8 rank among themselves according to the time of occurrence of the following events –
 - (a) if the relevant intermediary is itself the holder of the interest, when the agreement granting the interest is entered into;
 - (b) when a designating entry is made;
 - (c) when a control agreement is entered into, or, if applicable, a notice is given to the relevant intermediary.
4. - Where an intermediary has an interest that has become effective against third parties under Article 8 and makes a designation or enters into a control agreement with the consequence that an interest of another person becomes effective against third parties, the interest of that other person has priority over the interest of the intermediary unless that other person and the intermediary expressly agree otherwise.
5. - A non-consensual security interest in intermediated securities arising or recognised under any rule of the non-Convention law has such priority as is afforded to it by that law.
6. - As between persons entitled to any interests referred to in paragraphs 2, 3 and 4 and, to the extent permitted by the non-Convention law, paragraph 5, the priorities provided by this Article may be varied by agreement between those persons, but any such agreement does not affect third parties.

Article 14

[Priority of interests granted by an intermediary]

This Convention does not determine the priority or the relative rights and interests between the rights of account holders of an intermediary and interests granted by that intermediary that have become effective under Article 8.

CHAPTER IV – INTEGRITY OF THE INTERMEDIATED HOLDING SYSTEM

Article 15

[Rights of account holders in case of insolvency of intermediary]

The rights of an account holder under Article 5(1), and an interest that has become effective against third parties under Article 8, are effective against the insolvency administrator and creditors in any insolvency proceeding in respect of the relevant intermediary.

Article 16

[Effects of insolvency]

Subject to Article 23 and Article 31 ~~Unless expressly stated~~ ~~Subject to Article 23 and Article 31~~, nothing in this Convention affects:

- (a) any rules of law applicable in insolvency proceedings ~~relating to the avoidance of a transaction as a preference or a transfer in fraud of creditors~~; or
- (b) any rules of procedure relating to the enforcement of rights to property which is under the control or supervision of an insolvency administrator.

Article 17

[Prohibition of upper-tier attachment]

1. - No attachment of or in respect of intermediated securities of an account holder shall be granted or made against the issuer of the relevant securities or against any intermediary other than the relevant intermediary.

2. - In this Article “*attachment*” means 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 its availability to enforce or satisfy any future such judgment, award or decision.

Article 18

[Instructions to the intermediary]

1. - 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.

2. - Paragraph 1 is subject to:

- (a) the provisions of the account agreement, any other agreement between the intermediary and the account holder or any other agreement entered into by the intermediary with the consent of the account holder;
- (b) the rights of any person (including the intermediary) who holds an interest that has become effective against third parties under Article 8;
- (c) subject to Article 17, any judgment, award, order or decision of a court, tribunal or other judicial or administrative authority of competent jurisdiction;
- (d) any applicable rule of the non-Convention law; and
- (e) where the intermediary is the operator of a securities settlement system, the uniform rules of that system.

Article 19

[Requirement to hold sufficient securities]

1. ~~4.~~ An intermediary must, for each description of securities, hold securities and intermediated securities of an aggregate number and amount equal to the aggregate number and amount of securities of that description credited to securities accounts which it maintains for its account holders.
 2. For the purposes of paragraph 1, any securities and intermediated securities that are incapable of being allocated to account holders as a result of a declaration made under Article 21(5) shall not be included in the aggregate number and amount held by the intermediary.
- ~~3.~~ - If at any time an intermediary does not hold sufficient securities and intermediated securities of any description in accordance with paragraph 1, it must within the time required by the non-Convention law take such action as is necessary to ensure that it holds sufficient securities and intermediated securities of that description.
- ~~4.~~ - The preceding paragraphs do not affect any provision of the non-Convention law, or, to the extent permitted by the non-Convention law, any provision of the uniform rules of a securities settlement system or of an account agreement, relating to the method of complying with the requirements of those paragraphs or the allocation of the cost of ensuring compliance with those requirements or otherwise relating to the consequences of failure to comply with those requirements.

Article 20

[Limitations on obligations and liabilities of intermediaries]

1. - The obligations of an intermediary under this Convention and the extent of the liability of an intermediary in respect of those obligations are subject ~~to any applicable provision of the non-Convention law and~~, to the extent permitted by the non-Convention law, to the account agreement or the uniform rules of a securities settlement system.

~~2. - [An intermediary, including the] [The] operator of a securities settlement system, who makes a debit, credit, or designating entry (an "entry") to a securities account maintained by the [intermediary] [operator] for an account holder is not liable to a third party who has an interest in intermediated securities and whose rights are violated by the entry unless —~~

~~(a) — the [intermediary] [operator] makes the entry after the [intermediary]~~

~~[operator] has been served with legal process restraining it from doing so, issued by a court of competent jurisdiction, and has had a reasonable opportunity to act on that legal process; or~~

~~(c) — the [intermediary] [operator] acts wrongfully and in concert with another person to violate the rights of that third party.~~

~~3. — Paragraph 2 does not affect any liability of the [intermediary] [operator] —~~

~~(a) — to the account holder or a person to whom the account holder has granted an interest that has become effective against third parties under Article 8; or~~

~~(b) — that arises from an entry which the [intermediary] [operator] is not entitled to make under Article 18.~~

~~4. — The operator of a securities settlement system or securities clearing system to whose securities account securities are credited and who authorises a matching debit of those securities to its securities account is not liable to a third party who has an interest in intermediated securities and whose rights are violated by that credit or debit unless —~~

~~(a) — the operator receives the credit or authorises the debit after the operator has been served with legal process restraining it from doing so, issued by a court of competent jurisdiction, and has had a reasonable opportunity to act on that legal process; or~~

~~(b) the operator acts wrongfully and in concert with another person to violate the rights of that third party.~~

Article 21

[Allocation of securities to account holders' rights]

1. - 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 the former 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 for account holders other than itself.

2. - Subject to Article 14, securities allocated under paragraph 1 shall not form part of the property of the intermediary available for distribution among or realisation for the benefit of creditors of the intermediary.

3. - The allocation required by paragraph 1 shall be effected by the non-Convention law and, to the extent required or permitted by the non-Convention law, by arrangements made by the relevant intermediary.

4. - The arrangements referred to in paragraph 3 may include arrangements under which an intermediary holds securities in segregated form –

- (a) for the benefit of its account holders generally; or
- (b) for the benefit of particular account holders or groups of account holders;

in such manner as to ensure that such securities are allocated in accordance with paragraph 1.

5. - A Contracting State may declare that under its non-Convention law the allocation required by paragraph 1 applies only to securities that are held by the relevant intermediary in segregated form under arrangements such as are referred to in paragraph 4 and does not apply to securities held by the relevant intermediary for its own account.

Article 22

[Loss sharing in case of insolvency of the intermediary]

1. ~~4.-~~ This article applies:

(a) in any insolvency proceeding in respect of an intermediary unless otherwise provided by any conflicting rule applicable in that proceeding; or

(b) in any circumstance where the intermediary is not obliged to comply with Article 19(3)

2. - If the aggregate number or amount of securities of any description allocated under Article 21 to an account holder, a group of account holders or the intermediary's account holders generally is less than the aggregate number or amount of securities of that description credited to the securities accounts of that account holder, that group of account holders or the intermediary's account holders generally (as the case may be), the shortfall shall be borne –

(a) where securities have been allocated to a single account holder, by that account holder;

(b) in any other case, by the account holders to whom the relevant securities have been allocated, in proportion to the respective number or amount of securities of that description credited to their securities accounts.

3. - To the extent permitted by the non-Convention law, where the intermediary is the operator of a securities settlement system and the uniform rules of the system make provision in case of a shortfall, the shortfall shall be borne in the manner so provided.

Article 23

[Effect of debits, credits etc. and instructions on insolvency of operator or participant in securities settlement system]

1. - To the extent permitted by the non-Convention law, the following provisions shall have effect notwithstanding the commencement of an insolvency proceeding in respect of the operator of the relevant system or any participant in the relevant system –
 - (a) any provision of the uniform rules of a securities settlement system or of a securities clearing system in so far as that provision precludes the revocation of any instruction given by a participant in the system for making a disposition of securities, or for making a payment relating to an acquisition or disposition of securities, after the time at which that instruction is treated under the rules of the system as having been entered irrevocably into the system;
 - (b) any provision of the uniform rules of a securities settlement system in so far as that provision precludes the invalidation or reversal of a debit or credit of securities to, or a designating entry in, a securities account which forms part of the system after the time at which that debit, credit or designating entry is treated as irrevocable under the rules of the system.
2. - Paragraph 1 applies notwithstanding that any invalidation, reversal or revocation referred to in that paragraph would otherwise occur under any rule applicable in an insolvency proceeding.

CHAPTER V – RELATIONSHIP WITH ISSUERS OF SECURITIES

Article 24

[Position of issuers of securities]

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 in accordance with Article 5 of the rights attached to such securities which are so held, but need not require that all such securities be issued on terms that permit them to be held through intermediaries.
2. - In particular, the law of a Contracting State shall recognise the holding of such securities by a person acting in his own name on behalf of another person or other persons and shall permit such a person to exercise voting or other rights in different ways in respect of different parts of a holding of securities of the same description; but this Convention does not determine the conditions under which such a person is authorised to exercise such rights.
3. This Convention does not determine whom an issuer is required to recognise as the holder of securities.

Article 25

[Set-off]

1. - As between an account holder who holds intermediated securities for its own account and the issuer of those securities, the fact that the account holder holds the securities through an intermediary or intermediaries shall not of itself, in any insolvency proceeding in respect of the issuer, preclude the existence or prevent the exercise of any rights of set-off which would have existed and been exercisable if the account holder had held the securities otherwise than through an intermediary.
2. - This Article does not affect any express provision of the terms of issue of the securities.

**CHAPTER VI – SPECIAL PROVISIONS WITH RESPECT TO
COLLATERAL TRANSACTIONS**

Article 26

[Scope and interpretation in Chapter VI]

1. - This Chapter applies to collateral agreements under which a collateral provider grants a security interest in intermediated securities to a collateral taker [under Article 7\(4\) and Article 8\(2\)](#) in order to secure the performance of any existing or future obligation of the collateral provider or a third person.
2. - In this Chapter –
 - (a) “*collateral agreement*” means a security collateral agreement or a title transfer collateral agreement;
 - (b) “*security collateral agreement*” means an agreement between a collateral provider and a collateral taker providing (in whatever terms) for the grant of an interest other than full ownership in intermediated securities for the purpose of securing the performance of relevant obligations;
 - (c) “*title transfer collateral agreement*” means an agreement, including an agreement providing for the sale and repurchase of securities, between a collateral provider and a collateral taker providing (in whatever terms) for the transfer of full ownership of intermediated securities by the collateral provider to the collateral taker for the purpose of securing or otherwise covering the performance of relevant obligations;
 - (d) “*relevant obligations*” means any present or future obligations of a collateral provider or a third person;
 - (e) “*collateral securities*” means intermediated securities delivered under a collateral agreement;

(f) “*collateral taker*” means a person to whom an interest in intermediated securities is granted under a security collateral agreement or to whom full ownership of intermediated securities is transferred under a title transfer collateral agreement;

(g) “*collateral provider*” means an account holder by whom an interest in intermediated securities is granted under a security collateral agreement or full ownership of intermediated securities is transferred under a title transfer collateral agreement;

(h) “*enforcement event*” means, in relation to a collateral agreement, an event of default or other event on the occurrence of which, under the terms of that collateral agreement, the collateral taker is entitled to enforce its security or operate a close-out netting provision;

(i) “*equivalent collateral*” means securities of the same description as collateral securities;

(j) “*close-out netting provision*” means a provision of a collateral agreement, or of a set of connected agreements of which a collateral agreement forms part, under which, on the occurrence of an enforcement event, either or both of the following shall occur, or may at the election of the collateral taker occur, whether through the operation of netting or set-off or otherwise:

(i) the respective obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value or are terminated and replaced by an obligation to pay such an amount;

(ii) an account is taken of what is due from each party to the other in respect of such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party.

Article 27

[Recognition of title transfer collateral agreements]

1. - The law of a Contracting State shall permit a title transfer collateral agreement to take effect in accordance with its terms [so as to prevent the agreement from being recharacterised as a security interest under non-Convention law].

2. - If an enforcement event occurs while any obligation of the collateral taker to transfer equivalent collateral under a title transfer collateral agreement remains outstanding, that obligation and the relevant obligations may be the subject of a close-out netting provision.

Article 28

[Enforcement]

1. - On the occurrence of an enforcement event, the collateral taker may –

(a) realise the collateral securities provided under a security collateral agreement:

(i) by selling them and applying the net proceeds of sale in or towards the discharge of the relevant obligations; or

(ii) by appropriating the collateral securities as the collateral taker's own property and setting off their value against, or applying their value in or towards the discharge of, the relevant obligations, provided that the collateral agreement provides for realisation in this manner and specifies the basis on which collateral securities are to be valued for this purpose; or

(b) operate a close-out netting provision.

2. - Collateral securities may be realised, and a close-out netting provision may be operated, under paragraph 1:

(a) subject to any contrary provision of the collateral agreement, without any requirement that:

(i) prior notice of the intention to realise or operate the close-out netting provision shall have been given;

(ii) the terms of the realisation or the operation of the close-out netting provision be approved by any court, public officer or other person; or

(iii) the realisation be conducted by public auction or in any other prescribed manner or the close-out netting provision be operated in any prescribed manner; and

(c) notwithstanding the commencement or continuation of an insolvency proceeding in respect of the collateral provider or the collateral taker.

[provided that, this shall be without prejudice to any to any restrictions or requirements under non-Convention law on bringing into account claims ~~on close-out netting~~, on obligations to set off, or on netting, relating to their reciprocity or the fact that they have been concluded prior to when the collateral taker knew or ought to have known of the commencement \(or of any mandatory legal act leading to the commencement\) of insolvency proceedings in respect of the collateral provider.](#)

Article 29

[Right to use collateral securities under security collateral agreement]

1. - If and to the extent that the terms of a security collateral agreement so provide, the collateral taker shall have the right to use and dispose of the collateral securities as if it were the owner of them (a "right of use").

2. - Where a collateral taker exercises a right of use, it thereby incurs an obligation to replace the collateral securities originally transferred (the "original collateral securities") by transferring to the collateral provider, not later than the discharge of the relevant obligations, equivalent collateral or, where the security collateral agreement provides for the transfer of other assets [following the occurrence of any event relating to or affecting any securities provided as collateral], those other assets.

3. - Securities transferred under paragraph 2 before the relevant obligations have been fully discharged:

(a) shall, in the same manner as the original collateral securities, be subject to a security interest under the relevant security collateral agreement, which shall be treated as having been created at the same time as the security interest in respect of the original collateral securities was created; and

(b) shall in all other respects be subject to the terms of the relevant security collateral agreement.

4. - The exercise of a right of use shall not render invalid or unenforceable any right of the collateral taker under the relevant security collateral agreement.

Article 30

[Requirements of non-Convention law relating to enforcement]

Articles 27, 28 and 29 do not affect any requirement of the non-Convention law to the effect that the realisation or valuation of collateral securities or the calculation of any obligations must be conducted in a commercially reasonable manner.

Article 31

[Top-up or substitution of collateral]

1. - Where a collateral agreement includes:

(a) an obligation to deliver additional collateral securities –

(i) in order to take account of changes in the value of the collateral provided under the collateral agreement or in the amount of the relevant obligations;

(ii) in order to take account of any circumstances giving rise to an increase in the credit risk incurred by the collateral taker as determined by reference to objective criteria relating to the creditworthiness, financial performance or financial condition of the collateral provider or other person by whom the relevant obligations are owed;

(iii) to the extent permitted by the non-Convention law, in any other circumstances specified in the collateral agreement.

(b) a right to withdraw collateral securities or other assets on providing collateral securities or other assets of substantially the same value, the provision of securities or other assets as described in paragraph (a) and paragraph (b) shall not be treated as invalid, reversed or declared void solely on the basis that they are provided during a prescribed period before, or on the day of but before, the commencement of an insolvency proceeding in respect of the collateral provider, or after the relevant obligations have been incurred.

2. - A Contracting State may declare that paragraph 1(a)(ii) does not apply.

Article 32

[Declarations in respect of Chapter VI]

1. - A Contracting State may declare that this Chapter shall not apply under its non-Convention law.

2. - A Contracting State may declare that under its non-Convention law this Chapter shall not apply –

(a) in relation to collateral agreements entered into by natural persons or persons falling within such other categories as may be specified in the declaration;

(b) in relation to intermediated securities which are not permitted to be traded on an exchange or regulated market;

(c) in relation to collateral agreements which provide for relevant obligations falling within such categories as may be specified in the declaration.

CHAPTER VII – FINAL CLAUSES

Article X

[Applicability of Declarations]

A declaration made by a Contracting State under any article of this Convention is applicable only if the law of that Contracting State is the non-Convention law.