

UNIDROIT

INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW



UNIDROIT Seminar on
Intermediated Securities – Bern, Switzerland

15 - 17 September 2005



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NOTICE

The participants 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 institution, their Government or UNIDROIT.

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UNIDROIT 2005 - Study LXXVIII / SEM. 1 (English only)

PROGRAMME

Thursday, 15 September

- 14.00 Welcome and introduction (Hans Kuhn, Chairman)
- 14.15 Topic 1: Direct/Indirect Holding
Acquisition and disposition in both systems; tracing in direct holding systems;
loss-sharing as a necessary solution
Reporters: Francisco Garcimartín Alférez; Hideki Kanda
- 15.30 Coffee Break
- 15.45 Topic 2: Influence of corporate law
Registered shares/restricted registered shares; neutral and functional approach
regarding dividends and voting rights
Reporters: Philippe Langlet; Martin Thomas
- 17.00 Topic 3: Interdependency of core features
Good faith acquisition: effectiveness of book-entry; priorities; loss sharing
Reporters: Dorothee Einsele; Chuck Mooney/Joyce Hansen
- 18.15 Make-up of Working Groups 1 - 3
- 18.30 Adjourn
- 19.30 Reception

Friday, 16 September

- 09.30 Separate meetings
Working Group on Topic 1 (Chair: Sandra Rocks)
Working Group on Topic 2 (Chair: Karin Wallin-Norman)
Working Group on Topic 3 (Chair: Luc Thévenoz)
- 12.30 Lunch break
- 16.00 Coffee Break
- 17.30 Excursion

Saturday, 17 September

- 09.30 Report on Topic 1 (Sandra Rocks)
Clarifying Questions, Conclusions
- 10.30 Report on Topic 2 (Karin Wallin-Norman)
Clarifying Questions, Conclusions
- 11.30 Report on Topic 3 (Luc Thévenoz)
Clarifying Questions, Conclusions
- 12.30 Chairman's wrap up
- 13.00 End of meeting

SUMMARY

Mr Hans Kuhn of the Swiss National Bank, Chairman of the Committee of Governmental Experts for the preparation of a preliminary draft Convention on intermediated securities welcomed participants to the seminar. Recalling the Committee's conclusion on the need for inter-sessional work on key issues, the seminar gave participants a valuable opportunity to exchange views.

The first topic for discussion was entitled "**Direct and Indirect Holding**". Messrs Francisco Garcimartin Alférez and Hideki Kanda, members of delegations to the Committee from Spain and Japan respectively, gave presentations which helped to pinpoint the differences between the two types of holding systems (*cf. Appendices 2 and 3*). Before explaining in detail the Spanish system Mr Garcimartin Alférez described the Committee's objective as being to try, by adopting a "functional approach", to produce a common set of rules within which both systems could be accommodated. Mr Hideki Kanda emphasised the need for each system to be able to work with another when required to respond to, or to operate with, that other. He considered the functional approach more likely to achieve a successful outcome than an attempt to reconcile different holding systems from a common law, or from a civil law, perspective.

Mr Philippe Langlet, a member of the delegation from France and Mr Martin Thomas, representing the EU Commission, then gave a presentation on the second topic "**The influence of corporate law**". Mr Langlet (*cf. Appendix 4*) concluded that the defining difference between different systems was the presence or absence of a direct link between issuer and investor. A functional, neutral, approach should, however, enable harmonised substantive provisions capable of interacting with different national laws to be drafted. In France, both the law and practice of the securities industry were showing the way.

Mr Thomas described recent developments within the EU. He reported that the Commission had recommended the Council to approve the Commission's negotiating status, on behalf of member States, in relation to those provisions of the draft convention that are within the scope of existing Community law. Furthermore, the Council had asked the Commission for a legal assessment of certain issues relating to the Hague conferences' Convention on the law applicable to intermediated securities. Moreover, the legal certainty group, an advisory body to the EU Commission, was continuing with its work of examining differences between member States' laws relating to securities holding and transfer so as to determine which are significant and how far, in consequence, there is a need for harmonisation.

The final, third, topic for discussion was "**The interdependency of core features**" – namely, those Articles that provide for good faith acquisition, effectiveness of book entries, priorities and loss sharing.

In her presentation (*cf. Appendix 5*), Ms Dorothee Einsele, a member of the German delegation, described, from a civil law perspective, how those provisions of the draft convention on the acquisition of securities related to others which recognise that acquisition may not always be in good faith - and how she perceived the nature of the book-entry where credit to an account is not matched by a corresponding debit. Concluding that the rules on acquisition do not prevent the creation of more credits to securities accounts than an intermediary has securities to satisfy, Ms Einsele went on to describe how she interpreted those provisions of the draft convention that prescribe loss-sharing rules and those that provide for competing claims.

The presentation on key provisions of the draft convention given by Ms Joyce Hansen and Mr Chuck Mooney, members of the delegation from the USA focussed, by means of a series of examples, on the provisions that regulate priorities and provide for loss sharing (cf. Appendix 6). By testing these provisions against a number of possible scenarios they concluded that, while some provisions did, taken together, produce a clear, broadly acceptable result, others, as currently drafted, did not.

After the presentations, participants in the seminar split into three groups, each taking one of the three topics, to exchange views and discuss issues arising from them. The chairperson of each group then reported back on its conclusions to the seminar in plenary.

Ms Sandra Rocks, of the US delegation, acted as *rapporteur* for the first topic – **Direct and Indirect Holding** (cf. Appendix 7). The discussion had centred on provisions of the draft convention which were not easy to apply equally to both direct and indirect systems. Three problem areas were identified – first, limitations on upper-tier attachment, second, the relevance of “tracing” and third, the definition of “intermediary”. The policy on the first was to give creditors access to a debtor’s assets but only at levels where his identity is known. This limitation may not be relevant to direct systems, where identity may be known at all levels. Tracing, possible in direct systems, was not, in indirect where there was a clear policy that credits and debits should not be ineffective if they could not be “matched”. As to intermediaries, the differences in their functions made it difficult to agree on a common definition

Ms Karin Wallin-Norman of the Swedish delegation reported on the second topic – **The influence of corporate law** (cf. Appendix 8). The group had considered whether provisions of Article 4, which deal with the extent to which an account holder can exercise rights conferred under the terms of the issue of securities, were consistent with the requirement in some jurisdictions for investors’ names to be registered with the issuer. The group did not reach a conclusion on whether the way in which the draft convention provides for the effect of credits and debits was consistent with restrictions in national domestic law on the right to transfer and hold securities.

The report on the third topic – **Interdependency of core features** – was given by Mr Luc Thévenoz, of the Swiss delegation (cf. Appendix 9). The group had spent its time working through the hypothetical situations described in the presentations made by Ms Joyce Hansen and Mr Chuck Mooney, applying Articles such as those that deal with the authorisation of transactions and those that provide rules on priority, shortfalls and good faith acquisition. This had generated some disagreement. The outcome had, however, been positive. Despite fundamental differences in approach, the group had been able to suggest a number of ways in which the draft convention should be improved. Agreement had been reached on the controversial and important matter of loss allocation in the event of shortfall.

Mr Philipp Paech, UNIDROIT Secretary to the Committee of Governmental Expert, highlighted the fact that the participation in this seminar had exceeded expectation and thanked all attendees for finding the time to come to Bern. Moreover, he expressed UNIDROIT’s gratitude to Mr Hans Kuhn as representative of the Swiss National Bank which, for the third time since this project came into existence, so generously supported the project on intermediated securities. Finally, we thanked all reporters and chairpersons of the working group for their dedication and time invested in preparing the excellent presentations and papers which will give very valuable input to the forthcoming Committee of governmental experts.

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“DIRECT AND INDIRECT HOLDING: THE CHALLENGE OF THE FUNCTIONAL APPROACH”

(Prof. Francisco J. Garcimartín Alférez, Universidad Rey Juan Carlos de Madrid, Spain)

SUMMARY

§ 1. The concepts of directly and indirectly held securities

§ 2. Securities under Spanish law

§ 3. The central securities depository: the general structure of Iberclear

§ 4. Legal consequences:

4.1. No “new kind of property”

**4.2. Transmission of property by means of credits and debits
Excursus**

4.3. Credits and corresponding debits; Traceability

4.4. Lost allocations

4.5. Insolvency

4.6. Upper-tier attachment

§ 5. Conclusions

§ 1. The concepts of directly and indirectly held securities

1. This paper tackles the contrast between the so-called direct and indirect systems of holding securities. It is true that the pertinence of both concepts have been questioned¹. The reality is very heterogeneous. In comparative terms, the supra-concept of “book entry securities” encompasses a wide range of legal options each of them with its own peculiarities. That makes it very difficult to divide all national systems in two big categories. For many lawmakers it would be very difficult to offer a simple answer to the question: On which side are you playing? Direct or Indirect holding?

2. Nevertheless, my intuition is that if we agree to a common understanding of those two categories, they can be helpful to analyze certain comparative-law problems. To reach that common understanding we have to start from a very simple assumption: in principle, *all book-entry securities systems are de facto intermediated, and in this sense de facto indirectly held*. There is always somebody between the issuer and the account holder that has control over the books or the registry. The difference, therefore, does not relate to the fact that the investor does or does not physically possess the securities, but to the way in which the legal system copes with the “intermediated securities challenge”, *i.e.* how to prevent the custody risk and to facilitate investors the exercise of corporate rights in the case of intermediated securities.

3. *Direct holding.* In very broad terms, one group of systems considers that the intermediation does not call for the creation of a new legal product: *“intermediaries only have the function of a book-keeper and have no interest at all in the underlying securities”*. This implies that *ex lege* investors maintain a direct legal relationship with the issuer. Investors are the direct owners of all the rights arising from the securities, though they may need the collaboration of the intermediaries to exercise those rights. This is the case in Spain. Some countries, like Spain, have considered that they can protect the proprietary and the corporate rights of investors without the need for creating a new kind of property, and without breaking the legal link between the issuer and the investor.

4. *Indirect holding.* Another group of states considers that the intermediation process requires the legal creation of a new kind of property: An entitlement over the securities different from the underlying securities *and derived from the position of the intermediary*. In colloquial terms, their option is “we have to bite the bullet and admit that in the case of intermediated securities the investor does not have the securities any more, rather he is always in the hands of the intermediary”. The best way to provide him with a sound protection is through the legal creation of a new type of property. This is the case of the US or Switzerland (project)².

¹ See, *i.a.* *Explanatory Notes to the Preliminary Draft UNIDROIT Convention on Harmonized Substantive Rules regarding Securities*, in *Unif. L. Rev.*, 2005-1/2, p. 36 and ff., footnote 2; AFRELL/WALLIN-NORMAN, “Direct or Indirect Holding – A Nordic Perspective”, *Ibid.*, p. 277 and ff., p. 283 .

² See, GOODE, “The Nature and Transfer of Rights in Dematerialised and Immobilised Securities”, *B.J.I.L.F.*, 1996, p. 167 and ff. (arguing that dematerialisation does not by itself affect the direct relationship between investor and issuer, while immobilization necessarily does. This may explain why countries like France or Spain, where dematerialisation is the rules, have maintained the former approach). About the “new kind of property” introduced by the indirectly holding pattern, see *i.a.* REITZ, “Reflection on the Drafting of the 1994 Revision of Article 8 of the US Uniform Commercial Code”, *Unif.L.Rev.*, 2005-1/2, p. 357 and ff., p. 361 (“The key legal relationship must be between an investor or holder and its intermediary”); ROGERS, “Policy Perspective on Revised U.C.C. Article 8”, *UCLA L.Rev.*, 1996, p. 1431 and ff., p. 1455 (“...an entitlement holder’s property interest is a bundle of rights that can be asserted directly only against the entitlement holder’s own intermediary”); or FMLC Report on Property Interest in Indirectly Held Investment Securities, in www.fmlc.org (“... an account holder’s rights are solely against its own intermediary”). The best place to trace the origins of this construction, MOONEY, “Beyond Negotiability: A New Model for Transfer and Pledge of interests in Securities Controlled by Intermediaries”, *Cardozo L. Rev.*,

5. When faced with the “intermediated securities challenge” States are free to choose. They may accept that the creation of a new type of property “...avoids many difficult legal constructions and fictions”³. Or they may not. The *reasons* for opting in favor of one or the other are varied, one of the most important being the “legal path dependence”: the institutional framework under which each lawmaker was placed when it decided to design a new legal framework for intermediated securities. I am not going to elaborate on this here, but it is important to keep the “legal path dependence” element always in mind.

6. The UNIDROIT Preliminary Draft “...is intended to address both models”⁴. It seems to be based on the assumption that the difference between direct and indirect holding is most of the time a question of terminology (different conceptual frameworks) but not much else. Accordingly, the neutral and functional approach adopted can easily fit both systems of holding⁵.

The Preliminary Draft and the Explanatory Notes of the Conventions convey the impression that the direct/indirect issue is mainly a question of corporate law. One could argue that it is for the *lex societatis* to determine whether the account holder has a direct right *vis à vis* the issuer or not. The Convention does not interfere with that possibility (see Art. 2.1. (e) and 2.2.b of the Preliminary Draft and 4.1.e and 4.3.b of the 2005 Draft) and therefore can be accepted without too many difficulties by the direct holding model. As we will see hereafter, this is not necessarily true. The difference between direct and indirect holding is not only a question of corporate law.

7. The main purpose of this contribution is to check the validity of that assumption. That is, to check whether we can design a set of common rules, touching upon the core elements of the problem, that could be comfortably accepted by both systems; and whether the UNIDROIT project is oriented in the right direction. Obviously, my analysis should not be seen as an exhaustive report, but as mere “food for thought”

8. To illustrate my explanations I am going to use the Spanish system, not only because it is the one I am more familiar with but also because it can be seen as a paradigm of the direct holding model. I guess, however, that most of the following considerations can be applied to other legal systems sharing the same model. Moreover, I will focus my speech on domestic situations. (*i.e.* Spanish securities held in accounts located in Spain)⁶.

I will leave outside my analysis the case of foreign securities held by investors in Spain but outside the Spanish CSD. This kind of holding can be characterized as indirect holding and the legal Spanish system should not have any problem in accepting the indirect holding conceptual framework for these type of cases.

1990, p. 305 and following. From a civil law perspective, see THÉVENOZ, “The Legal Concepts regarding the Holding of Investment Securities for a Civil Law Jurisdiction – The Swiss Draft Act”, *Unif.L.Rev.*, 2005-1/2, p. 301 and ff.

³ THEVENOZ, *loc.cit.*, p. 308.

⁴ *Explanatory Notes*, footnote 2.

⁵ *Explanatory Notes*, para. 2.2.

⁶ My personal intuition is that in cross border cases, once we have accepted the PRIMA principle, whatever type we finally choose, it seems rather difficult to keep on using the directly held securities conceptual framework. PRIMA compartmentalized the law at each national level generating layers of rights. I am almost convinced that the appropriate analytical framework to cope with that scenario is provided for by the indirectly holding model. See also, SPINK/PARE, “The Uniform Security Transfer Act: Globalized Commercial Law for Canada”, 19 *Banking and Finance Law Review*, p. 321 and following, p. 360.

§ 2. Securities under Spanish law

9. From the point of view of the investor, a security operates in two capacities: on the one hand, it constitutes personal rights against the issuer, and on the other, it is an asset. The former is a matter of company law and the latter is a matter of property law. The interest of the *issuer* is to have clear and transparent rules regarding in favor of whom it must fulfill its obligations and to prevent the inflation of securities⁷. The interest of the *investor* is to have a sound protection of his property against the issuer (= *issuer risk*) but also, in the case of intermediated securities, against other creditors of the intermediary (= *custody risk*). The way to protect this second risk depends on the way the security is represented. So, for instance, if it is incorporated into a document, investors can prevent that custody risk by keeping the paper themselves.

10. Under Spanish law, securities can be represented in two ways: by means of a physical document (certificate) and by means of an electronic book entry. In the first case, the security, *i.e.* the contractual claim *vis à vis* the issuer, is incorporated into a piece of paper and transferable by physical delivery (or by endorsement and physical delivery in the case of registered securities⁸). In the second case, the security is represented by a bite of information recorded in an electronic registry. In principle, the issuer may choose the means of representation. Nevertheless, when securities are going to be listed in a regulated market, they must be represented by book-entries. This means that, for these types of securities, Spain, like other countries, has opted for a fully dematerialized scheme (not for an immobilization scheme)⁹. In quantitative terms, the vast majority of Spanish securities (listed companies, government securities,...) are evidence *only* by electronic means.

As it has been suggested, this may have some bearing on the option for a direct or indirect holding model. Fully dematerialization does not by itself affect the direct relationship between investors and issuers, while mere immobilization does¹⁰.

11. To prevent any misunderstanding, it is important to know what we mean by the word "*representation*". That is, what do we mean when we say that something (a piece of paper or a book entry) "*represents*" the security? A look at this concept will allow us to understand many of the traits of a directly held securities model. When a security is represented in form of a physical document, it means that all the rights and obligations *vis à vis* the issuer are now attached to the document, *i.e.* "*incorporated*" into a document. The main function of this reification is to facilitate the circulation and the exercise of the contractual rights incorporated into the paper. The incorporation of an intangible (the contractual rights) into a piece of paper permits the application of the rules of circulation laid down for tangible assets, in particular, the publicity linked to the physical possession of an asset. For instance, the good faith acquiror is protected to the extent that he has relied on the appearance offered by physical possession.

⁷ Inflation of securities is a problem for investors but also for issuers who are confronted with contradictory obligations.

⁸ Under Spanish law, registered securities are transferable by endorsement. The modification in the registry of the issuer is not a condition for the transfer of the rights over the security, it only has a legitimizing effect *vis à vis* the issuer.

⁹ See, articles 51-52, D.A. 1^a of the Ley de Sociedades Anónimas and 5-12 of the Ley del Mercado de Valores.

¹⁰ GOODE, *supra* note 2.

12. The conversion of an intangible in a tangible is obviously a fiction. But a legal fiction (somewhere between a *fictio iuris* and a *fictio iuristae*) and therefore it has a fundamental consequence: *according to the law, the creation, the transfer, and the exercise of the rights can only take place as a consequence of the creation, the delivery and the presentation of the document.*

13. When the legal system recognizes that a security can also be represented by means of an electronic record (book-entry) is also a fiction. But, again, it may be a legal fiction with legal consequences. The legal system can foresee that in cases of book-entry securities, the rights arising from the security are now attached to inscriptions in a registry. And it take this idea with all its consequences: the legal system may laid down the principle that *the creation, the transfer, and the exercise of the rights can only take place as a consequence of entries in an electronic registry.* To the extent that this registry is "centralized" that principle would satisfy the interest of both issuers and investors alike. One fiction (the paper represents the rights) is replaced by another fiction (the electronic entry represents the rights).

14. Somehow that was the point of departure of the Spanish lawmaker in the late eighties when it decided to set forth a model of dematerialization of securities¹¹. The Spanish law is construed on the assumption that the new means of representation (book-entry) does not call for a radical change on the legal and conceptual framework traditionally applied to securities. Naturally, some modifications were necessary to adapt the legal regime to the technical and operational particularities of book-entry securities. Adaptation yes, but not radical changes. The lawmaker considered that the Spanish legal system offered enough tools to adapt the basic principle of the traditional law to the new way of representation without reducing the protection of investors. Basically, the technical adaptations required were to replace the physical possession of the certificate, as instrument of protection, for entries in an electronic registry. That is, the electronic registry could fulfill a function equivalent to the possession of the physical document. For instance, the obligation of custody of the documents in the case of materialized securities is replaced by the obligation of keeping the book-entry registry, the principle of good faith acquisition based on the appearance of physical possession is replaced by the acquisition based on the appearance of the electronic registry, the transmission by delivery of the document is replaced by entries in the registry, and so on.

As we will see in the next paragraph, to meet those objectives it was necessary to lay down some degree of centralization in the electronic registry *and to borrow certain principles from land-registry law* (see Art. 16 of the Royal Decree 116/1992)). We can discuss the correction of this option from a policy perspective, but even those who maintain a critical position recognized that those ideas were the point of departure of the Spanish law. This strongly contrasted, for example, with the position of the Swiss lawmaker who, if I am not mistaken, considered that the rules governing book entry securities can not be extracted from the traditional rules applicable to negotiable instruments¹². The same holds for the US, where one of the basic choices was that "the legal platform for the intermediated sector of the securities market could not be merely

¹¹ It is very recommendable to read the article produced by one of the "fathers" of the new regulation, PAZ-ARES, "La desincorporación de los títulos-valor", in *El nuevo mercado de valores*, p. 81 and following. See also RECALDE "Los valores negociables", in ALONSO UREBA/MARTINEZ-SIMANCAS, *Derecho del mercado financiero*, I-2, pp. 265 and ff., p. 301. But this is not "typical Spanish", see KHIMJI, "Intermediary Credit Risk: A Comparative Law Analysis of Proprietary Rights in Indirectly Held Securities", *J.B.L.*, 2005, pp. 287 and following (arguing that under English, US and Canadian law, a perfectly adequate solution to intermediary risk is available under the traditional law of property).

¹² THÉVENOZ, cited *supra* footnote 2, p. 307-308.

an adaptation of the law in place for the older forms of securities holding”¹³. The Spanish lawmaker, on the contrary, considered that there was no need to change the essence and to create a new type of property. In the following paragraphs we are going to see how the Spanish legal system was *adapted* to the new means of representation without reducing the level of protection offered to investors.

§ 3. The central securities depository: the general structure of Iberclear.

15. The Spanish system is based on the idea of a single registry where entries take place (= *central record-keeping based on accounting entries*). The organisation of intermediaries involved in the maintenance of such a book-entry registry depends on whether the securities are listed in a Regulated Market or not.

16. For *non listed securities* (as foreseen in Chapter III of Title I of Royal Decree 116/1992) the book-entry registry will be maintained by a *sole financial entity* (credit entity or investment services firm authorised for the activity of securities custody and administration) that shall register, at all times, the amount of securities owned by each holder, *i.e.* registering the securities directly in the name of each holder. This requires for each holder to open a securities account in such an entity.

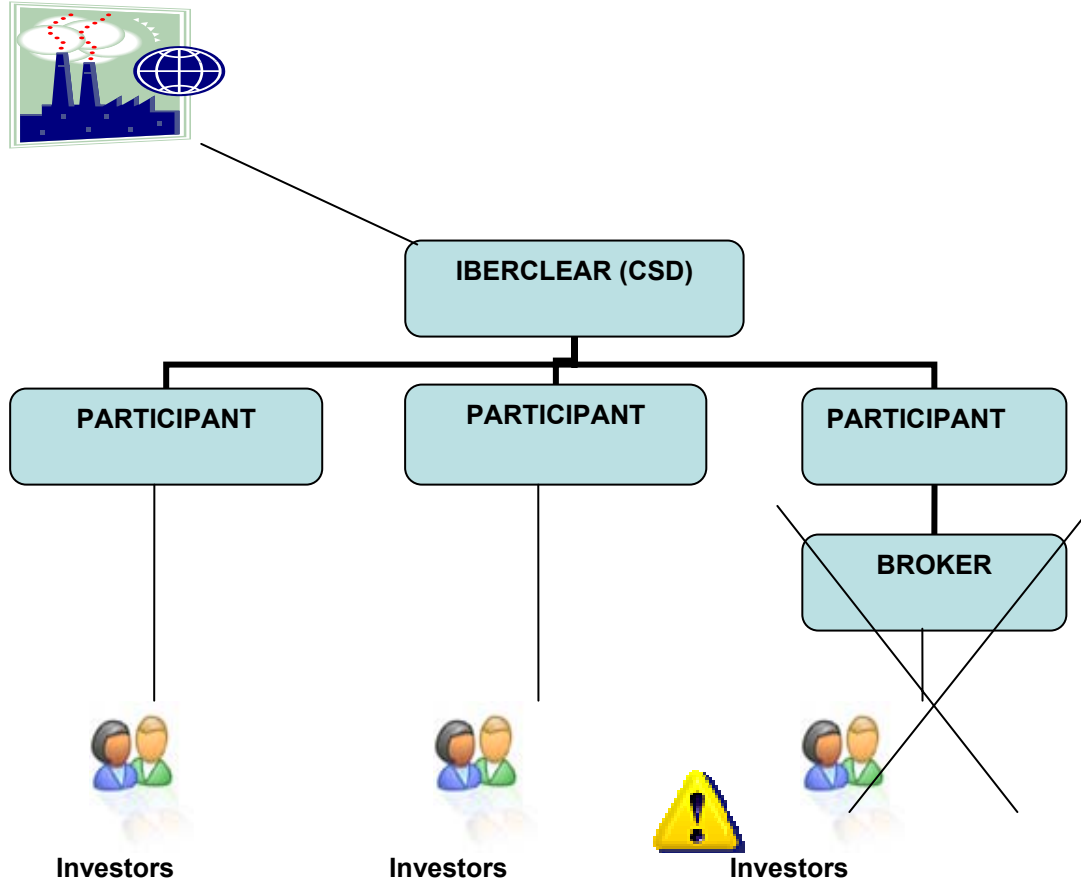
17. For *securities listed in Spanish Regulated Markets*, *i.e.* the Public Debt Market, Stock Exchanges and AIAF Fixed Rate Market, the book-entry registry is structured in a *two-tier system* (as foreseen in articles 29 *et seq.* of Royal Decree 116/1992). In such a system the registry is entrusted jointly to Iberclear and to its participant entities (the “participants”). The latter are financial entities that have a contractual arrangement with the manager of the system, *i.e.* the Central Securities Depository (CSD), Iberclear.

18. This book-entry two-tier registry system, is structured in *two levels*. First, a *central registry*, managed by Iberclear, containing the aggregate balances of securities issued in two types of accounts opened by Iberclear for each participant: (i) An account in which the securities owned by each participant are held; and (ii) Another account, different and entirely segregated from the latter, that reflects the total amount of securities held by each participant on behalf of its clients. Second, a so called *detailed registry*, managed by the participants in which each of them maintains in its own books the accounts opened by each investor, and in which the details of securities recorded in the name of each client is held.

¹³ REITZ, cited *supra* footnote 2, p. 361.

SPANISH HOLDING MODEL

Issuer



Two-tier centralized system:

First tier → Iberclear

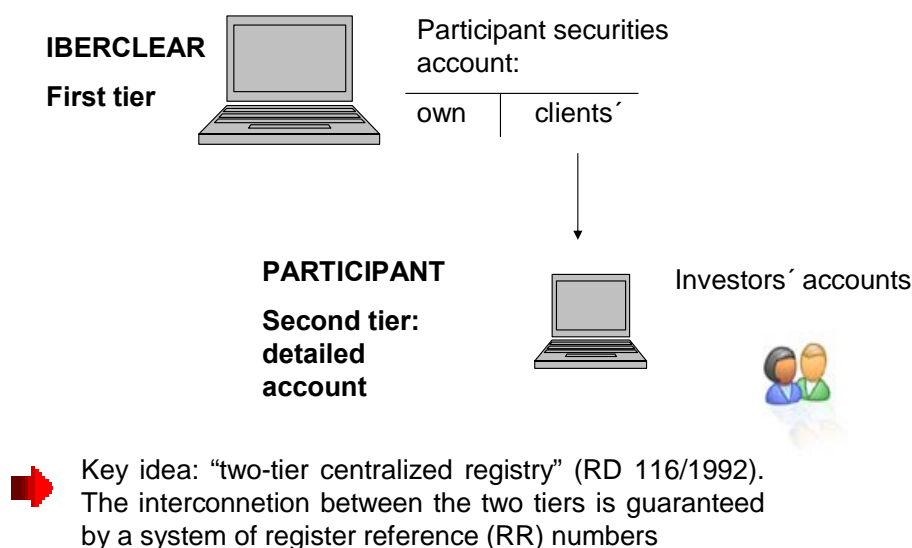
Second tier → Participants

19. Nevertheless, the law considers both levels as parts of the same registry (see Royal Decree 119/1996, "...a system of two tiers which is not contrary to the idea of a single electronic registry even though it is articulated through a central registry and detailed registries...")¹⁴. The system guarantees the *connexion* between those two levels by a code: the so-called *register references* ("referencias de registro"). This allows the system to keep a historical register of all operations and account entries. All operations are numbered, and Iberclear communicates this number to the participants who, in turn, file it away in order to facilitate later enquiries about a given operation or to resolve incidents.

¹⁴ The account on behalf of its clients that each participant has in Iberclear, though it reflects the total sum of all of its clients' securities, cannot be considered an *omnibus* account. The Spanish legal system only foresees *omnibus* accounts "outside Spain", when they are indispensable for conducting activities in foreign markets (see, article 2 of the Order of 7 October 1999).

As explained in the web page of Iberclear (www.iberclear.es/Iberclear/home/home.htm): "All operations are numbered,... The operation number consists of 15 digits, and in the case of Stock Market trade is supplied by the Stock Exchanges, as they are the source of that operation. When, as a result of a purchase or other type of change of ownership, securities are credited to new holders (or at the moment of the initial registration of the issue), the operation number becomes what is known as the Register References (RR). This RR number is entered into the register when the participant, by means of a sale, changes ownership or cancels it from the system. This results in the cancellation of the original ownership by replacing it by the RR. With the maintenance of these RR numbers and the rules for keeping them up to date, the aim is to strengthen the synchronisation between the central and the individual registers. This will avoid authorising the settlement of a sale trade against the overall balance of a participant whilst the participant is unable to identify the securities trade and their original owner."


REGISTRY AND ACCOUNTS



20. To summarise, an entry at the lower level formally can only be made when the corresponding register reference number has been assigned at the upper level, and accordingly any transfer at the lower level is reflected by a number at the upper level. As we are going to see in the next paragraphs, this has several consequences: (a) it prevents that a credit could take place without a corresponding debit, and therefore prevent situations of shortfall, (b) it allows to trace back operations, (c) or it may even give way to the application of the conceptual framework of the doctrine of appearance to the electronic entries¹⁵.

¹⁵ PAZ.ARES, *loc.cit. supra* footnote 11, at p. 100.

21. In order to present a clear picture of the Spanish system two more clarifications may be helpful.

22. *First.* Under Spanish law, the recording of the issue in the central registry (Iberclear for listed securities) determines that the securities are duly constituted as book-entry securities (Art. 8 of the Securities Market Act: “securities represented by book entry shall be classified as such by virtue of their entry in the relevant book entry records...”). Therefore (and for listed securities): *only securities recorded in securities account that are opened in the CSD and its participants are considered under Spanish law as authentic securities that generate a valid direct legal relationship between the issuer and the investor.* In this sense, it is very eloquent that the lawmaker has laid down an “exclusive denomination rule”: The expression book-entry securities (“valores anotados en cuenta”) can only be used in relation to securities registered in the CSD and its participants (Art. 5 of the Royal Decree 116/1992). This implies that all the Spanish legal system is construed on the idea of a “two-tier centralized registry” where “sub-tier intermediaries” (in Spain) are not acceptable (see first picture ¹⁶).

23. *Second.* The fungibility of the securities cannot be invoked as an argument against those principles. Under Spanish law, the fungibility character is only applicable for operational purposes, that is for clearing and settlement operations and implies that any unit is interchangeable for the purpose of delivery (art. 8 *in fine* of the Ley del Mercado de Valores). As has been pointed out “Though intangibles may not be capable of identification in the physical sense, they are capable of allocation, and this facilitates tracing”¹⁷. The RR number is electronically linked to a certain and traceable amount of fungible securities. That number is also used for corporate law purposes¹⁸. To the extent that there is a central registry with a historical record of all transactions over the securities, we can consider that investors are owners of an identifiable property (=direct holders of a certain amount of securities *vis à vis* the issuer and also *vis à vis* third parties).

24. This organizational and legal framework has relevant consequences for our analysis.

§ 4. Legal consequences

§ 4.1. First: no “new kind of property”

25. Under Spanish law the model of a “central record-keeping based on formal accounting entries” permits to maintain the conceptual framework of direct holding. The name of the owners of the securities (=investors) must appear in the detailed registries of the participants in Iberclear, and those owners have a *direct right vis à vis* the issuer and *vis à vis* third parties, including the right to receive and enjoy the fruits of ownership of the securities, the right to dispose of the securities, the right to cause the securities to be placed in the accounts of another participant in Iberclear, and so on. Accordingly, if the issuer does not fulfill its obligation, the investor is the only person authorized to sue the issuer, he therefore must act as plaintiff action on his own capacity. In cases of insolvency of the participant that manages the investor’s account, his securities are moved by the National Stock Exchange Commission *ex officio* to another participant (with more detail *infra* § 4.5). On the contrary, if the securities have not

¹⁶ RECALDE, *loc.cit.*, *supra* footnote 11, at p. 301.

¹⁷ BENJAMIN, *apud* GOODE, *loc.cit.* *supra* footnote 2, at p. 170.

¹⁸ For example only securities acquired before five days prior to the date of the General Shareholder’s Meeting may attend the meeting. As 6 out of the 15 digits of the RR number represents the date in which the securities were acquired (i.e. 905091541234567, the bold digits meaning 15 September 2005), only securities with the appropriate RR may attend and vote in the GSM. This is controlled through electronic means, as issuers receive on demand from IBERCLEAR a full list of all the RRs that are “alive” of a given issue when a GSM is called.

been credited according to the corresponding process to the account of the investor, in principle the investor is not going to be considered as holder of the securities (see Art. 11 of the Ley del Mercado de Valores)¹⁹. Spanish law is based on the principle that the real owner must appear in the books, and therefore whoever appears in the book is legally presumed to be the owner.

Of course, to exercise the rights arising out of the securities, the investor may need the assistance of the intermediary, but in doing so, the intermediary exercises *rights of the investor* in the capacity of an attorney or of an agent.

26. According to this approach, the Spanish lawmaker has not considered it necessary to create a “new type of property/asset” to cope with the book-entry securities world. There is no division of entitlements “in tiers”, nor any sort of split ownership between investors and intermediaries. There is no difference between legal and beneficial owners either (*i.e.*, there is no “*nominee accounts*”). And there is no room for any kind of legal entitlement different from the underlying security, not even for any kind of co-ownership over a pool of securities. It is important to insist on this point: under Spanish law (corporate or property law), neither the CSD nor its participants have any proprietary or personal right or interest over the securities of investors. *Intermediaries are mere record-keeping institutions.*

It may be the case that *de facto*, and contrary to the foresights of the Spanish lawmaker, an intermediary places himself between the participant in Iberclear and the final investor (see, in the diagram Broker). The position of the investor in this situation is not expressly contemplated by Spanish law. It could be argued that he only has a contractual right *vis à vis* his intermediary, or it could also be argued that under general rules of civil law he has a proprietary right to the extent that he can offer fully evidence that Broker was a mere fiduciary owner. The second understanding seems to be, *prima facie*, more sensible. However, this result can be achieved through the application of traditional principles of civil law, without reinventing the legal framework or creating a new type of entitlement.

§ 4.2 Second: transmission of property by means of credits and debits.

Excursus

27. Under Spanish law, the transmission of ownership over securities requires two elements: (a) the existence of a valid agreement and (b) the delivery of the security. In the case of “dematerialised securities”, the law has substituted physical delivery of the document by book-entry in the corresponding registry. This means that recording or crediting the securities in the securities account of the buyer has legally the same effects that are afforded to the delivery of physical securities. In this sense, article 9 of the Ley del Mercado de Valores states that “*Transfer of book-entry securities takes place by means of account transfer. The inscription of the transfer in favour of the acquirer will produce the same legal effects as the delivery of the physical securities*”. The same applies to the creation of a security interest, which is only perfected and binding *erga omnes* when recorded in the relevant securities account.

28. In relation to this, it is important to emphasize two other points. *First*, that a book entry is not in itself enough to transfer property. If there is no title (typically a contract) or the title is null and void, the mere credit of securities to a securities account does not create a valid proprietary right in favor of the account holder (see, for instance, Art. 9 I *in fine* of the Ley del Mercado de Valores and Art. 12.5 of the Royal Decree 116/1992)²⁰.

¹⁹ As in the case of land registries, where the person whose name appears in the registry is considered to be the owner of the land.

²⁰ *I.a.*, PAZ-ARES, *loc.cit. supra* footnote 11, at p. 100.

Apparently, the Spanish legal model does not fit well within the model of the UNIDROIT project, where a “principle of abstraction” of the transmission of property seems to be laid down (see, arts. 3, 4 and 5).

29. *Second*, that the terms “book-entry”, “credit”, and “debit” have a particular technical meaning. Though questioned by some legal scholars, Spanish law seems to turn around the idea that the transmission of property rights over the securities only takes place by means of credits and debits *made according to the rules of the system, that is, in the case of listed securities, under the rules aforementioned (supra § 3)*. So, for instance, a participant can only make a valid credit to a securities account of one of its clients, with proprietary effects, if the central system has assigned that participant the corresponding RR number²¹. In this sense, the “book-entry registry” is conformed as an ownership-in-securities *formal* registry made up not with paper books (as the Real Estate Registry), but with several securities accounts on which securities are inscribed and held in the name of their owners. Colloquially it can be said that, under Spanish law, “in order to determine the ownership we have to look into the computers of the intermediaries”.

Excursus. Under Spanish law, credits and debits imply more than a mere legal relationship. They require a record in the registry, and in a particular way: through the iberclear scheme (for listed securities). So, unlike in other countries where a credit takes place by a mere confirmation to the account holder or by any form that identifies the security as belonging to the purchaser²², under Spanish law an investor only acquires a proprietary right when the inscription in the “two-tier central registry” takes place. The investor may have paid and may have received a confirmation by his intermediary, but if a formal credit under the rules of the central system has not taken place, the investor does not have a proprietary right over the securities (naturally, he may have a contractual claim against his intermediary or may get the benefits of a public or private insurance). This may be good or bad policy, but it is a corollary of a model of book-entry securities based on a two-tier centralized registry.

In his well-known article in the UCLA Law Review, professor ROGERS put the following example: “Suppose that at Time 1, Broker acquires 10.000 shares of XYZ Co. common stock for its own property account at a time when none of Broker’s customers are holding XYZ Co common stock through it. Thereafter Customer places a buy order for 10.000 shares of XYZ Co. common stock through broker, to be credited to Customer’s securities account with Broker. Broker takes Customer’s money and falsely reports to Customer that it has purchased 10.000 shares for Customer’s account, but in fact, Broker does not do so. If Broker fails...Under revised Article 8, the answer is clear Customer wins”²³. This paragraph is very useful to illustrate the different approach to the concept of “credit” and “debit”. Under a fully-regulated and centralized book-entry system, the fact that Broker reports Customer the acquisition of the securities does not imply the acquisition of the ownership over the securities, so Customer would not have any proprietary right over the securities. Nothing has been credited. For the same reasons, ideas like “the creation of a security entitlement is not dependant upon whether an intermediary actually holds or acquires a financial asset”²⁴ are conceptually very difficult to accept in the cases of centralized registries.

²¹ As pointed out, this understanding is questioned by some scholars, nevertheless most of the rules issued by the competent authorities seem to be based on that assumption.

²² “Identification requirements”, see MOONEY, *loc.cit. supra* footnote 2, p. 331.

²³ ROGERS, *loc.cit. supra* footnote , at p. 1515.

²⁴ SPINK/PARÉ, *loc.cit. supra* footnote 6, p. 363.

This difference in the understanding of those two terms makes me think whether it would not be advisable to include a definition of credits and debits in the UNIDROIT Convention, or at least a definition of *the requirements under which a "credit and a debit" can take place*. Otherwise, in countries like Spain it would not be easy to interpret that a credit in a securities account takes place by a mere "report" to the investor.

30. *Mutatis mutandi*, the same approach holds for security rights. The creation of a security interest calls for an electronic entry which implies a sort of dispossession. A pledge, for example, implies an electronic entry in the registry of the intermediary which blocks the concrete RRs corresponding to the specific securities being pledged. It is a full "earmarking" inside the account.

This contrasts again with the text of article 2 of the 2004 UNIDROIT project according to which a security interest can be created by mere "designation", without any sort of electronic entry in the corresponding registry. Again, a system based on a fully-regulated "two-tier centralized book-entry registry" would usually require some form of electronic entry in the registry to perfect the security interest.

§ 4.3. Third legal consequence: Credits and corresponding debits. Traceability

31. In the typical indirect holding system an investor has a security entitlement. A security entitlement can be defined as the package of rights that a person has against the person's own intermediary with respect to the positions carried in the person's securities account. That package of rights is not, as such, something that is traded. In most cases, settlement of securities trade will involve termination of one person's security entitlement and acquisition of a new security entitlement by another person. That transaction is not, however, a transfer of the same entitlement from one person to another²⁵. The model is based on the idea of extinction and creation of rights. Therefore, there is no conceptual problem in accepting that there can be a credit without a debit. For the same reason, the rules of traceability have no place in this context (see also Art. 3 of the 2004 UNIDROIT Project, and in particular the Explanatory Notes accompanying that article).

32. In direct holding systems, the transfer is the transfer of the same asset: the securities and the rights arising thereof. That is why, in these systems, it is not conceptually easy to understand the idea of "credits without corresponding debits". One can only acquire a thing if there is somebody elsewhere who has lost it. The introduction of the *fungibility* element does not necessarily call for a reconsideration of this principle to the extent that the system is able *to allocate portions of fungible securities* (see *supra* n. 29).

33. Precisely, this is what happens under Spanish law. As we have already seen, all transferors and transferees are directly or indirectly connected with a central program. The system assigns portions of securities to account holders. Each portion corresponds to a number, which is also reflected in the central registry. When a transfer takes place, one register reference (RR) is cancelled (the one corresponding to the debit) and a new one is issued (the one corresponding to the credit). This guarantees the exactness in the matching of credits and debits, and therefore explains why the basic principle of the Spanish law, unlike the UNIDROIT project, is that there cannot be credits without corresponding debits (see Arts. 16 and 32.2 of the Royal Decree 116/1992 "no credit or debit can be undertaken if the corresponding reference registry number has not been cancelled and issued).

²⁵ See para 5 of the Official Comment to Rev. Art. 8-501 UCC

34. A corollary of this operational system is that theoretically it allows for traceability. The system stores the information of all transactions at least for five years (see Art. 28 of the Royal Decree 116/1992). This information permits the historical reconstruction of entries (credits and debits), and accordingly, if there is a mistake, the program can trace where it comes from.

Because of the operational rules of the system, the need to trace back a succession of entries would be very rare (and, naturally, without disturbing the principle of finality). But it does not affect the theoretical underpinning principle: traceability is factual and legally feasible. This contrasts, again, with the UNIDROIT Project (see *Explanatory Notes* corresponding to Art. 3).

§ 4.4 Fourth consequence: loss allocation. My securities belongs to me;

35. The basic principle, either in the *direct* holding systems or in the *indirect* holding systems, is the duty of the intermediary to hold sufficient securities of a given description with respect to the number of securities of that description that are booked to its clients' accounts. This is the rule in the UNIDROIT Project (see Art. 14 of the 2004 Project and 16 of the 2005 Project) and it is also the rule under Spanish law. In order to implement this principle, under the rules of the Spanish "two-tier centralized system", a participant cannot credit a security to one of its client's account without the corresponding credit in its account in the CSD. This is guaranteed by the register reference number (RR). A participant cannot make a credit to one of its client's account until it has received the corresponding RR number from the CSD. This number ensures the matching, *i.e.* that an equivalent amount of the same type of securities has been debited in the account of the transferor. This centralized control makes cases of shortfall very rare. It is important to keep this in mind to understand the following considerations.

36. The immediate obligation of the intermediary to eliminate an imbalance is also the rule under the UNIDROIT Project (see Art. 14.2 of the 2004 Project and 16.2 of the 2005 Project). An equivalent obligation is foreseen under Spanish law. If, for whatever reason, a credit in the client's account has not been effectively made, the intermediary must proceed to acquire the corresponding amount of securities and credit them to that client's account (see Art. 27.4 of the Royal Decree 116/1992)²⁶. In principle, it does not make any difference whether a system is characterized as direct or indirect holding to lay down this obligation.

37. Cases of shortfall calls for a more precise analysis. A shortfall may happen when the intermediary goes bankrupt or when there are no securities available in the market to cover the imbalance. In these situations, a provision for the allocation of the shortfall is needed. *Indirect holding systems* have no problem in accepting a rule of mutuality of losses: the remaining securities "...shall be allocated among the account holders to whose securities accounts securities of the relevant description are credited, in proportion to the respective numbers or amounts of securities so credited" (see Art. 16.1 of the 2004 UNIDROIT project and Art. 18.1 of the 2005 UNIDROIT project).

This solution does not pose any problem to the extent that, in indirect holding systems, the investor holds an entitlement over the pool of securities held by his intermediary. The only open question is the rule of distribution. The pro-rata assignation can be carried out "security by security" ("...among the account holders to whose securities accounts securities of the relevant description are credited", see Art. 16.1.b of the 2004 UNIDROIT project and 18.1.b of the 2005 UNIDROIT project), or by creating a "customer pool

²⁶ The rules of the systems allow the very CSD (Iberclear) to buy the corresponding securities in the market on behalf of the participant (see Circular 1/2002 of Iberclear).

fund", *i.e.* spreading the shortfall evenly among *all customers* (not just among those whose entitlement relates to the particular financial assets in which the shortfall occurs)²⁷.

38. For some *direct holding systems* the adoption of that rule does not present difficulties, but for others, like the Spanish system, it does. Some direct holding systems establish that the account holder is the *direct co-owner* of a pro-rata portion of the securities held with his intermediary. For these systems, in cases of shortfall, the rule of distribution adopted in the UNIDROIT project does not present too many difficulties²⁸.

39. On the contrary, in those systems based on a centralized registry with particular allocations of securities among account holders, that rule of distribution does not fit well. As we have explained, under the Spanish "two-tier centralized registry" each account holder has the guarantee that if the securities have been credited to his account, there will be a corresponding amount in the CSD to match that credit. The basic rule of "no credit without the corresponding debit" and the regulated process of crediting and debiting make situations of shortfall extremely rare. In fact, the Spanish law does not foresee a specific rule for shortfall cases. This can also be explained as a technical point: as in the case of traceability, by looking into the system it is possible to assign specific amounts of securities (in the CSD) to specific account holders (in the detailed registries of the participant).

One could argue: but what happens if the participant (intermediary) lies to the customer and falsely reports to him that a certain amount of securities have been credited to his account? Is it not a case of shortfall? (see Example given by professor ROGERS, *supra* n° 29).

This question brings us back to the concept of "credits and debits" (*supra* n° 29). Under Spanish law, a "credit" means a real credit in a two-tier centralized registry and according to certain operational rules. This makes it very difficult to imagine cases in which the same amount of securities are credited to two different account holders. In order to legally affirm that a security has been credited to a client's account it is not enough, for instance, a report –confirmation- of the intermediary to that client. Therefore if the intermediary falsely reports to his client that a security has been credited to his account, but actually it has not (according to the rules of the system), that client will have a contractual claim against that intermediary (which by law is obliged to buy the corresponding securities, see *supra* n° 36), will get benefit from investment guarantee schemes or any other kind of insurance, but he will not have a proprietary right over the securities duly credited to other account holders's securities accounts. These other account holders will cry: "my securities, duly credited to my account, belong to me" This results can be fair or unfair but, again, it is consistent within a model of book-entry based on a fully-regulated two-tier centralized registry.

§ 4.5 Insolvency

40. The former explanations pave the way to understand the solution adopted by the Spanish lawmaker in cases of insolvency of an intermediary (*i.e.* a participant in the Spanish CSD). The basic principle is common to other legal systems. In the case of securities credited in

²⁷ This seems to be the rule adopted in Canadian insolvency law, see SPINK/PARÉ, *loc.cit. supra* footnote 6, at p. 375.

²⁸ I presume that for these systems it would be more difficult to accept the "Canadian solution" (though I personally think that this solution is the most consistent within the indirect holding systems framework)

the securities accounts, the insolvency of the intermediary will not affect the investor's rights, since they are not contractual rights against the intermediary, but property rights recorded in the securities account held by the intermediary. Therefore, these rights recorded in the accounts are never commingled or otherwise mixed with the intermediary's assets.

41. One of the advantage of the Spanish "two-tier centralized system" is that it facilitates the exercises of the rights of *separatio ex iure dominii* from the insolvency estate. In the case of securities listed for quotation in official secondary markets, according to article 44 bis 9 of the Ley del Mercado de Valores, should an insolvency proceeding be opened against a participant in the Spanish CSD, the Stock Exchange Commission (CNMV) shall, immediately and at no cost to the investor, transfer the securities credited in his securities account to another firm authorised to perform this activity. In the same way, the owners of such securities may request for them to be transferred to another firm. If no firm is in a position to take on the responsibility for the aforementioned records, this activity shall provisionally be undertaken by the CDS itself until the owners request that the registration of their securities be transferred. This system is less cumbersome for investors than other options to the extent that they do not have to lodge any claim in the insolvency proceedings to implement his rights of *separatio*.

This rule can only be understood under the strict concept of "credits and debits" laid down by Spanish law (*supra* n° 29). Only those account holders who have their securities duly credited under the rules of the system can be identified and therefore get the benefits from this *separatio ex officio* carried out by public authorities.

§ 4.6. Upper tier attachment

42. In an indirect holding scheme a debtor's securities entitlement exists only against the debtor's own intermediary. That debtor has no rights against any other upper-tier intermediary or even against the issuer. That explains why it is legally impossible any upper-tier attachment in those systems. In fact, it could be argued that in those systems a rule prohibiting an upper-tier attachment would not really be necessary. It fulfills a mere function of clarification. As has been said "It is therefore impossible to draft a rule prohibiting the attachment of property within a legal framework where that property does not exist"²⁹.

43. In a direct holding scheme an upper-tier attachment is conceptually feasible. The fact that the investor is the direct owner of the securities necessarily implies that the asset is the same all along the chain and therefore that an attachment at the upper-tier should be conceptual acceptable. The only problem is of a *technical nature*: when at the upper-tier level it is not possible to segregate an amount of securities as pertaining to a particular investor, the attachment cannot be executed. However, if there is a technical way to identify the securities at an upper level, the upper-tier attachment should be accepted. What is more, it could be the only way to adequately protect the beneficiary of the attachment against abuses or fraudulent disposition by the debtor.

44. The "two-tier centralized model" underpinning the Spanish system may allow for that identification. In practice, credits, debits and attachments take place in the registry either in the central tier (kept by Iberclear) or in the detailed tier (maintained by its participants) of the registry. But in this latter case, Iberclear, as the upper-tier intermediary, records all transactions (credits and debits, and for debt securities also other kind of dispositions like security interest). Accordingly, with the pertinent information, nothing precludes an attachment at this upper level. In fact, this is what usually happens in certain cases: blockings or attachments of debt securities

²⁹ SPINK/PARÉ, *loc.cit. supra* footnote , at p. 369.

listed in the Public Debt Market or in AIAF Market, both of which are maintained and settled in a special platform (CADE), do produce a simultaneous attachment on either tiers or levels.

In this sense, the absolute prohibition of upper-tier attachment laid down by the UNIDROIT project (see Art. 8 of 2004 project and Art. 9 of 2005 project) should be revised. In cases of direct holding systems, where, at the upper-level, the operational rules permit the identification of a certain amount of securities as belonging to a particular investor, upper-tier attachment should be accepted.

§ 5. Conclusion

45. There are two main conclusions that can be drawn from the former analysis.

First. In principle, the functional approach underpinning the UNIDROIT project is feasible. Most of the practical rules can be designed to fit both conceptual models: direct or indirect holding systems. However, there are certain issues where the two systems may be irreconcilable and, if this is the case, the only way out is to foresee an exception to the general rules.

Second. As we have seen, this irreconcilability derives not so much from the “conceptual framework” (direct vs indirect holding) but from the characteristics of the operational and technical rules governing certain systems. System, like the Spanish, based on a “two-tier centralized registry” (a “hub and spokes scheme”) may call for certain exception to the general rules laid down by the UNIDROIT project.

Direct and Indirect Holding Systems

How can they coexist and be connected
internationally?

A functional approach

15 September 2005

Hideki Kanda

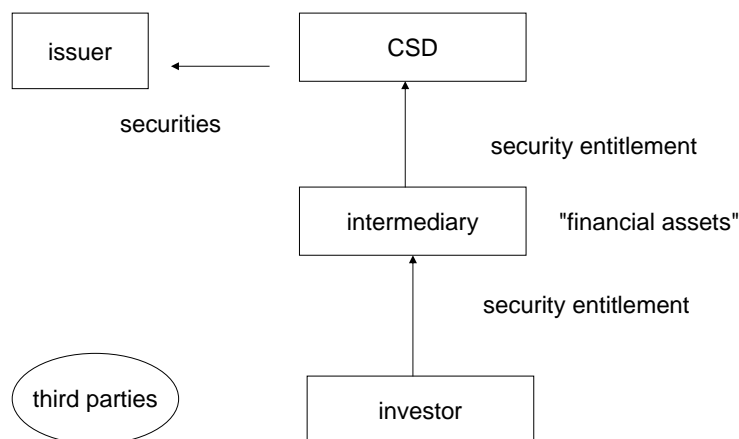
University of Tokyo

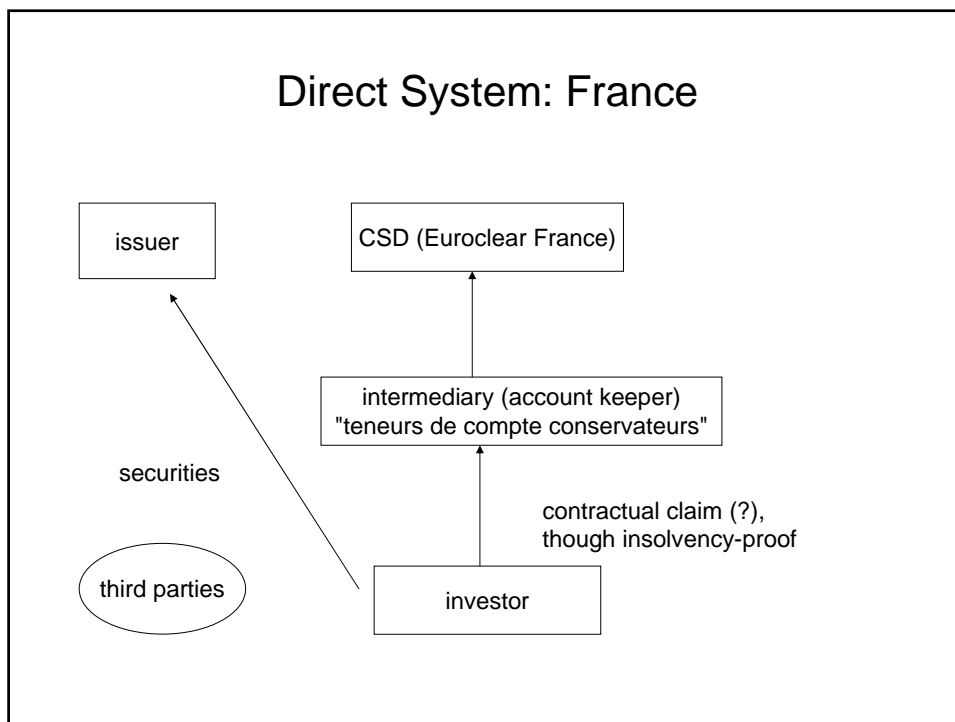
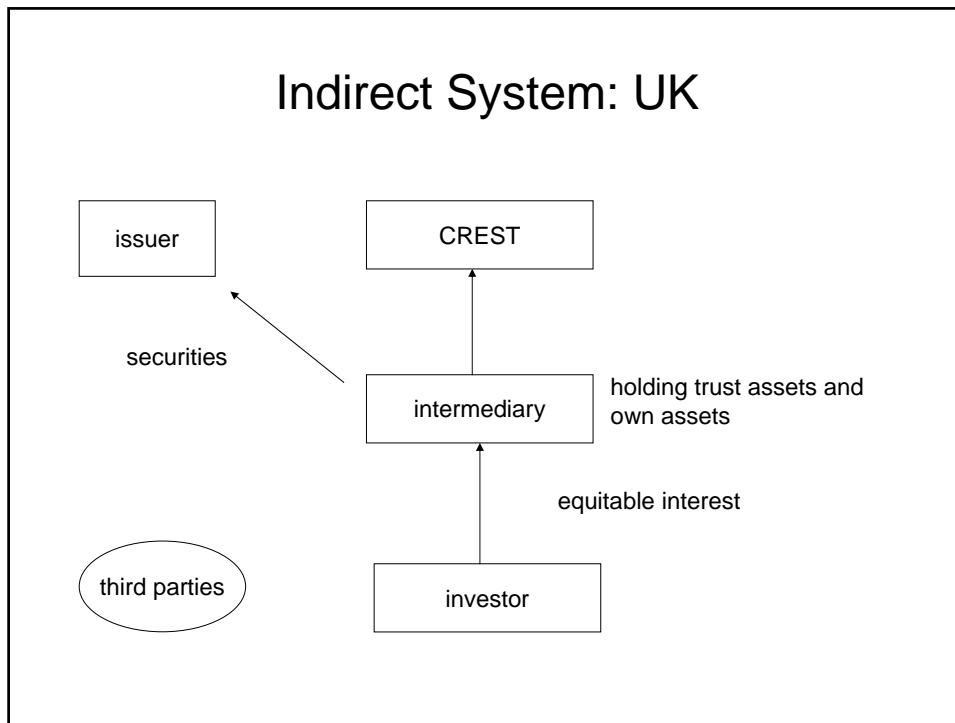
Topics in my presentation

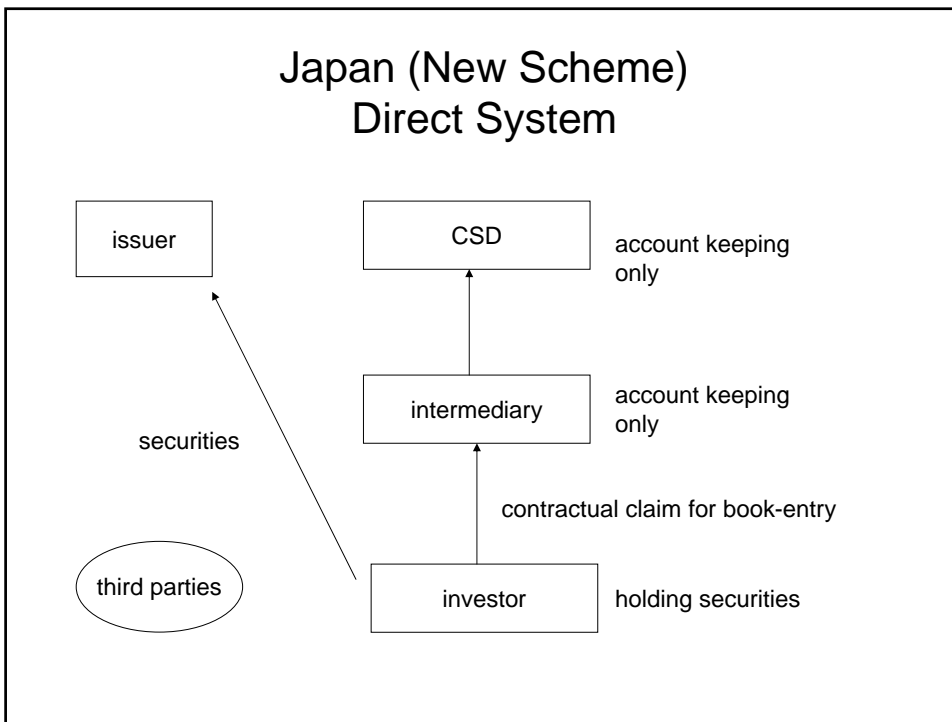
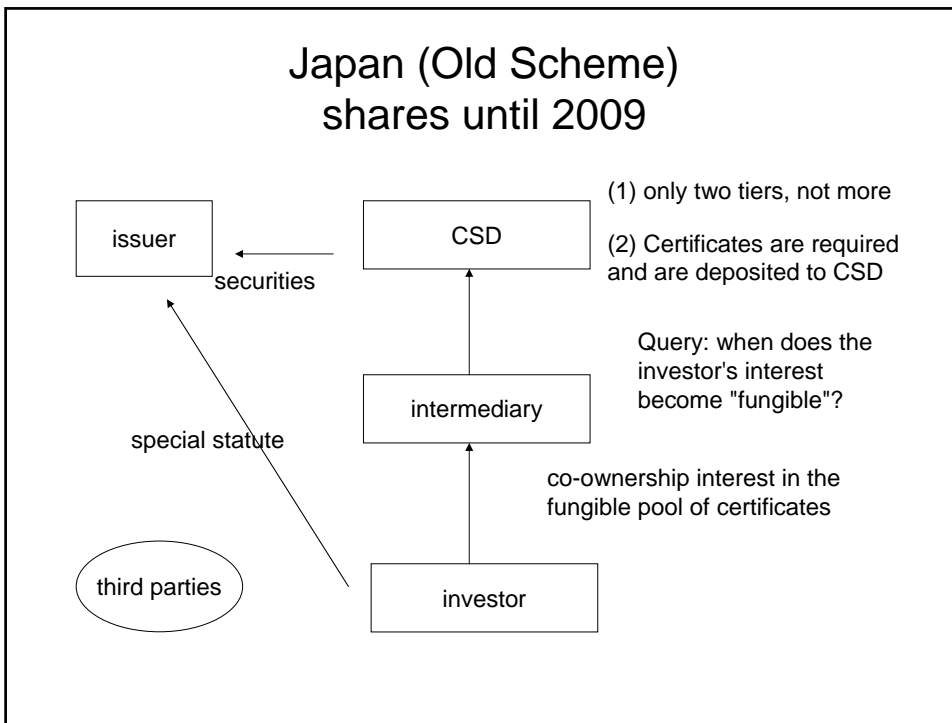
- Topics to be dealt with
 - "direct" versus "indirect" holding systems
 - acquisitions and dispositions (basics)
 - matching debit and credit entries
 - upper-tier identification and upper-tier attachment
 - tracing (in general) and loss-sharing
- Topics NOT to be dealt with
 - effectiveness of book-entry
 - good faith acquisitions

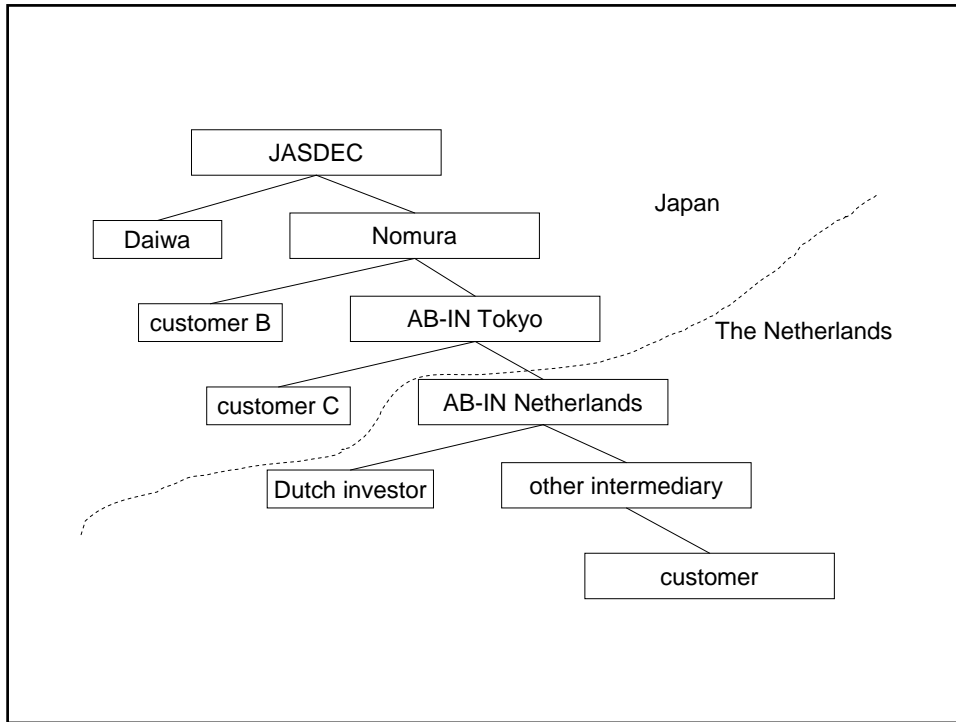
I. Direct versus Indirect Holding Systems

Indirect System: US









lower-tier intermediaries

JASDEC's Book

Nomura		Daiwa		customer A	
own	customer				

Nomura's Book

AB-IN Tokyo		other int.		customer B	
own	customer				

AB-IN Tokyo's Book

AB-IN Netherlands		other int.		customer C	
own	customer				

AB-IN's Book

other int.		other int.		Dutch Investor	
own	customer				

Description of current law

- The "common law - civil law" distinction is not helpful.
- Rules are hopelessly different among major jurisdictions.
 - US and UK are different.
 - France, Germany and Japan are different.

A Functional Approach: 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.

A Functional Approach:
Method of a transfer or pledge
Is a book-entry the necessary and sufficient
conditions?

US	UK	France	Germany	Japan
yes (in most cases)	?	yes	?	yes

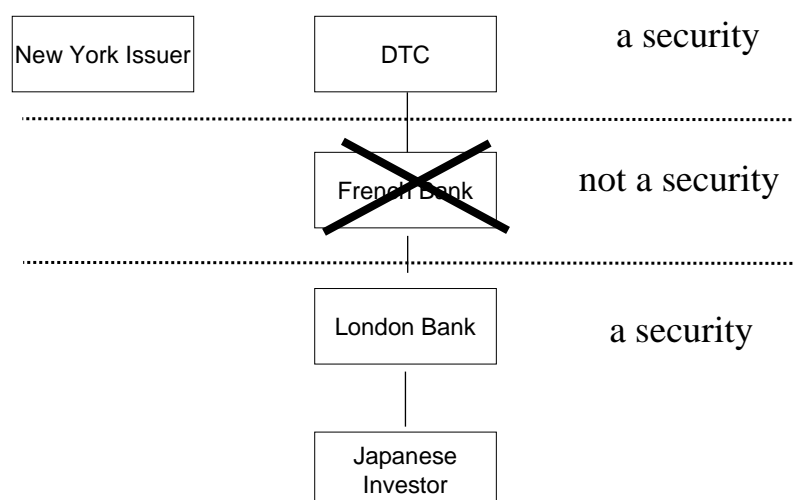
Prescription:
A functional approach

- internal soundness (workability):
 - Any system must operate properly as such in response to indirectly held situations.
- compatibility (connectibility):
 - Even if one system as such is "workable," two different workable systems must function properly when two systems are combined in international transactions.

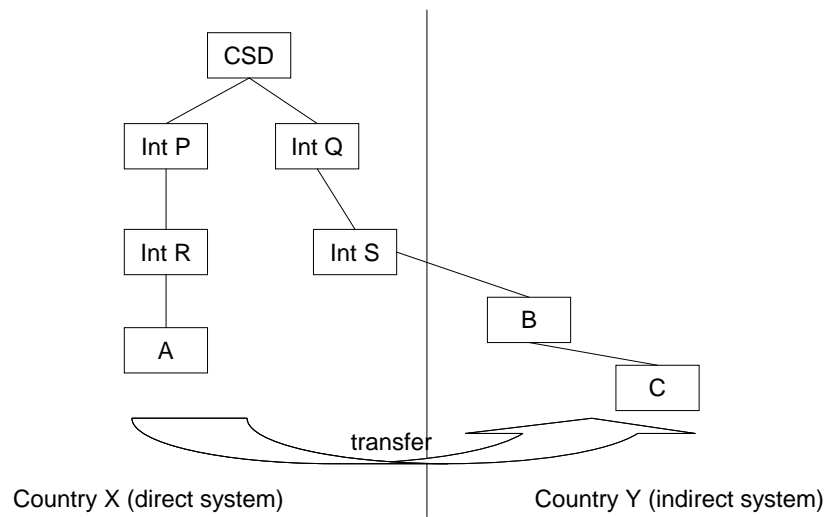
Prescription: A functional approach: a few items

- internal soundness (workability):
 - effect of the intermediary's insolvency
 - effect of book-entries
 - intermediary's right to use customers' securities
- compatibility (connectibility):
 - What if a financial instrument is a "security" in one jurisdiction, but not in another jurisdiction?
 - How can direct and indirect systems be combined?

An example for compatibility

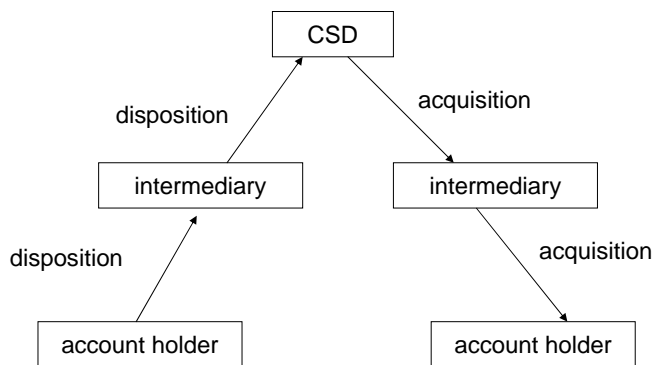


Another example: Is a book-entry the necessary and sufficient condition?

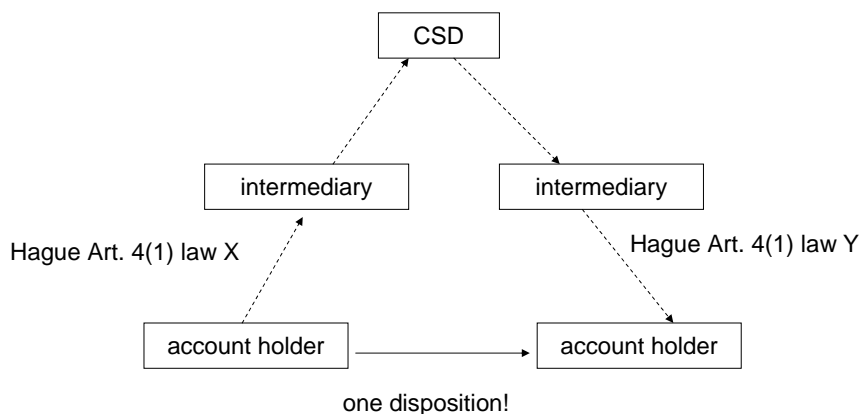


II. Acquisition and Disposition

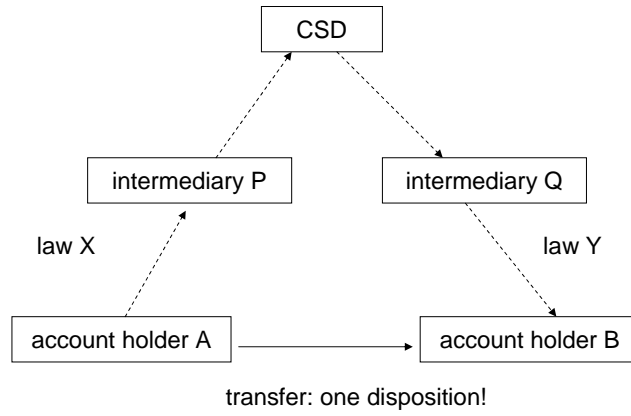
Dispositions in the stage-by-stage jurisdictions (indirect system)



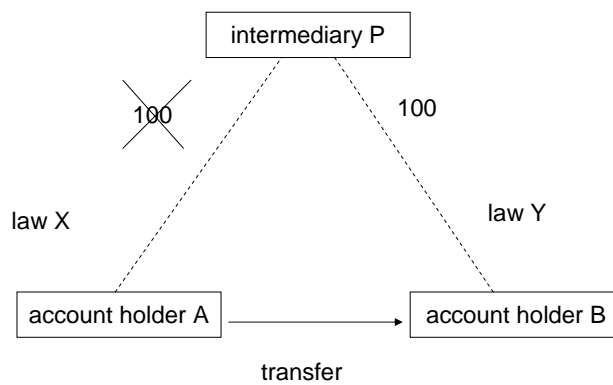
Dispositions in most civil law jurisdictions (direct system)



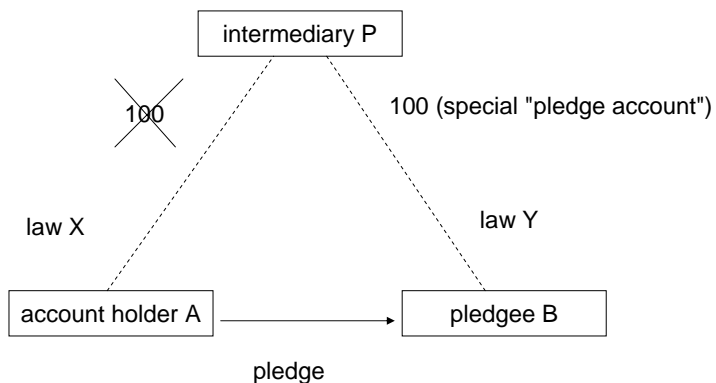
Page 37 /Footnote 28 problem (1)



Page 37 /Footnote 28 problem (2)



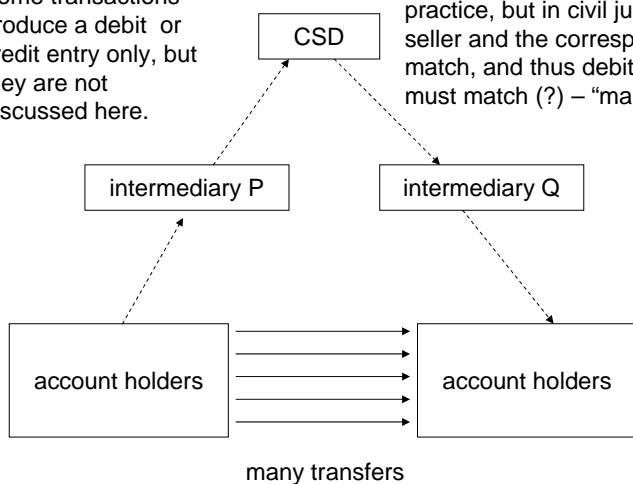
A pledge is credited to the pledgee's account in Japan (and in some other jurisdictions?)



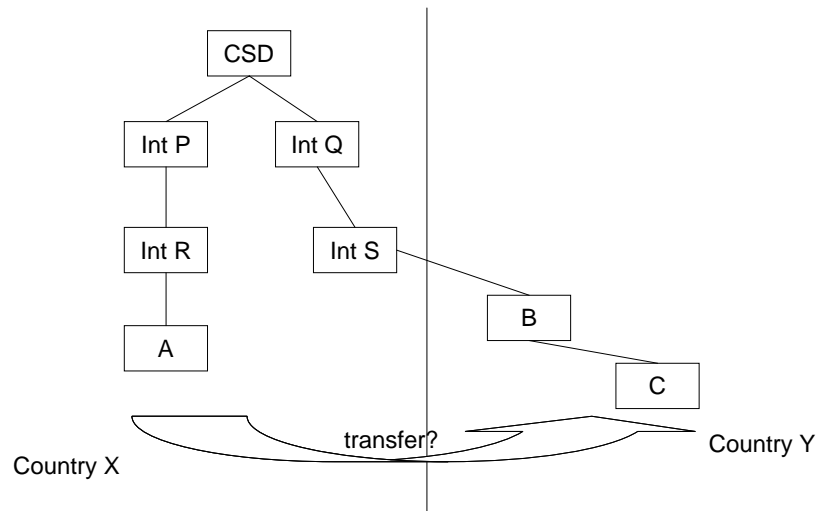
Matching debit and credit entries

Some transactions produce a debit or credit entry only, but they are not discussed here.

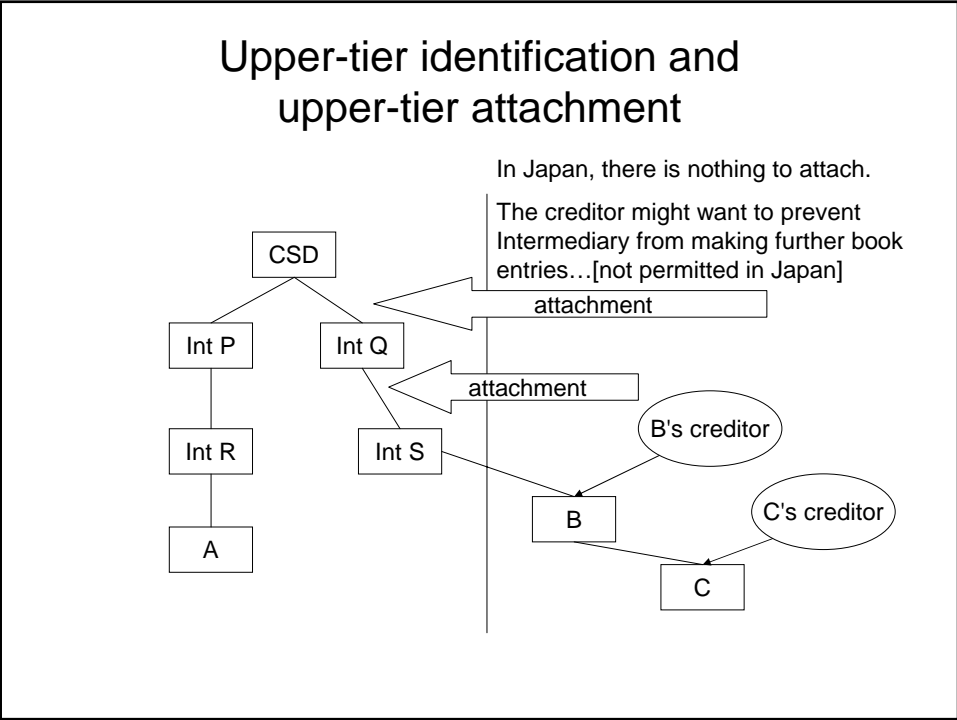
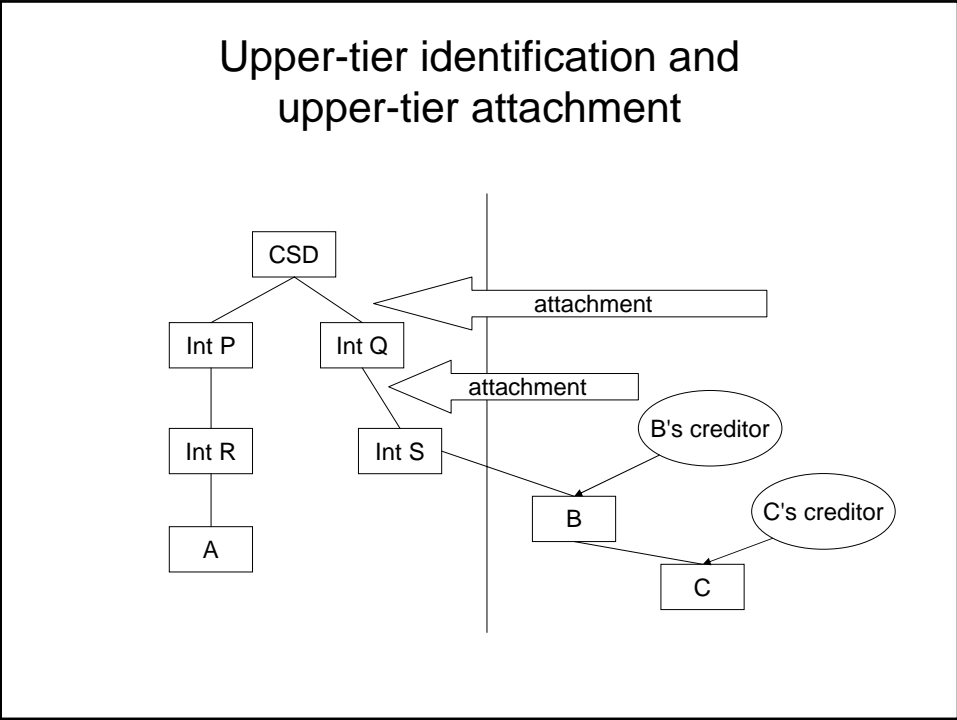
Each transfer cannot be identified in practice, but in civil jurisdictions, each seller and the corresponding buyer must match, and thus debit and credit entries must match (?) – "macro matching" (?)

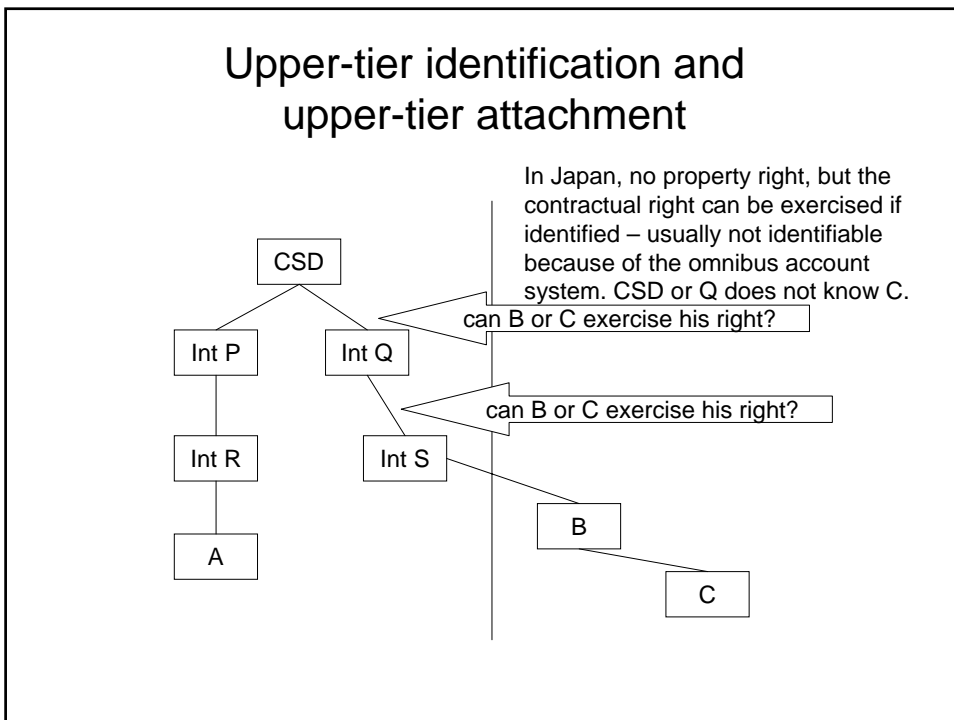
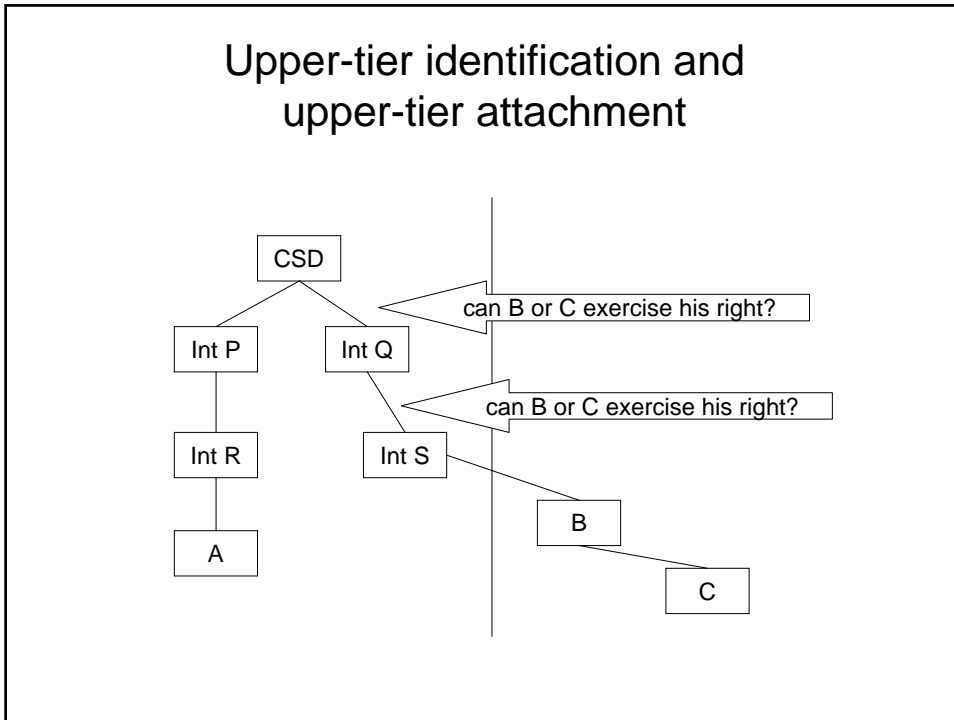


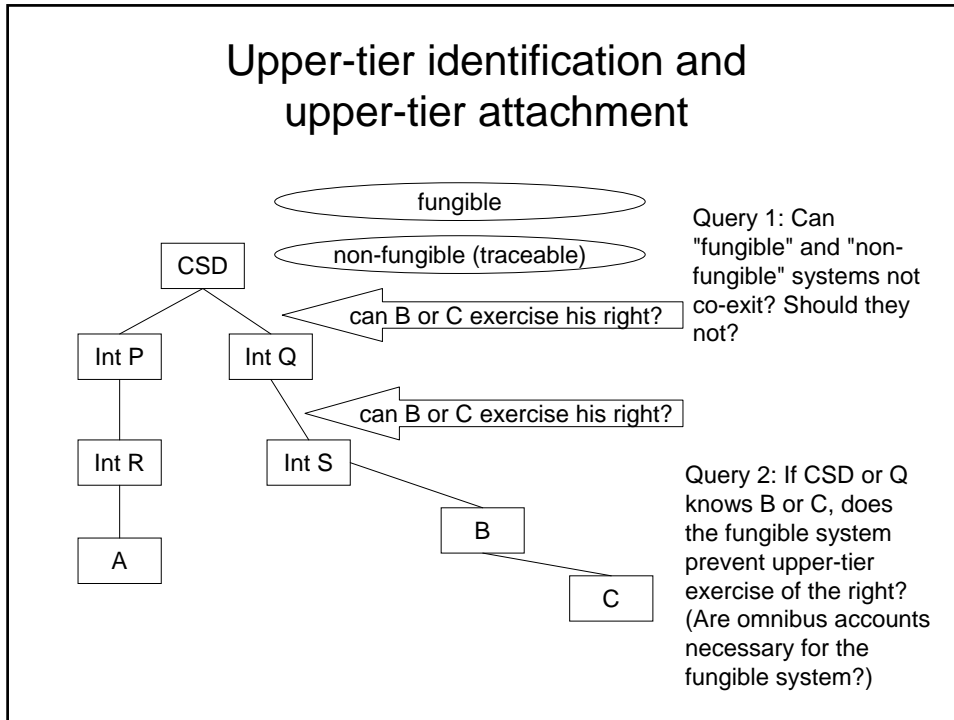
Matching or not – how to construct a transfer over two [common law and civil law] jurisdictions?



III. Upper-tier Identification and Upper-tier Attachment

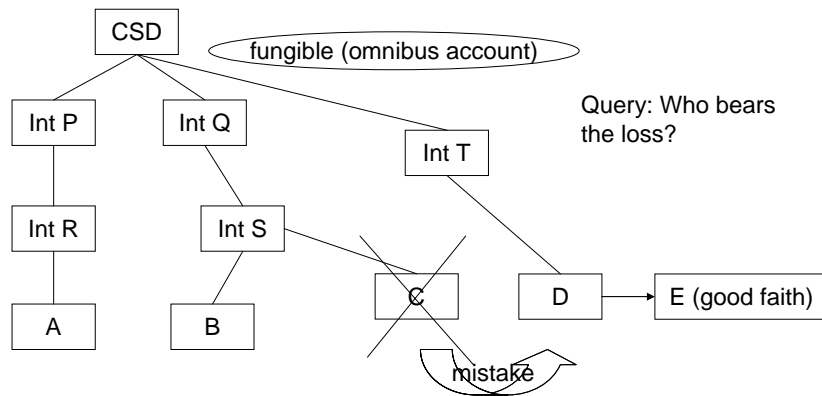




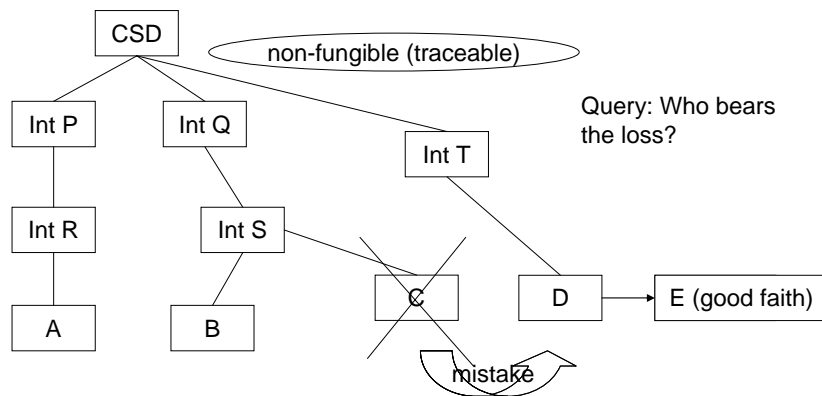


IV. Tracing (in General) and Loss-sharing

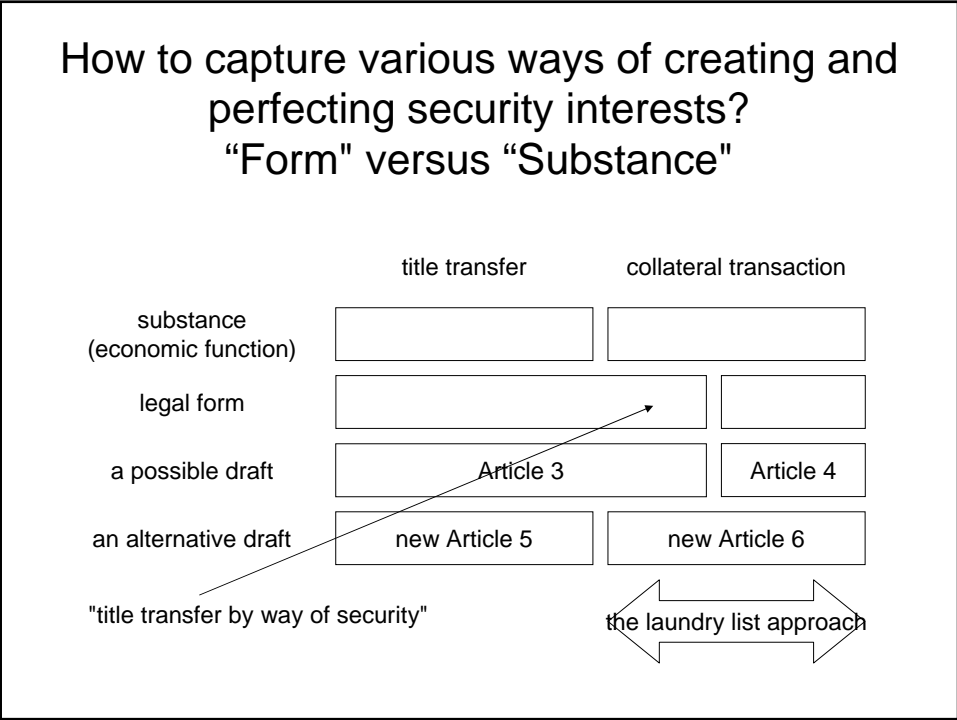
Tracing (in general) and Loss-sharing

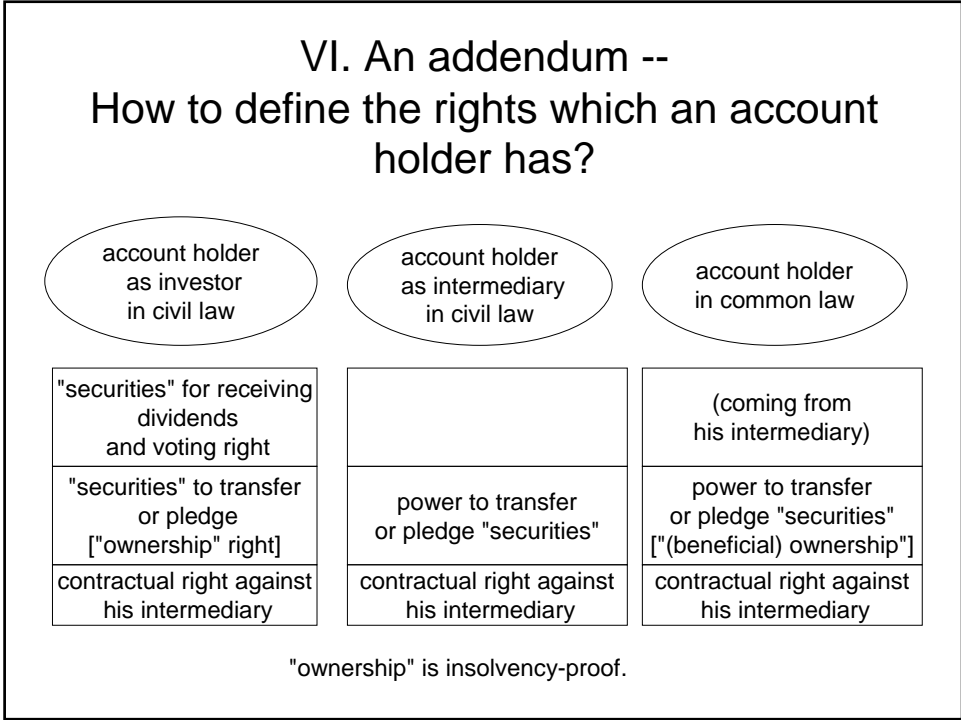
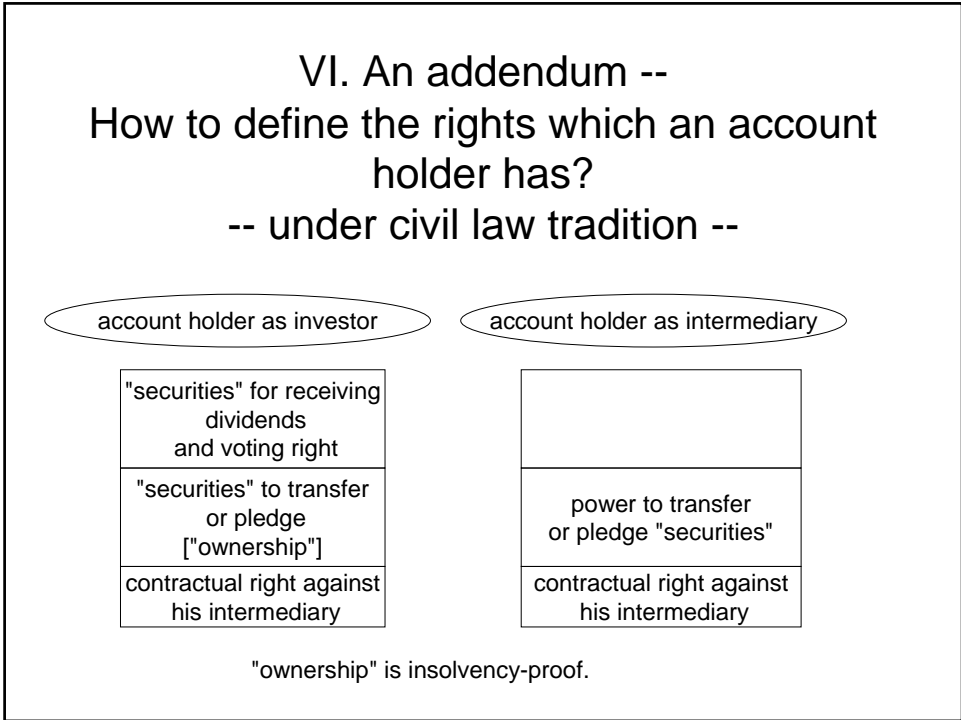


Tracing (in general) and Loss-sharing



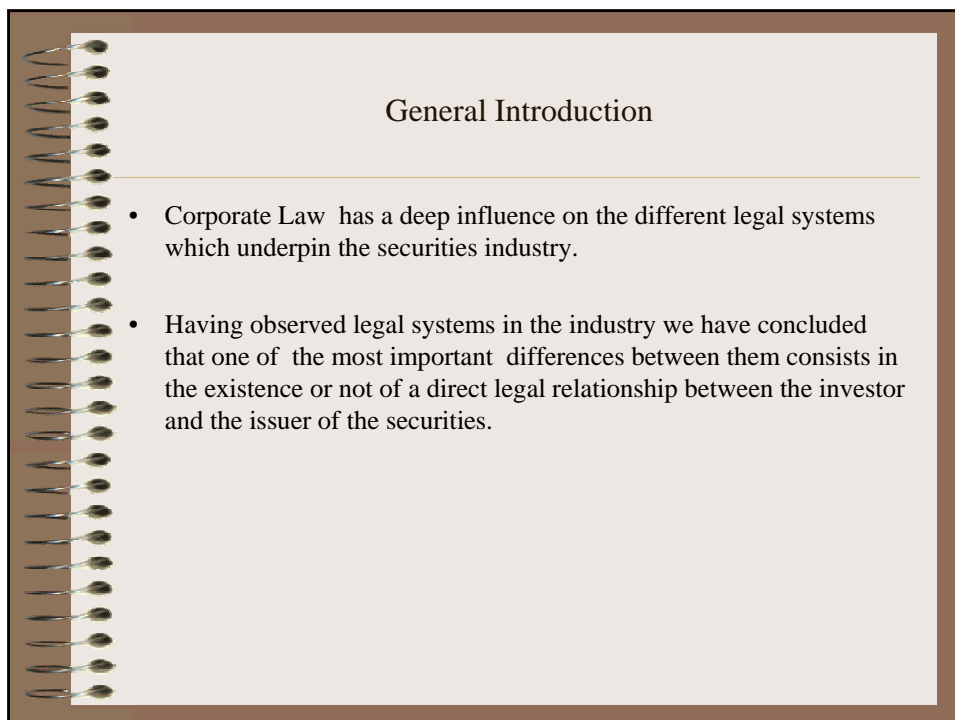
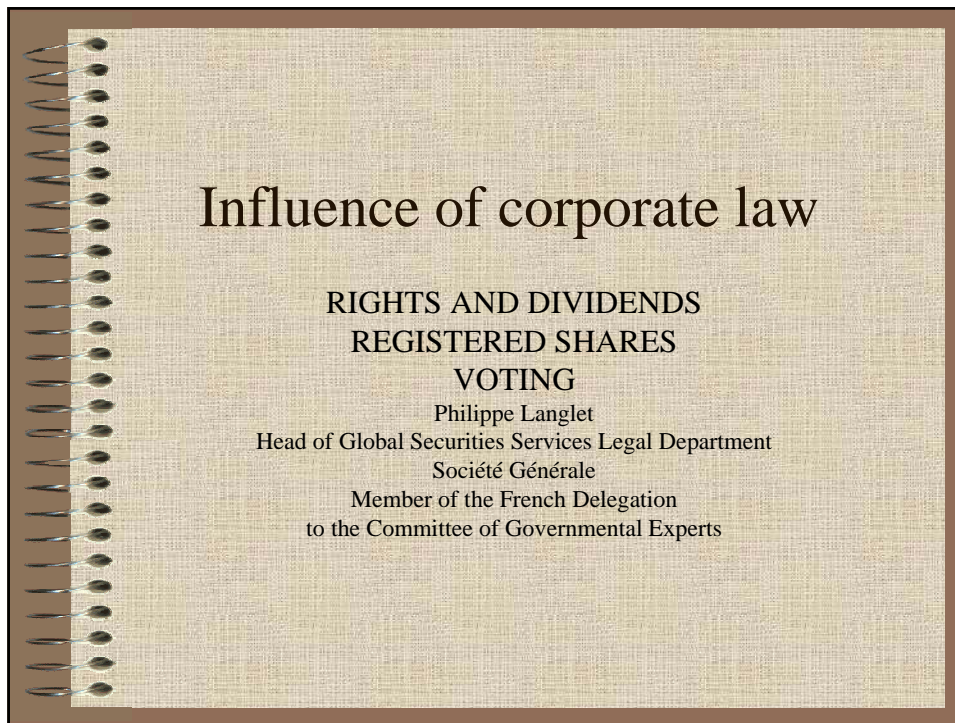
V. Ways of Creating and Perfecting a Security Interest

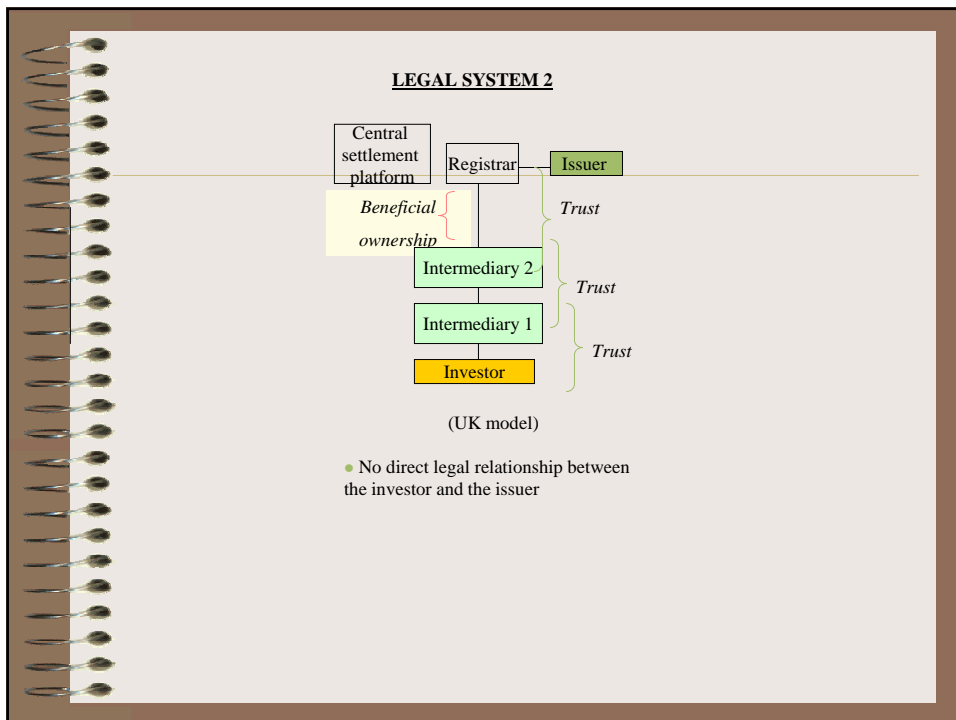
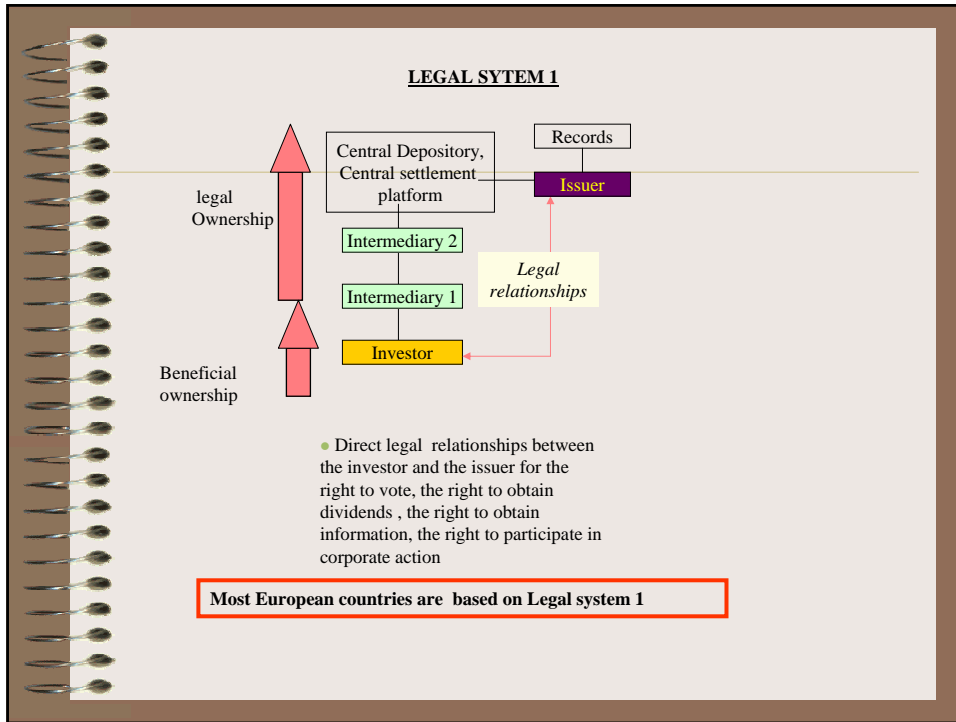


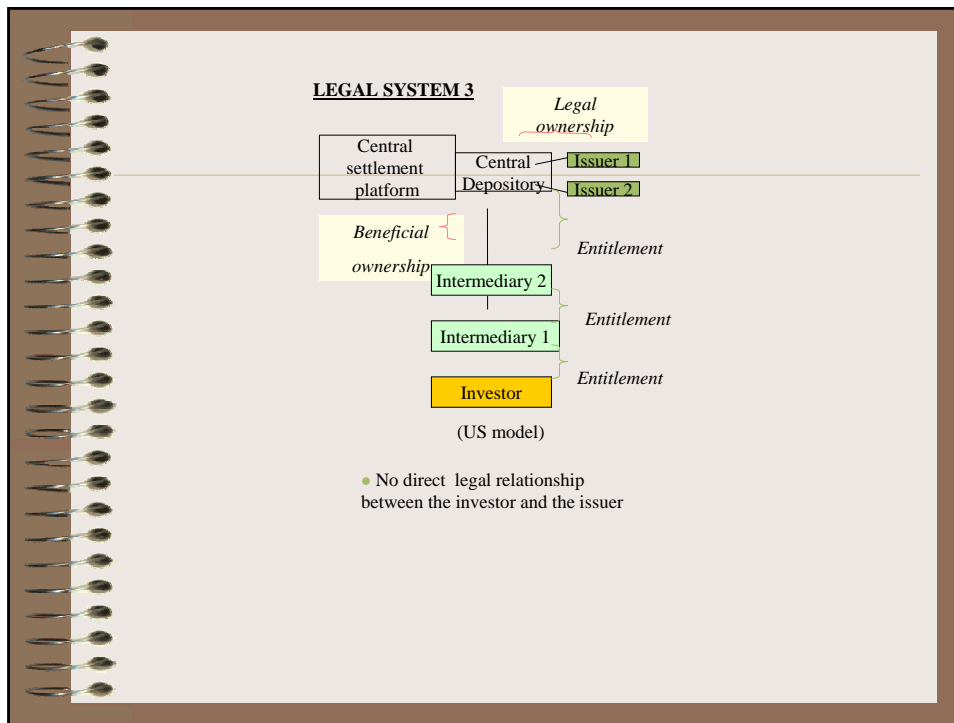


Summary

- What is essential, and what is NOT essential?
- Paper is not essential – the first key factor is book entry.
- For book-entry, we need intermediaries and thus the existence of intermediaries is unavoidable.
- The second key factor is that transfers or pledges are effectuated by book-entries.
- With these two essential factors, "functional" harmonization is possible without harmonizing direct and indirect holding systems.







I. REGISTERED SHARES

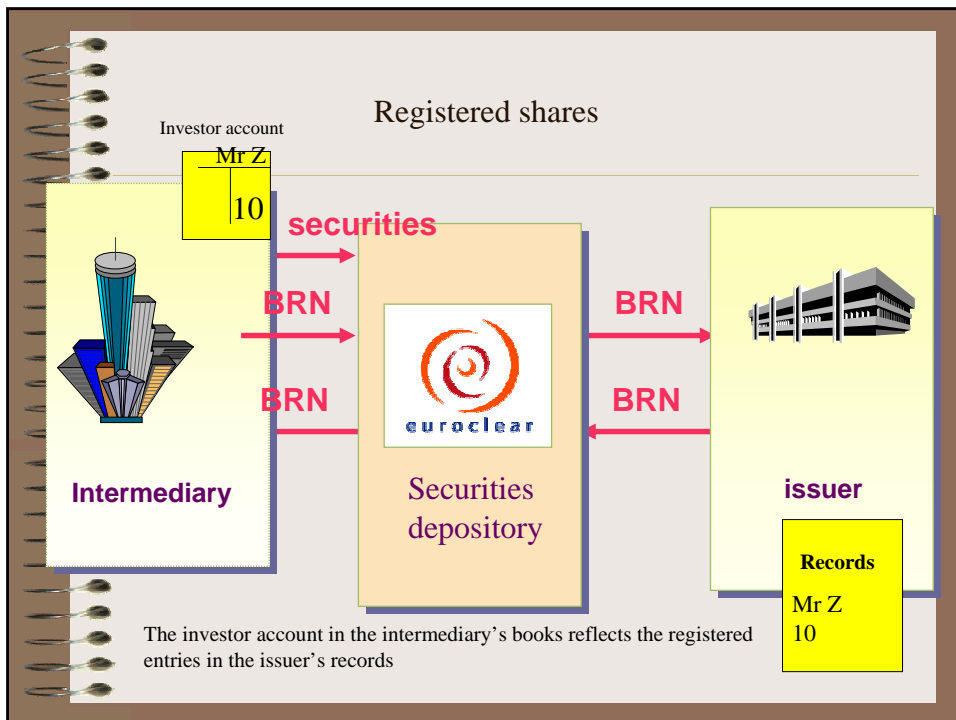
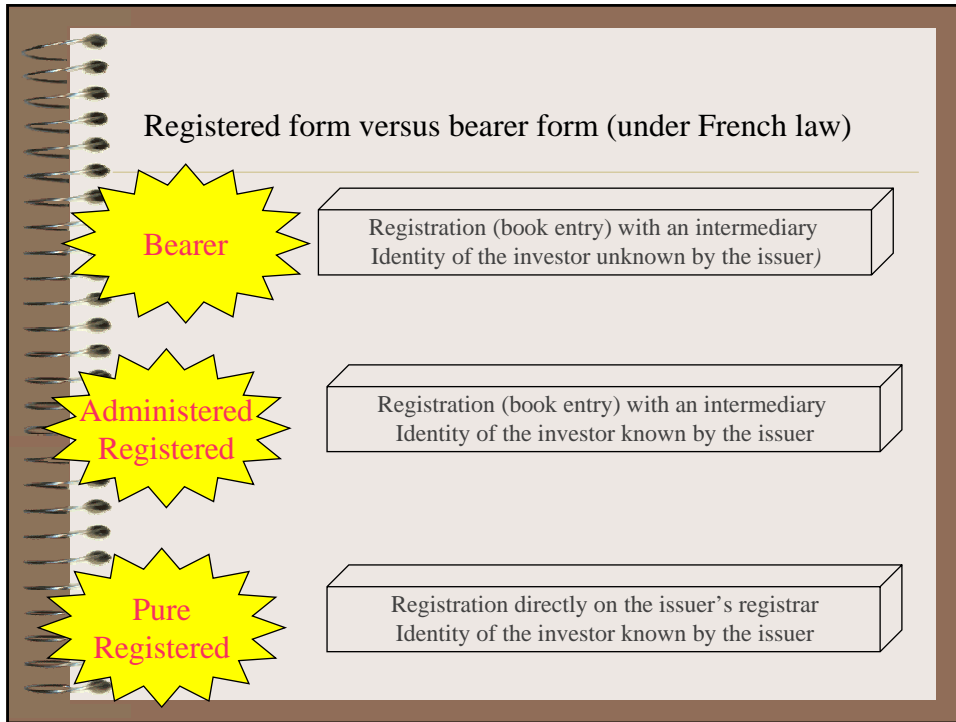
- 1) Generally speaking, the choice of the form of registration is due to:
 - a legal obligation such as in relation to specific sectors of the economy (the weapons industry, insurance, telecommunication ...)
 - the contents of the issuer's by laws or articles of incorporation (statutory reasons /every share is registered / up to a certain amount of owned shares, shares must be in registered form)
 - the choice of the shareholder (when registration is not required by the by laws of the company every shareholder has the option to hold shares either in bearer form or in registered form)
- 2) Registered securities form is also provided for in corporate law in Italy, in Spain, in Germany, in Belgium.

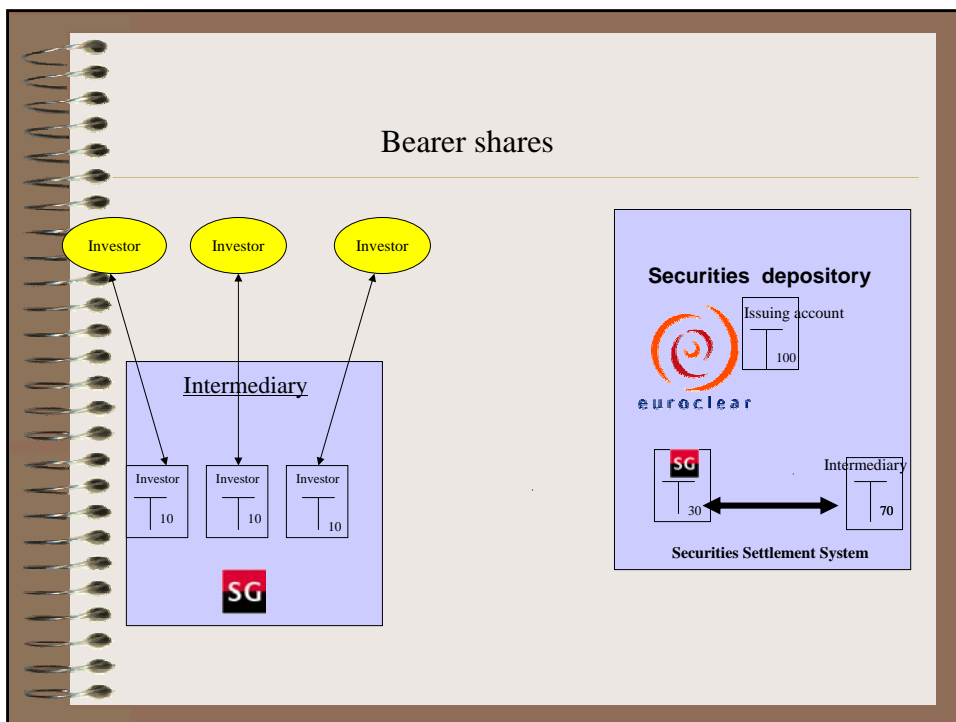
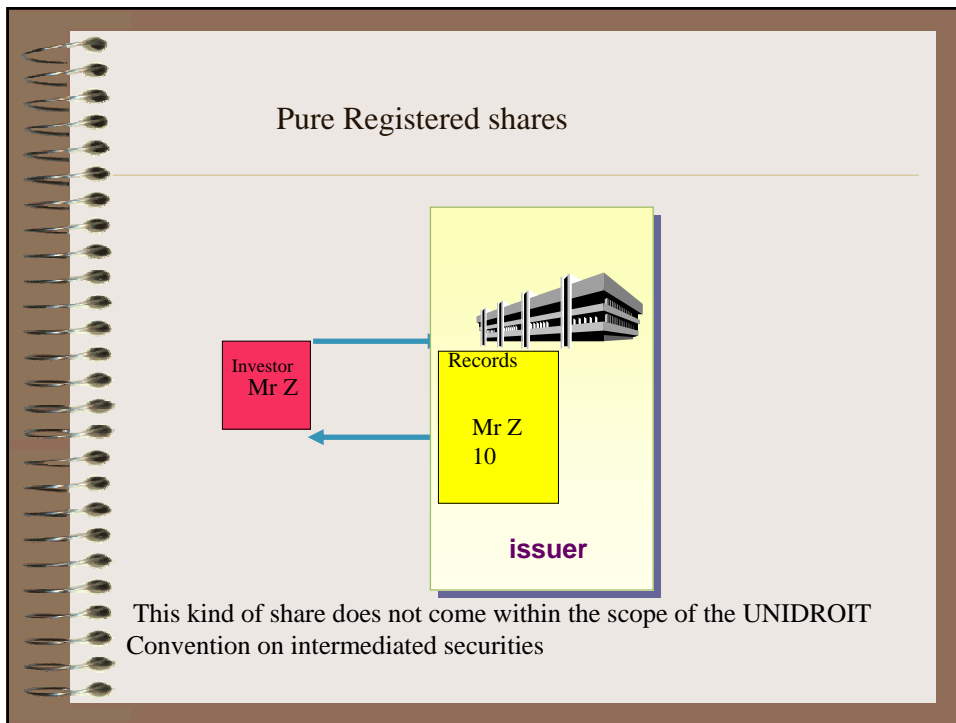
3) Benefits of the registered form for the investor (with French Law focus):

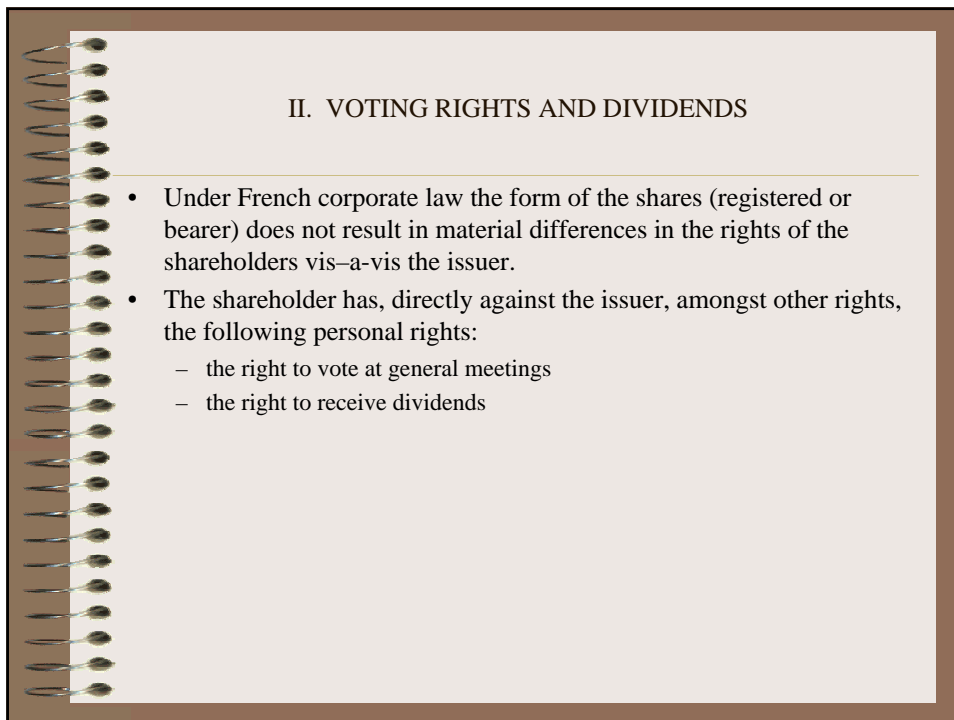
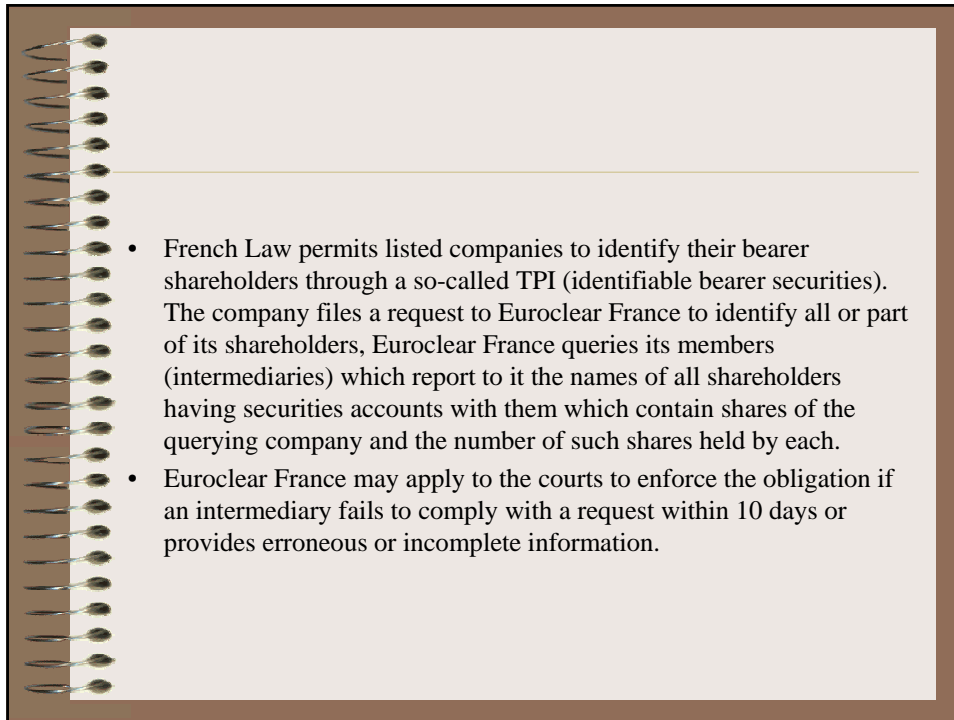
- certain companies grants benefits where shares held in registered form uninterruptedly for two years (by laws may require a longer period)
- the benefits may consist of extra dividends (extra shares, in case of allotment of bonus shares or stock dividends)
- the benefits may consist of the grant of a double vote
- the issuer can communicate directly with its shareholders (under French Law the obligation to provide information concerning the general meeting is to be performed by the issuer). The investor will always receive the general meeting convocation
- in many cases, such as inspection of the shareholder list, examination of the attendance sheet, petition of challenge draft resolution, the registered shareholder will not have to produce a book entry attestation.

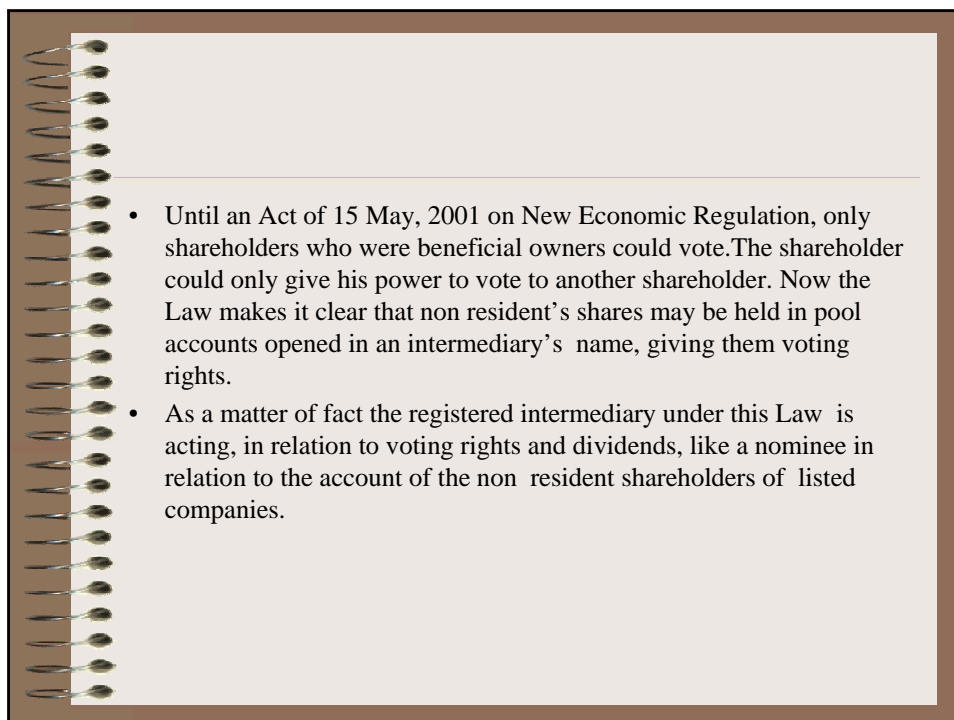
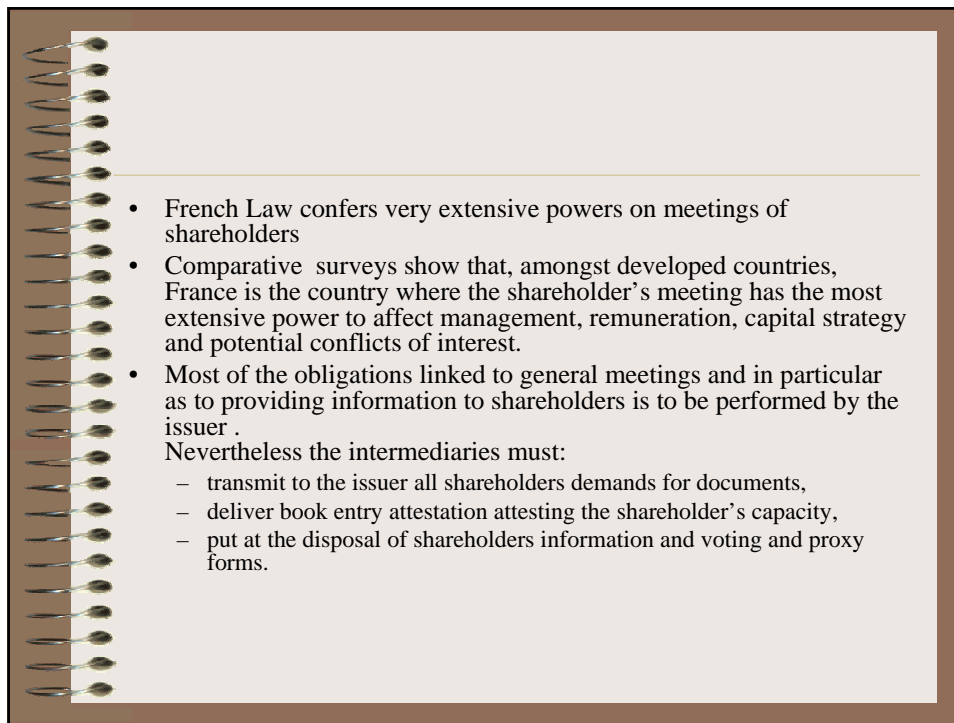
4) Benefits of the registered form for the issuer:

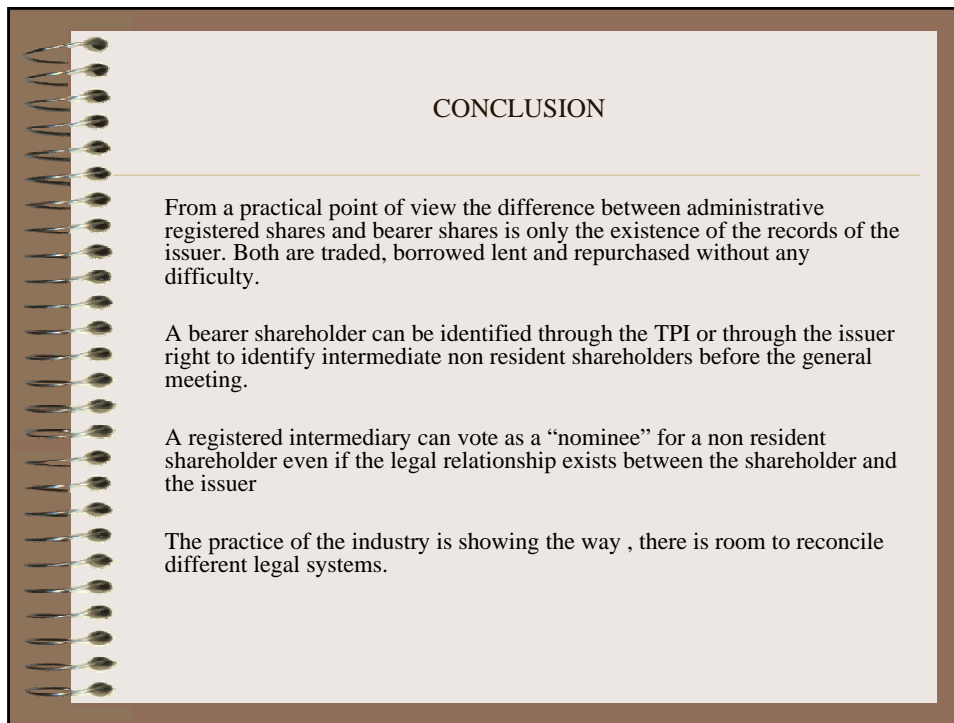
- permanent and perpetual knowledge of its shareholder component
- easier way of communicating with its shareholders
- ability to improve shareholder's loyalty towards the issuer (extra dividends, double vote)
- for employees shareholder's plan , the issuers find it easier to use registered form shareholding for their subsidiaries worldwide (Accor Sodexho, Gaz de France, Air France)
- Michelin, Lagardère, Air Liquide are CAC 40" blue chips" listed companies with a huge number of registered shareholders in their records.











**THE PRELIMINARY DRAFT CONVENTION ON INTERMEDIATED SECURITIES
("THE DRAFT CONVENTION"): INTERDEPENDENCY OF CORE FEATURES
EFFECTIVENESS OF BOOK-ENTRY; GOOD FAITH ACQUISITION; PRIORITIES; LOSS
SHARING**

(Prof. Dr. Dorothee Einsele, University of Kiel, Germany)

I. Outright transfers

1. Effectiveness of credit-entries without debit-entries under Article 5

Under the draft Convention a credit is effective without a debit (Article 5 (1) and (2)). This means that an account holder may acquire a right in the securities held by its intermediary by means of a credit entry only and even without the making of a corresponding debit entry (see also Article 5 (4)). This provision may surprise those lawyers who come from jurisdictions in which investors obtain legal ownership rights in securities, because Article 5 (4) seems to be contrary to the general rule that it is not possible for one person to obtain legal ownership rights without somebody else losing them. However, a possible explanation could be that in these circumstances the account holder obtains the right by way of *bona fide* acquisition from all other account holders (Article 11). The first question is, therefore: What is the relationship of Article 5 to Article 11?

2. Acquisition by an innocent person under Article 11 and its relation to Article 5

Is the effectiveness of a book-entry under Article 5 subject to the investor having acquired the right by way of *bona fide* acquisition under Article 11? I am of the opinion that this is not the case. First, the wording of the draft Convention suggests that an account holder is able to acquire a right without any consideration of whether the transferor is or is not the holder of that right. Article 5 (1) says, without any reference to Article 11, that the account holder may acquire intermediated securities by the credit of securities to that account holder's securities account and Article 5 (4) provides that "without prejudice to any rule... a credit of securities to a securities account is not ineffective because it is not possible to identify a securities account to which a corresponding debit has been made." The same is true of the wording in Article 11 providing that a person who acquires intermediated securities by a credit to a securities account under Article 5 and who does not at the time of acquisition have knowledge of an adverse claim with respect to the securities is not subject to that adverse claim. Therefore, Article 5 and 11, taken together, suggest that acquisition usually occurs and that Article 11 only addresses the question of whether this acquisition is, in exceptional cases, subject to adverse claims the knowledge of which has to be established by the person who claims that the right has not been acquired.

But much more important than the wording is the question of whether it would make sense to regard acquisition under Article 5 as occurring only where the acquirer has acted in good faith. I am of the opinion that this would not make sense. First, an investor generally believes that a transfer will be effective without considering whether the transferor (whom the investor does not usually know) is the holder of the right which the investor is about to acquire. To say it more precisely - apart from the investor's general belief that the system will function in such a way as to ensure acquisition, the investor has no factual basis for his belief that the transferor is the holder of the right being transferred. The investor usually has no inside view of the way the

system operates. Bank secrecy laws do not allow for him to verify whether the transferor in turn acquired the right. Instead, the settlement systems of today are black boxes for investors. A further disadvantage of interpreting Article 11 as a “classical” good faith acquisition rule is that in cases of “lost credits” or credits without debits, tracing would be necessary in order to find out whether the preconditions of acquisition in good faith have been met by each transferee respectively. Moreover, especially regarding the case of a credit without a debit, the prerequisites for *bona fide* acquisition would have to be met in respect of all account holders whose rights will be reduced rateably. These prerequisites are unlikely to be met.

Yet if Article 11 does not provide for the possibility of *bona fide* acquisition, how can it be explained? In my view, Article 11, by way of exception, limits the acquisition which generally occurs under Article 5. The account holder acquires a right in the respective securities without the need to establish that he was in good faith as to the transferor’s ability to transfer. Except in the exceptional cases where the account holder does have knowledge that the transferor is not able lawfully to dispose of the right, he will be able to acquire the right. Unless, however, the rare prerequisites for the application of Article 11 are met, the account holder acquires a right under Article 5 which has priority over rights created by any other method permitted by the domestic non-Convention law (Article 10 (1)). If the account holder has acquired a right under Article 5, but its intermediary does not have enough securities in its account to satisfy its account holders’ claims because of an illegal overcrediting, the loss sharing rule under Article 18 will apply.

3. Explanation for the rule “effectiveness of credit without debit”

Having clarified the relationship of Article 5 to Article 11 and 18, the question remains - “What kind of right does the investor obtain in the case of a credit without a debit?”. This question has to be examined further before going on to consider questions of priority and the loss sharing rule in relation to security interests. Since one investor acquires a right without another losing it, the acquirer of that right cannot be the legal owner of that right. The only reasonable explanation for the account holder acquiring a right in these circumstances is that the acquirer does not obtain that right by way of transfer or assignment, but by a reduction of the transferor’s rights against its intermediary and a new establishment of a right in favour of the acquirer by its intermediary. The account holder obtains a right against its intermediary which must be something more than a mere contractual right because of its protection in the event of the intermediary’s insolvency.

Other articles in the draft support the interpretation that the right which the investor obtains by a credit entry is a right against its intermediary which, at the same time, represents a right in the securities held with its relevant intermediary. For instance, the allocation rule in Article 17 shows that the relevant intermediary itself is obliged to fulfil its account holders’ rights in the respective securities, since the intermediary’s own securities are allocated to its account holders if the aggregate number or amount of securities do not equal the aggregate number or amount of such securities credited to securities accounts maintained by the intermediary. Moreover, since Article 17 not only provides for the relevant intermediary to be liable for damages, but allocates the rights held with the intermediary in its own account to its account holders, Article 17 shows as well that the rights represented by the credit entries are also rights in the securities. The same inference should be drawn from Article 4, even though this provision lost clarity after the revision of the former Article 2.

If one regards the account holder’s rights as rights which are directed against its relevant intermediary, it is necessary to the existence of an account holder’s rights that its relevant intermediary has committed itself to satisfy those rights. The credit entry in favour of its account holder must be seen as a commitment by the relevant intermediary.

These considerations, in turn, also imply that a *bona fide* acquisition rule is neither necessary nor sensible, since the account holder acquires the right not by way of a secondary acquisition from the transferor, but by way of a primary acquisition from its intermediary. Moreover, in any case, the preconditions for an acquisition in good faith would not usually be met. There is no factual basis from which the inference could be drawn that the transferor is the holder of the right. Nevertheless, there may be very rare cases in which the transferee knows of an adverse claim. In these cases, the ability for a transferee to acquire the right is restricted by Article 11.

II. Security interests

1. Grant of security interests – limitation by Article 11

In the case of the grant of security interests, the first question which arises is whether the preconditions for the creation of those rights under Article 6 are met. If this is the case, the next step is to consider whether the collateral taker, has, by way of exception, failed to acquire the right because of its knowledge of an adverse claim (Article 11). The relationship between Article 6 (the creation of a security interest) and Article 11 (the acquisition by an innocent person) is the same as described above concerning the relationship between Article 5 and 11.

2. Competing Rights

If the prerequisites of Article 11 are not met the collateral taker has therefore acquired the right, though a problem of competing rights may emerge. Bearing in mind the explanation for the rule “effectiveness of credit without debit”, there appear to be two possibilities: the first is that of secondary acquisition, i.e. the case where it is, also from a legal perspective, the transferor or the collateral provider who disposes of the respective right. In this case the purchaser or collateral taker may only acquire the right if the transferor or the collateral provider is the true holder of the right. Therefore, in relation to secondary acquisitions, the priority rule is applicable.

The second possibility which has to be considered is that of primary acquisition, i.e. the case where the right is not directly acquired from the transferor or the collateral provider, but where it is “transferred” by the reduction of the transferor’s rights against its intermediary and the new establishment of those rights in favour of the acquirer. In case of primary acquisitions it is the intermediary itself who is committed. In this case the priority rule is not relevant. The same is true regarding the grant of security interests, since the relevant intermediary may also commit itself *vis-à-vis* the collateral taker, the only difference to the outright transfer being that the intermediary’s commitment has the content of a security right.

Hence the question with regard to security interests is whether the intermediary has entered into an own obligation *vis-à-vis* the acquirer. If the intermediary has made a credit entry in favour of the collateral taker or the purchaser, it may be regarded as an own commitment by the intermediary. But considering the wording of Article 6, the steps taken by the intermediary in order to create the security interest are not always sufficient to be regarded as an own commitment by the intermediary *vis-à-vis* the collateral taker. For instance in case of Article 6 (2)(b) there clearly is not such an own commitment by the relevant intermediary. The same is potentially true as to Article 6 (2)(d), i.e. in case of a control agreement between the collateral provider and the collateral taker. It can be taken from the definition of a control agreement in Article 1(m) that notice has to be given to the relevant intermediary. But this definition does not presuppose that the intermediary has played more than a merely passive role. However, if the steps taken by the intermediary do not amount to a commitment by the relevant intermediary *vis-à-vis* the account holder, the acquisition of the security interest may only be regarded as a secondary acquisition from the collateral provider without the intermediary itself being obliged to

fulfil the collateral taker's potential rights in the securities. In this case the collateral provider who is first in time will prevail (under Article 10 (1) (b)). However, if the intermediary committed itself *vis-à-vis* the account holder, the collateral taker does acquire the security interest by way of an original acquisition from its intermediary granting its account holder a right with the content of a security interest. Therefore, generally speaking, in case of a primary acquisition of a security interest this right is effective even if there is no corresponding loss of this right just as in case of an outright transfer under Article 5. Yet, if the collateral taker has acquired the right under Article 6, but its intermediary has not enough security interests in its account to satisfy its account holders' claims, the loss sharing rule under Article 18 is applicable just as in case of an acquisition under Article 5.

III. Result

If the preconditions of Article 5 or 6 are met, the account holder acquires the right, unless the acquirer has knowledge that the transferor or the security provider is neither the holder of the right nor entitled to transfer it. Article 11 is not, in the strict sense, a bona fide acquisition rule. Instead, it places a limitation on the ability to acquire under Article 5 or 6. The result may be that more interests were credited by an intermediary in favour of its account holders than the respective intermediary is able to satisfy. This problem is addressed by Article 17 and 18. Hence, if the intermediary does not have a sufficient number or amount of securities in its customers' or own account, the loss sharing rule applies. Only if the security interests have been created without the relevant intermediary having entered into an obligation *vis-à-vis* its account holder, do the priority rules of Article 10 between competing interests of collateral takers or transferees apply. These rules apply independently of whether rights held with the same intermediary or with different intermediaries are concerned or whether the collateral taker is an intermediary or somebody other than an intermediary.

**EXAMPLES FOR DISCUSSION:
SHARING, PRIORITY, AND INNOCENT ACQUISITION**

(Prepared by Ms Joyce M. Hansen, Office of General Counsel, Federal Reserve Bank of New York, USA, and Prof. Charles W. Mooney, Jr., University of Pennsylvania Law School, USA)

The rules for resolving conflicting claims to securities accounts and intermediated securities credited to securities accounts are among the most important provisions of the draft Convention. The initial discussion of these issues in the plenary did not result in a consensus. Please find below some examples that illustrate some basic priority contests. Each also suggests an appropriate resolution of the priority contest (and, in some cases, alternative resolutions). The suggested resolutions are intended to provide a basis for discussion. As a package, they provide a coherent baseline for determining priorities in a legal regime for intermediated securities. For convenience, the examples refer only to intermediated securities, but the examples should be understood to apply to security interests in the entire securities account as well.

Two of the most basic priority schemes are found in Articles 10 and 11. (References to articles of the Convention text are to the articles as renumbered in the June 2005 draft (Doc. 24).) Article 10 provides a first-in-time rule and Article 11 provides a “take-free” rule (in effect, a last-in-time rule for qualifying acquirers). As was noted by several in the plenary, however, as currently written, the draft Convention is unclear as to when one or the other is applicable, or when the basic pro rata sharing rule of Article 18 is applicable. The resolutions suggested below indicate when and how these articles could best be applied.¹

The basic priority contests identified here are far from comprehensive. But forging a consensus on these examples would be an important step in the deliberative process.

Example 1 (priorities among account holders of a common intermediary)

Facts: A dispute arises concerning intermediated securities of the same description among account holders of the same intermediary and the intermediary fails to hold sufficient securities of a the same description to cover all intermediated securities of that description credited to its account holders’ securities accounts.

1. These examples do not address the issue of whether the pro rata sharing rule would be applied to the entire pool of securities or intermediated securities of the same description held by an intermediary both for account holders and for its own account or would be applied only to those securities or intermediated securities of the same description segregated by the intermediary for its account holders. The former approach would provide more protection to an intermediary’s account holders, but we understand that the latter may be considered as an opt-in alternative.

The intermediary's failure to hold sufficient securities may have occurred, for example, because an account holder was credited with securities after lodging a forged or invalid certificate with the intermediary and the account holder proves unable to provide genuine replacement securities to the intermediary. In the meantime, subsequent transactions among the intermediary's account holders may make it difficult or impossible to determine which of the account holders received the "bad" securities.

Resolution: This example illustrates a basic concept: priority as among account holders of a common intermediary should not turn on facts such as (i) when an account holder receives a credit to its securities account of a securities of the same description or (ii) the timing or manner in which the intermediary obtained securities or intermediated securities held with another intermediary. The account holders will not be in a position to know such facts in most cases. Moreover, they have cast their lot with a common intermediary. Article 18(1) appropriately provides for pro rata sharing among account holders in this situation (absent a different rule of the clearing or settlement system, as Article 18(1) appears in the current draft Convention). Neither Article 10 (first-in-time) nor Article 11 (last-in-time) should have a role in resolving priorities among account holders of a common intermediary. Of course, if the intermediary is not insolvent it should in most cases be able to obtain sufficient securities to satisfy all account holder claims or otherwise make account holders whole and there would ultimately be no priority contest. Revised article 16(4) will then determine whether and, if so, how the cost of doing so can be allocated to account holders.

Absent a pro rata sharing rule, if the introduction of "bad" securities caused the shortfall, it would be necessary to apply some purely arbitrary rule of convenience in order to trace the securities to the accounts of the intermediary's account holders. And, following that tracing, had those account holders entered into subsequent transactions, it would be necessary to apply the rule repeatedly.

Example 2 (priorities between a collateral taker from an account holder and other account holders of a common intermediary)

Facts: An account holder grants a security interest in intermediated securities to a collateral taker. Either (i) the intermediated securities are credited to the collateral taker's account on the books of the account holder's intermediary under Article 6(2)(a) and Article 5 (in which case, assuming that the intermediated securities have been debited to the account holder's account, the account holder no longer has rights to those intermediated securities²) or (ii) the account holder's account is not debited and another step occurs that renders the collateral taker's security interest effective against third parties under Article 6. A dispute arises concerning intermediated securities of the same description and the intermediary fails to hold sufficient securities to cover intermediated securities of the same description that are credited to its account holders' securities accounts.

Resolution: The collateral taker will share pro rata with the other account holders as in Example 1, either because the collateral taker has become an account holder itself or because its claim is based on and thus has the same priority as the debtor-account holder's claim.

2. Of course, *as between the debtor-account holder and the collateral taker*, the account holder would have certain rights such as a right of redemption or a right to the intermediated securities upon satisfaction of the obligations that they secure. In the interest of simplicity, however, the examples addressing priority contests involving collateral takers ignore those rights and duties between a debtor and collateral taker *inter se*.

Example 3 (priority of transferee (either buyer or collateral taker) from account holder of first intermediary when transferee receives a credit on the books of a second intermediary)

Facts: Account holder X (AH-X) of intermediary X (IM-X) grants a security interest to Y in, or sells outright to Y, intermediated securities credited to AH-X's securities account with IM-X. AH-X instructs IM-X to debit intermediated securities of the same description from its securities account and credit Y's securities account with Intermediary Y (IM-Y). (IM-Y may or may not be a direct upstream intermediary in which IM-X holds a securities account with respect to the relevant intermediated securities.) IM-Y credits Y's account. Subsequently, IM-X becomes insolvent and there is a shortfall in the relevant securities.

Resolution: If Y qualifies as an innocent acquirer that has acquired its intermediated securities free of any adverse claim under Article 11, neither the account holders of IM-X nor IM-X's insolvency representative should have any claim, much less any superior claim, as to the intermediated securities credited to Y's account with IM-Y. This protects the integrity and significance of a credit to a securities account. Article 10 should not apply and therefore the account holders of IM-X should not prevail under the principle of first in time.

Variation A: Assume that Y acquired outright ownership of the intermediated securities and was not a collateral taker. Subsequently, Y grants a security interest to a collateral taker whose interest becomes effective against third parties under the Convention.

Resolution A: The collateral taker from Y should enjoy the same priority vis-à-vis IM-X's account holders that Y enjoys.

Variation B: Assume that Y did not qualify as an innocent acquirer under Article 11.

Resolution B: The convention does not appear to address the resolution of this priority contest. (We doubt that Article 10's first-in-time principle is appropriate in the case of conflicting claimants who claim through securities accounts maintained with different intermediaries.) Further discussion should address whether the Convention should address this situation directly or whether the resolution might be left to the domestic non-Convention law.

Example 4 (priorities between security interests of competing collateral takers from a common debtor-account holder with a single intermediary)

Facts: Account holder grants to collateral taker X (CT-X) a security interest in intermediated securities. The necessary steps are taken under Article 6 (by a method other than credit to a securities account of CT-X) so that the security interest becomes effective against third parties. Subsequently, the account holder grants a security interest to its own intermediary in intermediated securities of the same description, which is effective against third parties under Article 6(2)(b).

Resolution: Under the first-in-time principle of Article 10, CT-X should have priority, because it received its effective security interest first. The intermediary should not be entitled to assert freedom from CT-X's adverse claim even in the (unlikely) event that it took without knowledge.

Variation A: Reverse the timing so that the intermediary acquired its security interest first.

Resolution A: Under the first-in-time principle of Article 10, the intermediary would have priority.

Variation B: After CT-X acquired its security interest, the account holder grants a security interest to another collateral taker, CT-Y. CT-Y's security interest becomes effective against third parties under Article 6 (by a method other than credit to a securities account of CT-Y).

Resolution B: Under the first-in-time principle of Article 10, CT-X would have priority.

Example 5: (priorities between security interests of competing collateral takers from a common debtor-account holder with a single intermediary; wrongful debit to securities account; credit to account of later collateral taker)

Facts: Account holder grants to CT-X a security interest in intermediated securities. The necessary steps are taken under Article 6 (by a method other than credit to a securities account of CT-X) so that the security interest becomes effective against third parties. Subsequently, the account holder grants a security interest to another collateral taker, CT-Y. On the account holder's instructions, but without the authority of CT-X, the intermediary debits the debtor-account holder's securities account for the relevant intermediated securities and credits the securities account of CT-Y maintained with the intermediary for an equivalent amount of the relevant intermediated securities.

Resolution: Under Article 7(1)(b) the debit was not effective against CT-X because it was not authorized by CT-X. At a minimum, CT-X should have a right of action against the intermediary for any loss caused by the wrongful debit. Should the intermediary be required to credit the account of the original account holder (to the extent necessary to protect CT-X) with the intermediated securities? If the intermediary is so required to recredit, but fails to do so, should CT-X have the same pro rata priority vis-à-vis the other account holders of the intermediary claiming intermediated securities of the same description as in Example 2? Affirmative answers to both questions would be appropriate. Negative answers would mean that the debit was effective. CT-X's legal position vis-à-vis the intermediary and its account holders should remain unchanged by the debit.

However, the *credit* to the account of CT-Y should remain effective (assuming that there is no basis for reversal under Article 7(5)). And, if CT-Y acted innocently without knowledge of CT-X's adverse claim, CT-Y should be entitled to the benefit of the credit and should be immune from any claim or liability to CT-X. Moreover, inasmuch as CT-Y received a credit to its own account, it is somewhat awkward to conceptualize that it received the same intermediated securities that had earlier been credited to the debtor-account holder's account. In most cases, the realities of modern intermediated holding systems will make it difficult, if not impossible, to establish a concrete link between the wrongfully debited intermediated securities and the credited intermediated securities. For that reason, in lieu of applying the innocent acquirer approach set forth in Article 11, in this context the Convention should provide, in addition to the "takes free" rule of Article 11, that an innocent person to whose account intermediated securities are credited is immune from all claims and liabilities relating to the intermediated securities (Note that this result differs from the result in Example 4, Variation B, in which CT-Y did not receive a credit to its account but otherwise acquired an effective security interest under Article 6. There, CT-Y's security interest was subordinate to CT-X's interest.) Protecting CT-Y in this situation recognizes the integrity and significance of a credit to a securities account and the need to protect the reliance interest of an account holder such as CT-Y.

If the intermediary has or acquires sufficient securities or intermediated securities to satisfy both CT-X and CT-Y, there would be no priority contest. If not, however, then both CT-X and CT-Y should be entitled to share pro rata along with the other account holders under Article 18. See Example 2. This illustrates another reason for applying a non-liability immunity protection for CT-Y in this context, rather than the innocent acquisition rule of Article 11. The

application of Article 11 to CT-Y's acquisition in the situation of a shortfall in securities of the same description would mean that CT-Y would take intermediated securities not subject to (i.e., free of) the property claims of the intermediary's other account holders. That result would conflict directly with the pro rata sharing rule of Article 18 but protecting CT-Y from any liability to CT-X (and other account holders) would not conflict with the sharing rule.

Variation A: Assume that CT-Y does not qualify as an innocent purchaser under Article 11 (or for the non-liability immunity protection proposed above).

Resolution A: Arguably, as in Example 3, variation B, the Convention does not address the resolution of this priority contest. Alternatively, either (i) the Article 10 first-in-time principle might work to prevent CT-Y from sharing pro rata to the detriment of CT-X and the account holders or (ii) CT-Y would share pro rata even though it did not qualify for protection under Article 11. Further discussion should consider whether the Convention should address this situation directly (and, if so, how it should address it) or whether the resolution might be left to the domestic non-Convention law.

**DIRECT AND INDIRECT HOLDING
ACQUISITION AND DISPOSITION IN BOTH SYSTEMS;
TRACING IN DIRECT SYSTEMS; LOSS-SHARING AS A NECESSARY SOLUTION**

*(Report on the findings of Working Group on Topic 1,
by Ms Sandra Rocks, Counsel, Cleary Gottlieb Steen & Hamilton LLP, USA)*

Niels C. Andersen, Kenneth Edgren, Federico de Tomasi, Francisco Garcimartín Alférez, Marjut Jokela, Hideki Kanda, Marianne Majbrink Rosenbeck, Maxime Paré, Peter Pöch, Sandra Rocks, (chair), Gilles Stuer, Jürgen Than and Peter M. Werner participated in the working group in their personal capacity. They did not intend to commit their delegation to the opinions expressed.

First, it became clear that the issue of direct vs. indirect holding is particularly important when it comes to cross border situations. Questions arise about the consequences of situations where the rules of the future UNIDROIT instrument “force” direct systems to function like indirect systems and *vice versa*, for the sake of cross-border compatibility; whether this can be an objective of our work or at least be accommodated by it. The working group identified the following three basic issues as most relevant to this problem:

- upper tier attachment of securities;
- matching debits and credits as requirement for a valid transaction;
- intermediary status, i.e. who is recognized as an intermediary

Upper tier attachment

In the first place, it is important to distinguish a restriction on attachment (*cf.* Article 9 of the draft UNIDROIT instrument) from limitations on the manner in which an account holder can exercise rights attached to the securities (*cf.* Article 15). As regards the former, and only this issue is the subject of the present discussion, the policy seems to be to have an attaching creditor “stand in the shoes of the debtor”: this lead to the basic agreement (a) to disallow attaching at levels where the account holder is not known, and, (b) not to make assets unreachable by creditors.

Against the background of the aforementioned principles, the working group identified as a major deficiency in the current draft a lack of recognition for “direct” systems. One thought was to add an exception permitting attachment to the extent permitted under the law governing the securities (issuer’s jurisdiction concept). This would, however, not suffice to accommodate the techniques applied in some specific systems as was pointed out by members of the group: such systems permit attachment even if the issuer’s jurisdiction does not allow for it and, additionally, always permit attachment at both the level of the CSD and the level of the intermediary within the system.

Matching debits and credits

First, the working group discussed this subject against the background of Article 5 (1), (2) and (4) of the draft UNIDROIT instrument. Here, paragraph (2) seems to displace/render ineffective domestic non-Convention law that requires matching credits and debits.

Second, consideration was given to Article 7(1)(a)/(b), which addresses the “authorization” necessary for a credit to a securities account to be “effective”. Currently that provision requires either the account holder’s consent or authority under applicable domestic non-Convention law. This seemed a bit loose, aside from the matching issue, and may need to be tightened. Consensus of the group seemed to support reading the requirement of “authorization” to include a system rule that requires debits and credits that are linked by technical means. The practical impact of such systems appears to be limited to a single jurisdiction and such requirements for matching appear, by their terms, not to apply cross-border. Moreover, such rules are mitigated by good faith acquisition concepts that continue to operate, even within systems which prevent from unmatched movements, by coercive technical means.

Third, the working group regarded the question of whether tracing should be allowed as closely linked to the issue of matching credits and debits. The general consensus was that the concept of tracing should in general be disappplied to intermediated securities. Although highly impractical, allowing such activity to remain effective would in any case have a negative effect on cross-border compatibility and investors’ confidence in their positions. This is true even in cases where tracing of a mismatch etc. would be possible, even if highly theoretical, with additional discovery, etc., in particular in the context of litigation. A good faith acquisition rule alone would not afford enough protection of that confidence.

Intermediary status

Here, the working group focused on the issue of what was an intermediary as opposed to the ultimate account holder and whether the rules applicable to this question differ or should differ when the holding chain goes cross-border.

The first question was whether an entity that is a “mere record-keeper” represents an intermediary for the purposes of the future UNIDROIT instrument. Consensus seemed to be that such an entity has the power to make changes in ownership interests of others, and so was an intermediary even if the entity’s presence in the holding chain did not interrupt or affect the flow of full ownership rights. Therefore, systems that are commonly classified as “direct”, i.e. where the existence of entities within the chain do not deprive the issuer from the knowledge of the ultimate “owner” and allow for direct communication between them (including the direct exercise of voting and receipt of dividends), are included within the group of intermediated systems.

The second question was whether the term “intermediary” includes entities that “did what intermediaries do” but “can’t be one” because otherwise applicable domestic law prohibits the relevant activity, either altogether or in respect of certain securities (e.g., in Spain a non-participant in the domestic Iberclear-system “cannot” effectively credit securities which are held in that system to an account for a third party on their own books). A concern here was with the possible negative consequences to the “little person” (a market participant which is commonly referred to as “consumer”) who thought it was having securities credited to its securities account because there is little if any basis for that person to know whether the entity in question is legally empowered to validly credit securities to an account.

The basic question here centered on the concept of "authorization" for making entries under Article 7. If the "or" became "and" so that domestic non-Convention law needs to provide authority, serious negative consequences to the internal soundness as well as harmonization goals of the Convention could result.

Serious consideration needs to be given by States applying rules similar to those described above, as to whether application of the Convention's rules would be acceptable "below" the level of the recognized settlement system, even if doing so validated behavior current law does not recognize. In such circumstances, the law invariably provides some way to analyze the entity-"acountholder" relationship and the question becomes whether the way the Convention would do so would be acceptable, given the Convention's limitations on how the rights of an "account holder" can be exercised.

**INFLUENCE OF CORPORATE, CONTRACT AND REGULATORY LAW ON THE ACCOUNT
HOLDER'S ABILITY TO ENJOY THE "FRUITS OF OWNERSHIP" AND THE RIGHT TO
TRANSFER SECURITIES**

*(Report on the findings of Working Group on Topic 2,
by Ms Karin Wallin-Norman, Nordic Central Securities Depository, Sweden)*

Manon Dostie, Alexander Dörrbecker, Joyce Hansen, Hans Kuhn, Philipp Langlet, Philipp Paech, Matthias Potyka, Martin Thomas and Karin Wallin-Norman (chair) participated in the working group in their personal capacity. They did not intend to commit their delegation to the opinions expressed.

I "Intermediated Securities" and Registered Shares

The term "registered shares" was understood by the Group to refer to the requirement, which exists in many jurisdictions, that, in order to be eligible to receive dividends and other distributions and to exercise voting rights, shareholders' names must appear in a specific register kept by or for the issuer/company. Similar requirements also exist in some jurisdictions in relation to other types of securities.

The question for consideration by the Group was whether such requirements are consistent with the provision made by Article 4.1.(a)^{1 2} regarding the right of the "account holder" to receive and exercise these "fruits of ownership".

The policy behind Article 4.1.(a) seems, in general terms, to be to the effect that, where the "account holder" is an "owner" or an "intermediary" they are entitled to receive the rights which it describes. Where the "account holder" is an "intermediary" he/she is obliged by Article 4(4) (subject to certain conditions) to pass them on to the underlying "account holders" so as to enable them to receive and exercise these rights.

Article 4.2. allows the terms of the issue and/or domestic non-convention law to determine who is entitled to the "fruits of ownership" – i.e., as a result it may be that the name of that person must appear in a specific register. The effect of Article 4.2. is that, if an "ultimate investor" has direct rights against the issuer under the terms of the issue and/or the law under which they are constituted, no "intermediary" "above" him (through which he may be obliged to exercise his rights) has those rights.

The general view held by the Group was that the extent to which an "account holder" is able to exercise his rights vis-a-vis the issuer might be limited by agreement between the "intermediary" and "account holder". An example of where this might be the case was where,

¹ References to "Articles" are references to Articles of the UNIDROIT preliminary draft Convention on intermediated securities as set out in the latest text of that draft in UNIDROIT Study LXXVIII – Doc. 24.

² Article 4.1.(a) provides " 1. The credit of securities to a securities account confers on the account holder: (a) subject to paragraph 2, the right to receive and exercise the rights attached to the securities, including in particular dividends, other distributions and voting rights;....". Article 4.2. provides "2. Where securities are credited to a securities account of an account holder who is acting in the capacity of intermediary with respect to those securities, that account holder has the rights specified in paragraph 1(a) only if that account holder, or another intermediary through which, directly or indirectly, it holds the relevant securities, is entitled to those rights against the issuer under the terms of the relevant securities and the law under which the relevant securities are constituted."

according to such an agreement, the “intermediary” does not have to pass on the rights to vote to the “account holder”. In this case the “account holder”, typically, would be in a position to demand a lower price for the “intermediary’s” services. The Group thought that this should be made clearer in the current text by some redrafting of “Version B” of its Article 4.5 (which describes limitations to the obligations to which an “intermediary” may be subject).

Conclusion. The provisions of Article 4 do not conflict with the use of registered securities.³

II Restrictions on the right to transfer or hold certain securities

There are many example of restrictions on the right to transfer or hold securities in domestic non – convention law. There are various reasons for this. Discussion in the Group highlighted the ways in which corporate, contract and regulatory law may restrict, make void or in other ways infringe upon, the right to dispose of securities.

The question for consideration by the Group was whether such restrictions were consistent with the rights of an “account holder” as set out in Article 4.1.(b) to (d)?⁴ If so, would domestic non-Convention law override the provisions of the Convention?

The policy, in general terms, behind Article 4.1.(b) to (d) seems to be that it is the “account holder”, whether the “owner” or an “intermediary” who has the right to dispose of securities credited to the account.

First, the Group generally agreed that restrictions of a regulatory nature – i.e. regarding holders of shares could not be overridden. When it came to restrictions on transfer under the terms of the issue – e.g. the need for the prior consent of the owner – or under corporate law - e.g. relating to shares not fully paid for – the view of the Group was that these should impact as little as possible on the “account holders” rights.

On the other hand it was felt that, on a literal construction of the provisions, the rights described in Article 4.1.(b) to (d) might well be able to be exercised without conflicting with restrictions on transfer because there was no mention in these provisions to “a right to transfer ownership” or to “transfer” at all. The Article only gives the “account holder” the right to instruct its intermediary to debit or designate the account. It does not give the account holder a general right legally to dispose of securities –i.e. either by transfer of ownership or pledge. It remains for domestic non –convention law to interpret such debit or designation as “transfer of ownership” or “pledge”. The position of the “account holder” should be compared to that of a person holding a security in paper form. Instructing the intermediary to debit/designate the account should be compared to physically (not legally) disposing of the paper security.

³ The Group considered that there is Article 4.1. is connected to Article 19 “Position of issuers of securities”. Since, however, the provisions of this Article are the subject of an *Ad Hoc* Working Group, no further comment on this link was thought appropriate.

⁴ Article 4.1.(b) to (d) provides –

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

(b) the right, by instructions to the relevant intermediary, to cause the securities to be debited to the securities account under Article 5 and credited to the securities account of another account holder (whether with the relevant intermediary or another intermediary) or to be delivered into the position or control of a collateral taker under Article 6;

(c) the right, by instructions to the relevant intermediary, to cause to cause the securities to be debited to the securities account under Article 5 and credited to the securities account of the account holder with a different intermediary;

(d) the right, by instructions to the relevant intermediary, to cause the securities to be debited to the securities account under Article 5 and credited to a securities account of the account holder with a different intermediary; ..”.

Conclusion. The Group did not reach a final conclusion on the question it had considered. However, it was noted that if, according to domestic non-convention law, an “account holder” has no ownership rights – e.g. because he is not entitled to be an owner of aerospace industry shares – then a debit to his account will not confer ownership on the transferee, even if the transferee becomes an “account holder” with such shares credited to his account

It was for careful consideration whether, if restrictions in domestic non-convention law declare a credit/debit of securities by book-entry void and of no effect, that was a satisfactory result. Might not some other result be more “efficient” such as loss of “fruits of ownership”, the imposition of a fine or some other administrative measure?

**DRAFT REPORT OF THE WORKING GROUP ON
EFFECTIVENESS OF BOOK-ENTRIES, PRIORITY AND LOSS SHARING**

*(Report on the findings of Working Group on Topic 3,
by Prof. Luc Thévenoz, Centre for European Legal Studies, University of Geneva, Switzerland)*

To fulfil its remit, the working group chose to test some of the core provisions of the draft Convention against hypothetical cases prepared by Charles W. Mooney, Jr., and Joyce M. Hansen.

Olaf Christmann, Ulrik Bang-Pedersen, Dorothee Einsele, Klaus Löber, Maria Chiara Malagutti, Allison McMillan, Chuck Mooney, Guy Morton, and Luc Thévenoz (chair) participated in the working group in their personal capacity. They did not intend to commit their delegation to the opinions expressed.

Applicable provisions of the draft Convention

The working group started by identifying the provisions of the June 2005 draft Convention that may come to bear on the hypothetical cases discussed.

- **Article 7:** Authorisation, timing, conditionality and reversal of debits, credits, etc. (As it now stands, this article is too extensive and would benefit from splitting into smaller provisions.)

In particular,

- **Article 7(1)** about authority of the account holder (AH) and (when applicable) any collateral taker (CT) as a necessary condition of debits, credits, and designating entries. We questioned the inclusion of credits in that list. Does it really need to be said that credits must be authorised by the AH of the credited account? Is not that authorisation an implied term of every securities account? At a minimum, it is important to make clear that the fact that the AH of the debited account makes the debit entry ineffective but does not affect the effectiveness of the credit. This is the result of **Article 5(4)** which, by the way, was also the underpinning of some of the disagreements we had. I will not dwell on this since it is one of the topics covered by Working Group 1.
- **Article 7(5)** dealing with reversal of credits, debits and designating entries by operation of the rules of a securities clearing and settlement system (CSS) or of the domestic non-Convention law.
- **Article 7(6) and (7)** stating that onward transfers to bona fide transferees shall not be affected by the reversal of a credit in the transferor's account. These are key provisions that came to play in many of our examples.
- **Article 10** ordering priority among competing interests. Actually, in our five examples and their variations, we only came once to apply Article 10. It cannot be said that we have yet thoroughly tested that provision.
- **Article 11** about acquisition by an innocent person. Here again, our hypotheticals only twice led us to apply that provision. This might suggest that, it now stands, the scope of this provisions is more restrictive that we originally thought. Sometimes, we were wondering

whether it was at all necessary. We actually wondered whether the effects of an effective book-entry and the additional protection that results from the innocence of the account holder as to his acquisition might be better stated in one article re-grouping Article 7(6) and 11. It also was suggested that an “immunity” concept rather than a “takes free” concept be considered for those who innocently receive a credit. However, the group’s discussions emphasized results rather than the technical drafting and structure of the convention.

- **Article 17** Allocation of securities to AHs’ rights: securities so allocated not property of the intermediary.
- **Article 18** on shortfalls, i.e. Effect of insufficiency of securities held in respect of AHs’ rights.

Policy and time-trigger of Article 18 on shortfalls

The working group noted that the Committee of Governmental Experts has not yet fully discussed the policy of Article 18 on shortfalls. However, that provision is the underpinning of many solutions discussed in the working group and this led to repeated discussions on its merits and on the time when it applies, a question that is not mentioned in the current Draft Convention.

The discussion offered the following insights:

- Article 18 can be seen as the result of a general proposition of property law: at any given time, the credits in all accounts maintained by a given intermediary (IM) represent a pro rata interest in the securities held by that IM. At any given time, there may be a shortfall, and it may go unnoticed. Shortfalls do not matter as long as IM complies with its duty under Article 16(2) and promptly takes such action as required to ensure that it holds sufficient securities of any given description.
- This view seems abhorrent to some of us who are familiar with direct holding systems, where IM do not create the property interest of their AH but merely record (in a bookkeeping approach) the interests of their AHs in an undivided pool of (certificated or dematerialised) fungible securities held by the upper-most IM. In that approach, “shortfalls” are only temporary book-keeping errors that may always (or almost always) be corrected, and must be. In that approach, a book-keeping error may not and cannot create securities or extinguish the property of AHs. Some proponents of such systems may even say that these systems can be designed in such a way that shortfalls, i.e. unbalanced accounts, will never occur.
- The majority view in the group was that operational failures, including fraud, can be minimised, but never completely excluded. In most situations, it does not matter because, if errors cannot be corrected – including by reversal of credit and debit entries by the operation of the DNCL or the rules of a CSS, Article 7(5) – the IM will buy in missing securities. The only time when this does not happen when it will not be corrected is when the IM becomes insolvent. That is when Article 18 comes to apply. It is a loss sharing provision, pro-rating shortfalls among all AHs in whose accounts securities of the same description are credited, and among all CTs deriving their interest from these AHs¹.
- In addition to this majority view, which I find compelling, my personal view is that “direct holding systems” with a strong policy that errors must be corrected so that the loss is not suffered by the community of AHs but rather allocated to the one party to whom it should

¹ This does not apply to CTs who have perfected their security interest by obtaining credit of the securities to an account with another intermediary. Reasoning below under Example 5.

rightly be attributed may want to provide for more cases of reversals under Article 7(5). The Convention does not interfere with that freedom of the national lawmakers. The only constraint that is enshrined in the draft Convention and which we found is of the greatest importance is that onward transfers to innocent AHs must not be upset by the reversal of book-entries in the transferor's account.

Summary of the findings of the working group

The findings of the working group as to effectiveness of book entries, priority and loss shoring can be summarised as follows.

- **As among creditors with a security interest over securities credited to the same account, first-in-time is the fundamental principle.** Article 10 is the overarching rule among creditors who perfect their security interest in the securities credited to the account of the collateral provider otherwise than by credit to another account. For security interest made effective against third parties in accordance with Article 5, see below.
- **Bona fide acquisition under Article does not pre-empt the priority rule of Article 10.** In other words, the collateral taker who gets a security interest after a first security interest has been granted on the same securities ranks second, even if he had no reason whatsoever to think that a previous security interest had been granted. Whether the junior secured creditor can claim damages against the intermediary which did not disclose the existence of a senior interest is a matter for the domestic non-Convention law, contracts and torts,
- There is **one exception** to the first-in-time rule. When the intermediary has obtained a first security interest and participates in the perfection of a subsequent security interest in favour of a third party collateral taker, then its failure to disclose its own, senior interest must be deemed an implied waiver of that seniority, or in other words an implied agreement to subordinate its interest in accordance with Article 10(4). This **should be clarified in the Convention** for cases such as the intermediary's signing a 3-party control agreement without disclosing its prior interest, or confirming the notification of a 2-party control agreement without disclosing its prior interest, or designating the securities in favour of the junior collateral taker without entering first a designation of its own interest.
- **Collateral takers taking their interest by credit to their own securities account with the same intermediary.** A collateral interest may also be perfected under Article 5, by credit to a securities account of the collateral taker. This applies to transfer-of-title security interest as well as to other security interests ("pledge accounts"). The senior collateral taker (CT1), who has perfected his interest otherwise, is not affected by the transfer to the subsequent collateral taker (CT2) because CT1 did not authorise the debit to the account of the collateral provider, and such debit is thus ineffective as against him, Article 7(1). The credit to the account of CT2 may be reversible under the domestic non-Convention law, unless CT2 was innocent, i.e. did not know and had no reason to know of CT1's prior interest. If CT2's credit is not reversed, then the majority view is that this is not a priority contest any more. In the rare case where the intermediary is incapable of making both whole (remember that the intermediary IM credited the securities to CT2's account, therefore committing itself toward CT2 who did not know and should not have been aware of CT1's prior interest), both collateral takers share in a possible shortfall along with all other account holders of the same intermediary.

Changes to the draft Convention

The discussions in the working group confirmed that the Articles of the draft Convention need to be revisited in particular so as to **clarify their respective scope of application and the sequence in which they should be applied.**

In particular, it seems that the proper sequence in applying the rules should be the following:

- Is any given book-entry effective? Should it be reversed because it was not authorised, or because it is conditional and the condition has not been satisfied, or because it must be reversed under the domestic non-Convention law or under the rules of a clearing and settlement system?
- The integrity of the system and the central significance of book-entries require that innocent parties are not affected by such corrections. The plenary may want to merge Article 7(6) and 11 as well as extend the effects of Article 11 beyond a “take free of adverse claim” rule towards an “immunity” rule.
- The rule on priorities probably only applies to competing interests on securities credited to one account. It does not apply to competing claims of account holders (whether or not as collateral takers) based on credits to their respective accounts. Such claims fall in the scope of Article 18 on shortfalls.
- Article 18 is a loss-allocation rule based on the policy decision that it is preferable that operational failures that cannot be easily corrected, and that lead to a loss in the rare cases where the intermediary is incapable of buying in the missing securities, should be spread among all account holders who have decided to keep their securities with that intermediary. This loss sharing is preferable to the allocation of the loss to the account holder in whose hands the Black Peter, the rotten apple, happens to land at the time the loss becomes final.

I must make a final remark as to the self-perfection of an intermediary interest under Article 6(1)(b). This was not our mandate, and we did not spend time on it. However, one member of the group expressed his concern that self-perfection is not offered as an alternative to Contracting States, but as a required way to perfect the interest of an intermediary.

Discussion of examples

These examples are substantially drawn from a document submitted by Joyce M. Hansen and Charles W. Mooney, Jr., which is enclosed with this note. Slight amendments and additional variations reflect the discussions of the working group.

EXAMPLE 1

Facts: A dispute arises concerning intermediated securities of the same description among account holders of the same intermediary and the intermediary fails to hold sufficient securities of a the same description to cover all intermediated securities of that description credited to its account holders' securities accounts.

Variation 1.1: The intermediary's failure to hold sufficient securities has occurred because an account holder was credited with securities after lodging a forged or invalid certificate with the intermediary and the account holder proves unable to provide genuine replacement securities to the intermediary. In the meantime, subsequent transactions among the intermediary's account holders may make it difficult or impossible to determine which of the account holders received the "bad" securities.

Discussion: The credit given to the account holder who lodged an invalid certificate **may be** subject to reversal under the account agreement with the intermediary or under the domestic non-Convention law, see Article 7(5). There is no need for a uniform rule. This would eliminate the excessive credits unless the securities were transferred to a bona fide transferee, who is and must be protected under Article 7(6). The account agreement or the domestic non-Convention may also require the account holder to procure replacement securities or compensate the intermediary.

If the problem is not solved otherwise, this excess credit situation (= insufficient securities) is not a priority contest among account holders. If the intermediary is unable to purchase sufficient securities, the loss must be shared among all account holders with the same intermediary* under Article 18.

Variation 1.2: The intermediary's failure to hold sufficient securities has occurred because it was instructed to transfer the securities to another account and, by mistake, gave credit for the same securities to two different securities accounts.

Discussion: The situation is substantially the same. It is likely that the unintended credit is subject to reversal under Article 7(5), which would eliminate the excess credits. However, the securities may also have been transferred to a bona fide onward transferee protected under Article 7(6). If the excess credit cannot be solved otherwise, the loss must be shared in accordance with Article 18. In particular, the onward transferee will share in the shortfall with all other account holders of the same intermediary.

EXAMPLE 2

Facts: An account holder (AH) grants a security interest in intermediated securities to a collateral taker (CT).

Variation 2.1: The intermediated securities are debited to AH's account and credited to the CT's account on the books of the account holder's intermediary under Article 6(2)(a) and Article 5.

Variation 2.2: AH is not debited and another step occurs that renders CT's security interest effective against third parties under Article 6.

A dispute arises concerning intermediated securities of the same description and the intermediary fails to hold sufficient securities to cover intermediated securities of the same description that are credited to its account holders' securities accounts.

* Please note that « all account holders with the same intermediary » designate only those account holders whose accounts are credited with securities of the same description as the missing securities, see Article 18(1).

Discussion: In Variation 2.2, CT's interest derives from AH's interest in the securities credited to AH's account. As discussed above, CT and AH together share the loss with all other accounts holders with the same intermediary.

In Variation 2.1, CT is an account holder distinct from AH. Because CT is credited with securities debited from AH's account, CT shares in the loss with all other account holders, while AH does not. Upon realisation of its security, CT will have to return the balance to AH.

Please note that if, by mistake, AH's account has not been debited with the securities credited to CT's account, the debit should probably be entered before any shortfall is allocated. If that is not possible – e.g., protection of a bona fide onward transferee under Article 7(6) –, the situation remains similar to Example 1. CT and the onward transferee share in the shortfall with all other account holders of the same intermediary.

EXAMPLE 3

Facts 3.1: AH, account holder of intermediary IM1, grants a security interest to CT in, or sells outright to CT, intermediated securities credited to CT's securities account with IM2. AH instructs IM1 to debit intermediated securities of the same description from its securities account and credit CT's securities account with IM2. (IM2 may or may not be a direct upstream intermediary in which IM1 holds a securities account with respect to the relevant intermediated securities.) IM2 credits CT's account. Subsequently, IM1 becomes insolvent and there is a shortfall in the relevant securities.

Discussion: There is no priority contest in this case. Account holders of insolvent IM1 have no claim against CT because CT obtained his interest by way of a credit to his securities account with IM2, another intermediary, thus avoiding the intermediary risk of IM1. After realising his security, CT may have to return the balance to AH.

Variation 3.2: Assume that CT did not qualify as an innocent acquirer under Article 11.

Discussion: This is not relevant to the protection of CT unless (i) AH did not have enough securities with IM1 and (ii) CT knew or should have been aware of it.

Variation 3.3: AH knows that IM1 is nearly insolvent or has a shortfall in the same securities and transfers its securities to his account with IM2, another intermediary.

Discussion: AH does not share in the shortfall of IM1 because he now holds his securities with IM2. Applicable bankruptcy law may provide for avoidance of the transfer. This is not dealt with by the draft Convention.

This solution of 3.1 and 3.3 are necessary to achieve the integrity of the intermediated system and the relevance of book-entries.

EXAMPLE 4

Facts: AH grants to CT a security interest in intermediated securities. The necessary steps are taken under Article 6 (by a method other than credit to a securities account of CT) so that the security interest becomes effective against third parties. Subsequently, AH grants to IM, its own intermediary, a security interest in intermediated securities of the same description, which is effective against third parties under Article 6(2)(b).

Discussion: This is the typical priority contest contemplated by Article 10(1). CT has priority over IM. Good faith and Article 11 are irrelevant here.

Variation 4.1: Reverse the timing so that the intermediary acquired its security interest first.

Discussion: This is similarly a case for Article 10(1). In general, IM has priority over CT. However, the working group found that IM may be deemed to have waived its priority in certain circumstances.

Variation 4.1A: In accordance with Article 6(2) and domestic non-Convention law, CT's interest is perfected through a control agreement notified to IM but not confirmed by it.

Discussion: CT could not rely on the assumption that it was perfecting a first interest in the securities. IM's interest ranks prior to CT's interest.

Variation 4.1B: In accordance with Article 6(2) and domestic non-Convention law, CT's interest is perfected through a 3-party control agreement signed by CT, AH and IM.

Discussion: By concurring in the perfection of CT's interest without giving it notice of its prior interest, IM must be deemed to have waived its priority and subordinated its interest. This is in line with Article 10(4), but should be made explicit. However, this implied subordination agreement only apply to the interest of the intermediary, not the interests of any other party, as evidence by the next variation.

Variation 4.2: AH grants to CT1 a security interest in intermediated securities. The necessary steps are taken under Article 6 (by a method other than credit to a securities account of CT1) so that the security interest becomes effective against third parties. Subsequently, AH grants to CT2 a security interest in intermediated securities of the same description, which is also perfected by a method other than credit to a securities account of CT2.

Discussion: CT1 has priority over CT2. CT2's good faith and Article 11 do not protect CT2 against CT1's senior interest. If IM concurred in the perfection of CT2's interest and failed to give CT2 notice of CT1's prior interest, this does not give CT2 precedence over CT1 but may oblige IM to compensate CT2 under the control agreement and the domestic non-Convention law.

EXAMPLE 5

Facts: AH grants to CT1 a security interest in intermediated securities. The necessary steps are taken under Article 6 (by a method other than credit to a securities account of CT1) so that the security interest becomes effective against third parties. Subsequently, the account holder grants a security interest to CT2, another collateral taker. On AH's instructions, but without the authority of CT1, the intermediary debits the AH's account for the relevant intermediated securities and credits the securities account of CT2 maintained with the intermediary for an equivalent amount of the relevant intermediated securities.

Discussion: CT1 is protected because the debit to AH's account is ineffective under Article 7(1). The credit to AH's account must be restored to the extent necessary to restore the interest of CT1. CT1 (through AH) and CT2 being two different account holders, there is no priority contest among them under Article 10. If the intermediary became insolvent and could not obtain enough securities to satisfy CT1 and CT2, CT1 and CT2 share in the shortfall with all other account holders.

Variation 5.1: CT2 was aware of CT1's senior interest and insisted upon perfecting its own security interest by having the securities credited to CT2's account with the same intermediary.

Discussion: While it may not be clear under the current wording of Article 11, CT2 acquisition is not protected because it was aware of AH's not having the power to transfer securities out of his account without the consent of CT2. "Adverse claim" may be too narrow.

Variation 5.2: CT2 was not aware of CT1's senior interest. CT2 perfected his interest by having the securities credited to his account with another intermediary (IM2).

Discussion: CT1 is not affected, because the debit to the original account is ineffective as against him. CT1 is exposed to the intermediary risk with IM1 in case of a shortfall. CT2 is protected against any tracing. CT2 is now exposed to IM2's intermediary risk, not to IM1. He is therefore unaffected by a shortfall with IM1. CT2 may, in special cases, be exposed to bankruptcy avoidance for fraudulent preference, but this is not regulated by the Convention.