"Legal Risk and Market Efficiency"

UNIDROIT Seminar on

Harmonised Substantive Rules regarding Securities Held with an Intermediary

Rome, 12 November 2003

Report (February 2004)

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Notice

The members of the UNIDROIT Study Group and other speakers at the seminar are each expert in the field of financial markets law in the legal system of their country. However, they participate in the work of UNIDROIT on a strictly personal basis. The views expressed in this paper are those of the speakers and do not necessarily reflect those of their institutions or of UNIDROIT.

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UNIDROIT 2004, Study LXXVIII Doc. 12

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LEGAL RISK AND MARKET EFFICIENCY

Developing Harmonised Substantive Rules

regarding Indirectly Held Securities

Seminar

The seminar is intended to be a starting point for an in-depth discussion on issues relating to legal uncertainties in the field of securities clearing and settlement, notably related to the phenomenon of holding of securities through intermediaries. Representatives of member States' governments, international governmental and non-governmental organisations, central banks, stock exchanges, central securities depositories and the private financial industry will be introduced in the work of the UNIDROIT Study Group and invited to reflect on further perspectives for harmonisation of substantive law with a view to improve legal certainty and economic efficiency of securities holding.

Proceedings will be based on the Position Paper by the UNIDROIT Study Group on Harmonised Substantive Rules regarding Indirectly Held Securities, August 2003, available www.unidroit.org.

UNIDROIT
Palazzo Aldobrandini, Rome
12 November 2003

PROGRAMME

10:00 Registration/Badges

Opening

11:00 Welcome (Herbert Kronke, Secretary General, UNIDROIT)

11:10 Chairman's opening remarks (B. Sen, Chairman of the UNIDROIT Study Group)

11:20 Improving compatibility and internal soundness - Introduction to the project and public response (Philipp Paech, UNIDROIT)

11:45 Legal Risk and its impact on Market Efficiency (Guy Morton, Freshfields Bruckhaus Deringer, London)

12:10 A U.S. perspective on the UNIDROIT project in the light of industry experience under U.C.C. Article 8 and related law (Sandra Rocks, Clearly, Gottlieb, Steen & Hamilton; New York)

12:35 The double objective: improving existing systems and providing guidance for emerging capital markets (Wu Zhipan, University of Beijing)

13:00 Break

Improving Compatibility and Internal Soundness

14:30 Is Common Law vs. Civil Law a core-problem? (Hideki Kanda, University of Tokyo)

15:00 Raising the issues: The need for an instrument on substantive law and its appropriate form (Curtis Reitz, University of Pennsylvania),

followed by

15:15 Round table - questions and comments (Curtis Reitz [Moderator]; Michel Deschamps, McCarthy Tétrault, Montreal; Li Rui Qiang, China Securities Depository, Beijing; Antoine Maffei, De Pardieu Brocas Maffei & Leygonie, Paris).

16:15 Coffee-break

16:45 The book entry as linchpin of further discussions (Dorothee Einsele, University of Kiel)

17:15 Raising the issues: Focus on the scope of the project (Philippe Dupont, Arendt & Medernach, Luxembourg),

followed by

17:30 Round table - questions and comments (Philippe Dupont [Moderator]; Spiros Bazinas, UNCITRAL; Dorothee Einsele, University of Kiel; Edgar Jelonche, University of Buenos Aires; Guy Morton, Freshfields Bruckhaus Deringer, London).

Conclusions

18:30 Outlook from the perspective of domestic law reform (Hans Kuhn, Swiss National Bank)

18:55 End of the session

Cocktail

Introduction To The Project

Philipp Paech, UNIDROIT

In recent years, there have been several consultative initiatives around the world addressing issues of clearing and settlement of securities; for example, the IOSCO/CPSS recommendations for clearing and settlement systems in 2001, the G30 report on global clearing and settlement of January 2003, and, on a European level, the second Giovannini report on cross-border clearing and settlement and the EFMLG report on rights evidenced by book entries. As for legal reforms, early reports began with a very strong emphasis on conflict of laws issues, and then in the G30, the Giovannini and the EFMLG report, they evolved to address substantive law reforms as well, with some emphasis on legal issues arising from the indirect holding of securities.

There are three common aims in all of these initiatives: (1) The protection of market participants such as investors collateral takers and intermediaries (2) the protection of the financial system in the event of a major institutional failure and (3) gains of economic efficiency.

The initiatives also propose similar means to achieve these ends. First and foremost, these initiatives have involved the harmonisation of operational questions. Although, this is an area a legal organisation like UNIDROIT cannot deal with, our work addresses the legal framework surrounding them. This involves, generally speaking, an analysis of conflict of laws issues as well as substantive law reforms.

In terms of the legal aspects, there have been both consultative initiatives as mentioned above, as well as less numerous law-creating initiatives. First of all, there is the Hague Convention on rights regarding securities held with an intermediary, which deals with conflict of laws issues. However, by the very nature of this convention, two concerns cannot be addressed. The first question is whether the domestic law identified by the Hague convention is an internally sound and satisfactory law. This means, when the convention points to a national jurisdiction, is that jurisdiction reliable? The second question is, even if there are several jurisdictions involved and they are all internally sound, do the domestic laws combine effectively in a cross-border context?

It became clear during the process of the Hague Convention that there was also a need to develop substantive harmonised laws in this area. On a regional level, there is already EU law such as the Financial Collateral Directive and the Settlement Finality Directive to address these issues. But on a global level, the substantive law is to be addressed by the UNIDROIT project. However, there is a risk that regional harmonisation may conflict with global harmonisation and we must be careful to ensure that these two processes run along the same lines.

As regards the first question regarding substantive law that the Hague Convention could not deal with, the UNIDROIT Study Group came to the conclusion that every system must be internally sound, that the rules must be clear, and that the investors and the other market participants must be able to rely on the functioning of every national system as such.

Secondly, there is the concern that several jurisdictions may fail in combination even if they are internally sound. In the Study Group process, this is called the problem of compatibility. Thus, the instrument will address issues affecting the ability of different legal systems interact with each other.

The Study Group is aware of the complexity of this task and therefore has tackled a rather limited approach, as it recognises the need for a political consensus because there are a lot of political issues at stake.

Therefore, the Study Group is aiming for a functional and neutral approach, so that the future instrument will be the least intrusive possible. How this should work in detail will be left to one of our round tables today to discuss further. Moreover, we should limit our approach to where harmonisation is absolutely required to achieve these three aims: first, protection of market participants, second, protection of the market as such including and, third, improving market efficiency.

Another means of delimiting the difficulty of the future instrument is the split between a mandatory and a benchmark part of the future instrument. This is because there are a lot of member states who need more general guidelines to improve their securities laws. However, all of these rules cannot be included in the mandatory instrument because it would make the future instrument too complicated and overburdened for countries that already have a sophisticated system in place. Therefore, the mandatory part should only concentrate on few core issues.

As far as the scope of the mandatory list is concerned, I have done some rearranging of the original list and have now placed the recognition of book entries as the only condition for a disposition at the top.

Outline of the Scope

1. Recognition of book entries as only condition for a disposition
2. Role of „informal dispositions“
3. Clear and simple rules for creation and realisation of collateral
4. Good faith acquisition
5. Net settlement
6. Finality and irrevocability
7. Possibility of provisional credits
8. Loss allocation
9. Preclusion of upper tier attachment

This is because many of the comments that the Study Group received indicated that preclusion of upper-tier attachment should not be at the top of the list, as it is self-evident that upper tier attachment should be abolished and the issue of the recognition of book-entries is far broader and more difficult to address.

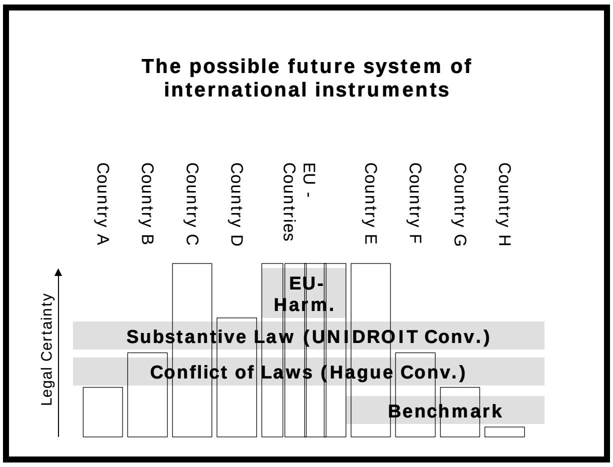
Professor Dorothee Einsele will address the significance of book entries later in her presentation. Many commentators suggested that many of the other issues are related directly to the effect of book entries and she may be able to shed further light on this issue for us.

The list of items regarding the annex, or “benchmark”, is difficult to categorise succinctly. For example, there are crucial questions such as insolvency protection that must maybe be included in the annex because they are too difficult to tackle by means of a mandatory instrument. There are working and reliable systems in place all over the world, but to find a uniform solution could be very difficult because the ways of achieving the insolvency protection are too different from each other.

There are also politically delicate issues under the annex, such as the right of use. There are countries where intermediaries and collateral-takers are allowed to use assets for their own purposes. In other countries, it may be politically difficult to explain to the investors, that their investments are used with or without consent. We should probably not burden the convention with these aspects.

Finally, terms specific to emerging markets should also be put in the benchmark. This would not be a code for all markets: rather, they would be rules that are of use to emerging markets but that are no longer of use to already developed financial markets. It is clear that not all of these rules should be brought together into the international negotiation process under the mandatory list.

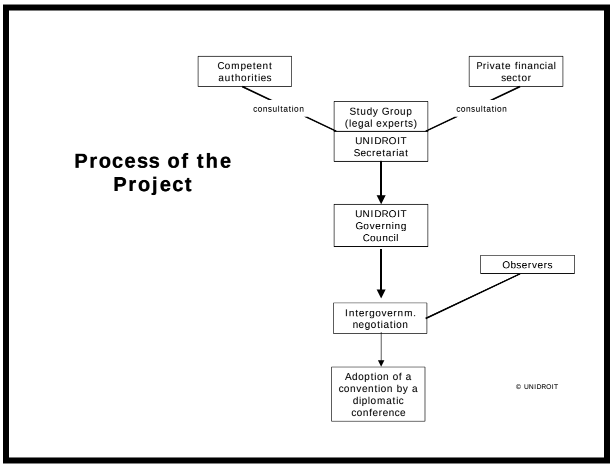
The last question that I would like to address is the potential conception of a future international instrument:



The first set of countries on the left of the diagram are of countries with developed securities markets. On the right of the diagram, I have placed countries with emerging securities markets. The level indicates the degree of legal certainty that they are able to achieve. The benchmark could serve as a basic structure together with other existing instruments for trading in securities in developing countries. Countries that do not follow the benchmark will not have as much legal certainty regarding securities holding and dispositions. There may be a second layer of countries who have adopted the conflict of laws rules from the Hague Convention, providing them with an even greater level of legal certainty. At the end of the spectrum, substantive law harmonisation through the future UNIDROIT Convention could provide a maximum level of legal certainty.

It is possible under this framework that a group of countries, such as those in the EU, may pursue an even higher degree of harmonisation. This would be fine, and to everyone's benefit as long as EU harmonisation does not start at a different level and remains compatible with this substantive law instrument, and, by the way, also with the Conflict-of-Laws instrument as well. Otherwise, the splintered effect would take out the EU countries from process of global harmonisation, which would be to the detriment of all.

The last point that I wanted to raise is the process of the project. At the moment, we are at the Study Group stage. The Study Group will develop a preliminary draft, which will be passed onto the UNIDROIT Governing Council to determine whether it should be transferred to a conference of intergovernmental experts. They would have two or three sessions similar to what you all know from the Hague negotiation process. This would hopefully lead to the adoption of a UNIDROIT Convention on indirectly held securities.



At the Study Group stage, we instigate direct contact with competent authorities such as central banks and supervisors. We also maintain close contact with the private financial sector because they provide the expert knowledge and may know best what is needed in the market. Therefore, we strive for close and permanent co-operation through the installation of a capital markets working group.

We hope that the financial industry in the future will support this project by conducting parallel meetings and providing common comments. We have already asked two lawyers, Ms. Sandra Rocks, New York, and Mr. Antoine Maffei, Paris, to co-ordinate the efforts of the private sector.

At the intergovernmental negotiation stage, there will be official observers from interested organisations such as ISDA, ESF and ECSDA and other capital markets organisations. Co-operation with these groups is crucial for the project because we need continuous feedback on the one hand, and on the other hand, we want to promote the project and foster it in mutual trust.

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LEGAL RISK AND ITS IMPACT ON MARKET EFFICIENCY

Guy Morton, Freshfields Bruckhaus Deringer, London

My talk will address not only legal risk in the context of market efficiency but also systemic risks that impair market efficiency. These are the two key tests that the Study Group has set down in the Position Paper as the benchmark against which initiatives and problems in this area should be measured.

I would like to begin by emphasising the importance of this project with the following, rather crude statistics. It has been estimated that the securities held worldwide in the indirect holding system have a value of roughly 50 trillion Euros. In addition, transaction turnovers are also very high. It has been estimated that a similar amount of securities - approximately 50 trillion- turn over at peak times every two or three days. That compares with a worldwide gross domestic product of about 35 trillion.

Admittedly, this is a very rough comparison but it is worth emphasising to get an order of magnitude for what we are up against. This is an area where even very small risks can have very serious effects. Therefore we need not be concerned about descending to a rather obsessive level of detail and an in-depth assessment of these issues.

In this speech, I propose to set out a framework of relevant legal risks. I will look at few examples of each kind of risk and of their effect and then I will very briefly to try to place the main issues that are addressed in the Position Paper within that framework.

First, what sort of legal risk are we talking about? Legal risk is a term that is often used, however it may cover a wide range of different concepts. I will focus here on general legal risks or, risks from the general legal environment. The following formulation provides a working definition: The risk that the law fails to deliver predictable and practical result.

This kind of risk may arise in a number of ways. A law may be uncertain, widely misunderstood or not clearly defined, or a law may be very clear and well understood but simply not up to the task. It may be defective; it may be incomplete; it may leave gaps which simply do not permit people to do the transactions they would like to do, or it may be burdensome; it may impose irrelevant antiquated or simply over engineered procedural requirements which make it expensive and cumbersome to operate. All of those I would classify for this purpose as different kinds or different facets of the same overall legal risk that we are concerned with.

Let us look at these aspects individually. Where the law is uncertain or is misunderstood, two obvious potential consequences arise. The first is that individual parties may enter into transactions in ignorance of the true state of the law and as a result, they may incur specific legal risks. By specific legal risks, I mean the obvious legal risks that affect a party in particular as opposed to parties generally. The level of seriousness of these risks depends on how large the transaction is and how terminal the problem is, but it can nonetheless be serious.

This sort of problem also has systemic implications that emerge when the law is finally understood. When the first really serious specific risk surfaces, everybody who has a similar problem will probably take fright. When this emerges in an uncontrolled way, as it very often does, the result can easily be a loss of confidence in the market and a domino effect leading to much wider systemic damage. That is a real problem and we have seen some instances or near misses in this area over the last 20 or 25 years.

Consider the following examples. The Hague Convention itself was somewhat of a case study of this effect although fortunately it was possible to handle it in a way which did not give rise to the sort of uncontrolled general legal contagion that I mentioned earlier. There were for some years various arrangements around which arguably were unperfected or inadequately perfected because the state of a law on the identification of the right conflicts rule was simply inadequate. The Hague Convention managed to correct this problem and fortunately, it was able to do so without inflicting any serious harm in the process.

Regrettably, there have been other examples where this has not been the case. For some years in the UK, institutions thought they could enter into swaps transactions with local authorities on the basis that these were transactions that, in certain circumstances, the authorities had the power to do. It transpired that this was not the case and as a result quite a few institutions lost quite a lot of money. That was a problem for the predictability of English law and fortunately not a market systemic problem in the way it unfolded.

A second example of this occurred in the US in 1987. Professor Jim Rogers who, as many of you will know, was the *Rapporteur* for the 1994 revised version of Article 8 of the US Uniform Commercial Code, tells a story in this regard which I suspect some of you will have already heard.

When the market crashed in 1987 and there were concerns about liquidity, the authorities called some of the major players together and suggested arrangements which might be made for extra liquidity to be put up against the security of investor's holdings. As Jim recounts, they turned to the lawyers and asked, "*there won't be a problem in getting good collateral, will there?"* The answer was: *"that is a very interesting question!"*

This is an answer that lawyers are often prone to give in time of stress. What we need, of course, are not interesting answers but boring answers because the answer should be obvious and that disconcerting experience proved to be the impetus behind the rewriting of the relevant provisions of Article 8 into the form in which they now stand.

We had a similar experience in the UK in the late eighties. It is perhaps unfair to describe this as an example of uncertainty because I think the law was clear and it was understood, although it was not appreciated at the time. It was more a question of how it applied to the traditional, rather informal, documentation that the stock lending industry had used.

The problem was that there were chains of transactions where people took collateral and passed it on to their own lenders. Nobody focused on the fact that if they took collateral on the pledge, as they did, it was unclear how they could pass on a good pledge to a third party.

When attention finally did focus on this point, it was fixed very quickly. This was because there was a real concern that if it got out in an uncontrolled way, the stock lending market would rapidly dry up and that would have been, of course, a very serious problem.

But happily there was a much more positive result. That episode actually spurned the development of title transfer collateral documentation which has been enormously influential ever since. At least in that case, some good came out of evil, but these are still examples of near misses or cases where uncertainty could easily have led to systemic problems.

To summarise, if the law is uncertain, parties may simply be unwilling to undertake transactions. This acts as a damper on an economic activity because people will not undertake new and risky transactions if they are not satisfied with the legal framework. It is difficult to obtain concrete examples, but I have no doubt that there have been numerous cases where economic activity has been choked for this reason.

People talk about it in the case of some emerging markets where law reform has not proceeded swiftly enough. I have come across some anecdotal examples, where, for example, banks, having done a great deal of due diligence, simply conclude there is no satisfactory basis on which to do business with certain counterparties. Of course, this is disappointing for the banks but more seriously, it is extremely damaging for counterparties and for the affected market.

Similarly, where the law is defective, people may be unwilling to deal until it is amended. Emerging market problems may be an example of this.

Another example concerns title transfer documentation. I mentioned already how the 1989 stock lending experience provided the impetus for the increased use of title transfer as a technique. This demonstrates that, under a number of laws, title transfer was a relatively new form of financing and it had no very clear or at least comprehensively legal basis. What we saw throughout the nineties was a series of legislative interventions in a number of European jurisdictions to actually set up for the first time a clear comprehensive regime for title transfer.

Let us move on then to cases where the law is not particularly unclear or misunderstood but it is difficult to operate. There are a lot of examples of cases where the traditional legal framework takes time to catch up with modern securities structures and market practices. As a result, there are often features or procedures that arguably serve no purpose or no commensurable purpose in the modern environment but nevertheless are absolutely necessary to achieve legal clarity. In an extreme case, if the burden of those additional features is prohibitive, the effect will be to deter activity all together.

For example, in medieval England, the transfer of a parcel of land required the parties to travel to the land and the transferor to take the piece of earth to hand it to the transferee and utter the words*: “enter this land and God give you joy!”* This may have been a harmless and rather uplifting formula for the times, but it is clearly something that we find a little inconvenient in the context of a modern securities market.
I am not aware if there is anything as extreme as that still around but there are things that can act, at the very least, as a severe drag on the efficiency of market infrastructure. These are also some of the things which this project must carefully address in detail.

What is the effect of these additional burdens? One effect was that in the latter stages of The Hague process, once the problem was at least “*appreciated*”, some lenders used to go to the trouble of perfecting their security under the rules of several jurisdictions. They took the view that even if the correct target was unclear; at least if they had all the targets, they were bound to be right. This was a prudent, but rather expensive, approach and obviously it is one that requires an assessment of the importance of going ahead with a given deal. For a peripheral deal, one might easily conclude that it may not be worth the effort. Therefore, even at the edges, you get some choking off of economic activity.

I will provide a few other examples. A long time ago, the rules of Belgian law required formal notification of pledges by an official called a *Huissier.* This meant that some unfortunate notaries and Euroclear officials spent a great deal of their time reciting daily lists of pledge transactions. Happily, that is now a thing of the past, as the law was amended to remove such a clearly outdated requirement in the context of the securities market.

Some such features are more enduring. If you look at the structure of the Euro bond issue that has developed over the past forty years, some of its features serve no obvious purpose, at least, not nowadays. The concept is founded on the traditional negotiable instrument and, both for legal and market reasons, that concept has proved very tenacious. So there are still pieces of paper around which purport to be negotiable instruments.

I use the word “purport” – advisedly I think – in the case of global notes because I am not aware of any case where anyone has ever sought to negotiate a global note and personally I rather doubt what the consequences might be if anyone did. I think it is quite unlikely that a bank would take a five hundred billion dollar piece of paper at is face value without enquiry. Hopefully, that is not a question I will ever be called on to answer.

The point I am trying to make in this context is that there were, and there still are to some extent, features of that structure which simply wouldn’t be included were they to be redesigned from scratch as they add expense.

In the past, when people felt the need to print definitive bond certificates, that expense was quite considerable. This was because those certificates might genuinely be negotiable. Therefore they needed to be printed to the same standard of security to guard against fraud and that was an expensive process. When the market developed to avoid this problem, because nobody ever really used definitives, then other legal problems emerged. There still needed to be something to enable bondholders to enforce their rights without necessarily the concurrence of the trustee or depository. This is because the trustee or depository might be unwilling to incur the responsibility of enforcing everybody's rights in the event of an insolvency. If there aren't individual bonds, something else needs to be invented and added to the existing structure. And while such an instrument may do the job, it may not bring desirable results in the long run. This is simply another effect of an incremental response to legal problems. Those are just a few examples of the sort of legal risks we are dealing with and some of the consequences that will arise if there are not properly addressed.

In the final part of the talk, I am going very briefly to go through the main elements identified by the Study Group as areas for further work and to suggest a few questions as to how they fit into this map of legal risks.

I will raise the concern of upper-tier attachment despite the fact that most people regard it as a bit of non-issue or at least a question with an obvious answer. It is, if you like, a risk that is clearly identified and a low risk but it has a very serious consequence should it materialise.

As far as we know, upper-tier attachment hasn't materialised and isn't likely to. But if it did, it would fatally undermine one of the key features of the multi-tier holding system. Therefore I do not agree that it is a non-issue. It remains something that clearly has to be addressed in a modernised system.

Transfer and collateral formalities address the core issues of what is a book entry and what should a book entry be sufficient to do. Clearly this is enormously important in terms of efficiency. Anything over and above the book entry hugely complicates the process of transfers. The effect will be compounded if there are formalities, especially different formalities at different tiers in the holding system.

Are these systemic issues? I suspect that one could say no, because it is certainly possible to design a multi-tier holding system that works even though there are different formalities at different tiers. In fact, it may not be that simple, because unless everyone clearly understands that position and the procedures of the various "*intermediaries*" are structured accordingly, there is considerable scope for error. So there may indeed be systemic questions to address.

Everybody agrees, however, that there must be net settlement. There must be recognition of the fact that transfers between two clients of the same intermediary require only entries on the books of that intermediary. That is, one must not have to go all over up the chain to the issuer and all the way back down the same chain to the same intermediary. In the absence of net settlement, the number of processes that have to be done may be multiplied by a factor of four, eight or sixteen, depending on how many tiers there are.

I believe that the law is clear in this respect and so far I don't think that we have identified any instance where it is not. It would be nice to be absolutely sure about this because again if a problem were to emerge, this would undermine a fundamental feature of the system.

In respect of good faith acquisition, or, "good faith debits and credits," I suspect that the law is not currently clear, uniform or understood. That is not particularly surprising because this is one of those situations where one of two or more innocent parties has to suffer. Inevitably different legal systems break in different ways to make that unpleasant choice and to burden the loss onto one of them.

The historical tendency is for parts of the financial system where certainty and speed are key to tip the balance in favour of the transferee. A classic example is the negotiable instrument. The principle that the negotiable instrument passes current and that a good faith acquirer can acquire title even from someone who has a defective title is a common feature to all legal systems and for a very good reason. One of the components of our Position Paper is the suggestion that the multi-tier securities holding pattern is currently, and is moving still further, in that category. There is debate over this, but if it is correct, then it follows that conflict between two innocent parties will need to be resolved in the same way everywhere. If not, then different answers are bound to undermine clarity and with the number and speed of change of transactions, it would rapidly to systemic importance.

Finality and irrevocability are very difficult areas because they stray into the field of insolvency law. This is a problem for two reasons. First, there is a lot a variety in insolvency laws. This is for very good reason, of course, because, and this brings me to my second point: insolvency law has a huge content of public policy. Different countries take very different views about how to reconcile the different interests in an insolvency. Therefore, this area needs considerable work.

It is also important to note that this is one of those areas where The Hague Convention is not really of assistance because The Hague Convention deals only with issues of property law. It did not attempt, for very good reason, to enter into the minefield of reconciling the rules on international law and jurisdictional insolvency. Those remain where they were and incidentally, they are by no means clear or fully developed.

It is clearly an area where a failure to produce a satisfactory common system has systemic implications. That is because these are often very large transactions. If one of them is tainted, potentially, with the insolvency of a previous party, there is a domino effect and the infection will carry through the entire system very rapidly.

Therefore, this is an area that I believe must be tackled. Interestingly, in the European Union context, it has been identified as a key area that was tackled initially by the Settlement Finality Directive and also the collateral directive for the reasons that I have just suggested. It reflects the particular systemic importance of payment and settlement systems in the modern economy.

I will now return to my starting point and raise the issue of compatibility. How does legal risk fit in to the compatibility question? In other words, are there cases where the lack of a uniform analysis in the different tiers of the system could give rise to systemic or efficiency questions? As to systemic questions, in principle, the answer ought to be no, because if each layer of the system is sound on its own it should not be beyond the wit of good and efficient lawyers to build a structure which fits them all together. I say “in principle” because it is easier to say than to do and modern systems are extremely complex.

Even if I have explored the systematic question, there is clearly a profound issue of market efficiency at play. Law is a great protectionist technique. If the effect of having different systems of law is that each country’s core-settlement system has to be a separate silo, that has some very wide-ranging implications for the structure of the international system, for its capacity to adapt and for its capacity to drive costs down. I will close with that thought: Even if compatibility issues are not systemic in character, there is a clear need for us to address them in this context. Ideally, we need to produce a result that would avoid that silo phenomenon from being entrenched in the system.

* * *

A U.S. Perspective on the Unidroit project in light of industry experience under the Uniform Commercial Code Article 8 and related law

Sandra Rocks, Clearly, Gottlieb, Steen & Hamilton, New York

As the title of my presentation indicates, I will be offering you a perspective on the UNIDROIT project from the point of view of a lawyer whose practice has focused primarily on security interest and bankruptcy law issues in the context of representing industry participants in capital market transactions including derivatives, securities lending, margin lending, repurchase transactions and securitizations, as well as the rather more straightforward secured bank loan facilities. It is probably worth noting at the outset that in some cases it is not clear whether a transaction involves an outright transfer of property or a posting of collateral.

In the U.S., putting aside some fascinating aspects of our federal system, the commercial law rules governing transactions involving investment securities – whether outright conveyances or security interests – are part of a statutory scheme called the Uniform Commercial Code. Technically, this is a model law that is offered to the States for adoption, and only when so adopted does it have any force of law. And as an aside, industry plays a significant role in the commercial law revision process. Two articles of this code are relevant for this discussion: Article 8 – entitled "Investment Securities" and Article 9 entitled "Secured Transactions." All 50 states and the District of Columbia have adopted versions of these two articles that are uniform in all respects relevant for our purposes. It is important to note, however, that these articles operate within a context of general contract law as well as a context in which many – but not all (and this is important) of the relevant players are subject to regulatory oversight.

A long, long time ago, these two articles dealt with investment securities only in physical form. With a very narrow exception for clearing corporation activities (which for the most part was located entirely in New York), there was no real commercial statutory law recognition of the multi-layered holding patterns that have become so prevalent. Indeed, when the U.S. Treasury decided to take action in the face of the "paper crunch" in the sixties – in which securities transactions in large numbers failed to settle due to inability to deliver the paper certificates in timely fashion as trading volume grew – it took two contradictory steps.

First, it created completely dematerialised securities. There were no certificates at all; only entries on the records of Federal Reserve Banks (which served a quasi-transfer agent role). These securities could then be moved by electronic entry alone. (Many countries have now done this, of course). And yet, for commercial law purposes – since this is not really a subject of federal law – the enacting regulations "deemed" these securities to be maintained in "bearer definitive form at the Federal Reserve Bank". Technology was obviously out in front, but the securities needed to find a home in a commercial code that knew only paper.

In the regular corporate market in the U.S., dematerialization did not occur, but another phenomenon had similar effect: immobilisation and intermediation. More and more securities were held by – and in some cases issued directly into – clearing corporations, to be held for participants who in turn held for their customers and, so on. The split between what one might consider "legal title" – for example, the person who is the registered owner as far as the issuer is concerned – and beneficial ownership – or the person to whom the economic benefits of ownership were to flow – was recognized in practice but not explicitly as a matter of statutory language. Revisions to the UCC in the late 70's attempted to recognize these phenomena by creating a definitive list of how interests in securities could be conveyed (whether outright or by way of security interest) and introduced a pro rata sharing rule for situations in which holdings were insufficient to cover the positions of investors.

Without belabouring the historical aspect of this presentation, I will simply note that the definition of security limited the scope of the statute's applicability, notwithstanding the market's identical treatment of many different types of investments, the rules suggested that the most basic, determinative factor was whether the security itself was certificated or uncertificated, and each person having an interest in the security was treated as though that person had an interest in the underlying security itself, which interest could (potentially) be traced into the hands of any purchaser (with a limited exception for transfers within the clearing corporation context).

Although these shortcomings were becoming widely recognized, and the uncomfortable fit of the federal regulations for securities maintained solely in the form of entries in the records of Federal Reserve Bank with the state commercial law scheme was a significant source of legal uncertainty, it took a fairly significant market disruption in the late '80's (although Guy Morton referred to this as a "crash", for the record it was a "market break") to jump start the law revision process. Efforts on the state law and federal regulatory fronts played leap-frog, as drafts of proposed revisions to federal regulation were put out for comment and the appropriate groups began the process of revising Article 8 (with conforming amendments to Article 9).

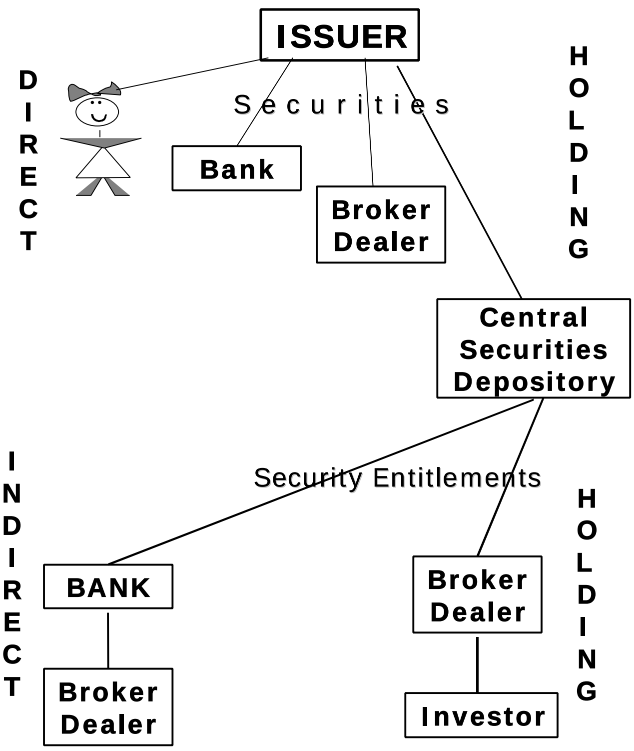
Simultaneously, various revisions to U.S. bankruptcy law – which generally annoy creditors and counterparties by interrupting enforcement of rights and sometimes avoiding transfers of interests in property – were adopted during the 80's and 90's to free certain market participants from these adverse consequences. Briefly – and these are very technical rules with many limitations that do not need elaboration for our purposes – repurchase agreements, securities contracts, and swap agreements are now afforded special protection. These revisions allow certain counterparties to exercise their contractual remedies and access and retain the value of their collateral notwithstanding a bankruptcy proceeding in respect of the other party This "safe harbour" phenomenon appears not only in the U.S. Bankruptcy Code, which is available to most general corporate entities, but in FIRREA, which governs most depositary institutions. These parallel movements had a common goal: to increase legal certainty in contexts for which systemic risk was a concern.

Turning to a more in-depth look at the principal features of the UCC, I would like to outline what I believe to be the key, or over-arching principles of the commercial law rules relating to interests in securities held with intermediaries that have provided a framework which accommodates market developments in securities holding and trading patterns and thus a foundation for the robust legal certainty required by credit departments and regulators alike.

PRINCIPLE 1 - Recognize and, to the extent possible, anticipate innovations in holding patterns and the assets that may become subject to such innovations.

As pointed out in the comments by Mr. Biswanath Sen, Chairman of the UNIDROIT Study Group, the law needs to grow with the market. Right now in many jurisdictions the market is way out front. No one needs to be told that any commercial law revision project should aim to address the manner in which assets are in fact being held and transferred – assuming there is no policy reason to the contrary. The harder task is to craft rules that have a good long shelf life, and are thus flexible enough to accommodate future holding patterns.

UCC Article 8 attempts to be accommodating in two ways: first, by recognizing a concept of indirect holding that was unlimited in terms of participants and the number of potential intermediaries in any given chain, and second, by being even more limitless (and this concept exists – see Cantor's Theorem) in terms of what might in the future be held in the indirect holding system as we know it. This latter accommodation was accomplished through the use of the wide-open gatekeeping definition of financial asset which, as many of you may know, includes <u>any property an intermediary agrees to treat as a financial asset</u>. Under the UCC, the terminology used for securities as to which a person has a direct relationship with the issuer is called "direct holding" and for securities or other financial assets held through intermediaries, "indirect holding."



The question of who, as a corporate or regulatory matter, is permitted to act as an intermediary and what such intermediaries are permitted to hold and deal with on behalf of themselves and others was left to other law. (And the commercial law governing a financial asset in its natural state – i.e., outside the securities account itself – was also untouched.)

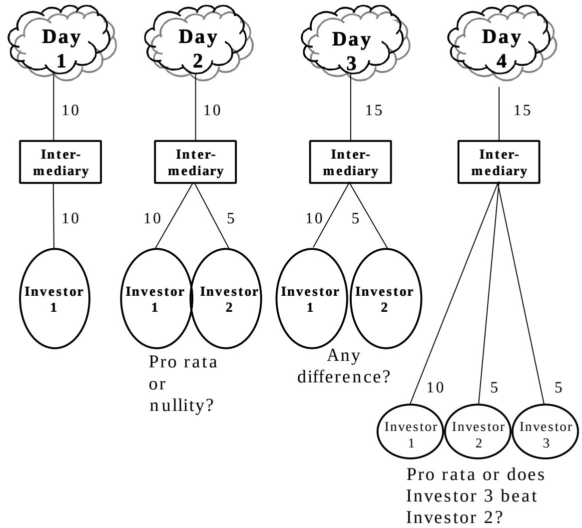
PRINCIPLE 2 – Recognize and/or create a new concept of property interest.

In the U.S. – generally speaking – the corporate and commercial law rules regarding the nature of an investor's relationship with an issuer of securities (part of the direct holding system) did not need adjustment – nominee holdings, split legal and beneficial interests, passing through of benefits, etc. were already recognized and thus ready for the intersection with the indirect holding system. But the extent of intermediation that had developed and the inherent fungibility of many of the financial assets involved led to a departure from viewing an investor's interest in securities held indirectly as a property right traceable in all respects to an underlying security or other financial asset.

For indirect holding, the question became what is the nature of the beneficial "owner's" property interest and what are the basic rights a beneficial owner has against its intermediary with respect to that underlying security.

So, in U.S. law, a "security entitlement" (defined in Section 8-102(a)(17)) was born: "'Security Entitlement' means the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5", which rights and interests include a property interest, the right to receive the benefits (e.g. distributions and voting) of ownership, and the right to direct the disposition of this interest. As indicated in the comments from Canada on the UNIDROIT Position Paper, much flows from this recognition. Under the UCC, the investor's rights are neither simply a derivative property interest of assets that happen to be held for customers, because the intermediary has an obligation to promptly obtain and thereafter maintain sufficient financial assets to cover the security entitlements it creates, nor immune from dilution, because the investor's rights *vis-à-vis* each other do not depend on time, and although the intermediary's financial assets are considered customer property to the extent necessary to satisfy their customers' claims and thus unavailable to general unsecured creditors, significant classes of creditors are afforded priority over customers.

Another illustration might help here:



Under the UCC, on Day 2, the "overcrediting" would generally be effective and Investor 2 would be considered as obtaining a security entitlement, and Investor 1's position is diluted. On Day 3 the intermediary would be in compliance with its obligations to both investors, and Day 4 would again involve dilution, not a "trumping" by last in time Investor 3.

Regarding this fact pattern: is the securities intermediary allowed to do this (pre-credit)? It depends: if the action is fraudulent, no; in the U.S. if the position is created pending settlement and there is an open failure to receive, yes (for a limited period of time). (And of course we are not at this point addressing "mistaken" credits or debits.)

Conversely, recognising a new concept of property interest in a security entitlement enables the prevention of "upper tier attachment" and itself enhances certain aspects of finality – both of which are essential to the smooth functioning of the markets. The intermediary that is maintaining the securities account for the investor is the only place the investor's attachable property resides. UCC Article 8 makes clear that the customer's interest cannot, except in very limited circumstances, be asserted against any other intermediary (or purchaser) – and modified a rule to clarify that a creditor could attach the customer's interest only at that level by process against the intermediary (or, if a secured party were the customer with respect to pledged assets, by process against the secured party).

This also means that in the event of an intermediary's insolvency customers will share pro rata (financial asset category by category), and it seems to me that this must be made explicit in conjunction with any recognition of the effects of holding securities through an intermediary.

PRINCIPLE 3 – Provide Enhanced finality.

The U.S. is certainly far from unique in recognising the concept of a good faith or other type of protected purchaser, especially in the world of tangible movables. In such a case a rightful owner can be prevented from recovering wrongfully transferred property. But in the indirect system how would such a rule be implemented? The asset is certainly far less traceable, but that doesn't answer the question.

As someone once said, whoever controls the hypothetical controls the answer, so here is my hypothetical:
Two investors, one whose securities were improperly moved out by an intermediary and one who acquired securities those securities without notice that their transfer was improper. Putting the burden on the first feels unfair – and therefore there are some who might suggest that this plaintiff should enjoy the right to recapture. The question, however, is not really whether this plaintiff should have redress – of course she should. The question for the UNIDROIT project is really whether the "innocent" (and we can debate the contours of innocence) transferee should be at risk. For the transferee to be at risk in any meaningful way of course presumes traceability, which is quite unlikely in the vast majority of cases. One might therefore feel comfortable supporting recapture rights under the theory that there will be few successful attempts anyway. On the other hand, in most cases the recipient has no idea where the purchased securities are coming from, and just the possibility of such a right has been thought (and felt, through market experience) to constitute something of a cloud on title. The potential ripple effect in the market of tracing wrongfully transferred securities through multiple purchasers could have negative consequences geometrically exceeding the benefit to the wronged original owner. For these reasons, the policy choice made in the UCC was to permit *any* purchaser – which term includes secured parties – who gives value and obtains control (more on that later) without notice of a particular adverse claim to be protected against the assertion of that adverse claim. It is for that reason that I believe the better – and perhaps more honest – outcome would be to provide clear and widely available adverse claim cut-off rules, which promote systemic confidence and thus work to the benefit of investors large and small. I note that several comments submitted support this notion.

Another aspect of finality which is of vital concern to market participants is finality notwithstanding the insolvency of a transferor. Zero hour and other recapture rules have a chilling effect on the market and for that reason in the context of such an interlinked trading system should be eliminated or limited to the fullest extent possible.

PRINCIPLE 4 – Provide a flexible approach to effectiveness, perfection and priority, including the reduction or elimination of formalities.

Flexibility should be a goal in two major respects: first, in terms of what the purchaser (especially a secured party) needs to do or have done in its favour; and second, what the debtor can continue to do.

Since we are here dealing only with the indirect system, the requirement of physical delivery of a security in certificated form is not under attack. But once the indirect system is recognised for what it is – a vast electronic grid in which securities and other financial assets are moved in response to transfer or other instructions – it seems most efficacious to accommodate these realities of the market place in recognising new ways to effect transfers of interests. In the U.S. (and soon, it appears, Canada) the concept of control was introduced as a statutory construct: a transfer is perfected if the transferee has the right, enforceable against the intermediary, to direct the disposition of the subject assets.

Such control can materialise in one of three types of situations: first, a transferee who has the financial assets credited to its own securities account is considered to be in control of the financial assets – and this is the one that involves a "book-entry" in the classic sense of a debit and corresponding credit; second, the intermediary with which a securities account is maintained is considered, as a matter of law, to be in control of the financial assets carried in that securities account I would think that no book-entry is needed in such a fact pattern – market participants can easily be expected to assume that an "upper tier" intermediary, often involved in the clearing and settlement of securities on behalf of its customers (think also of margin accounts), would have a lien without making a notation on its books; and third, a transferee who obtains the agreement of the intermediary to act on the transferee's instructions without further consent of the transferor has obtained control (as an aside: the UCC states explicitly that an intermediary is under no duty to enter into such an agreement and is prohibited from doing so without its customer's consent).

This last situation requires agreement but no "book-entry" and has proved enormously useful, especially for individual investors. (In the U.S. perfection by filing is always an option although this affords less priority. In addition, we also have "automatic" perfection when an intermediary is doing the pledging – although again this does not afford very high priority). In no case is registration of any sort required, nor is a book-entry the only way to effect a transfer of an interest.

There are other settings in which requiring a book-entry would seem inappropriate - net settlement systems do not make debits and credits for each movement of financial assets – that would defeat the whole purpose; gifts and inheritances, a bankruptcy trustee's assertion of jurisdiction over estate assets – all these are likely to need effectiveness notwithstanding the lack of a book-entry. It's a dim memory now, but the 1978 version of Article 8 of the UCC had the word "only" before the list of 13 ways in which securities could be conveyed, and it generated significant concern and was probably – and appropriately – disregarded in many circumstances.

The second aspect is permitting a debtor to continue to use the property transferred (and here we're really talking about the security interest context, although other transaction forms could be involved).

The U.S. concept of control does not require exclusivity: thus a debtor can continue to maintain its portfolios with existing intermediaries who may not wish to extend credit, and can continue to trade its portfolios of securities, including through direct instructions to the relevant intermediary, notwithstanding the secured party's parallel right to originate such instructions. The limits, if any, and the interplay of these rights are left to the parties' agreement. The secured party may or may not be comfortable allowing debtor access, and the debtor may seek to limit the circumstances in which the secured party can take action, but effectiveness of a secured party's interest as against third parties remains intact.

PRINCIPAL 5 – Recognise a secured party's right to reuse collateral.

In the first place, as noted earlier, the line between ownership and security interest is often blurred under the law of a single jurisdiction, and when the situation goes cross-border it only gets worse. This is where numbers are also typically mentioned: trillions of dollars in value are involved in the reuse of financial assets transferred under securities contracts, repurchase transactions and swap agreements – forming long chains of reuse. The U.S. has chosen to permit this explicitly whenever a secured party is in possession or control, while the U.K. has required the form of transfer to be "outright" – at least in form – in order to accommodate this. This is what the market *does*. The UNIDROIT project needs to recognise this and permit it – hopefully in a way that does not elevate form over substance. (This does not mean that an intermediary is permitted to use fully paid customer securities, of course. In the United States this would require the customer's permission and in that case could be subject to various restrictions).

PRINCIPLE 6 – Provide flexible realisation rules, including self-help.

In the U.S., the limitation is in the form of a requirement that the secured party's actions be commercially reasonable, but for commonly traded financial assets prompt collateral liquidation without the need for any sort of judicial intervention is one of the hallmarks of the type of commercial law rule this market requires.

PRINCIPLE 7 – Provide clear choice of law rules.

The new Hague convention of course supplies such rules for securities held with intermediaries, and the UCC has very similar rules that focus on the relevant securities account relationship rather than the location of or relationship to an underlying asset.

Even recognising the foregoing principles, there are of course differences that need to be faced in any private international law project:

The UCC itself sits in a nest of other law and regulation, some of it flexible enough and some of it too restrictive insofar as a great many market transactions are concerned. Such "other law and regulation" is not the same elsewhere. We know that, outside the U.S. for example, many benefits of law reform are limited to regulated entities – which seems unfortunate and is not the case within the U.S. This is not to say that all players must be treated equally going back to creditors – creditors of intermediaries who obtain control generally have priority over customers. Regulation and supervision determines the right of an intermediary to use non-proprietary assets in this manner.

One exception of note is the case of clearing corporations acting as pledgors – which is common for the limited purpose of obtaining liquidity lines to backstop settlement in the case of a participant default. Since clearing corporations are typically in direct relationships with the issuers of the underlying financial assets, and requiring lenders to obtain control of direct holdings – e.g., possession of physical certificates, re-registration of uncertificated securities – would be time consuming and disruptive, liens created by clearing corporations (which in the U.S. are highly regulated and do not maintain proprietary positions in the securities they handle) are given priority over the claims of customers.

It is important to keep in mind, however, that the real benefit of the U.S. commercial law rules is only partly found in the commercial context – the benefit of clear, flexible and realistic rules is complemented by selective insolvency law relief for certain transactions. But this insolvency relief in the U.S. has followed a "silo" safe harbour approach – which has itself become a source of concern and an impediment to legal certainty in the context of many common transaction types – especially in the case of cross-product collateralisation and netting.

There is a message from industry: market practices will evolve and need clear and flexible commercial law rules to support these evolutionary tendencies; unless there is a public policy at stake, market practices and their participants need to have a comfortable home in the commercial law world. The clearest choice of law rules, the most advanced perfection, priority, finality and shortfall allocation rules are absolutely desirable and, in fact, necessary to comply with regulatory capital requirements. However, addressing these aspects will not entice capital flows without adjusting creditor access and retention in the case of default -both outside of insolvency proceedings, through the exercise of self-help, and notwithstanding insolvency proceedings – through the clear, enforceable right to liquidate positions and the collateral supporting them and, with very limited exceptions, retain the value of that collateral. And this will take adjustments to more than what has traditionally been considered the bailiwick of commercial law.

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Legal Issues of Chinese Registration and Clearance Systems of Securities: The Present Two-Tier System and Future Developments

Wu Zhipan, University of Beijing

In all, my speech is divided into three parts. First, I will describe some of the current issues in this area. In the second part, I will briefly introduce the Securities Registration system of China. In the third part, I would like to give my personal opinion on the Hague Convention as well as the draft convention.

I. Some examples of current issues

In 1999, a listed Chinese company called Zhengbaiwen that was primarily involved in TV sales suffered great losses due to a dramatic change in TV selling prices. Faced with a debt crisis and difficulty in repaying a bank loan, the management of this listed company colluded with its accountants to mask the appearance of severe problems. In this way, the listed company continued to carry on business for a while. But eventually, just as "paper can not wrap up a fire", the accounting fraud of the listed company was disclosed. This lead to Zhengbaiwen's punishment by the China Securities Regulatory Commission (CSRC) as well as by the Stock Exchange.

According to securities market regulatory experience, a listed company under such circumstances faces the de-listing of shares and bankruptcy, unless can change its financial conditions by overcoming the debt crisis and by making profits within a year. At that time, a company showed its intention to take over “Zhengbaiwen” by a Q&M agreement. When the shareholder meeting of “Zhengbaiwen” was called on to discuss the issues of the takeover by agreement, the majority shareholders voted on the take-over by agreement even though the take-over price would “shrink” substantially. However, the minority shareholders voted against this kind of take-over. In other words, the minority shareholders preferred to take action against the management of the listed company rather than simply “bowing to compromise”. Under the circumstances, as the controversy could not be resolved, the majority shareholders were forced to pass through the resolution in favour of the take-over.

Following the meeting, “Zhengbaiwen” signed the take-over agreement and went to the Securities Registration and Clearing Company so as to have the shareholder Registration records changed. Then the minority shareholders took legal proceedings against the listed company and even the Securities Registration and Clearing Company.

The Securities Registration and Clearing Company dared not to have the record changed rashly before the courts made a decision. Meanwhile, the majority shareholders also took action and asked the courts to affirm the validity of the shareholder meeting resolution. After a hearing, the local court confirmed the validity of the shareholder meeting resolution. At this point, the Securities Registration and Clearing Company changed the registration for the new “Zhengbaiwen”.

This situation raises four important legal issues: First, should the company, which was punished by the regulatory authorities for accounting fraud, have been allowed to stay at the securities market by way of take-over? Second, as there was no specified regulation regarding the issue under “Company Law”, could the majority shareholders force the minority shareholders to accept the resolution for a take-over? Third, when the majority shareholders passed the shareholder meeting resolution and signed the take-over agreement, should the Securities Registration and Clearing Company have changed the registration of the listed company? Fourth, when there was no specified regulation regarding the issue under “Company Law”, the majority shareholders went to the court and asked the judge to affirm the validity of the shareholder meeting resolution. But is this an effective approach to resolve these kinds of problems in the future?

The second example involves B-shares. In China, B-shares were originally designed specifically for institutions or individual investors abroad who bought shares of listed companies at home by foreign currencies. Because B-shares were traded through a foreign brokering agent of securities institutions abroad, the registration of B-shares was done by way of a mere nominee. Thus, if the beneficial owner were outside the nation, the SD&C in China would have no idea of who they were. In 2000, China took an important measure to reform B-shares, so that citizens at home could also use their own foreign currencies to buy B-shares. Currently, it is said that 90% of B-shares are held by Chinese citizens at home. However, the SD&C uses the method of direct holding. Therefore, while A shares and B-shares held by Chinese citizens in China are registered through a direct holding system, the registered name of B-shares invested by foreigners abroad is through an indirect holding system.

This gives rise to quite an interesting situation. The A-shares and B-shares of the same listed company in China have two kinds of registration methods, simply because the A-shares are traded by RMB while the B-shares are traded by foreign currencies. The reason for this is that a foreign currency management policy still exists in China at the moment.

For example, if Mr. Zhang, a Chinese resident, uses RMB to buy A-shares of a listed company at home, the registered name on book account will be his real name as a beneficial owner. However, when a foreigner buys B-shares of the same listed company in foreign currencies, the registered name will be the name of his securities brokering company as a mere nominee rather than his own. In this way, when Mr. Zhang mortgages his shares to guarantee other debts, if he mortgages the A-shares, creditors will obtain the legal rights of the mortgage, but when the foreigner uses the B-shares to mortgage in China, the situation is complex. As the Securities Registration and Clearing Company did not register his name, one can only go to the Securities Company to find out that Mr. Zhang has bought the B-shares. But the problem is that the securities company registered is only the agent and not the investor. Clearly, B-share mortgages raise complicated legal issues. At present, we still have no knowledge of what will happen in this respect, but we have to address how Chinese laws will deal with them in the future.

These are some of the current issues faced in China. For example, should the operational rules of the *Securities Depositing and Clearing Company* (SD&C), as a semi-business and semi-government institution, be adopted by the courts in their decisions? To put it another way, as the Chinese railway department is also a semi-business and a semi-government department, should the courts adopt the rules made by the railway department to settle the disputes between the railway department and its customers?

Currently, there is still no law regarding the relationship between Qualified Foreign Institute Investors (QFII) or B-shares with their respective Securities Registration and Clearing Companies in China. When investors abroad have disputes with their agent banks, Chinese laws should be available to verify that the SD&C has registered the QFII or B-shares. But, what kind of Chinese laws could give an accurate explanation of this? Unfortunately, China does not yet have a specific law for this situation.

Of course, the relevant legal issues are not limited to those I mentioned above, but I will not list them one by one in this article. Now we have the chance to learn from foreign experiences regarding these issues, as Chinese experts have taken part in the legal research workshop on how to co-ordinate the indirect holding, sponsored by the Association of the International Uniform Private Law.

II. A Brief Introduction to the Chinese Two-tier Registration Systems of Securities[1]

It is a significant feature of the Chinese Clearance and Settlement system that there are numerous clearance and settlement accounts. The *China Securities Depository and Clearing Corporation Limited* (SD&C) has a parent company in Beijing that provides post-trade infrastructure services such as registration through its two

[1] In reference to materials offered by the *China Securities Depository and Clearing Corporation Limited* for the “Legal Forum of the International Registration and Clearance of Securities” held in Beijing on Nov 11, 2003.

subsidiaries: the Shanghai Branch and the Shenzhen Branch, where the only two stock exchanges in mainland China are located. The SD&C is the nation's sole provider of account openings and provides the following services: registration, custody, centralised clearance and settlement. It also acts as an agent to process dividends and interest etc.

The scale of the present Chinese securities market is about 5000 billion RMB, amounting to 620 billion US dollars. According to May 2003 statistics, the China Securities Depository and Clearing Corporation Limited held 1469 securities in custody, including 1244 stocks of listed companies, 60 closed-end and open-end mutual funds, over 60 treasury bonds, 25 corporate bonds and 12 redemption corporate bonds. There are about 230 participants at home and 70 overseas participants with 70 million settlement accounts of investors in China in all.

China has a unified system of securities account regulation. Although there are two kinds of securities markets in China, the management of rules for securities accounts has been unified. For example, it is the SD&C that provides serial numbers for securities accounts and maintains information on each account.

Direct holding is a main feature of the Chinese securities holding system. In China, investors at home open, register and settle accounts directly. In other words, most securities in China are registered directly in the name of real holders and not nominal holders.

Investors of B-shares are subject to an indirect holding system, as they have to open and settle the accounts through agent intermediaries abroad and the registered names of the B-shares are nominal holders. Usually these nominal holders are agent banks and Clearance and Settlement members abroad. Therefore, there are two kinds of the clearance and settlement systems in China. That is, the direct holding and indirect holding systems have been adopted in China to adapt to the different A-Share or B-share investors at home and abroad.

Issuers and securities holders are the securities business participants. Before securities are listed, an issuer must have the SD&C work as custody-holder to register the issuing securities. The public company has to show certification attesting that it has been registered by the SD&C before it can apply to the stock exchange for listing.

The participants in Chinese securities custody mainly include the following: investors, securities institutions and fund trustees. Securities institutions and investors set up the custody relationship by an agreement clarifying the rights and obligations of the two parties. At present, there are two ways to establish the custody relationship: the first is the "designated trading system" which is executed mainly on the Shanghai Exchange. According to this system, as soon as investors holding or trading the securities listed in Shanghai Exchange confirm designated trading, the custody relationship of the investors and the designated trading institutions comes into effect.

The second is the "custody broker-dealer system" (also called "buy-in custody") which usually proceeds on the Shenzhen Exchange. Once an investor who is ready to hold or trade the securities listed on the Shenzhen Exchange buys securities at a designated securities institution, the investor forms a custody relationship with the designated securities institution.

The SD&C offers a service for securities institutions by providing them an account balance of investors and relevant materials. At the same time, if an investor applies to transfer a name not because of trading, the securities institutions have to hand in the application to the SD&C, then the SD&C will change the name of owner in a register of the corresponding account balance. In addition, the SD&C not only directly holds in custody the non-liquidated stocks (state-owned shares and institutional shares), but maintains these securities accounts directly.

The SD&C is responsible for providing the clearance and settlement services for the exchanges. The participants of A-share Clearing and Settlement who own exchange seats include: securities institutions, fund custody banks, insurance companies and financial companies and so on. The securities companies, which obtain the B-share business qualifications and the custody banks home and abroad make up the B-share clearance and settlement participants.

Nowadays, settled one by one with full amounts, the electronic system of the SD&C automatically transfers the book-entries of the sellers to the securities accounts of the buyers. Acting as the central counterpart the SD&C simultaneously consolidates all debits and credits from these net positions in all securities into one final net money position for each firm. The cycle of clearing and settlement of A-shares is "T+1", while for B-shares it is "T+3". Regulators and the industry have set one or three business days to complete the clearance and settlement of equity and bond trades to minimise risk.

Acting as the central counterpart the *SD&C* executes centralised clearance risk management. The securities companies are all members of the SD&C. At the closing time of each day, each participant has to deposit in the lowest Clearance and Settlement reserve fund no less than 10% of average daily trading volume of the last quarter at the CSDCCL, which may be used for everyday settlement. The CSDCCL has the power to raise the ratio of the lowest Clearance and Settlement reserve fund of some participants. Moreover, China has also established a Clearance and Settlement Margin and Clearing and Settlement Risk Fund.

The Shanghai Exchange calculates the Clearance and Settlement Margin as follows: The Clearing and Settlement Margin is handed in at the regular time according to the exchange seat. The first exchange seat of the broker-dealer should hand in 200,000 RMB, later on, each added exchange seat should hand in more than 50,000 RMB. The Shenzhen Exchange collects the Clearing and Settlement Margin will at certain ratio of the average daily trading volume. Given the exchange seat multiples of 250,000 RMB as the calculation base, the amount of the Clearance and Settlement Margin will be the exchange seats multiplied by 250,000 RMB, if the average daily trading volume of last quarter does not exceed the calculation base mentioned above; otherwise, it will be collected at 10% of the average daily trading volume of last quarter.

A Clearing and Settlement Risk Fund has been specially designed for losses above 20,000,000 RMB or other severe risk accidents. In addition, the SD&C has also set up a Committee for Risk Management, the chairman of which is also the general manager of the SD&C.

Decades of experience have proven that the registration and clearance system of China has been feasible and effective. While there may still be some problems, the relevant laws and regulations only need further specification and improvement. The legislature of China should eventually be able to resolve these problems.

III. The Prospects for Chinese Depositing and Clearing Systems of Securities

Over two years of conferences and research work have made Chinese experts, as the members of the Study Group of the UNIDROIT, fully aware of the significance of this work. It is also a great opportunity for China to learn the important legal practices of other nations.

We recognise that the registration and clearing systems of China are facing four major challenges. The first of these is the result of rapidly changing electronic technology. It is quite common that nowadays the Clearing and Settlement system of securities is dematerialised. China expressly eliminated paper certificates right from the start, when securities markets were established 10 years ago. With the development of the wireless communication and mobile telephone information transfers, the mobility of securities trading has become a trend. The CSDCCL has held more than 70,000,000 accounts in custody. Therefore, when accounts move with mobile telephones, securities laws overlap with communication laws. The problems of technologies have made the registration and clearance of securities more complicated. "Electronic technology determination" has challenged traditional Chinese legal conceptions and we are still finding it difficult to adapt.

Second, huge multinationals increasingly involved in international financial markets have obtained the technologies, experts, market experiences and also somewhat of a monopoly power. These multinationals usually adopt agreements to handle many concrete legal problems. The flexibility and feasibility of these methods of agreements have been quite swift to deal with many problems. This kind of trend has caused many transitional market countries such as China to accept standard agreements made by multinationals from advanced countries. These agreements work as potential guidelines for transitional countries drafting laws such as clearance and settlement services for international credit cards, international roaming services for mobile telephones, and international airway services etc. The rise of multinationals has brought about the concept of "international market share" which also challenges traditional legal conceptions.

Third, in the field of international finance, the culture and language of Europe and the U.S. have predominant status, while transitional nations such as China do not enjoy this kind of privilege. It takes time and efforts to learn from the advanced countries. If we consider that Japan began to learn from Europe as early as Meiji Restoration (1868), we should not forget that China started this kind of study only after the Openness and Reform of 1978. We have to admit that it takes time to learn the financial culture, language and experiences from Europe and the U.S.

Fourth, the RMB of China is still not a freely convertible currency, as the RMB can only convert freely in current account while the capital account has foreign exchange control. Therefore, the division of A-shares and B-shares in Chinese securities markets will last for a while. As long as this kind of division exists, the two-tier system (direct and indirect holding) will remain. Meanwhile, the indirect holding of QFII will also exist. It is a rare situation that there are two-tiers of securities holding registration existing in one country. On the one hand, there are no precedents to follow for good management, on the other hand, we also realise that it takes time to improve and reform the clearance and registration system of China.

Given this background, the reform and development of the registration and clearing system of our country should conform to global trends. We should assess our own experiences and spend time learning from others, especially those of the UNIDROIT, to draft relevant conventions, such as the Hague convention on private international law.

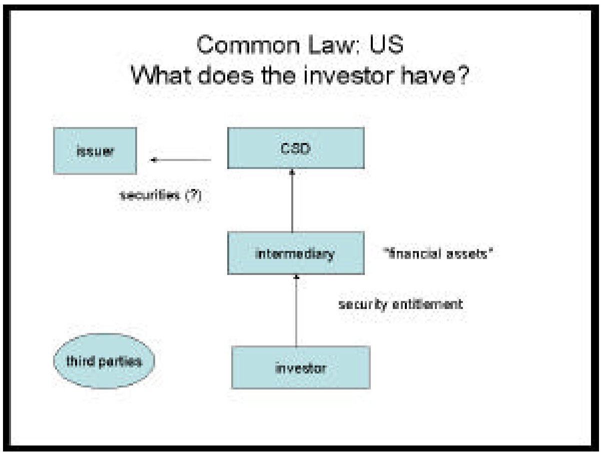
* * *

IS COMMON LAW VS. CIVIL LAW A CORE PROBLEM?

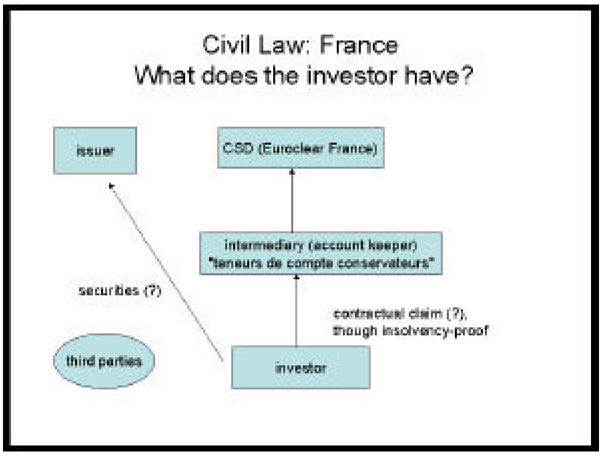
Hikedi Kanda, University of Tokyo

I may have been invited to address this topic because I am from Japan and the Japanese legal system has both civil and common law transplants. Japan imported a civil law system from France and Germany approximately 100 years ago and since that time, it has also imported many US common law rules into its system. Given my experience in a mixed legal system, I have found that the distinctions between common law and civil law traditions are not always helpful in certain areas of the law. In the field of indirectly held investment securities, I believe that as a descriptive matter, the distinction does not help to describe the current state of legal rules in various countries. Therefore, I conclude that as a normative or prescriptive matter, this distinction should not be of great concern for the development substantive harmonised rules in this area either.

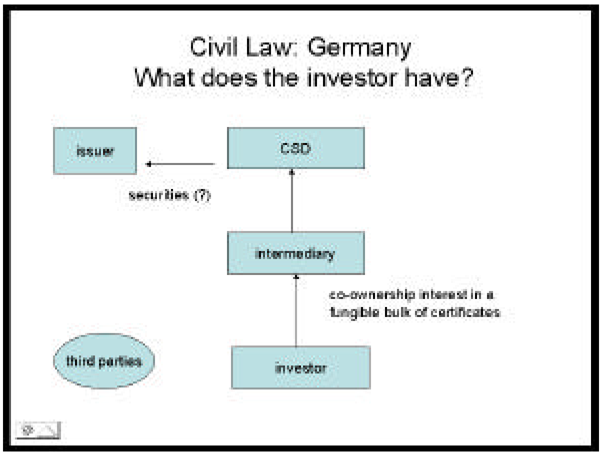
First, let us consider the question of the kind of rights investors have in different jurisdictions.



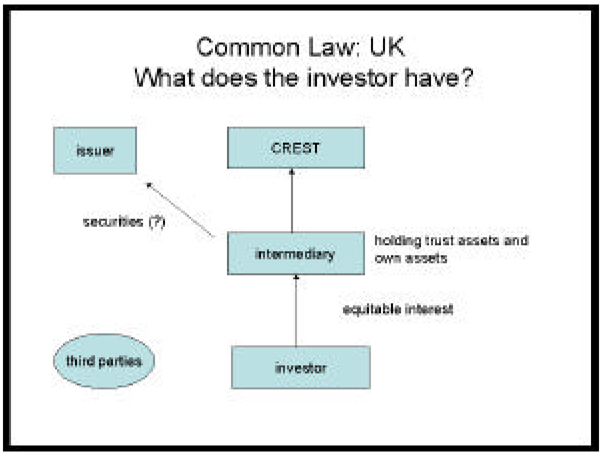
In the United States, there are competing claimants against investors. Under Article 8 of the Uniform Commercial Code (UCC), investors have securities entitlements against their intermediaries and intermediaries have a distinct kind of securities entitlement in respect of the Central Securities Depository (CSD). The CSD is the direct security holder *vis-à-vis* issuers according to Article 8 of the UCC, however, corporate law may dictate otherwise. For example, under Delaware corporate law, investors may have different rights under indirect holding systems. The UCC a statutory creation, not a common law tradition. However, investors have equitable interests in respect of intermediaries under general common law trust principles.



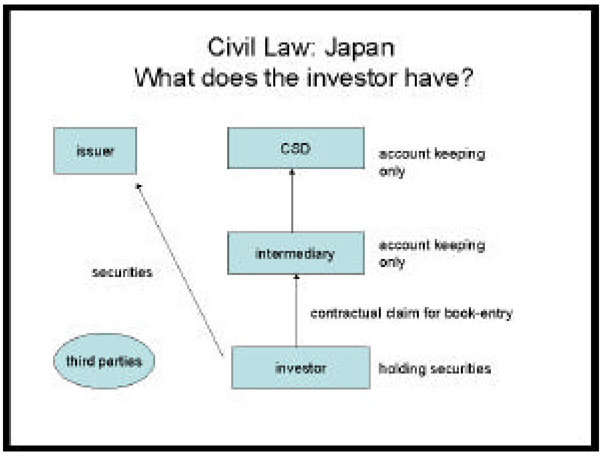
In France, intermediaries are account-keeping institutions and investors have the right to contractual claims against them. However, there is a special statute that provides that these contractual claims are protected in the event that an intermediary becomes insolvent. I am unfamiliar with French law and do know who would be the securities holder in regard to the issuer in this situation. However, it is clear that overall, the French system does not have a very traditional civil law flavour to its scheme in this area.



In Germany, investors have a co-ownership interest in a fungible bulk of certificates, and if there are no certificates, the investor has some rights against the intermediary to the extent that the certificates are from the certificates holder CSD. Unlike France, which has created a new statutory scheme, Germany has maintained a very strong civil law tradition in this area.



Similarly, the United Kingdom and the United States have different systems: the UK maintains a traditional common law regime while the US has created a new statutory scheme.



In Japan, there is a statutory system where investors are the securities holders whereas upper-tier intermediaries and the CSD only maintain books and do account keeping functions. Therefore, investors have security against their issuers as well. Given all of these different systems, there do not seem to be similar tendencies between common law countries and between civil law countries.

Nonetheless, all of these common law and civil law countries have specific arrangements for the protection of investors against insolvency by an administrator or an intermediary. In the US, there is a special provision under the UCC; in the UK, common law traditions and general trust principles protect the trust assets of beneficiaries. In France, there is no evidence of strong civil law traditions as investors have contractual claim against intermediaries despite special statutory provisions for investor protection. Germany maintains a more traditional civil law approach to property rights in that the assets of investors remain with the investors and not with their intermediaries. Of course, there is a risk of shortfall in all of these jurisdictions, a risk that must be born by individual investors. All investor protection regimes are of course subject to different existing insolvency regimes in their respective jurisdictions.

Description of current law:
What if the intermediary becomes insolvent?

	US	UK	France	Germany	Japan
Investor protection	yes	yes	yes	yes	yes
Doctrine	special provision	general trust principle	special provision	general property law	general property law

Note: There is a risk of shortfalls in all jurisdictions.

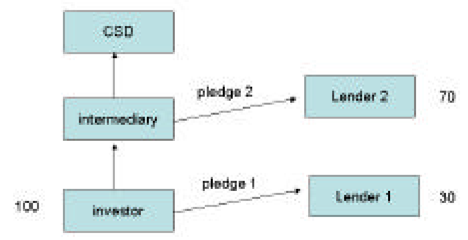
With respect to whether book entries are sufficient or necessary conditions for pledges or transfers, the situation also differs in each country, regardless of whether they are common law or civil law jurisdictions. In the US, book entries are not necessary to perfect security interests if the pledgee has control, but book entry crediting is a sufficient condition. In the UK, although I am not sure, I believe they would not be. In France, book entries are necessary, whereas I believe that in Germany, they are probably not. In Japan, book entries are necessary and sufficient conditions under a special statute that stipulates that indirectly held securities cannot be pledged in ways other than by book entry.

Description of current law:
Method of a transfer or pledge
Is a book-entry the necessary and sufficient conditions?

US	UK	France	Germany	Japan
yes (with exception for pledge)	?	yes	?	yes

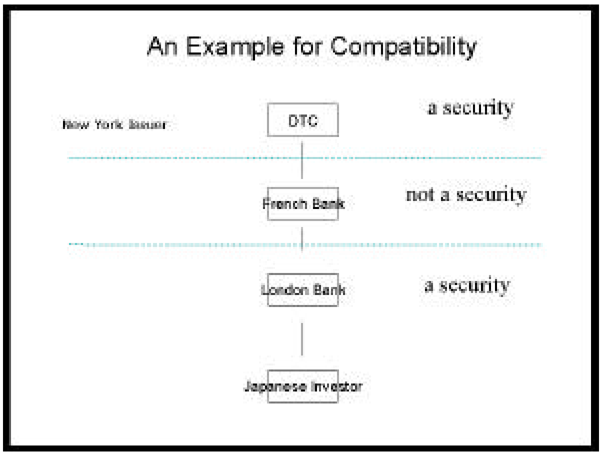
The next issue to be addressed is the right of intermediaries to use the securities of their customers. This assumes that an investor may pledge his or her securities to intermediaries on the condition that they must be unencumbered such that the investor reserves the right to use part of the securities for his own purposes.

Description of current law:
Intermediary's right to use customers' securities



In the example above, if an investor pledges 100 securities on these grounds on day 1, and on day 2, the same investor pledges 30 out of 100 securities to lender 1 to borrow money from him, those 30 securities are now encumbered. On day 3, if the intermediary uses these securities to pay to lender 2, who wins if the investor goes into bankruptcy? In all jurisdictions the insolvency administrator will lose, subject to an insolvency regime, however, I only know the answer as to who will win between lender 1 and lender 2 in the US and the Japanese systems. Nonetheless, this is one of the issues that we as a Study Group have been focusing on.

As a matter of prescription for the future, we have two approaches as developed by our team. It is more important for us to focus on comparability aspects. That is, even though one system is workable as such, once it is combined with another system, the systems must be compatible. If one particular financial instrument is a security instrument in one jurisdiction and not in another, investors' interests may not be sufficiently protected where there is a conflict between the two regimes.



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THE BOOK-ENTRY AS LINCHPIN OF FURTHER DISCUSSIONS

Dorothee Einsele, University of Kiel

One of the common elements of indirect securities holding systems world-wide is the book-entry, as the transfer or creation of a right usually involves at least one debit entry on the account of the transferor and a credit entry on the account of the transferee. Therefore, it is clear that the book-entry plays a decisive role not only for the transfer of rights in indirectly-held securities, but also for other important substantive law issues that arise in the process of harmonising or unifying indirect holding systems.

As to the legal meaning of book-entries, a preliminary determination has already been made by the Hague Convention on indirectly held securities that one cannot acquire an internationally-recognised right without a credit book-entry. Nevertheless, although indirect holding systems are combined with book-entries all around the world, book-entries do not necessarily have the same legal importance and function in every jurisdiction.

I. The Legal Meaning of Book-Entries

In dematerialised holding systems, book-entries may function as a substitute for paper certificates. Leaving aside this completely different function of book-entries, the effect of the book-entry must first be distinguished from the content of the right that the book-entry represents. For the sake of clarity, what is meant here by book entries are essentially credit entries. Of course, the legal meaning of debit entries may also be unclear. But this in turn is dependent on the legal meaning of credit book-entries. That is to say, a seller will not and should not lose its rights in securities merely upon a debit-entry, but only once a purchaser has acquired them.

The Effect of the Book-Entry

Creating the right | Evidencing (documenting) the right

As the *only* requirement | In combination with *additional* (legal or contractual) requirements

To explain this diagram briefly, the book-entry may have the effect of creating the right in favour of the transferee. In this category, the subgroup where the book-entry is the only prerequisite for creating the right, can be distinguished from the subgroup where the book-entry has only the effect of creating the right in favour of the transferee or collateral taker in addition to other prerequisites. For instance, some legal systems require additional steps for the perfection of security interests (such as formal notification or registration).

However, additional prerequisites for the transfer of interests can also be established in the general terms and conditions of the financial intermediary or the central securities depository as well as in statutes. For instance, it may be determined that the transfer of the ownership of the securities to be delivered shall be deemed to occur when several conditions have been met; one of them being that the central depository has conducted cash clearing. Therefore, additional requirements for the transfer of rights can be based on legal as well as on contractual provisions. In the latter case, the additional contractual requirement for the transfer of ownership may be qualified as a precedent condition, but the result would be the same as if it were an additional legal requirement: the transfer will not occur until the additional requirements will be met. Therefore, provisional credit entries may also address the issue of whether additional requirements to effect dispositions other than the book-entry, have to be met or whether such measures should be allowed.

Alternatively, and, under some legal systems, apart from the effect of book-entries creating the right, book-entries may also merely have the effect of evidencing the right in favour of the transferee or collateral taker. This is, for instance, commonly the case under German Law. As co-proprietary rights that account holders own are usually transferred according to the rules for the transfer of property, credit book-entries are only the usual result and evidence that dispositions were made not by book-entry but under an agreement made by the transferor and the transferee and - according to the prevailing opinion in Germany, – by transferring the co-possession in these rights.

The Content of the Interest Represented by the Book-Entry

Proprietary right	Right between a proprietary right and a mere claim	Mere Claim

The content of the right that a (credit) book-entry represents may be divided into three sub-groups as set out in the diagram above. The credit book-entry may represent proprietary or co-proprietary rights (which is usually the case under German Law). Proprietary rights or co-proprietary rights can be considered as a direct, immediate relationship of control between a party and assets (including a fungible bulk of securities). This relationship usually arises between parties and tangible things, but it could also arise between parties and dematerialised assets. That is to say, to my understanding, proprietary rights do not necessarily presuppose materialised securities as long as there is direct control of dematerialised securities by the account holder.

Secondly, book-entries may also represent mere contractual claims, as seems to be the case under Taiwanese law. And thirdly, book-entries may represent something that can be categorised between mere contractual claims and classical proprietary rights. This is the case for “right entitlements” under American law. Under German Law, an investor in foreign securities that do not qualify as securities under the German Securities Deposit Law usually obtains what is called a Gutschrift in Wertpapierrechnung. This is arguably also something between a classical proprietary right and a mere contractual claim (even though it is not certain whether German courts would recognise these rights as a ‘Treuhand’).

II. Interdependencies between the Legal Meaning of Book-Entries and the Issues Identified by the UNIDROIT Study Group for the Preparation of Harmonised Substantive Rules Regarding Securities Held with an Intermediary

The following considerations are based on the assumption that within a given legal system, there should be internal consistency.

Finality and Irrevocability

The finality of book-entry transfer is a problem which has no immediate interconnection with the content of the right that is represented by a book-entry. This is because the transfer of a proprietary right as well as the transfer or establishment of mere claims or entitlements may be revoked and is not final. It has only to do with the content of the interest represented by the book-entry in so far as the different rights may also be transferred in different ways. The question whether and how long such transfers can be revoked is therefore dependent on how the right is being transferred or disposed of and is therefore dependent on the effect of the book-entry.

As a starting point, one could consider that a fully completed and executed disposition is final and not unilaterally revocable, unless the disposition itself or the underlying contract shows certain defects. However, insolvency proceedings and provisions should not be considered in this framework, as they tend to follow special rules and concepts. From the diagram, it is clear that in a system that has no additional prerequisites apart from the book-entry for dispositions to be effective, dispositions are completed and fully executed at the moment the book-entry is made. Of course, there may be defects in either the disposition itself or the underlying contract. Nonetheless, if there are clear rules for the disposition of indirectly held securities, this should be a relatively rare case.

The situation is different in legal systems that have additional prerequisites to effect dispositions. As long as these additional prerequisites are not met, the transfer will not be effective, with the result that it is not final and may still be revoked. This is also true in case of additional contractual requirements such as cash clearing, which results in book-entries that are only provisional. If there are additional requirements, one has to ascertain at any rate that the book-entry does not pass the usual deadline for the revocability of dispositions. The same is true in the case of dispositions that, from a legal perspective, are not executed by book-entries but are rather, for instance, executed according to the general rules of property law and merely evidenced by book-entries. Then the question of when a disposition is fully completed is determined by the relevant rules of property law. The result is that one cannot be certain that a disposition is final and irrevocable at the moment when a book-entry is made.

2. Good Faith Acquisition

Good faith acquisition in this context refers to the question of whether one person loses its right when another acquires this right in good faith from somebody who is neither the owner of the right nor has the authorisation to dispose of it. The question of whether bona fide acquisition is possible is, generally speaking, one that has to do with the kind of right represented in book-entries, but also with the way the right is transferred. To my knowledge, not only under German law but also under other legal systems, bona fide acquisition is only possible as to the transfer of some types of rights. Moreover, it is only possible for some kinds of transfers of rights: essentially, there must be something in which the transferee can believe in good faith. Therefore, in a general sense, the problem of good faith acquisition may also involve the effect of the book-entry as well as the content of the interest represented by the book-entry.

To my knowledge, there is no legal system where a bona fide purchase is possible as to mere contractual claims. This is logical, since in the case of mere claims there exists no manifest basis or no sign in which one could believe in good faith. Therefore, good faith acquisition is not possible in systems where mere claims are established in favour of the acquirer.

Consider the case of a legal system in which the acquirer obtains a kind of entitlement: In a system based on the concept of "trust" rights (such as the American system or the German system for securities that do not qualify as securities under the German Securities Deposit Act), it is important to note that there is no transfer in the sense that the right which the former holder has is the right that the transferee obtains. The system is rather based on the concept of rights that are, after the 'transfer' of the right, newly established in favour of the transferee by the financial intermediary.

Therefore, this system is comparable with the functioning of a money transfer. For example, a financial institution in charge of a customer's selling order may reduce that customer's account representing the rights of that customer against the financial institution, while the financial institution in charge of the purchasing order establishes corresponding rights for the purchasing customer to itself. Thus, the question of bona fide acquisition in the sense of a person obtaining a right that the former owner loses will not arise in such a system either. However, it should be stressed that account holders are also protected in this system, as they can rely on the rights once acquired, unless they later transferred these rights to another person.

Obviously, a system based on proprietary rights would usually allow acquisitions in good faith. Yet, in indirect holding systems, there is another problem: an acquirer has no basis to rely on in good faith, as he or she has no inside view into the operation of the system and bank secrecy laws do not allow for him or her to verify whether the transferor in turn acquired the right. This is true independently of whether book-entries suffice to transfer the right as long as there is no manifest sign to third parties that a certain customer is the holder of the right. Therefore, an acquisition in good faith could only be justified where the financial intermediary acts as agent for the acquirer and where his or her good faith could be attributed to the acquiring customer. Yet, for legal or practical reasons in many systems, the financial intermediary, acting as agent for an acquirer, cannot verify book-entries for the benefit of a seller either.

In systems that require additional prerequisites for the transfer of ownership or even in systems where ownership is legally transferred according to the general rules of property law rather than by book-entries, and especially in an international context, it becomes even more unlikely or rather impossible that financial intermediaries could verify a seller's ownership rights. Moreover, as in some countries investors are required by law to use a certain system, it is questionable whether the risk of such a system should be attributed to individual investors. This question remains, aside from the practical difficulties of tracing assets that inevitably arise in systems based on the concept of bona fide acquisition. Last but not least, the possibility of bona fide acquisition means that only one party, and usually only the purchaser, can be confident that he has obtained the interests that are booked in his account. By contrast, the former holder cannot rely on the book-entries in favour of him, in so far as his rights may have been lost without his consent through a bona fide acquisition.

To conclude, even though, at first sight, good faith acquisition seems to be possible, the preconditions for bona fide acquisition will usually not be met. And even if they are met, one has to realise that the concept of one person acquiring the right to the detriment of another one, the loss of the right not having been induced by the latter (that is to say, the former holder of the right), can hardly be justified and is not desirable. Therefore, even though it is necessary for an efficient and speedy system that the account holder can be confident that entries in its account with its intermediary represent interests that are good against the intermediary and third parties, this result cannot and even should not be achieved by way of good faith acquisition.

3. Allocation of Shortfalls

Shortfalls are defined in this context as where customers have acquired more interests in securities than are available in the customer account of the relevant intermediary. Having already addressed good faith acquisition, it is important to note that if an account holder loses its interests in favour of another person acquiring them, the problem of a shortfall will not arise. This is because, in such a case, the amount and number of rights held by the financial intermediary for his customers equals the rights that its customers have against this financial intermediary. Therefore, in so far as a system allows and ultimately also affirms good faith acquisition, the problem of a shortfall will quite rarely arise.

A shortfall may arise when a person acquired an interest without another one losing the right. But again, this will quite rarely be the case, as usually the transferee will acquire no right if the right which he is to acquire cannot be attributed to a certain transferor. Therefore, in a system based on proprietary rights and on the condition of the traditional, if undesirable in my view, concept of good faith acquisition, the problem of how to allocate shortfalls will almost never arise. Yet the lack or rather the unlikelihood of a shortfall is achieved in such a system by a model whereby the customer cannot be confident that the entries in its account with its intermediary represent interests that are good and remain good against the intermediary and third parties.

However, the issue of shortfalls will certainly and probably often emerge in systems based on the establishment of trust rights to the financial intermediary. Depending on the meaning of ‘interests in securities’, shortfalls may even occur in systems based on the concept of mere contractual claims if they relate to a customer account. In such systems, a financial intermediary has to satisfy the customers` claims as long as it holds the relevant securities in its account.

Therefore, the problem of shortfalls is or should be resolved in the first place by the financial intermediary having to use its securities in order to satisfy the clients’ rights. But in so far as the financial intermediary is not in a position to satisfy all claims, the general rule can only be that the shortfall has to be borne by the account holders in proportion to their holdings of the relevant securities with their financial intermediary.

An argument that can be put forward for such a solution is that, in a system in which there are no specific securities rights or co-ownership rights in a fungible bulk of securities attributed to specific customers, the loss can only be shared rateably. Apart from that, one could also argue that all customers benefit from the system and they all have the same influence or rather non-influence on the working of the system and therefore they should all bear the same risk.

4. Upper Tier Attachment

With respect to upper tier attachment, Courts will usually attach the debtor's (i.e. the customer's) rights in a way that will prevent the holder of the right from exercising it. In addition, in some cases, Courts will enable the creditor to exercise this right or at least some aspects of this right. Therefore, the issue of upper tier attachment is primarily related to the kind of right to be attached and not to the way it is transferred. Where a debtor has proprietary rights in movables, the debtor will usually be prevented from exercising the right and the creditor will be able to exercise it if the alleged right is attached where it is situated. Thus, the issue of upper tier attachment is likely to arise in systems that are based on the concept of proprietary rights, as the relevant security in which the debtor/customer has a proprietary interest is deposited with the central depository.

On the other hand, this problem is unlikely to arise in systems that are based on the concept of mere contractual claims to its financial intermediary, as the relevant right in this case is the claim and the holder of this right will already be prevented from exercising this claim if its financial intermediary is informed about the attachment. Moreover, the issue of upper tier attachment is less likely, but not completely ruled out, in a system based on rights that can be qualified as rights between mere claims and (classical) proprietary rights. The reason is that, in such a case, the right will have some features of a property right and some features of a contractual claim.

5. Investor Protection in Case of Insolvency Proceedings against a Financial Intermediary

There is no doubt and it is also common opinion among the members of the UNIDROIT Study Group for the Preparation of Harmonised Substantive Rules Regarding Securities Held with an Intermediary that investors should be protected in the event of insolvency proceedings against their financial intermediaries. Yet to my knowledge, there is no legal system where, as a general rule, mere contractual claims are protected if there are insolvency proceedings against a party who must satisfy these claims. And even if a legal system provides special rules for the preferential treatment of investor interests in the event of insolvency proceedings against a financial intermediary, these rules are unlikely to be universally recognised, if the investors' interests are mere contractual claims against the intermediary. Therefore, a system that is based on mere contractual claims against the intermediary cannot be recommended.

However, in systems based on proprietary rights as well as on trust rights, investor protection is possible in the event of insolvency proceedings against a financial intermediary. This is not completely certain in cases of trust rights, as trust interests are something between proprietary interests and mere contractual claims, but it is conceptually possible and it would fit into the system.

III. Conclusions

To determine the legal meaning of book-entries, there must be a separation between the effect of the book-entry and the content of the right that is represented by a book-entry. The problem of finality and irrevocability is closely interrelated with the effect of the book-entry. If the book-entry is the only prerequisite for the transfer or creation of the right, the finality or irrevocability of dispositions can quite easily be achieved. An efficient and speedy transfer system for indirectly held securities requires undoubtedly that the account holder can rely on the book-entries in its account. Yet, in my view, this aim cannot and even should not be attained by way of bona fide acquisition and, considering the factual conditions of indirect holding systems, this is true irrespective of what rights and how they are being transferred.

However, if one takes a different view and provides investors with the possibility of good faith acquisition in systems based on proprietary rights, one investor is protected to the detriment of another. On the other hand, shortfalls are much less likely to arise in a system which is based on classical proprietary rights and the possibility of bona fide acquisition. But this result is purchased at the expense of one investor either losing its right or another one not acquiring the right. The intrinsic problem of a concept based on classical proprietary rights is that the risk of the system is attributed to individual investors.

The issues of upper tier attachment and of customer protection in the event of insolvency proceedings against a financial intermediary are interrelated with the content of the right that is represented in book-entries. As to this, reasonable results may be achieved in systems that are based on the concept of proprietary rights, but also in systems which are based on the concept of rights that can be qualified as being neither mere contractual claims nor classical proprietary rights.

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OUTLOOK FROM THE PERSPECTIVE OF DOMESTIC LAW REFORM

Hans Kuhn, Swiss National Bank

1. Introduction

The presentations and discussions that took place at this meeting have certainly made it evident that the law of indirectly held securities is the subject of a comprehensive and ambitious law reform exercise. This exercise involves work undertaken by international bodies like UNIDROIT as well as a number of law reform projects on a national or regional level. Hopefully, this process will result in the not too distant future in a well-founded, clearer, and more transparent legal framework for domestic and cross-border securities transactions. While the ultimate destination of the journey is clear, it might be less obvious what road to take to get there.

As pointed out in the working group Position Paper[1], Switzerland is one of the jurisdictions that is currently in the process of reforming its law of indirectly held securities. Earlier this year, the Ministry of Finance appointed a commission to review proposals for a Securities Deposit Act drawn up by a private-sector working group[2]. The working group which is chaired by the Swiss National Bank is expected to deliver a draft Securities Deposit Act and an explanatory report in the first quarter of 2004. At the same time, the ratification of the Hague Securities Convention[3] is being prepared by

[1] The UNIDROIT Study Group on Harmonised Substantive Rules Regarding Indirectly Held Securities, Position Paper, p. 9.
[2] The private-sector draft is available only in German; it is accessible under < http : // www. vondercrone. Ch / WVG% 2006 .01 .2003.pdf> (visited January 12, 2004)
[3] Hague Convention on the Law applicable to certain rights in respect of securities held with an intermediary.

Switzerland. In this context, the working group has also the task to ensure compatibility between the domestic substantive rules and the Hague Securities Convention.

Early on in this law reform process, it became clear that a critical requirement any draft would have to fulfil is its compatibility with foreign legal systems. Cross-border compatibility is crucial for the simple reason that in Switzerland cross-border transactions are much more frequent than simple domestic transactions. This results from the fact that more than 80 per cent of all securities held in securities accounts with financial institutions in Switzerland –without foreign branches of Swiss banks – are issued by issuers outside of Switzerland. We take it that most of these securities are located outside our country. Hence, in a vast majority of cases, dispositions of securities held in a securities account with an intermediary in Switzerland will result in the interaction of two or more legal systems.

Reaching the conclusion that, as a matter of policy, the future Securities Deposit Act must pass a compatibility test is one thing. Implementing this policy on a conceptual and drafting level is something completely different. One decision that has been much influenced by compatibility considerations was that the new act will not prescribe a specific form for indirectly held securities; for example, it will not impose a system of dematerialised securities. Rather, it will be left to issuers, and to investors, ultimately whether they prefer securities in traditional paper form, as a global certificate, or as fully dematerialised securities. Compatibility will also be ensured by leaving it to the law of the issuer to define what will qualify as securities, and by broad and functional definitions of securities intermediaries. Beyond these few points, however, the possibilities of ensuring compatibility and a smooth functioning of systems across borders through domestic substantive rules for cross-border situations are quickly exhausted.

This is the reason why throughout the reform process, the initiatives aimed at reforming the substantive law of indirectly held securities have been followed with great interest in Switzerland. In particular, the Swiss securities law commission has gained inspiration from the UNIDROIT project on Harmonised Substantive Rules Regarding Indirectly Held Securities and the Study Group's Position Paper. Switzerland was one of the jurisdictions visited last summer by one of the Study Group's fact-finding missions, and this mission was certainly useful also for domestic law reform. Finally, the Swiss National Bank looks forward to receiving the Study Group for a plenary meeting in Switzerland next spring.

This presentation will first explain in more detail how the domestic law reform process benefits from the work undertaken by UNIDROIT and other international bodies engaged in securities law reform. A second part will discuss a number of core issues that are really at the heart of securities law reform. A third part will make a few comments on a possible framework for the work done by UNIDROIT.

2. The importance of securities law reform

In Switzerland, the degree of immobilisation and dematerialization of securities is well advanced. Like in many other legal systems, however, the legal framework has remained unchanged for most of the last century. In the absence of specific statutory rules, the multi-tiered indirect holding system is based on general principles of property and contract law, legal opinions construing and adapting these property and contract law rules, and internal rules and regulations of central securities depositories and other financial intermediaries. The only notable law reform was an amendment to the Federal Banking Act in 1994 which improved the protection of the investors interest in indirectly held securities in an insolvency of an intermediary[4]. Furthermore, the Federal Act on Stock Exchanges and Securities Trading enacted in 1995 recognised the concept of book-entry securities without, however, regulating it in some detail[5].

Even though this legal framework hardly qualifies as well founded, clear, and transparent, the private sector remained reluctant for a long time with respect to calls for securities law reform put forward by academia. Yet this consensus that reform is actually needed is the first and most basic requirement for any successful law reform. Governmental officials and national legislators will not be willing to devote scarce resources to law reform if there is not an excellent case for it. This is particularly true if the body of law in question is rather complex and technical in nature and if the deficiencies are not obvious, because, for example, not many cases have been tried in court. A good case for reform is not only a critical precondition for domestic law reform, but also for the success of international instruments; those, too, must ultimately be ratified or implemented by national legislations. It is therefore immensely helpful that the need for securities law reform has been emphasised by an impressive number of reports, papers and recommendations. It was the broad consensus that the existing private international rules applicable to disposition of indirectly held securities had become dysfunctional that made it possible to prepare and adopt the Hague Securities Convention in an unprecedented fast track procedure in less than two years. It seems to be equally uncontroversial today that any effective reform will require changes to substantive law. There is no doubt that the Hague Securities Convention is an extremely important step forward in eliminating uncertainty and legal risks, and that the Convention should therefore quickly be ratified by as many states as possible. However, the Hague Convention, on its own, is not sufficient since many legal systems simply do not provide a reasonable legal framework. And even if a legal system may provide a perfectly coherent and sensible framework for domestic transactions, it may not well interact with foreign legal systems in cross-border situations. Hence, even though the Hague Securities Convention is a first and possibly the most important step in order to achieve more legal certainty and transparency, law reform cannot stop there.

For well over 100 years now, the remedy for discrepancies among national laws that impede international trade has been institutionalised unification of commercial law. This has been a process that yielded impressive results, taken as a whole and despite many setbacks. It is also a process that can rely on well-established and tested institutions and procedures. From a global perspective, it is the only realistic way to achieve sufficient harmonisation of the legal framework for cross-border securities transaction. The UNIDROIT project therefore is not an alternative to harmonisation on a regional or on a national level, but an indispensable complement.

[4] See articles 16, 37b Federal Law on Banks and Savings Banks [RS 952], English translation under <http://www.kpmg.ch/library/translations/bbanking/index.asp?rid=9066612&cDetail=1290&redl1=0&redl2=684> (visited January 12, 2004).

[5] See article 2(a) of the Federal Act on Stock Exchanges and Securities Trading [RS 954.1], English translation under <http: //www. swx. Com /swx / bog300e.pdf> (visited January 12, 2004).

3. Elements of securities law reform

Although the need for a „well-founded, clear and transparent" legal framework for the custody and the clearing and settlement of securities has been underscored in a number of initiatives, most interventions remained rather vague as to what exactly constitutes the distinctive marks of a legal framework that satisfies this test. Of course, early on agreement was reached on certain elements such as, for example, the need to protect an investor's rights in securities against claims of the intermediary's general creditors in case of its insolvency. However, this is, as a matter of policy, rather obvious and, from a drafting point of view, fairly easy to implement. Beyond such easy points, however, it has remained largely unclear what requirements must be met in order to pass as a „well-founded, clear and transparent" legal framework.

The detailed discussion and analysis of the elements of a sound legal framework in the Study Group's Position Paper therefore means breaking new ground – as does the EFMLG-Report published immediately before the Position Paper. Both papers may pass as a first draft of what eventually will become a blueprint for an internally sound, robust and transparent legal framework.

At the very heart of the Position Paper is the concept that dispositions of securities held with an intermediary are effected through and effective for an entry in the relevant intermediary's securities account. This book-entry approach, which is also the key to the EFMLG proposal and the Swiss draft, has the merit of reflecting long-standing market practices. Moreover, on the face of it, it seems to be a simple enough concept. There is also something comforting about reducing complex institutional structures and processes that characterise global clearing and settlement to a series of bookkeeping operations.

Of course, the concept of bookkeeping as used in securities law reform is anything but easy and to this extent the term is rather misleading. In fact, in my view, the book-entry concept is likely to be the most complex part of the whole exercise. At the same time, it is also a key element to compatibility; compatibility in cross-border transactions will most likely not be achieved if the basic features of the book-entry concept are not sufficiently harmonised.

The complexity of this seemingly simple approach stems both from operational and legal problems. Unless the parties to a transaction maintain their securities accounts with the same intermediary, a transfer of securities occurs through a whole series of credits and debits in different books that use non-harmonised formats and that do not necessarily occur in sequence. Credits and debits will usually not be directly linked to each other; in many instances, for example, if a CCP is being used, such a direct link is institutionally impossible. These operational features have important repercussions for legal analysis. For example, temporary shortfall will most probably occur not only as a result of error or fraud, but will be inherent to a certain degree in such a dynamic system. The lack of a direct link between debits and credits also creates the possibility that the number of securities circulating in such a system exceeds the number of securities issued.

Regulating the basic design of a book-entry system requires answers to a number of details, including what exactly are the relevant books, what is an entry that is sufficient to effect a transfer of securities, at which precise moment in time will such a transfer take effect, and what are the entries to be made in order to pledge securities. It might well be possible to answer these questions in a number of ways and still get a coherent system. However, what I do not know is to what extent compatibility will be affected if different legal systems are using different approaches.

It should therefore be a top priority to further clarify the basic design of the book-entry system. This would mean determining whether a globally compatible book-entry system can be designed without achieving previous harmonisation of technical and business practice standards for securities clearing and settlement systems. Many of the remaining issues the Position Paper lists as elements of securities law reform – like upper-tier attachment, creation and realisation of collateral, net settlement, finality and irrevocability, provisional credit and allocation of shortfall – can more easily be resolved if there is firm common ground with respect to these basic features.

It should be perfectly clear that this is not about technicalities. What is emerging here is a fundamentally new concept of securities law that differs fundamentally from how we see and understand this body of law today. What is needed therefore is a fundamental re-conception of securities law.

4. The timeframe for law reform

One of the critical points to which the Study Group should give careful consideration is the time frame for the conclusion of its project. Numerous initiatives are under way or in the process of being launched at national, regional, or international level that are aimed in one way or another at securities law reform. The timeframe envisaged for many of these projects is ambitious. The EU Account Certainty Project proposed by Giovannini II recommended a period of three years for completion. The G-30 report proposed aligning the development and introduction of global standards with the life cycle for the update and replacement of software and systems, an update and replacement that typically occurs in a cycle of 5 – 7 years. It can be assumed that most national law reforms currently in sight will also be achieved roughly within this time frame.

Whether the UNIDROIT project will be able to benefit from this momentum will be crucial for its outcome. This should make it clear that time is of the essence. Of course, I realise that the process of unification of law takes time. But I also believe that we might have a window of opportunity that will close again in the not so distant future. I have no suggestions to make how to deal with this situation. One conclusion, however, one might draw is that the Study Group's deliberations should be as open as possible in order to have as much impact as possible on the work currently under way.

5. Conclusion

It is my firm conviction that the Study Group's work on harmonised substantive rules regarding indirectly held securities is a critical element in the current endeavour to create a harmonised legal framework for an increasingly globally linked marketplace. It is the only realistic and promising way to achieve the minimal worldwide harmonisation necessary for the legal systems to interact on a global scale. Therefore, the UNIDROIT project and the law reforms under way on a regional or national level should not be considered as competing, but rather as complementing elements of a comprehensive law reform process. However, it goes without saying that these various elements must evolve in a co-ordinated fashion; otherwise the chance for a meaningful improvement of the legal framework on a global level would be forfeited. Furthermore, the global perspective of UNIDROIT ensures that securities law reform is not confined to a few financial centres, but also benefits emerging markets.

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LEGAL RISK AND MARKET EFFICIENCY

DEVELOPING HARMONISED SUBSTANTIVE RULES REGARDING INDIRECTLY HELD SECURITIES

Seminar, 12 November 2003

UNIDROIT, Rome

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