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LA LOI APPLICABLE AUX ACTES DE DISPOSITION DE TITRES DETENUS DANS LE CADRE D'UN SYSTEME DE DETENTION INDIRECTE

Rapport établi par Christophe Bernasconi
Premier secrétaire au Bureau Permanent

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THE LAW APPLICABLE TO DISPOSITIONS OF SECURITIES HELD THROUGH INDIRECT HOLDING SYSTEMS

Report prepared by Christophe Bernasconi
First Secretary at the Permanent Bureau

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INTRODUCTION *

I. History of the project

The *Special Commission on General Affairs and Policy of the Hague Conference on Private International Law*, which met from 8–12 May 2000 in The Hague at the Peace Palace, recommended, among other things, that the following item be included, with priority, in the Conference's agenda for future work:

> "the question of the law applicable to the taking of securities as collateral, it being understood that, without waiting for the Diplomatic Conference, a working group open to all Member States, to experts and associations specialised in the field, should convene to examine, in collaboration with other international organisations, notably UNCITRAL and Unidroit, and the private sector, the feasibility of drawing up a new instrument on this topic."[1]

It had been stressed during the discussions that work on this subject not only could be, but should be, expedited in view of the immediate practical need for legal certainty. The Special Commission felt that this matter was indeed timely and important and needed to be addressed quickly.[2] It is against this background that the Secretary General of the Hague Conference has convened a *Group of Experts* to meet from 15–19 January 2001 in order to examine the possibility of preparing and adopting, through a "fast-track" procedure, a new instrument on this issue,[3] if possible even before the end of 2001.

This Report is designed to identify and illustrate the most important questions relating to

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* Given the very specialised nature of the subject matter, the Permanent Bureau has sought external advice to assist with the drafting of this Report. The Permanent Bureau is particularly grateful to RICHARD POTOK (of Potok & Co), who has acted as Legal Expert to the Permanent Bureau, and GUY MORTON (of Freshfields Bruckhaus Deringer) for their invaluable assistance and support in this matter. We would also wish to acknowledge the very helpful comments made on previous drafts of this Report by a group of other experts whose names are mentioned in Appendix A to this Report. We are also grateful to Mr Potok for permission to reproduce the charts and factual examples used in this Report. These will form part of a book entitled *Cross-Border Collateral: Legal Risk and Conflict of Laws*, edited by Mr Potok, which is due to be published by Butterworths during the first half of 2001. Furthermore, we would like to acknowledge the helpful assistance of ALEXANDRA SCHLUEP, research assistant with the Permanent Bureau, and CHRISTIAN REBER, doctoral candidate at Zurich University and practising lawyer in New York, in particular for their help in preparing the comments on Swiss law (see *infra* pp. 55 *et seq.*). The Permanent Bureau also wishes to thank De Pardieu Brocas Maffei & Leygonie for having provided the French translation of this Report, which was originally prepared in English.

1 See the *Conclusions of the Special Commission of May 2000 on General Affairs and Policy of the Conference*, prepared by the Permanent Bureau, Preliminary Document No 10 of June 2000, for the attention of the Nineteenth Session, pp. 25-26 and 27; these Conclusions are available on the website of the Hague Conference (http://www.hcch.net) under the heading *Work in progress*. See also Annex VI to the Conclusions, reproducing Working Document No 1 which introduced the joint proposal made by the Experts of Australia, the United Kingdom and the United States for the Hague Conference to develop a "short multilateral Convention clarifying applicable law rules for securities held through intermediaries" (p. 1 of Annex VI).

2 The Special Commission recognised that there was a real possibility of working expeditiously in this area because preliminary studies had already been carried out and experts in this field were prepared to collaborate with the Hague Conference on this project. See *Conclusions of the Special Commission of May 2000, op. cit.* (footnote 1), p. 26.

3 The Special Commission in May 2000 did not formally discuss what form the instrument should eventually take (in particular, convention or uniform law). Thus, the *Conclusions of the Special Commission* adopt the broad and neutral expression "*instrument*". The use of the term "*Convention*" in this Report, following the original Working Document introducing the topic at the Special Commission in May 2000 (see *supra*, footnote 1), obviously does not prejudice the form the instrument will ultimately take.

the topic and to examine possible solutions, with a view to serving as a basic working document at the meeting of the Group of Experts in January 2001.

II. Scope of project

A. The principal issue: updating the law to reflect market reality

Traditionally, securities were held, traded and settled in a "*direct holding system*" in which owners of securities had a direct relationship with the issuer – the investors would either be recorded on the issuer's register or be in physical possession of bearer securities certificates.[4] Within this traditional holding system, transfers of securities had to be settled through the physical delivery of paper certificates and instruments of transfer, making such transactions labour-intensive, time-consuming and expensive. They were also risky, because the paper documents could be lost, mislaid, stolen or counterfeited. The costs of protecting against such risks and of delivering documents across long distances made the transfer of securities in a direct holding system an expensive process. Furthermore, while in transit to the transferee, the securities were not available for use or investment, causing what has been referred to as "pipeline liquidity (or illiquidity) risk."[5]

These disadvantages have led to the evolution of a system under which, for the vast majority of securities, the investor no longer has a direct relationship with the issuer. Rather, the investor's interest in respect of the underlying securities is recorded on the books of an intermediary, which in turn has its interest recorded with another intermediary and so on up the chain until some intermediary either (i) is recorded as the registered owner on the books of the issuer or the issuer's official recordholder or (ii) holds the certificates or other documents of title representing the securities.[6] Thus, this *"indirect holding system"* has one or more tiers of intermediaries between issuer and investor, and interests in respect of underlying securities are recorded by book entries at

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4 In many cases, holders of registered securities will also be issued with a certificate, which may merely evidence ownership only or may be a document of title delivery of which is capable of creating proprietary rights in the securities.

5 See ROY GOODE, *The Nature and Transfer of Rights in Dematerialised and Immobilised Securities*, in: Fidelis Oditah (ed.), The Future for the Global Securities Market: Legal and Regulatory Aspects, Oxford 1996, pp. 108-109; RANDALL D. GUYNN, *Modernizing Securities Ownership, Transfer and Pledging Laws*, A Discussion Paper on the Need for International Harmonization, Capital Markets Forum, Section on Business Law, International Bar Association 1996, p. 16, and the further reference there given (this paper is available in pdf format on the Internet at http://www.dpw.com/iba/modernization.pdf). For a detailed analysis of the evolution of the indirect holding system in the United States in particular, see KENNETH KETTERING, *Repledge Deconstructed*, U. Pitt. L. Rev. 1999 (vol. 61), pp. 45 *et seq.;* STEVEN L. SCHWARCZ, *Intermediary Risk in a Global Economy*, 50 Duke L.J. April 2001 (forthcoming).

6 This Report uses the term "intermediary" as a general term including all the various kinds of financial institutions through which investors' interests are held, for example, brokers, nominee companies, banks and other custodians, settlement systems and depositories. For clarity, the intermediary on whose books the investor's interest is recorded is often referred to as the "immediate intermediary". The terms "custodian", "sub-custodian", "depository" and "depositary" are used in the market in a variety of contexts and there is frequently a substantial degree of overlap between them. This Report attempts to follow the terminology believed to be used in practice, but the use of particular words is not intended to imply significant legal distinctions as regards the functions of the relevant institutions as part of the various holding patterns described in this Report. For purposes of the conflict of laws analysis in this Report, the various terms are broadly interchangeable.

various levels in the chain. Transfers of such interests often occur through book entries without any form of delivery, whether constructive or actual.[7]

In most jurisdictions, neither the substantive laws governing securities transactions nor the rules determining the law applicable to such transactions have been updated adequately to reflect this market reality. In other words, in most countries the legal regime currently in place to cope with the indirect holding system dates back, to a greater or lesser extent, to a time when securities were still directly held in certificated form by investors. The concepts of (physical) possession and delivery, however, do not operate satisfactorily in the context of the modern indirect holding system, as there can be no actual possession or delivery of the intangible property interests arising under that system.[8]

The traditional conflict of laws rule for determining the enforceability of a transfer of property or a pledge of securities[9] effected in the direct holding system is the *lex rei sitae* (also referred to as the *lex cartae sitae* or the *lex situs*).[10] Under this rule, the validity of the transfer is determined by the law of the place where the security is located. In the case of *bearer* securities,[11] this is taken to be the law of the jurisdiction where the recipient of the collateral (collateral taker) takes possession of the securities certificate at the time of transfer. In the case of *registered* securities,[12] the *lex rei sitae* is either the law of the issuer's jurisdiction or the law of the jurisdiction where the securities records of the issuer or its official recordholder are located at the time of transfer.[13] But how does the *lex rei sitae* apply to a system where the securities are held through multiple tiers of

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7 The precise structure and nature of this indirect holding system will be described in more detail, see *infra*, pp. 12 *et seq.* For a very instructive presentation of the commercial and legal developments on both the money and the securities sides of transactions, see GUYNN, *op. cit.* (footnote 5), pp. 16-21 and 21-25. See also GOODE, *op. cit.* (footnote 5), pp. 112-115, which analyses a number of key issues arising from indirect holding systems.

8 See *e.g.*, UNIFORM LAW CONFERENCE OF CANADA (ULCC), *Tiered Holding System - Uniform Legislation Project*, Report of the Production Committee, April 30, 1997, drawn up by ERIC SPINK (Reporter), with updates presented in 1999 and 2000. The Report and the updates are available on the ULCC's website (http://www.law.ualberta.ca/alri/ulc/current/etiered.htm#c).

9 For a description of these terms, see *infra*, p. 6.

10 See *e.g.*, DICEY & MORRIS, *The Conflict of Laws*, 13 ed., London 2000, pp. 915-937; H. BATIFFOL / P. LAGARDE, *Traité de droit international privé*, Paris 1983, Vol. II, pp. 163-173; B. AUDIT, *Droit international privé*, 3rd edition, Paris 2000, pp. 630-658; H. DE VAUPLANE, *De la détention nationale à la détention internationale de titres: où sont les titres ? Problèmes juridiques liés à la dématérialisation des moyens de paiement et des titres*, Conseil National du Crédit 1997; the principle of the *lex rei sitae* in respect of collateral is enshrined in the second para. of Art. 3 of the French Civil Code which provides that French law governs the legal regime of real estate property (*immeuble*) located in France even when title to such property is held by a foreign person; this principle has been extended by the French Supreme Court to movable property (*Cour de cassation*, Req. March 19, 1872, *Craven*, D. P. 74. I. 465, S. 72. I. 238; see also *Cour de cassation*, Req. May 24, 1933, S. 935. I. 253 note BATIFFOL, *RCDIP* 1934, p. 142, note J.P.N.); since then, the principle has been confirmed by the French Supreme Court on several occasions (*Cour de cassation, 1ère civ.*, July 8, 1969, *Société DIAC, Clunet* 1970, p. 16, note DERRUPPE; *Cour de cassation 1ère civ.*, May 3, 1973, *Clunet* 1975, p. 74, note FOUCHARD); K. FIRSCHING / B. VON HOFFMANN, *Internationales Privatrecht*, 4th ed., Munich 1995, pp. 422-432; BERNARD DUTOIT, *Commentaire de la loi fédérale du 18 décembre 1987*, 2nd ed., Basle & Frankfurt 1997, *ad Art.* 100. For further references, see GUYNN, *op. cit.* (footnote 5), footnote 41. See also THILO ROTT, *Vereinheitlichung des Rechts der Mobiliarsicherheiten*, Tübingen 2000, pp. 3-5, with numerous comparative law references.

11 See *infra,* p. 8 for the terminology used here.

12 *Ibid.*

13 R.D. GUYNN / N.J. MARCHAND, *Transfer of Pledge of Securities held through Depositories*, in: Hans van Houtte (ed.), The Law of Cross-Border Securities Transactions, London 1999, pp. 49 and 55. A third possibility is that, where the certificate issued in respect of a registered security is treated as representing the security (for example, as being a negotiable instrument) the *lex rei sitae* will be the law of the jurisdiction where the collateral taker takes possession of the certificate at the time of the transfer.

intermediaries located in different jurisdictions? Is there another connecting factor which is more appropriate in these circumstances? This Report examines precisely these issues.

B. Application of the proposed Convention confined to proprietary aspects

It should be noted that there are always two components to a collateral transaction or transfer of property: first, the *contractual* element, describing the parties' obligations under the transaction and, secondly, the *proprietary* element, dealing with the transfer of rights in the property.

The rule discussed in this Report relates to the identification of the appropriate law to govern *proprietary* aspects of a disposition of interests in securities, in particular:

(i) the creation, perfection and enforcement of pledges[14] over such interests;[15]

(ii) the completion of a transfer of title or outright sale of such interests; and

(iii) issues of priority between competing dispositions.

In other words, the proposed Convention will only deal with the *proprietary* component of a collateral transaction or transfer of such securities. The contractual aspects of an agreement under which such a disposition is made are covered by separate conflict of laws rules. These rules are usually straightforward and allow the parties to choose the applicable law. Within the context of transactions in respect of indirectly held securities, these rules do not create specific problems which would need to be addressed in the proposed Convention.[16]

C. Issues not covered

At the outset, it should be noted that the proposed Convention will be confined to *conflict of laws issues*. There are therefore various issues that it will not address.

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[14] See *infra*, p. 6 for the sense in which the term "pledge" is used in this Report.

[15] A further aspect of pledges which may be regarded as raising proprietary issues is the validity of a provision under which the collateral taker is given the right to use the pledged securities for its own purposes, including the right to transfer them to a third party. Such a right is sometimes referred to as a right of "rehypothecation", though it generally extends to all kinds of onward dispositions and not merely to onward dispositions by way of pledge. Whether such a right may validly be created will be a matter both of the law governing the relevant contract and of the law governing proprietary aspects of the transaction. This is, therefore, one of the matters with which the proposed Convention will need to deal. In this context, one may note that Art. 6 of the proposed EU Collateral Directive (see *infra*, the references in footnote 31 *in fine*, as well as text on p. 52) would require Member States to ensure that such a right is recognised as valid under their substantive law.

[16] As regards the distinction between proprietary and contractual elements, an analogy may be drawn with the *Hague Convention of 1958 on the law governing transfer of title in international sales of goods*, which was negotiated as an instrument distinct from the *Hague Convention of 1955 on the law applicable to international sales transactions* (texts available on the website of the Hague Conference, in French only).

1. Nature of investor's interest and method of transfer

The proposed Convention will not impose changes on a State's substantive law regarding the nature of an investor's interest in securities held through indirect holding systems. Consequently, it may be assumed that the interests which an investor holds in the securities under local law prior to providing these interests as collateral or transferring them to a purchaser (be they proprietary or contractual,[17] the result of a new legal structure not involving co-ownership[18] or trust[19] interests) will *not* be altered by the proposed regime. The proposed Convention will not impose any obligations as to how such interests may be provided as collateral or transferred.

2. Upper-tier attachment

The proposed Convention will also not address the substantive law issue of so-called "upper-tier attachment" – that is, the problem that arises where a person with an interest at a lower level in the chain of holdings (for example, an investor or a person claiming to have acquired rights from an investor) seeks to attach or otherwise claim an interest in securities or an interest in securities held at a higher level where there is no record of that person's entitlement.[20]

3. Creation and issue of securities

Furthermore, the proposed Convention is not intended to alter the rules governing the creation and issue of the underlying securities or the rights and duties of the issuer as against direct holders of such securities and third parties.

4. Insolvency law

Perhaps most importantly, the proposed Convention will not interfere with a State's existing legal order in the field of *insolvency law*. Hence, the effects of a bankruptcy of one of the parties involved in a collateral transaction or sale,[21] be it the collateral provider/transferor, the collateral taker/transferee or the intermediary, will not be affected by the proposed Convention but will continue to be subject to each State's own (national, regional or international) regime.

5. Other forms of property held through indirect holding systems

Finally, it could be argued that the issues raised by indirect holding systems for securities also apply where other property (for example, physical commodities) is held in a similar

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17 For a presentation and discussion of these interests, see *infra*, p. 19 *et seq*.

18 *Infra*, p. 23.

19 *Infra*, p. 54.

20 See *infra*, footnote 113, and accompanying text.

21 For a description of these terms, see *infra*, p. 6.

way. However, it is not suggested that the scope of the proposed Convention should extend beyond the securities area.

To sum up, the proposed Convention should enable financial market participants to ascertain readily and unequivocally which law will govern the proprietary aspects of dispositions of interests in respect of securities held through indirect holding systems. The proposed Convention is thus intended to provide certainty and predictability on a limited but crucial aspect of such dispositions.

III. Terminology

The analysis of the questions raised in this Report requires frequent reference to a variety of technical terms which either may not have the same meaning in all jurisdictions or may refer to concepts which have no precise equivalent in some jurisdictions. In order to avoid any misunderstandings, it is therefore essential to describe briefly the meaning of the principal terms used in this Report.

A. "Pledge" and "security interest"

In this Report, the word "pledge" is used as a generic term and includes not only *possessory* security interests but also *non-possessory* forms of security interests such as mortgages and charges.[22] It is preferred to the alternative generic term "security interest"[23] because of the inevitable confusion with "interest in securities".[24] Under a pledge, the collateral provider retains ownership of the securities pledged.[25]

B. "Collateral", "collateral transaction", "transfer of title" and "sale"

In today's economy, there are numerous ways of raising money and obtaining protection against credit exposure. Not all the ways of obtaining such protection operate through the pledge mechanism: some use a *title transfer* mechanism, under which ownership of the collateral is transferred outright to the collateral taker, who only has a contractual obligation to redeliver equivalent securities. Examples of title transfer arrangements achieving a similar economic effect include "repurchase agreements",[26] "buy/sell-back

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[22] GUYNN, *op. cit.* (footnote 5), p. 13, uses the term "pledge" in the same broad sense.

[23] The term "security interest" is used in particular in the UNIFORM COMMERCIAL CODE (U.C.C.) of the United States; see Art. 1-201(37), which defines a security interest as "an interest in personal property or fixtures which secures payment or performance of an obligation", and Art. 9 U.C.C., which sets out the actual rules on "security interests" in investment securities.

[24] We fully recognise that the term "pledge" originally was limited to *possessory* interests in physical property only. Because of the potential confusion surrounding the expression "security interest" in an international (and multilingual) context, we nevertheless prefer to use the term "pledge" and deliberately extend its traditional meaning so as to cover *non-possessory* interests as well.

[25] Where a pledge includes a right for the pledgee to use the pledged securities for its own purposes (see *supra*, footnote 15), the exercise of the right will inevitably transfer title to a third party and the pledgor will thereafter have only a right to call on the pledgee to deliver equivalent securities.

[26] A "repurchase agreement", also referred to as "repo", "RP" or "buyback agreement", is a contract to sell securities with an agreement subsequently to repurchase equivalent securities on a specified date at a specified price. Repos may fall within one of four maturity categories: intra-day, overnight, open or term. An *intra-day repo* is one that matures at a later time on the day on which it was entered into. An *overnight repo* is one that matures on the day following its original settlement date. An *open repo* has an indefinite term; either party may terminate the transaction on demand. A *term repo* has a set maturity of more than one day. Finally, a "reverse repo" is a repo viewed from the perspective of the buyer, that is, a contract to buy securities with an agreement subsequently to sell back equivalent securities on a specified date at a specified price. See BANK FOR INTERNATIONAL SETTLEMENTS (BIS), *Cross-Border Securities Settlements, Report prepared by the Committee on Payment and Settlement Systems of the central banks of the Group of Ten countries*, Basle, March 1995, Glossary, p. 40 and pp. 41-42 (with a further differentiation according to the arrangements for custody of the repo securities: *delivery repo*, *tri-party repo* and *hold-in-custody repo*); see also

transactions,"[27] "securities loans"[28] and swap transactions using a title transfer structure.[29] A title transfer arrangement undoubtedly can be used to fulfil a *security function,* and where it does so is to be regarded as a collateral transaction, even if – technically speaking – it does not create a pledge over collateral.[30] Hence, the term "collateral transaction" has to be understood in a broad sense so as to encompass *every*

GUYNN / MARCHAND, *op. cit.* (footnote 13), p. 54, footnotes 12 and 13; DE VAUPLANE / BORNET, *Droit des marchés financiers,* Paris 1998, No. 847, p. 730. Repos have the advantage of avoiding both the difficulties linked with perfection rules applicable to pledges and restrictions on the reuse of the pledge by the collateral taker. Parties to such title transfer transactions may, however, face the risk that the repo is recharacterised as a pledge by a court, with the consequence that if the perfection requirements for a pledge have not been satisfied, the whole collateral arrangement might be void. As the proposed Convention is not intended to interfere with national substantive laws, it will not offer protection against such a recharacterisation risk. On recharacterisation risk in particular, see JOANNA BENJAMIN, *Recharacterisation Risk and Conflict of Laws*, Oxford Colloquium on Collateral and Conflict of Laws, Special Supplement to Butterworths Journal of International Banking and Financial Law, September 1998, pp. 29-37, and RICHARD FENTIMAN, *Cross-Border Securities Collateral: Redefining Recharacterisation Risk*, *ibid.*, pp. 38-46.

[27] A "buy/sell-back" or "buy/sell" transaction is an arrangement under which the parties contemporaneously enter into two separate transactions in respect of the same security: a sale of the security is arranged for normal or same-day settlement, and a forward transaction is arranged for the seller to repurchase the security on a specified date at a specified price. This transaction can serve the same purpose as a repo, but it may also be used when repo transactions are restricted. Furthermore, parties may choose not to document buy/sell-back transactions under a master agreement, because of a desire to preserve the independent identity of the two parts of the transaction. See BIS, *op. cit.* (footnote 26), p. 41; see also GUYNN / MARCHAND, *op. cit.* (footnote 13), p. 54, footnote 14.

[28] A "securities loan" is an agreement in which securities are lent to a counterparty, usually against cash or other collateral, BIS, *op. cit.* (footnote 26), pp. 40 and 41; see also GUYNN / MARCHAND, *op. cit.* (footnote 13), p. 54, footnote 16. The transfer of the borrowed securities, and in many cases also the transfer of any securities, is made by way of full title transfer, with the recipient having the obligation to deliver equivalent securities on the unwinding of the loan. It will be seen that a securities loan in many respects resembles a repo, particularly where it is made against cash collateral. The main difference is that in the case of a securities loan the borrowed securities are not transferred by way of sale – the consideration for the transfer of the borrowed securities is the undertaking to return equivalent securities plus, generally, a borrowing fee representing compensation for the benefit of the use of the borrowed securities. The transfer of cash serves a collateral function rather than being the direct consideration for the transfer of securities.

[29] The 1995 International Swaps and Derivatives Association's (ISDA) Credit Support Annex (Transfer Version) uses such a structure. For more information, see the *Guidelines for collateral practitioners*, published on ISDA's website (http://www.isda.org/press/pdf/colguide.pdf); see also KENNETH KETTERING, *op. cit.* (footnote 5), pp. 45 *et seq.*, and KOLIFRATH, *L'annexe AFB remise en garantie*: RD, *bancaire et bourse*, No. 62, 1997, p. 142.

[30] See in this respect the Explanatory Memorandum of the Belgian Act dated 2 January 1991 on public debt instruments, making the distinction between the economic purpose of a repo and its legal categorisation. Some jurisdictions, such as Italy, have a category of "irregular pledge" which confers on the pledgee rights substantially similar to transfer of title and should therefore be regarded for purposes of this Report as falling within the transfer of title as opposed to the pledge category. Mexican law also recognizes irregular pledges over fungible securities, the effect of which is to pass title to the pledgee. Some other jurisdictions, such as Brazil, do not recognize title transfer as a means of effecting a valid collateral transaction.

transaction intended to secure outstanding credit, whether or not it creates a pledge over the property to which it applies.[31] Equally, the term "collateral" is to be understood to apply to any property which is the subject of a collateral transaction.[32]

This Report focuses mainly on collateral transactions because, in practice, it is normally in relation to collateral transactions that the most significant issues tend to arise. However, there seems to be no reason to distinguish for this purpose title transfers under collateral transactions from ordinary transfers by way of sale. Consequently, the conflict of laws rules should be the same for all types of transfers.

C. "Perfected" and "completed" interests

In secured transactions law, the term "perfection" refers to the conditions necessary to protect a security interest, as far as the law permits, so as to make it valid against third parties generally.[33] We use "completed" in an equivalent sense for title transfer, that is, to describe the full transfer of title to the transferee.

D. "Certificated" and "uncertificated" securities; "bearer" and "registered" securities; "physical" and "dematerialised" securities; "immobilised" securities

Securities may be described or classified by reference to various distinctions which may be useful in different contexts. As will be explained in more detail below, the uncertainties which the proposed Convention is designed to address apply regardless of which classification is adopted. Accordingly, the classifications are not of fundamental importance in the context of this Report, and except where indicated, no distinction is

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[31] See GUYNN, *op. cit.* (footnote 5), p. 13; DE VAUPLANE / BORNET, *op. cit.* (footnote 26), No. 717, p. 607. See also ROY GOODE, *Security Entitlements as Collateral and the Conflict of Laws*, Oxford Colloquium on Collateral and Conflict of Laws, Special Supplement to Butterworths Journal of International Banking and Financial Law, September 1998, p. 24, footnote 13; RICHARD POTOK, *Rapporteur's Summary*, *ibid*., p. 4, footnote 2; CHRISTIAN REBER, *The Indirect Holding System of Securities and Collateral Transactions: Conflict of Law Issues*, Term paper presented at New York University for a Seminar on the Regulation of Financial Markets (spring 2000), on file with the author of this Report, pp. 8-9.

The factors relevant to the party's choice between pledge and transfer of title structures may include tax, accounting, infrastructure and other considerations, it being understood that the most important economic difference between the two forms of transaction is that under a title transfer arrangement the collateral provider incurs a credit exposure to the collateral taker to the extent that the value of the collateral is greater than that of the corresponding obligation, whereas this is not the case where a pledge only is taken, as long as the collateral is not being used. Again, the proposed Convention would not interfere with or require modifications of existing substantive law provisions in this matter. For a proposed measure which goes further and also deals with issues of substantive law, including insolvency, but whose territorial scope is regional and not global, see the proposed *Directive of the European Parliament and of the Council on the cross-border use of collateral* (the proposed EU Collateral Directive). This Directive is intended to harmonise the legislation of EU Member States in order to create a uniform minimum regime for the provision of securities as collateral under both pledge and title transfer structures; see the *Working document on Collateral from the Commission to relevant bodies for consultation, First preliminary draft proposal for a Directive*, Document number C4/PN D(2000), dated 15 June 2000; on the conflict of laws rule embodied in this Directive, see *infra*, p. 52.

[32] Many collateral transactions include a provision that, after the initial delivery of securities has been effected, further collateral movements are triggered by changes in the value of the securities; this additional collateral is referred to as "top-up collateral" or "variation margin". Even though top-up collateral movements may raise specific issues under insolvency laws, there is no reason to treat them differently from other collateral transactions for the purposes of the conflict of laws analysis.

[33] See *e.g.*, ROY GOODE, *Commercial Law in the Next Millennium*, London 1998, pp. 58 *et seq.*

drawn between different categories of securities. Nevertheless, it may be helpful here briefly to describe the main terms which are in frequent use.

Securities are *certificated* if the issuer issues one or more certificates in respect of them. Such a certificate may be a document of title, in the sense that possession or delivery of it will of itself confer proprietary rights over the securities; alternatively, the certificate may merely be evidence of title, with some other or additional document being required to transfer proprietary rights. Certificates may be issued either in respect of individual holdings or in the form of one or more "jumbo" or "global" certificates created in respect of the entire issue.[34] *Uncertificated* securities are securities in respect of which no certificate is issued.[35]

The expression *bearer* securities generally refers to securities which are represented solely by physical certificates or other documents of title, each of which gives the bearer rights with respect to the securities which it represents; the issuer maintains no register or other record of the identity of individual owners of the bearer securities. *Registered* securities are securities in respect of which such a register is maintained. The register may or may not be the conclusive record of ownership of the securities.[36]

A *dematerialised* security, in the full sense of the word, is a security the issue and holding of which are evidenced solely by computerised or electronic entries in a system maintained by the issuer or by a recordholder acting for the issuer.[37] The expression *physical securities* is generally used to refer to certificated securities.

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[34] Many securities issued by corporations and governmental bodies are still issued in *certificated* form. In many instances, however, the issuer will issue one or more *jumbo* or *global* certificates representing most, if not all, of the issued and outstanding shares of the corporation's stock or bonds of the relevant issue: individual certificates either will not be issued at all or, in some cases, will only be issued to investors who specifically request them. The jumbo or global certificate is issued to and held by the appropriate clearing corporation or depository institution, and individual holdings are represented by accounts held with the clearing corporation or depository institution; the securities are therefore immobilised (for a description of the term *immobilised,* see below in text). For a presentation of a global bond issue, see MOUY / DE VAUPLANE, *Dématerialisation et titres internationaux,* Revue Banque, no° 565, Deventer 1995, p. 56.

[35] An issue of securities may be wholly uncertificated, where holders never have the right to request the issue of certificates, or partially uncertificated, where holders who wish to hold certificates may request them.

[36] For example, in jurisdictions where title to a certificated registered security may pass by delivery of the certificate, examination of the register alone will not establish the position as to title – indeed, the register may in some instances not reflect the true position, since possession of the certificate may confer the best title.

[37] A good example of an uncertificated security is a United States *Treasury security*. Such securities are maintained in the book-entry system operated by the Federal Reserve System on behalf of the United States Treasury, and ownership of the securities is recorded on the books of the Federal Reserve Banks. Only banks which are members of the Federal Reserve System and certain other parties have accounts with the Federal Reserve Banks. Accordingly, member banks, in addition to holding their own securities, also act as intermediaries for their clients and other financial institutions. The relevant regulations refer to the interests recorded on the books of such intermediaries as "securities entitlements", using the terminology of Art. 8 of the U.C.C. (see *infra*, p. 23).

France has introduced a fully dematerialised securities regime. It has, however, maintained the distinction between securities in bearer form (*titres au porteur*) and securities in registered form (*titres nominatifs*). In respect of bearer securities, transfer occurs from an account in the books of an authorised financial intermediary to another account held with an authorised financial intermediary. In respect of registered securities, the transfer needs to be recorded on the register maintained by the issuer or by the agent designated by the issuer.

There are also certain "hybrid" forms of securities, for example, German Federal Debt, which is issued in entirely dematerialised form, but to the extent that securities of the issue are held through Clearstream Banking Frankfurt, those securities are evidenced by a global certificate held by Clearstream. Another example exists in Peru, where certain securities can be held by investors in certificated form, but once they are deposited in Cavali, the Peruvian central securities depository, they are dematerialised. For a description of Clearstream and the operation of central securities depositories, see *infra,* p. 12.

Securities may be *immobilised* through an arrangement under which most or all of the securities of an issue are held by one or more depositories and interests in or in respect of the securities are represented by accounts maintained by the depository.[38] As we have seen, such an arrangement is a key feature of the indirect holding system.[39]

All these categories of securities can be held either directly or through accounts with one or more tiers of intermediaries. The differences between the categories are not important for the functioning and practical operation of the indirect holding system, though they may in some cases be important when the legal nature of the investor's interest in the securities needs to be determined.[40]

E. "Fungible" / "omnibus" versus "non-fungible" / "traceable" accounts

A key distinction for the purposes of this Report is that between:

(i) holding patterns under which an investor's interest in respect of securities is recorded solely on the books of the immediate intermediary with whom the investor's account is maintained, and

(ii) holding patterns under which the investor's interest not only is recorded on the books of its immediate intermediary but also is separately recorded on the books in which that intermediary's interests (including interests of other investors for whom it acts as intermediary) are recorded.

Under the former holding pattern, the immediate intermediary will hold all its interests held for investors in a single account (often referred to as an "omnibus account"), which may be designated as a "customers" account but which will not include any information about the identity or entitlements of individual customers. The accounts of investors under this structure are referred to in this Report as "fungible"[41] accounts.[42]

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[38] Immobilised securities may be referred to as "book-entry only" or "BEO" securities in circumstances where the entire issue is held in immobilised form – for example, where a global certificate representing the entire issue is held by a depository, with no facility for individual holders to obtain definitive certificates and interests of individual holders are transferable only through book entries in accounts maintained by the depository or by other intermediaries.

[39] See *supra,* p. 2; for more details on the structure and functioning of indirect holding systems in general, see *infra,* p. 12 *et seq.*

[40] See the example of Switzerland, *infra* pp. 55 *et seq.*

[41] It is true that most securities, even directly held securities, are strictly "fungible" in the sense that securities of the same issue cannot, unless specifically numbered, be distinguished one from another and are therefore treated as equivalent. However, the use of the term more generally in relation to accounts is helpful in pointing to the key feature of absence of specific identification of the individual investor at the higher level.

[42] For a more detailed description of fungible and non-fungible accounts, see GOODE, *op. cit.* (footnote 5), pp. 116-117.

Under the latter holding pattern, each intermediary in the chain between investors and the issuer will maintain separate accounts or sub-accounts in which the identity and interests of specific investors are recorded. Accounts of this kind are referred to in this Report as “non-fungible” or “traceable” accounts.

IV. The structure of the present Report

This Report is divided into three parts. In Part One, we explain *the basic structure and functioning of the indirect holding system* (often also referred to as the *multi-tiered* holding system). In order to ascertain the relevant conflict of laws rule for transactions effected through the indirect holding system, it is necessary to begin by portraying its essential traits and features. In Part Two, we analyse *how* the *legal nature* of the *investor's interest* in respect of securities held in an indirect holding system might be *categorised* (property rights, contractual claims, security entitlements). Although the proposed Convention will *not* affect the different types of interest provided for under national substantive laws, this question needs to be addressed in the conflict of laws analysis, as it is only after having determined *what* the interest in the securities is that one may properly ascertain *where* this interest lies (*lex rei sitae)*. The actual *conflict of laws analysis* is discussed in Part Three of the Report.

PART ONE:

THE INDIRECT (MULTI-TIERED) HOLDING SYSTEM

Section 1 — The structure of the indirect holding system

Securities clearance and settlement systems have developed over time to respond to new demands of the changing market. Settlement by physical delivery of certificates to the buyer or the buyer's agent worked adequately until the 1960s, when a sharp increase in trading volumes overwhelmed the system: the gigantic amount of paper that had to be physically moved around the globe began to pose insurmountable logistical problems, eventually leading to the famous "paperwork crisis" on Wall Street in the late 1960s.[43] This provided the impetus for a number of legal, regulatory and operational innovations to clearance and settlement systems. One of the most important objectives of the restructured system was to immobilise the vast amount of paper, if not eliminate it altogether. This goal was achieved by introducing the indirect or multi-tiered holding system.

As its name suggests, this structure is made up of various tiers, often with an increasing number of entities involved in each of the tiers, thus making the structure look like a *pyramid*.[44] The top tier comprises *national* and *international central securities depositories* (CSDs and ICSDs, respectively), where large pools of securities of different issuers are immobilised or otherwise concentrated. Most (if not all) of the issues of many governments and major corporations are held by such institutions.[45] In the case of

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[43] See references in REBER, *op. cit.* (footnote 31), p. 9, footnote 23. Whereas in 1960 the average trading volume on the New York Stock Exchange was around 3 million shares per day, by 1968 this had more than quadrupled to almost 13 million shares per day (Securities Industry Study, Report of the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives, 1972, pp. 1, 3). As a comparison, in 1999 the average daily trading volume was over 809 million shares per day (http://nyse.com/pdfs/activity99.pdf).

[44] See *e.g.*, GOODE, *op. cit.* (footnote 31), p. 22; REBER, *op. cit.* (footnote 31), pp. 9-10.

[45] The oldest CSD was the *Wiener Giro- und Cassenverein*, founded in 1872 in Austria, which was later followed by the German *Kassenverein*, now part of Clearstream International. The predecessor of Sicovam, the present French CSD, was established during World War II. Plans of the New York Stock Exchange to set up a similar entity in the United States before World War I did not materialise; it was only after the paperwork crisis that *The Depository Trust Company* (DTC) was established. In September 1999, *The Depository Trust & Clearing Corporation* (DTCC) was established as a new holding company that has as its subsidiaries DTC and the *National Securities Clearing Corporation* (NSCC). Today, DTC is the world's largest CSD. In 1999, the company had custody of over 2 million equity and debt securities issues worth $ 23 trillion. It processes more than 250 million institutional trade confirmations yearly. During 1999, DTC processed more than 189 million book-entry deliveries valued at more than $ 94 trillion. Increasingly, DTC is servicing non-US issues as well as US issues, and non-US participants as well as US participants. NSCC processes practically all broker-to-broker equity and corporate and municipal bond trades in the US. For more information, see the websites of DTCC (http://www.dtcc.com), DTC (http://www.dtc.org) and NSCC (http://www.nscc.com).

The most important ICSDs are Euroclear and Clearstream (formerly Cedel). Founded in 1968 by the Brussels office of Morgan Guaranty Trust Company of New York following the "paperwork crunch", the *Euroclear System* has become one of the world's largest clearance and settlement systems for internationally traded securities. In 1999, its turnover amounted to EUR 43.6 trillion. Over 130,000 securities are accepted in the Euroclear System, covering internationally traded debt instruments, convertibles, warrants and equities. In 1972, Euroclear was sold to the *Euroclear Clearance System Public Limited Company* (ECSplc, UK), which in turn is owned by 119 of the world's major banks, broker/dealers and other financial institutions actively using the Euroclear System as participants. In 1986, ECSplc licensed the Euroclear System to the *Euroclear Clearance System Société Coopérative*, a Belgian cooperative corporation formed to give more users an opportunity to participate in ownership. Morgan Guaranty Brussels, however, continues to operate the system. This role will be taken over by a new, market-owned *Euroclear Bank* in early 2001, subject to obtaining all regulatory approvals. In March 2000, Euroclear and Sicovam announced their plans to fully merge the two entities. The merger is expected to become effective in early 2001. The annual turnover value of transactions settled in the merged entities will then surpass EUR 80 trillion. For more information, see the website of Euroclear (http://www.euroclear.com).

certificated issues, the actual certificates evidencing or representing the securities are kept either in the vault of the CSD itself or in the vault of the CSD's custodian or sub-custodian. Registered securities held by the CSD are entered in the issuer's records under the name of the CSD or a nominee.[46]

The next tier consists of a limited number of financial institutions, brokers, depositories and other professional investors who have direct contractual relationships with the CSDs and who hold their interests in securities in book-entry accounts with a CSD.[47] These intermediaries are called the *participants* of the CSD.[48] These participants, in turn, hold in their accounts interests in or in respect of securities either for themselves or for their customers, such as institutional or retail investors or further intermediaries, and so forth until accounts are held for the investors. As a result, there may be a variable number of tiers between the investors at the bottom of the structure and the securities themselves located with or registered in the name of the CSD (or its custodian, sub-custodians or nominees). This structure allows the issuer to deal with a single entity, the CSD.[49] The

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Cedel stands for *Centrale de Livraison de Valeurs Mobilières* and was incorporated in 1970 as a limited company under Luxembourg law by 66 financial institutions from eleven countries as a neutral and independent capital markets infrastructure. It is currently owned by 92 financial institutions from Europe, the Americas and Asia. In 1999, Cedel International (the parent company of the Cedel group) announced a merger with *Deutsche Börse Clearing AG* to create a European clearing house, *Clearstream International*. At the beginning of 2000, Cedel International contributed its entire clearing, settlement and custody business to Clearstream International in return for a 50% participation. Cedel International remains as a holding company representing the interests of its shareholders. Under the new corporate structure, clearing and settlement activities are conducted by two subsidiaries, *Clearstream Banking Luxembourg* and *Clearstream Banking Frankfurt*. These entities have custody of securities' issues worth more than EUR 9 trillion; they settle and clear 500,000 transactions a day and more than 150 million transactions per year. For more information, see the website of *Cedel International* (http://www.cedelinternational.com).

[46] In the United States, the shareholder records of large corporations whose shares are publicly traded generally show a single entity – CEDE & CO. – as the registered owner of approximately 83% of all shares listed on the New York Stock Exchange, 72% of all shares traded on Nasdaq and 91% of all corporate debt securities listed on the New York Stock Exchange. CEDE & CO. is the nominee name used by DTC: see THE AMERICAN LAW INSTITUTE, National Conference of Commissioners on Uniform State Laws, Uniform Commercial Code, Official Text – 2000, Revised Article 8 (1994 Revision), Prefatory Note, p. 655 (hereinafter U.C.C. 2000).

[47] In some countries, for example Sweden and Finland, it is possible for investors as well as intermediaries to hold accounts directly with the relevant CSD. In Norway, in fact, local investors must hold directly with the CSD.

[48] By way of example, DTC has some 600 participants – primarily broker-dealers, banks and depositories, see U.C.C. 2000, *op. cit.* (footnote 46), p. 655. Euroclear has approximately 1,900 participants located in more than 80 countries.

[49] In some instances, for example, Daimler-Chrysler shares, issues may be structured so that the securities are held through two or more CSDs. See *e.g.*, DIETRICH SCHEFOLD, *Grenzüberschreitende Wertpapierübertragungen und Internationales Privatrecht – Zum kollisionsrechtlichen Anwendungsbereich von § 17a Depotgesetz*, IPRax 2000, p. 470, footnote 18 and accompanying text.

CSD, in turn, deals with a limited number of large players, who in turn will deal with a greater number of smaller participants, and so on through the pyramid.

The investors do not appear on any register of ownership maintained by or on behalf of the issuer,[50] nor do they have actual possession of certificates. The records of a CSD show the securities held on behalf of its various participants, and the records of each such participant show the securities held on behalf of their individual customers.[51]

Within an indirect holding system, it becomes apparent that it is the *account* rather than the *certificates* that is the source of the investor's entitlement.[52]

The efficiency of the indirect holding system is further improved by the practice of most CSDs and intermediaries of holding securities in *fungible pools*. Under this structure, participants or customers lose the right to call for delivery of specific securities and have instead the right to call for securities of the issue, type and quantity corresponding to their book-entry holdings. The effect of this structure on the legal analysis of the rights of CSDs, intermediaries and their customers is examined in Part Two below.[53] This concept of fungibility is critical to ensure liquidity of issues.[54] Fungibility also reduces the administrative costs associated with the custody of securities.

Today, the great majority of actively traded securities are held through a system of intermediaries.[55]

Here is a *typical fact pattern* [56] under the indirect holding system. The fact pattern is schematically depicted in FIGURE A below:

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[50] However, rules of corporate law may entitle or require an issuer to obtain details of the identity of persons entitled to, or interested in, securities – for example, for purposes of voting or of ascertaining the level of particular holdings. Such rules do not form part of the rules governing ownership and will not determine the position as regards proprietary rights. The *lex societatis*, will of course continue to govern matters between the issuer and its members, such as voting rights.

[51] With respect to *titres nominatifs* in France, see *infra,* p. 23.

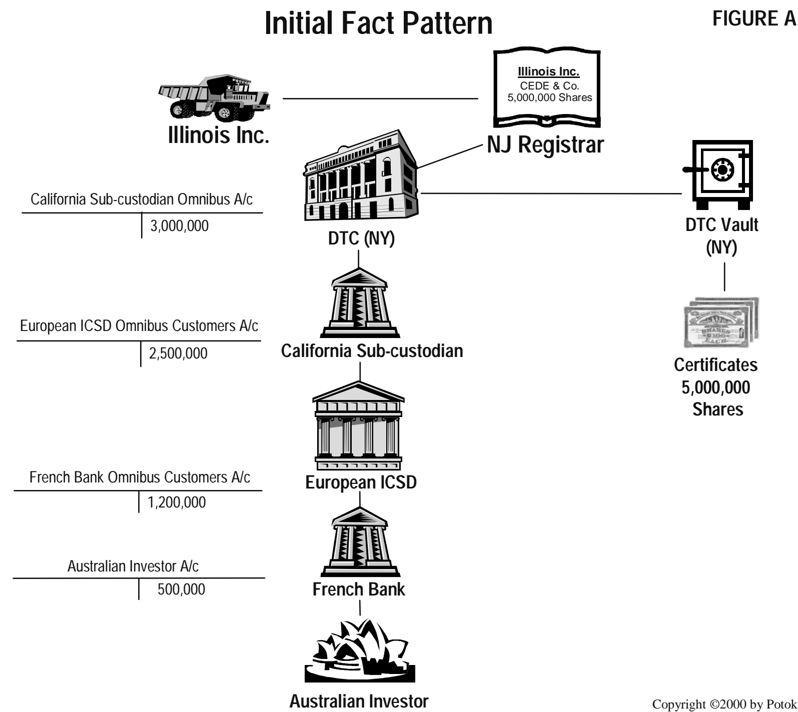
[52] See *e.g.*, GOODE, *op. cit.* (footnote 31), p. 23, and DE VAUPLANE, *De la détention nationale à la détention internationale de titres : où sont les titres ?,* Annexe au Rapport du Conseil National du Crédit et du Titres, Problèmes juridiques liés à la dématérialisation des moyens de paiement et des titres, Paris, mai 1997, p. 157.

[53] See *infra*, pp. 19 *et seq*.

[54] Some CSDs and intermediaries also agree to hold interests for participants or customers on a non-fungible, that is, identifiable basis (see also the comments *infra*, p. 20); for an analysis of the possible application of the proposed Convention to such non-fungible structures, see *infra*, p. 46. In Canada, securities held in such an account and actually registered or in the process of being registered in the name of the customer are known as "customer name securities" in contrast to securities held on a pooled basis, which are known as "customer pool fund securities".

[55] For more detailed presentations of the indirect holding system, see the references in GUYNN / MARCHAND, *op. cit.* (footnote 13), p. 52, footnote 6.

[56] For the sake of simplicity, the examples used in this Report involve only shares of a single company. The fact patterns occurring in practice, particularly where portfolios of securities are provided as collateral, will often be much more complicated. However, we believe that the simplified fact pattern illustrates the relevant issues.



Australian Investor is a corporation formed in Sydney, Australia. It holds an interest in respect of 500,000 Illinois Inc. shares through the indirect holding system.

Illinois Inc. is incorporated in Illinois in the United States. Illinois Inc. has 5,000,000 shares outstanding. They are all held through DTC, which is incorporated and has its principal place of business in New York.[57] DTC keeps the actual physical certificates representing the Illinois Inc. shares in its vault in New York. Illinois Inc. maintains a share register in Newark, New Jersey, with a registrar, NJ Registrar, located there. DTC's nominee, Cede & Co., is recorded in the share register as the registered owner of the 5,000,000 outstanding Illinois Inc. shares.

Australian Investor's ownership interest in respect of the 500,000 Illinois Inc. shares is reflected by a book entry credited to an account entitled "Australian Investor Account" at its intermediary, French Bank, located in Paris.

French Bank, in turn, holds interests in respect of the Illinois Inc. shares corresponding to Australian Investor's interest, together with interests of other customers of French Bank, through book entries credited to an account entitled "French Bank Omnibus Customers Account" on the books of a

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[57] DTCC maintains its management headquarters in New York City. The operations centre and data-processing facilities for DTC and NSCC are located in New York State. Representative offices are located in Chicago, San Francisco and London (information from the website of DTCC at http://www.dtcc.com).

European ICSD. In total, French Bank holds for all its customers (including Australian Investor) interests in respect of 1,200,000 Illinois Inc. shares.

European ICSD, in turn, holds interests corresponding to French Bank's interests in respect of the Illinois Inc. shares, together with interests of other participants in the European ICSD system, through book entries credited to an account entitled "European ICSD Omnibus Customers Account" on the books of the ICSD's sub-custodian in the United States, California Sub-custodian, located in Los Angeles, California. In total, European ICSD holds for all its customers (including French Bank) interests in respect of 2,500,000 Illinois Inc. shares.

California Sub-custodian, in turn, holds interests corresponding to European ICSD's interests in the Illinois Inc. shares, together with interests of other customers of California Sub-custodian, through book entries credited to an account entitled "California Sub-custodian Omnibus Account" on the books of DTC. In total, California Sub-custodian holds for itself and all its customers (including European ICSD) interests in respect of 3,000,000 Illinois Inc. shares.

Each of the intermediaries in this indirect holding system holds interests in securities on an unallocated, fungible or pooled basis – that is, on terms that none of its account holders has an interest in any specific securities held by the intermediary at a higher level. Thus, for example, French Bank's custody agreements provide that Australian Investor and French Bank's other customers are not entitled to any specific securities held in the "French Bank Omnibus Customers Account". Similarly, European ICSD's Terms and Conditions specify that no European ICSD account holder has any interest in any specific securities held by European ICSD with sub-custodians or central securities depositories.

In this situation, if Australian Investor wishes to provide its interests in the Illinois Inc. shares to a credit provider under a pledge mechanism the contractual aspects of which have been submitted by the parties to English law,[58] the credit provider needs to know before entering into the transaction which requirements have to be fulfilled so as to ensure that the credit provider will receive an interest that will prevail over the interests of third parties (including the interests of the liquidator should Australian Investor enter insolvency).

In order to assess this question, the credit provider (collateral taker) needs to ascertain which jurisdiction's law will govern the proprietary aspects of the transaction. In the current fact pattern there are a number of possibilities – among others, is it:

(i) Illinois law, as the law of the place of incorporation of the issuer of the underlying securities?

(ii) New Jersey law, as the law of the place of the register for the underlying securities?

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[58] Using "pledge" in the broad sense explained above (see *supra*, p. 6); the document is likely to be termed a "fixed charge" under English law.

(iii) New York law, as the law of the place where the underlying security certificates are kept?
(iv) New York law, as the law of the place of the national CSD?
(v) California law, as the law of the place of European ICSD's sub-custodian?
(vi) the law of the place where European ICSD is located?
(vii) French law, as the law of the place of Australian Investor's intermediary?
(viii) English law, as the law chosen by collateral provider and collateral taker in the pledge agreement?
(ix) English law, as the law of the place of the collateral taker?
(x) Australian law, as the law of the place of the debtor (collateral provider)?

We return to this fact pattern in Part Three of this Report.

Section 2 — Importance of the indirect holding system

Today, the indirect holding system accounts for the vast majority of securities around the world. The system caters to the needs of a global marketplace: it reduces the processing and settlement costs and risks of loss, theft and counterfeiting associated with a direct holding system,[59] and the transfer of interests in securities by mere accounting entries on the books of one or more intermediaries also allows for a rapid and efficient disposition of those interests, both domestically and across borders. The fact that the settlement time frames have shrunk and that these interests can be rapidly transferred enhances the efficiency of the indirect holding system compared to a traditional direct holding structure. The velocity of transactions has grown and continues to grow. The efficiency of the indirect holding system is further enhanced by the practice of *netting*,[60] under which market participants are able to limit their credit exposure, and by the fact that transactions within indirect holding systems are usually settled on the basis of *delivery versus payment* (DVP).[61]

Section 3 — Transfers within indirect holding systems

In order to effect a transfer between two investors who are customers of a single intermediary in an indirect holding system, it is sufficient to make debit and credit entries in the books of that intermediary. No delivery of physical securities or entry on the issuer's register is required. All that happens is that a book entry is made in the relevant

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[59] See *supra*, p. 2.

[60] Netting is an agreed offsetting (compensation) of mutual positions or obligations by trading partners or participants in a settlement system so that a large number of individual positions or obligations are reduced to a smaller number of positions or obligations, GUYNN / MARCHAND, *op. cit.* (footnote 13), p. 55, footnote 21. Netting is a technical and complex subject, a full description of which is beyond the scope of this Report.

[61] This means that cash and securities are exchanged simultaneously in electronic book-entry form. The fact that DVP is simultaneous eliminates the risk of a seller delivering securities without receiving payment from the purchaser, or of a purchaser making payment without receiving securities from the seller.

accounts of the investors on the books of the intermediary; no entries are made on the books of upper-tier intermediaries or the issuer.[62] As far as these are concerned, nothing changes with regard to actual possession or record ownership of the securities. Hence, in most cases, only the immediate parties to a transaction know the identity of the person ultimately entitled to the securities.[63]

In the case where the two investors hold their interests in respect of securities through different intermediaries, the transfer will be slightly more complicated; the transferor's intermediary will generally arrange for the appropriate quantity and type of securities to be credited to the transferee's intermediary in the books of a CSD or other intermediary with whom both the transferor's and the transferee's intermediary hold accounts.[64] Again, there is no delivery of physical securities and no entries are made on the books of any higher intermediary or the issuer.

The technical details of a transfer within indirect holding systems are presented below (with charts).[65]

In sum, there is no doubt that the establishment of CSDs and the related move to book-entry transfer systems have significantly increased the efficiency of the transfer of securities. These efficiencies led the Group of Thirty (G30)[66] to recommend in 1989 that each domestic market should establish a CSD to hold securities in the relevant market.[67] As of today, most jurisdictions around the world have adopted the principle of the indirect holding system, although the details often vary.[68]

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62 An example may illustrate the operation using the fact pattern schematically depicted in Figure A above: Australian Investor buys 1,500 shares of Illinois Inc. through French Bank, and Swiss Investor sells 1,500 shares of Illinois Inc. through the same Bank; the trade can be settled by entries on French Bank's books. None of (i) European ICSD's books showing French Bank's total position in Illinois Inc., (ii) California Sub-custodian's books showing European ICSD's total position in Illinois Inc., (iii) DTC's books showing California Sub-custodian's total position in Illinois Inc., or (iv) Illinois Inc.'s books showing DTC's total position in Illinois Inc., need to be changed to reflect the settlement of this trade. It is easy to assess the importance of such a streamlined settlement if one considers that a single major bank may be acting as securities custodian for many thousands of mutual funds, pension funds, other institutional investors, other banks, securities firms and individual clients. On any given day, the customers of that bank may have entered into a large number of trades, and yet it is possible that relatively little of this trading activity will result in any net change in the bank's positions on the books of European ICSD.

63 GUYNN / MARCHAND, *op. cit.* (footnote 13), p. 53; GUYNN, *op. cit.* (footnote 5), p. 23; REBER, *op. cit.* (footnote 31), p. 12.

64 If the immediate intermediaries of the transferor and transferee do not hold their respective interests in respect of the securities directly through the same CSD or upper-tier intermediary, the position will be more complicated. Essentially, a book entry transfer will always be made on the books of the lowest level intermediary with which both the transferor and the transferee, or a lower intermediary through whom, directly or indirectly, they hold their interests, maintain securities accounts.

65 See *infra*, pp. 31 *et seq*.

66 The Group of Thirty, established in 1978, is a private, non-profit, international body composed of very senior representatives of the private and public sectors and academia. It aims to deepen understanding of international economic and financial issues, to explore the international repercussions of decisions taken in the public and private sectors and to examine the choices available to market practitioners and policy makers. For further information, see the G30 website at http://www.group30.org.

67 See the reference in GUYNN / MARCHAND, *op. cit.* (footnote 13), p. 54, footnote 19.

68 See GUYNN, *op. cit.* (footnote 5), pp. 21 and 24, with further references.

PART TWO:

THE LEGAL NATURE OF INTERESTS IN SECURITIES HELD THROUGH INDIRECT HOLDING SYSTEMS

Section 1 — The traditional legal analysis – direct property rights and the problem of commingling

The basic legal model of securities ownership is that of the *direct holding* of securities. In the case of *bearer* securities, the owner has direct possession of the certificates. In the case of *registered* securities, the owner's name is recorded on a register of the securities maintained by the issuer or by a third party on the issuer's behalf. Under both these patterns, the owner's interest is a direct property right.[69]

The concept of a direct property right becomes difficult to apply in the context of indirect holding systems. This is because under traditional legal principles commingling fungible property terminates direct property rights of owners of the individual commingled items. According to traditional principles which applied under both *common law* and *civil law* legal systems, and whose origins are rooted in Roman law,[70] a person who deposits property with a depository retains whatever property rights that person has in the property, as long as the deposited property is *not commingled* with similar property of the depository or of other depositors. If, however, the property is commingled, the consequences will depend on the precise terms on which deposits are made. The depositor may have only a contractual claim for the return of the same amount and type of property initially deposited; alternatively, the depositor whose property has been commingled may have some form of common or co-proprietary interest with other depositors in the commingled bulk.

For the reasons of efficiency explained above, depositories that hold securities for investors generally do so through commingled omnibus customers accounts.[71] The effect of such commingling is to *preclude the continuing existence of direct property rights* of individual owners in the specific securities held prior to the commingling and to give each investor either *a mere contractual right* to the delivery of equivalent securities or *co-ownership* of the commingled fund of securities, according to the terms of the agreement between the investor and the depository.

There are a number of ways of dealing with this difficulty. These are discussed in Section 2 below.

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[69] In some jurisdictions, title to registered securities may pass by delivery of a physical certificate. This does not affect the basic point that the interest of a direct holder of securities is a direct property right.

[70] See the reference in GUYNN / MARCHAND, *op. cit.* (footnote 13), p. 56, footnote 24, and GUYNN, *op. cit.* (footnote 5), p. 20, footnotes 25 and 26.

[71] See *supra*, p. 10 for the terminology used here, and p. 14 for the explanations on the efficiency. An example of a case where such commingling is *not* permitted, is the *Streifbandverwahrung* under Art. 2 of the German *Depotgesetz* (for a more detailed reference to this statute, see *infra* footnote 75). The *Streifbandverwahrung* refers to the situation where an intermediary holds in its vault bundles of physical certificates tied together by a ribbon on which the name of the actual owner of the certificates is mentioned; although this system goes back to the last century and is no longer used for new issues, some German intermediaries still hold such bundles in their vaults.

Section 2 — Responses to the problem of commingling

I. No commingling

In principle, it is possible to preserve the direct property right by ensuring that there is *no commingling*. Some depository systems do offer the facility of non-fungible accounts in which securities attributable to individual investors are separately identified by the depository. Here the holding pattern could be as follows: (i) the investor's interest is recorded on the books of its intermediary in an account in the name of the investor; (ii) in turn, the intermediary's interest is recorded on the books of the intermediary's sub-custodian in an account or sub-account that identifies not only the intermediary but the investor as well; and (iii) in turn, the sub-custodian's interest is recorded on the books of the CSD in an account or sub-account that identifies not only the sub-custodian but the intermediary and the investor as well.

However, for the reasons explained above, the great majority of securities are held in omnibus customers accounts and no information about the interests of individual investors is recorded at the various upper levels of the indirect holding system.

II. Mere contractual right

One possible consequence of commingling would be that the rights of an investor against its immediate intermediary are no more than personal claims – that is, mere *contractual rights* to the delivery of the appropriate quantity of securities of the appropriate description. The fundamental difficulty with this is that the investor becomes wholly reliant on the integrity and solvency of its immediate intermediary. Should the intermediary wrongfully dispose of the securities or become insolvent, the investor would be exposed and could be left with rights of limited or no value.[72]

As a result, structures have evolved under which the individual investors continue to have rights that are protected in the event of the insolvency of the immediate intermediary.[73]

III. Co-proprietary right (co-ownership)

One model which has this effect is to treat the commingled securities held for investors as a separate pool of property in which the investors have some kind of co-proprietary interest.[74]

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[72] See *e.g.*, GOODE, *op. cit.* (footnote 5), pp. 119, GUYNN, *op. cit.* (footnote 5), pp. 29-30; for a more detailed presentation, see *e.g.*, DOROTHEE EINSELE, *Wertpapierrecht als Schuldrecht - Funktionsverlust von Effektenurkunden im internationalen Rechtsverkehr*, Tübingen 1995.

[73] In the Netherlands, the custody of securities that are not subject to the *Wet giraal effectenverkeer* (Securities Giro Transfer and Administration Act), the Dutch equivalent of the German Depotgesetz, is undertaken by special purpose vehicles which have no other activities, thereby in practice avoiding the investors being exposed to intermediary risk, see WILLEM A.K. RANK, *Custody of Securities in the Netherlands,* in: Vertrouwd met de Trust, Trust and Trust-like Arrangements, December 1996, pp. 319-338.

[74] See *e.g.*, ULRICH DROBNIG, Dokumenteloser Effektenverkehr, in: Karl Kreuzer (ed.), *Abschied vom Wertpapier? Dokumentelose Wertbewegungen im Effekten, Gütertransport- und Zahlungsverkehr,* Neuwied 1988, pp. 24-27; for Switzerland, see Art. 484 of the Code of Obligations and Art. 727 of the Civil Code; see also the comments *infra*, pp. 55 *et seq.* See also GUYNN / MARCHAND, *op. cit.* (footnote 13), p. 58.

The precise nature of an individual investor's interest in this separate common pool may vary from jurisdiction to jurisdiction. The co-ownership regime may be either a statutory creation or a development of existing law and may involve co-ownership either of the actual pool of commingled securities or of a notional pool of securities.

A. Co-ownership of actual pools of securities

In Germany, the *Depotgesetz*[75] distinguishes between *sole ownership*, which is maintained in case of *separate* (segregated) safe custody of securities, and *co-ownership* in case of *collective* (commingled) safe custody. In the latter case, the law grants the depositor (investor) co-ownership of the securities held in collective safe custody by the depository.[76] A collateral taker who obtains a pledge on a fractional property right, which is legally traceable to an actual pool of fungible securities, is deemed to have acquired *constructive possession* or *record ownership* of a fractional portion of the actual pool, even though the collateral taker has no actual possession or actual record ownership of any of the pool.

Another example of co-proprietary rights is the Spanish *Ley del Mercado de Valores* under which an investor who holds dematerialised, registered securities is treated as having a co-proprietary right in a pool of fungible securities.[77]

In Canada, securities which are held by a broker for its customers on a commingled basis at CDS, the Canadian central securities depository, are regarded as owned in common, *pro rata*, by all the investors concerned. None of the investors has a traceable interest at the level of the issuer's register or the broker's account with the CSD.

In England,[78] the concept of co-ownership in this context is derived from a traditional trust law analysis: individual investors are regarded as being co-owners in equity (beneficial co-owners) of the pool of securities, which the immediate intermediary holds for its customers in a trustee or similar fiduciary capacity.[79]

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[75] The full title in German reads as follows: *Gesetz über die Verwahrung und Anschaffung von Wertpapieren;* it may be translated into English as the *Law on the Safe Custody and Procurement of Securities* (*Law on Securities Deposits* for the short title). This law was initially enacted in 1896 and was revised in 1937, with important revisions being passed in 1972, 1985 and 1994. It is currently known as the *Depotgesetz of 11 January 1995* (the German text is available on the Internet (http://www.jurathek.de/tom/gesetze/).

[76] For more details on the German *Depotgesetz*, see JÜRGEN THAN, Cross-Border Safe Custody and Settlement of Securities Transactions: Some Aspects under German Law, *International Bar Association* paper (mentioned *supra* in footnote 5), pp. 73-77.

[77] See Art. 8-10.

[78] For an overview of English law, see GOODE, *op. cit.* (footnote 5), pp. 119-121.

[79] In the case of bearer securities, it is in theory possible to construct an alternative analysis based on bailment, but this will not extend to registered or dematerialised securities and the trust analysis is generally now followed. See JOANNA BENJAMIN, *The Law of Global Custody*, London 1996, pp. 44-46; *id.*, *The Law of Global Interests in Securities,* Oxford 2000, Chapter 2; see also *infra*, p. 54.

B. Co-ownership of notional pools of securities

1. Belgium: Royal Decree No. 62

Belgian Royal Decree No. 62, adopted in 1967, was originally designed for the transfer and pledging of interests in securities held through the Belgian national clearing agency (CIK). Article 13, however, allowed for the extension of the scope of application of the Royal Decree to relations between a CIK affiliate and its customers. It was amended in 1995 to clarify the nature of a person's interest in securities held through indirect holding systems.[80] This interest is regarded as a *co-proprietary right to a portion of a notional pool of securities of the same type* held by the intermediary on behalf of the collective interest holders.[81] In other words, the Royal Decree has expressly transformed what would have been mere personal contractual claims against Belgian intermediaries into *co-proprietary* rights in *notional* pools of securities evidenced solely by book entries on the records of the intermediary, regardless of where the individual securities or actual pools of fungible securities are located.[82] The Royal Decree also grants the investor a right of *revendication*,[83] exercisable in the event of the insolvency of the intermediary.[84]

2. Luxembourg: Grand-Ducal Decrees

The *Luxembourg Grand-Ducal Decree of 17 February 1971* (as amended in 1994 and 1996), as interpreted by leading lawyers,[85] defines the interest of an investor holding securities through accounts with an intermediary in Luxembourg as a right of *ownership in a given number of non-individually identified securities of the same type* held by the intermediary in a pool on behalf of all owners of the same type of securities (Art. 1 and 2).[86] As with the Royal Decree, the Grand-Ducal Decree also grants the investor a right of revendication, exercisable in the event of the insolvency of the intermediary (Art. 9, para. 1).[87]

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[80] *Arrêté royal No 62 du 10 novembre 1967 favorisant la circulation des valeurs mobilières*, as modified by a statute dated 7 April 1995. A subsequent revision of the law was promulgated by a statute dated 10 March 1999; the 1999 modification, however, does not appear to be relevant for the subject matter of this Report.

[81] See in particular Art. 10, para. 1 of the Decree, and the Explanatory Memorandum of the Act dated 6 April 1995, Doc. Senate (1994-1995), 1321/1, pp. 10-12.

[82] See VAN RYN / HEENEN, *Principes de droit commercial,* vol. III, 2nd ed., 1981, nos 162 and 164; GUYNN, *op. cit.* (footnote 5), pp. 43-44; GUYNN / MARCHAND, *op. cit.* (footnote 13), p. 58.

[83] A right of revendication (*rei vindicatio* in Roman Law) is an action *in rem*, available to the owner against any person in possession of the property, entitling the owner to the return of possession of the property.

[84] Art. 10, para. 2, of the Decree.

[85] GUYNN, *op. cit.* (footnote 5), p. 44; see however comment on draft law in footnote 86.

[86] *Règlement grand-ducal du 17 février 1971 concernant la circulation de valeurs mobilières*, modifié par un Règlement grand-ducal du 8 juin 1994, un Règlement grand-ducal du 7 juin 1996 et par une loi du 3 septembre 1996. A draft law which would further amend the Grand-Ducal Decree was introduced by the Luxembourg Government on 16 August 2000. If adopted in the form of the draft, the law will clearly state that the depositor has a right *in rem* of an intangible nature on the entirety of the securities or other financial instruments of the same nature held with the depository. It will also provide that this right *in rem* can only be exercised against the depository.

[87] GUYNN, *op. cit.* (footnote 5), pp. 44-45.

IV. Legal structure not involving co-ownership

Another response is to create a legal structure which ensures that property rights continue to exist notwithstanding the commingling that arises from indirect holding systems, but without using a co-ownership concept. A number of countries have adopted a form of this response, which may involve either a new application of traditional concepts or the development of a completely new form of property right.

A. France

Pursuant to Article 94-II of law n° 81-1160 of 30 December 1981, which became effective on 3 November 1984, France introduced a fully dematerialised securities system. This system covers all types of securities issued in France. Thus, since 1984, securities issued in France must be registered in a securities account opened with the issuer or with an authorised financial intermediary and certificated securities no longer exist.

The dematerialised system continues to distinguish between securities which are treated as bearer securities ("*titres au porteur*", which in practice constitute the great majority of securities) and securities where the name of the investor appears on a register maintained either by the issuer itself ("*titres nominatifs purs*") or by a third party on behalf of the issuer ("*titres au nominatif administré*"). In relation to the former category, registration of an investor as the holder of securities in an account with an authorised financial intermediary gives the investor a property right in the securities concerned. Sicovam (the French CSD) and any intermediaries standing between Sicovam and the investor's immediate intermediary administer the system and maintain records of the accounts held at the various levels but do not have any proprietary rights in the securities. The introduction of a fully dematerialised system has not modified the legal nature of the investor's interest, which remains a *property* right.[88] The legislation incorporates a number of features to protect investors against the risks of a completely dematerialised system, in particular against the consequences of the insolvency of any intermediary.[89]

In the case of securities treated as *titres nominatifs*, the register maintained by or on behalf of the issuer constitutes the definitive record of title.[90]

B. Italy and Brazil

Italian and Brazilian law specifically provide that a deposit of securities, even on a commingled basis, is a "regular" deposit.[91] Both Italian and Brazilian law thus provide a

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[88] It is not a co-proprietary right, which is not recognised under French securities law. See FRÉDÉRIC NIZARD, *La notion de titre négociable*, Thèse Paris 2, June 2000, who argues that as certificates no longer exist and an investor's rights are only evidenced by book entries in fungible accounts, the investor holds neither a property right nor a co-proprietary right but rather a "*title titularité*".

[89] Art. 30 of law n° 83-1 of 3 January 1983 provides that in the case of insolvency of the intermediary, investors' interests are transferred to an account of another intermediary and are therefore insulated from the effect of bankruptcy.

[90] It is worth noting that even though the name of the investor is recorded both on the books of the issuer or its official recordholder and on those of its immediate intermediary, it is not recorded in segregated or traceable accounts with Sicovam or any other intermediary – that is, it is not a non-fungible account (see *supra*, p. 10).

[91] That is, a deposit where the property deposited can be specifically identified; contrast an "irregular" deposit where the property deposited is commingled with other property to form a fungible bulk.

legal fiction as to the ability to identify specific securities, which has the effect of ensuring that investors cannot lose their "property" rights to listed securities in the event of a failure of their intermediary or any other intermediary up the chain.

C. United States: the 1994 version of the U.C.C. introducing the "security entitlement"[92]

Article 8 of the U.C.C. deals with investment securities. This provision underwent major changes in 1994, after the October 1987 stock market crisis had plainly revealed uncertainties surrounding the application of the old principles of the 1978 version of Article 8, which was exclusively based on a direct holding system.[93] The 1994 revision explicitly addresses the new market reality of the indirect holding system.[94]

Revised Article 8 contains express definitions of key terms such as "securities intermediary",[95] "security"[96] and "securities account",[97] and also stipulates the various duties of a securities intermediary to its security account holders.[98] The most important feature for current purposes, however, is the introduction of the concept of the *"security entitlement"*.[99] Under this concept, the investor does not have a traceable property right to a specific security located somewhere in a vault. Instead, the investor has a package of rights and interests against the securities intermediary with whom the investor has a direct contractual relationship. Professor Rogers, the official Reporter of revised Article 8, has described the nature of this new concept as follows:

> "A security entitlement is not a claim to a specific identifiable thing; it is a package of rights and interests that a person has against the person's security intermediary and its property. The idea that discrete objects might be traced through the hands of different persons has no place in the Revised Article 8 rules for the indirect holding system. Rather, the fundamental principles of

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92 The earlier, 1978 version of Art. 8 defined the rights of depositors as fractional or co-proprietary rights which were legally traceable to actual pools of individual fungible securities – see GUYNN / MARCHAND, *op. cit.* (footnote 13), p. 58. This model was, therefore, similar to the co-ownership model described *supra*, p. 20. The roots of Art. 8 lie with the Negotiable Instruments law of 1896 (debt securities) and the Uniform Stock Transfer Act of 1909 (equities). This Act became Art. 8 when the U.C.C. was promulgated in 1951.

93 See U.C.C. 2000, *op. cit.* (footnote 46), pp. 653 *et seq*.

94 As was to be expected, the revision of such an important provision as Art. 8 of the U.C.C. has generated a lot of academic writing; the number of law review articles published is indeed impressive, both in terms of quality and quantity; an authoritative presentation of revised Art. 8 has been produced by its official draftsman: JAMES STEVEN ROGERS, *Policy Perspectives on Revised U.C.C. Article 8*, (1996) 43 U.C.L.A. L. Rev. 1431; see also the useful presentation of the key attributes of the revised U.C.C. Art. 8 contained in the ULCC Report of 1997, *op. cit.* (footnote 8).

95 See *infra*, p. 45.

96 § 8-102(a)(15), see also *infra*, footnote 137 and accompanying text.

97 § 8-501(a).

98 § 8-504 provides that a securities intermediary must maintain a sufficient quantity of financial assets to satisfy the claims of all its entitlement holders. § 8-505 provides, for example, that distributions such as dividend payments, made by the issuer of the securities, have to be passed on to the security account holder.

99 The term is defined in § 8-102(a)(17) as "the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5." Part 5 then specifies the various rights and property interests that comprise a "security entitlement". The concept of the security entitlement has also been endorsed by the U.S. TREASURY/RESERVE AUTOMATED DEBT ENTRY SYSTEM (TRADES) regulations. The TRADES regulations are the U.S. Federal rules applicable to the ownership, transfer and pledging of most U.S. government and agency securities.

> the indirect holding system rules are that an entitlement holder's own intermediary has the obligation to see to it that the entitlement holder receives all of the economic and corporate rights that comprise the security, and therefore that an entitlement holder look only to that intermediary for performance of the obligations. The entitlement holder cannot assert rights directly against other persons, such as other intermediaries through whom the intermediary holds the positions."[100]

Thus, a security entitlement is itself a form of *property interest, combined with a package of* in personam *rights against the intermediary*.[101] Most importantly, the entitlement holder (investor) does not take the credit risk of the intermediary's other business activities. If the intermediary becomes insolvent, its securities holdings corresponding to customer claims satisfy these claims before any are available to satisfy the claims of general creditors.

These key attributes reflect a rational description of the unique form of property interest that is central to the indirect holding system.[102] By the same token, the search for the location of a security interest ends at the intermediary, as the interest is located at the place where the account in which it is recorded is maintained.

Section 3 — Proposed Convention not intended to change substantive law

In *summary*, an investor's interest in securities held with an intermediary or custodian may in principle take the form of:

(i) a *direct interest* held through a non-fungible, segregated account and *traced through* into underlying securities held by the intermediary or custodian;

(ii) a mere contractual *right* to the delivery of a quantity of securities;

(iii) a *co-ownership interest or equivalent proprietary right* in a pool of securities held by the intermediary or custodian for its customers on a commingled basis; or

(iv) a *co-ownership interest in a notional* pool of securities or a *special category* of *property right* created by, and with characteristics defined by, legislation.

It is not the purpose of the proposed Convention to alter these categories or to harmonise the way in which they are analysed as a matter of substantive law. The key objective of

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[100] ROGERS, *op. cit.* (footnote 94), p. 1456-1457.

[101] See U.C.C. 2000, *op. cit.* (footnote 46), p. 659-660.

[102] On 15 September 2000, 49 States, the District of Columbia and Puerto Rico had enacted Art. 8 (1994). South Carolina and the territory of the U.S. Virgin Islands are also expected to enact it during 2001. Finally, it may be worthwhile to note that Art. 8 (1994) has been supported by the following institutions: Securities and Exchange Commission; Federal Reserve Bank of New York; American Society of Corporate Secretaries; American Stock Exchange; DTC; Investment Company Institute; National Association of Securities Dealers; National Securities Clearing Corporation; New York Clearing House; New York Stock Exchange; Securities Industry Association. Information provided on the Uniform Law Commission's homepage (at the following address: http://www.nccusl.org/uniformact_factsheets/uniformacts-fs-ucca8.htm).

the proposed Convention is to adopt a conflict of laws rule that will apply rationally and consistently to all the approaches described above.[103] Harmonising the substantive law relating to the nature of interests in respect of securities held through intermediaries is a major undertaking that may be considered by UNCITRAL or UNIDROIT in the near future.[104]

The next section of this Report considers the conflict of laws analysis applicable to each of the forms of interest described above.

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[103] For an analysis of the possible impact of the proposed Convention on the two approaches mentioned in (i) and (ii) in particular, see *infra* p. 46.

[104] A parallel may be drawn with the *Directive 98/26/EC of the European Parliament and of the Council of May 1998 on settlement finality in payment and securities settlement systems*, OJEC 1998, L 166/45 (*the Settlement Finality Directive*). This Directive, required to be implemented in all Member States by 11 December 1999, does not introduce a uniform categorisation of the legal nature of an investor's interest in securities held through an indirect holding system; it does, however, contain a provision intended to clarify the conflict of laws when such securities are taken as collateral, see *infra*, p. 48.

PART THREE:

THE CONFLICT OF LAWS ANALYSIS

Introduction

Historically, the usual approach adopted to determine the law applicable to proprietary issues in the case of traditional direct holding patterns was to apply the *lex rei sitae* rule.[105] In the case of bearer securities this was relatively straightforward, because there was an obvious logic in regarding such securities as situated wherever the relevant certificate was located at the time of the relevant transfer or disposition.

The attribution of a *situs* to registered securities involves a greater degree of artificiality, which has been reflected in a somewhat greater range of approaches. Where registered securities are not in dematerialised form, some jurisdictions have continued to regard the location of the relevant certificate as the determining factor.[106] Another approach is to regard registered securities as located at the place where the register of registered owners of the securities is maintained.[107] A third approach is to regard the securities as being located in the jurisdiction in which the issuer is incorporated.[108]

These are the approaches that have evolved in relation to direct holdings of securities. While a degree of artificiality needs to be acknowledged, they generally produce a clear and satisfactory result for direct holding patterns.

By contrast, the current situation in relation to indirect holding systems is highly unsatisfactory. The fundamental difficulty is that an attempt to apply the traditional approach to indirect holding systems requires an approach that "looks through" tiers of intermediaries to the level of the issuer, register or actual certificates (the "look-through approach"). For reasons explained in more detail below, such a "look-through approach" gives rise to severe difficulties.[109]

A second difficulty (which largely flows from the first) is that in many countries it is unclear what conflict of laws principles would currently be applied. In order to assess the magnitude of this second difficulty, a questionnaire, prepared by Richard Potok, Legal Expert to the Permanent Bureau, has been distributed to legal experts in 28 jurisdictions.[110] The questionnaire set out a relatively simple example of a pledge, title transfer and sale of indirectly held securities and asked the experts to identify the laws

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[105] See *supra*, p. 3.

[106] Typically, this approach is likely to be adopted where the certificate is regarded as representing the interests of the investor, for example, as being a negotiable instrument.

[107] This approach can be expected to be adopted where entry on the register, rather than possession of a certificate, conveys legal rights to the securities.

[108] The conceptual basis for this approach is, broadly, that because a corporate body is an artificial legal creation, the law which creates it must be taken to decide when and how interests in it are validly transferred. While logical, this approach illustrates most starkly the artificiality of the concept of *situs* in this area.

[109] See *infra*, p. 28; for a general description of these problems, see *e.g.*, SCHEFOLD, *op. cit.* (footnote 49), pp. 469-470.

[110] For the list of jurisdictions surveyed in the questionnaire, see Appendix B to this Report.

which the courts of their jurisdiction would regard as applicable to various issues arising out of the transaction, including, in particular, issues of perfection/completion and priorities. The experts were asked for the probable answer and also for any possible answers where the law was not clear on these issues. The text of the questionnaire, charts summarising the answers provided and a list of the experts consulted will be presented at the Experts meeting as Working Document No 1, submitted by the Legal Expert to the Permanent Bureau. Some of these charts summarising the answers to the questionnaire are considered in relation to the fact patterns in Section 3 below.

Section 1 — The "look-through approach"

Where securities are held through *non-fungible accounts*,[111] in which securities attributable to an intermediary's individual customers are separately identified and credited to separate designated accounts in the books of the intermediary, the "look-through approach" continues to be logical. Under such structures each intermediary will be "transparent" and the investor's interest will be recorded at each level all the way through to the issuer's register. Thus, it is appropriate to treat the investor's interest as located at the place indicated under the traditional approach, for example, at the place of the issuer's register.[112]

The position is quite different where securities are held through *fungible accounts* (omnibus accounts). Under such a system, there is no record of an individual investor's interest in respect of the securities at the level of the issuer's register or that of any intermediary other than the intermediary with whom the investor has a direct relationship. Thus, if the investor, or a person such as a collateral taker asserting a claim against the investor's interest in respect of the securities, were to try to enforce that claim at any of these higher levels, the response would be that at each level no record exists of any interest of the investor against which the claim could be pursued.[113] *The only record of the investor's interest is to be found on the books of the intermediary with which the investor has a direct relationship, the investor's immediate intermediary.* This problem demonstrates that any attempt to apply the "look-through approach" under a fungible custody structure runs counter to the widespread conflict of laws principle that jurisdiction over proprietary aspects of dispositions of movable property should broadly be attributed to the jurisdiction where orders in respect of that property are capable of being enforced.[114]

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[111] See *supra*, p. 10 for the terminology used here.

[112] In jurisdictions where the certificate issued in respect of registered certificated securities is regarded as a document of title (that is, the certificate represents the interest of the investor), the location of the investor's interest under such a "transparent structure" will depend on where the certificate is.

[113] See *e.g.*, *Fidelity Partners, Inc.* v. *First Trust Co.*, 1997 U.S. Dist. LEXIS 19287, No. 97 Civ. 5184, 1997, WL 752725 (S.D.N.Y., Dec. 5, 1997). In this case, a judgment creditor sought to execute against an interest in bonds held by a judgment debtor through an indirect holding system; the bonds were payable in New York, but the judgment debtor's interest was recorded only on the books of an intermediary located abroad (Philippines). The court refused to order execution in New York. Claims of this nature are often referred to as "*upper-tier attachment*" claims. Whether such a claim has such a prospect of success will depend on the substantive law of the jurisdiction in which the claim is asserted. Although therefore the possibility of upper-tier attachment may be a problem that ought to be addressed in some countries, as a matter of substantive law, it is not one with which the proposed Convention can deal.

[114] See JOANNA BENJAMIN, Determining the *situs* of Interests in Immobilised Securities, ICLQ 1998 (vol. 47), pp. 923-934.

The "look-through approach" also creates severe *practical difficulties*.[115] In today's market, it is very common for investors to provide collateral in the form of interests in respect of a diversified portfolio of securities issued in a number of different jurisdictions. The "look-through approach" compels the collateral taker to satisfy the perfection requirements of a multitude of jurisdictions for each such transaction.[116] In addition, in many jurisdictions it is uncertain exactly what the legal rule is when applying the "look-through approach" – is it the law of the place of the *issuer*, the place of the *register* or the place of the *underlying securities*?[117] Finally, even if the collateral taker did know what the test is, it is often not possible to obtain the necessary information to ascertain how to apply the test; for example, it is one thing to say that the test is the law of the place of the certificates, but an investor holding through various tiers of intermediaries may not be able to discover where the national CSD actually stores the certificates.[118]

Uncertainties as to the approach to be adopted and as to the effect of the "look-through approach", if applicable, lead to significant expense for market participants (including collateral providers, because the expense of investigating perfection requirements is likely to be passed on to them by collateral takers). Moreover, because the position in many cases cannot be satisfactorily determined, there remains an element of risk, which, given the size of transactions involved and the identity and importance of the relevant financial institutions, must prudently be regarded as *systemic* in character. Accordingly, agreement on a convention that produces a uniform and rational resolution of these issues would bring very important benefits to market users, market participants and the financial system as a whole.

It is therefore necessary to develop a new approach, one that reflects the reality of the indirect holding system and follows the sensible legal principle that the law applicable to proprietary matters should be the law of the place where the record of title is maintained and where, therefore, orders in respect of the property can be effectively enforced. In indirect holding systems based on fungible accounts, the record of an investor's title is maintained by the intermediary with whom the investor has an immediate relationship and it will be on the books of the investor's immediate intermediary that any disposition of the investor's interest in favour of a collateral taker or purchaser will be recorded. This suggests an approach that looks to the law of the place where that intermediary is located. This has become known as the "place of the relevant intermediary approach" or "PRIMA". Before describing the key attributes of PRIMA, one needs to address briefly the situation where the investor holds merely *contractual rights* against the intermediary.

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[115] For the practical difficulties described in this paragraph, see *e.g.*, GUYNN, *op. cit.* (footnote 5), pp. 27-29.

[116] R. POTOK / M. MOSHINSKY, *Cross-Border Collateral: A Conceptual Framework for Choice of Law Situations,* Oxford Colloquium on Collateral and Conflict of Laws, Special Supplement to Butterworths Journal of International Banking and Financial Law, September 1998, p. 15; REBER, *op. cit.* (footnote 31), pp. 15-17; SCHEFOLD, *op. cit.* (footnote 49), p. 470. One might add that an investor would have to repeat this investigation each time the investor added securities to the portfolio or replaced securities with others, GUYNN / MARCHAND, *op. cit.* (footnote 13), p. 60.

[117] See *Macmillan Inc. v. Bishopsgate Investments Trust plc* (No 3) [1996] 1 WLR 387, and the comments by POTOK / MOSHINSKY, *op. cit.* (footnote 116), p. 15.

[118] For the practical difficulties facing an investor whose identity is only recorded on the books of its immediate intermediary, see in particular JAMES STEVEN ROGERS, *Of Normalcy and Anomaly: Thoughts on Choice of Law for the Indirect Holding System,* Oxford Colloquium on Collateral and Conflict of Laws, Special Supplement to Butterworths Journal of International Banking and Financial Law, September 1998, pp. 47-51.

Section 2 — In the case of a personal or contractual claim

If an investor holds merely *contractual rights* against its intermediary for the delivery of the appropriate quantities of securities of a particular description, the investor has only a personal right or claim against the immediate intermediary and has no proprietary rights in any securities. In a purely contractual context, it no longer seems accurate to refer to the *"lex rei sitae"*.[119] Rather, the applicable law has to be ascertained by reference to the conflict of laws principles for contractual matters. It is argued in this Report that these principles, although differing in their approach and terminology, would in most cases[120] lead to the application of the law of the intermediary (be it under the heading of the "characteristic obligation", "the most significant relationship" or "the proper law"). In other words, the law applicable in such a case is deemed to be the law of the intermediary's office against which the claim is exercisable.

The outcome of this analysis is similar to PRIMA, in that it leads to the law of the jurisdiction where the office whose accounts evidence the claim is located. This point is, however, unlikely to be relevant in practice since the contractual approach is rarely adopted because of the problems mentioned above.[121]

Section 3 — The "place of the relevant intermediary approach" (PRIMA): some key attributes

As will be described later in this Report, PRIMA has already been adopted in a number of jurisdictions as the conflict of laws rule to be applied to the proprietary aspects of collateral transactions. Furthermore, PRIMA is at present being considered for enactment in various other jurisdictions. Before addressing these legislative developments, it seems appropriate, first, to show how PRIMA would work in practice by reference to some hypothetical fact patterns and, secondly, to discuss in more detail the key attributes of PRIMA.

I. In general

Within indirect holding systems, the records of the immediate intermediary on which the entries effecting a pledge or transfer are made play a pivotal role. Hence, the place of that intermediary is the most reasonable "location" of the interest pledged or transferred. Whether PRIMA simply constitutes a development of the traditional *lex rei sitae* principle so as to adapt it to the new market realities or should be regarded as a new concept, is ultimately of no real significance.[122] What matters is the certainty and

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[119] But see GUYNN / MARCHAND, *op. cit.* (footnote 13), p. 57.

[120] There are, however, exceptions: for example, in Ontario the applicable law would be that of the domicile of the collateral provider.

[121] See *supra*, p. 20.

[122] But see GOODE, *op. cit.* (footnote 31), p. 26, who argues that it is preferable to treat PRIMA as a free standing rule rather than an extension of the traditional *lex rei sitae* principle.

predictability this solution provides, because the search for a *situs* always ends at the intermediary on whose books the pledge or transfer is recorded.[123]

The major advantage of PRIMA is that it subjects all of an investor's interest with respect to a portfolio of securities to the law of one single jurisdiction, even where the issuers and certificates evidencing such underlying securities are situated in many different countries. Parties to a transaction are hence able to determine in advance, with certainty and without undue cost, which jurisdiction's substantive law will govern their rights and obligations.[124]

II. Application of PRIMA and how to identify the relevant intermediary – an analysis on the basis of four fact patterns

In order to illustrate how PRIMA works, and in particular which intermediary is the "relevant" intermediary, we will consider four variations on the fact pattern described in Part One, Section 3 above and schematically depicted in FIGURE A above:[125]

> An Australian Investor holds an interest in respect of 500,000 shares of Illinois Inc. through its intermediary, French Bank. French Bank, in turn, holds through European ICSD, which holds through California Sub-custodian, which holds through DTC. DTC's nominee, Cede & Co., is recorded as the registered owner of the securities in the register maintained by NJ Registrar in New Jersey. The physical share certificates representing the Illinois Inc. shares are kept by DTC in a vault in New York.

Australian Investor wishes to borrow money with the Illinois Inc. shares to be provided as collateral for the loan. We will consider four variations on this. The first three consider the situation where Australian Investor seeks a loan from London Bank, an international investment bank incorporated in the United Kingdom and based in London. In the fourth variation, Australian investor seeks the loan from its immediate intermediary, French Bank.

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[123] In substance, this position has now also been adopted by the textbook DICEY & MORRIS, *op. cit.* (footnote 10), in Rule 118, note 24-064: "If it is accepted that the expectation of all parties to the transaction is that the investor has a proprietary interest which is capable in principle of being assigned, and that the rules for choice of law should seek where possible to accommodate this reasonable expectation, the better view [that is, better than applying Art. 12 of the Rome Convention or traditional common law choice of law rules] would be that the investor's proprietary rights are located at the place where his account with the depository is maintained, and that the law which governs dealings with these rights is the law which governs his relationship with the broker. This will be the law governing the relationship between investor and broker, under which the rights of the investor arose, and it will often be the *lex situs* of the rights the investor has against the broker. For present purposes it is submitted that choice of law rules designed in the nineteenth century for the assignment of policies of life insurance and interests under trusts should not be applied uncritically as the basis for regulating the assignment of intangibles of a kind, and by processes, then unknown." [footnote omitted]

The references in this passage to "depository" and "broker" are perhaps not entirely clear. It seems reasonably clear from the context in which the passage quoted appears, however, that both terms refer to the intermediary with which the investor maintains the account (shortly before the passage quoted, reference is made to investors maintaining an account with "an intermediary or broker"). See also BENJAMIN, *op. cit.* (footnote 114).

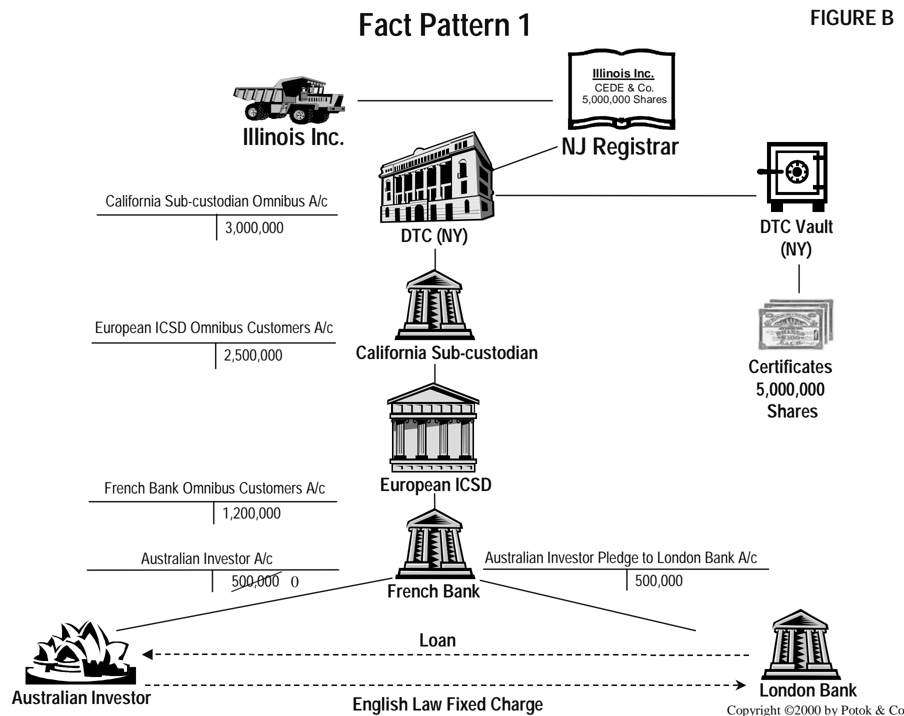
[124] GUYNN / MARCHAND, *op. cit.* (footnote 13), p. 61.

[125] See *supra*, pp. 14 *et seq.*

A. Fact Pattern 1 – Collateral provider and collateral taker hold through same intermediary and collateral provided by way of pledge

In this first example, London Bank (the collateral taker) holds its interests in respect of securities through the same intermediary as the Australian investor (the collateral provider), namely French Bank.

> Australian Investor pledges its interest in respect of the Illinois Inc. shares to London Bank under a pledge mechanism, the contractual aspects of which are governed by English law. As schematically depicted in FIGURE B below, the pledge is represented on the books of French Bank by a debit to the "Australian Investor Account" in respect of 500,000 Illinois Inc. shares and a corresponding credit to an "Australian Investor Pledge to London Bank Account". The pledge does not result in any change on the books of European ICSD, California Sub-custodian or DTC.



> After executing the pledge in favour of London Bank, Australian Investor also enters into a pledge agreement in respect of the same 500,000 Illinois Inc. shares with Italian Bank. The second pledge is valid under Italian substantive law (the governing law chosen by Australian Investor and Italian Bank in their pledge agreement).
>
> Australian Investor then enters insolvency in Australia. The liquidator asks the Australian court to rule on whether the pledges in favour of London Bank and Italian Bank should be treated as valid and, if both pledges are to be treated as valid, how they should be regarded as ranking against each

> other. In order to answer these questions, the insolvency court would need to determine which law will govern the proprietary aspects of the transaction.[126]

In this first fact pattern, PRIMA would result in proprietary issues such as perfection and priority being determined under French law, as the law of the place of French Bank, the intermediary on whose books the pledge in favour of London Bank is recorded.

B. Fact Pattern 2 – Collateral provider and collateral taker hold through different intermediaries and collateral provided by way of pledge

In this example, London Bank, the collateral taker, does not hold its interests in respect of Illinois Inc. securities through French Bank but rather holds through a different intermediary, Swiss Bank, which is incorporated in Switzerland and located in Zurich. In turn, Swiss Bank maintains an account entitled "Swiss Bank Omnibus Customers Account" on the books of European ICSD in which it holds 100,000 Illinois Inc. shares for its customers.

> When Australian Investor asks for the loan, London Bank requires that Australian Investor move its interest in respect of the Illinois Inc. shares to Swiss Bank, with the pledge to be recorded on the books of Swiss Bank. By moving the shares to the books of an intermediary that London Bank trusts, London Bank is avoiding any exposure to French Bank, in particular, to the possible consequences of administrative error, wrongdoing or insolvency of French Bank (or the likely influence that Australian Investor may have with French Bank).
>
> Thus, as schematically depicted in FIGURE C below, *prior* to the pledge, Australian Investor's interest in respect of the 500,000 Illinois Inc. shares would be debited to the "Australian Investor Account" at French Bank and credited to an "Australian Investor Account" at Swiss Bank.

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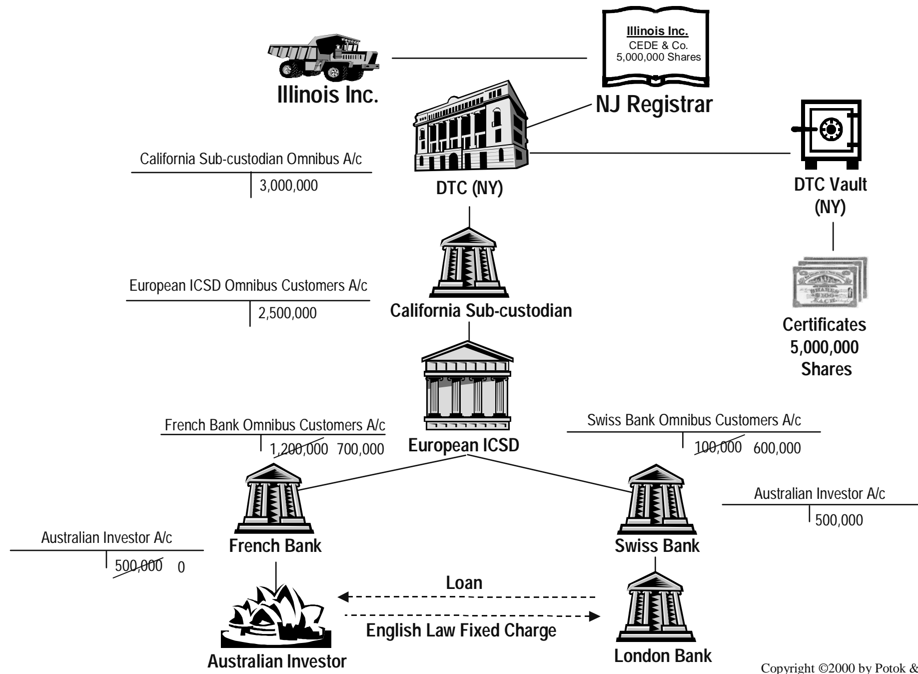
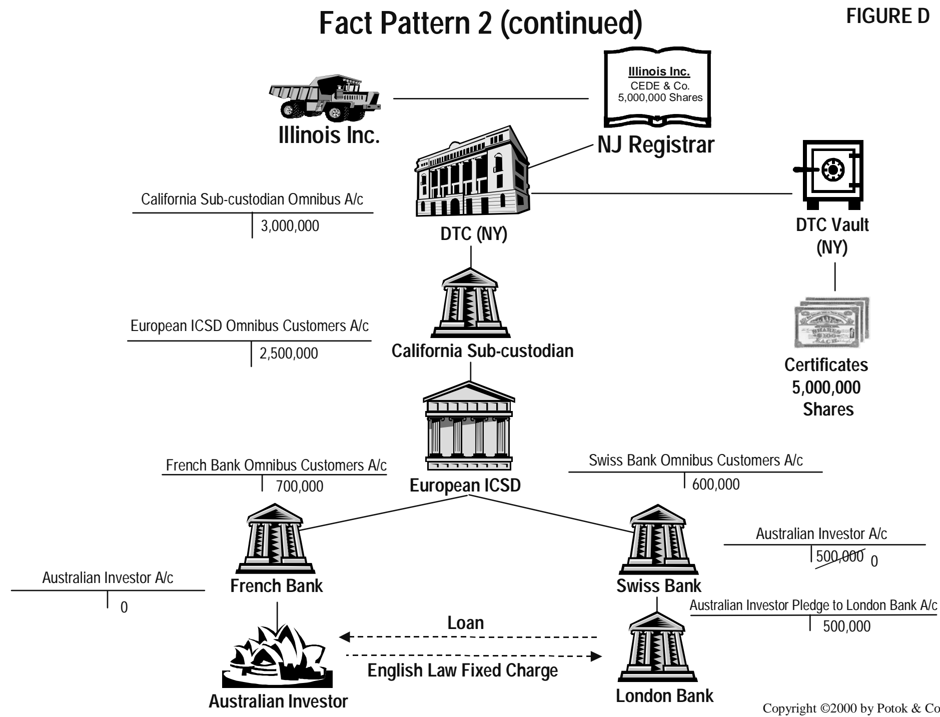
[126] This is in addition to any question as to whether either pledge may be invalidated under rules of Australian insolvency law, for example, as a preference. As explained above, it is not intended that the proposed Convention would affect such insolvency rules, see *supra*, p. 5.



The transfer from French Bank to Swiss Bank of interests in respect of 500,000 Illinois Inc. shares will result on the books of European ICSD in a debit to the "French Bank Omnibus Customers Account" (reducing the balance from 1.2 million to 700,000) and a corresponding credit to the "Swiss Bank Omnibus Customers Account" (increasing the balance from 100,000 to 600,000).

Australian Investor pledges its interest in the Illinois Inc. shares to London Bank under a pledge mechanism, the contractual aspects of which are governed by English law. As schematically depicted in Figure D below, the pledge is represented on the books of Swiss Bank by a debit to the "Australian Investor Account" of 500,000 in respect of the Illinois Inc. shares and a corresponding credit to the new "Australian Investor Pledge to London Bank Account". The pledge does not result in any change on the books of European ICSD (because both these accounts are accounts in the books of Swiss Bank and there is no change in the "Swiss Bank Omnibus Customers Account) or on the books of California Sub-custodian or DTC.



After executing the Pledge Agreement in favour of London Bank, Australian Investor again enters into a pledge agreement in respect of the same 500,000 Illinois Inc. shares with Italian Bank. The second pledge is valid under Italian substantive law (the governing law chosen by Australian Investor and Italian Bank in their pledge agreement).

Australian Investor then enters insolvency in Australia. The liquidator asks the Australian court to rule on whether the pledges in favour of London Bank and Italian Bank should be treated as valid and, if both pledges are to be treated as valid, how they should be regarded as ranking against each other.

In this second fact pattern, under PRIMA, *proprietary* issues, such as whether London Bank received a perfected interest in respect of the Illinois Inc. shares and whether London Bank has priority over the interest of Italian Bank, would be governed by Swiss law, as the law of the place of Swiss Bank, the intermediary on whose books the pledge in favour of London Bank is recorded.[127]

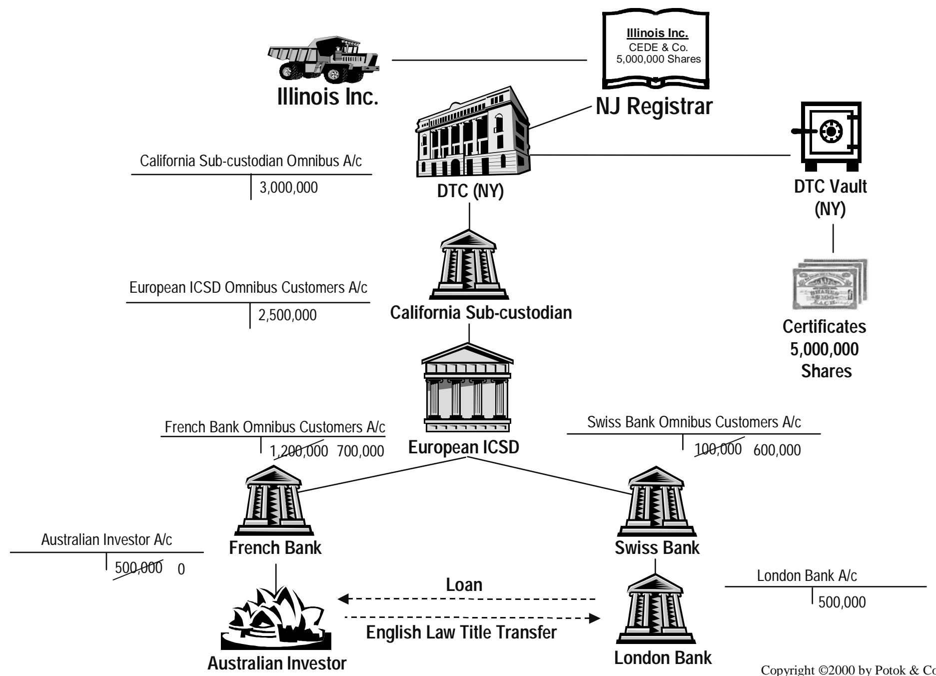
C. Fact Pattern 3 – Collateral provider and collateral taker hold through different intermediaries and collateral provided by way of title transfer

The facts are the same as in Fact Pattern 2, except that instead of using a pledge mechanism, in return for a loan, Australian Investor transfers to London Bank title to its interests in the 500,000 Illinois Inc. shares under English law transfer of title

[127] This fact pattern was considered by experts in 28 jurisdictions surveyed by the Legal Expert to the Permanent Bureau. The state of confusion in the current law in many jurisdictions can be seen in the results. The multitude of probable and possible answers under current law are shown in schematic form in Figure 1 (perfection of pledge) and Figure 2 (priorities) in Appendix B to this Report.

documentation. Under the title transfer arrangement, London Bank promises to return equivalent shares once the loan is repaid.

> Prior to the title transfer, Australian Investor's interest in respect of the Illinois Inc. shares is recorded as a credit to the "Australian Investor Account" on the books of its intermediary, French Bank. The title transfer results in a debit to the "Australian Investor Account" on the books of French Bank for 500,000 Illinois Inc. shares and a corresponding credit to the "London Bank Account" on the books of London Bank's intermediary, Swiss Bank. This change will also be reflected on the books of European ICSD with a debit to the "French Bank Omnibus Customers Account" that results in a decrease for interests in respect of Illinois Inc. shares from 1.2 million to 700,000 and a corresponding credit to the "Swiss Bank Omnibus Customers Account," so that the balance increases from 100,000 to 600,000 in respect of Illinois Inc. shares. The pledge does not result in any change on the books of California Sub-custodian or DTC.
>
> After signing the transfer of title documentation but prior to completing the transfer to London Bank (through the appropriate book entries), Australian Investor also enters into a pledge agreement in respect of the same 500,000 Illinois Inc. shares with Italian Bank. The pledge is valid under Italian substantive law as the governing law chosen by Australian Investor and Italian Bank in the pledge agreement. After Australian Investor enters into the pledge agreement, the title transfer is completed by the necessary book entries.
>
> Australian Investor then goes into insolvency in Australia. The liquidator asks the Australian court to rule on (i) whether the pledge in favour of Italian Bank should be treated as valid, (ii) whether London Bank should be regarded as having acquired a valid and completed interest and (iii) if the answers to both (i) and (ii) are "yes", whether London Bank's interest should be treated as subject to Italian Bank's pledge.



This example is more complicated than the first two fact patterns because Australian Investor's interest is not transferred directly to London Bank, since Australian Investor never holds an interest with the same intermediary as London Bank (this contrasts with Fact Pattern 2, in which Australian Investor's interest is moved to Swiss Bank before the pledge to London Bank takes effect). Instead, Australian Investor instructs its intermediary, French Bank, to transfer interests forming part of French Bank's pool of customer securities held through European ICSD to Swiss Bank's pool of customer securities also held through European ICSD, with a request to Swiss Bank to credit London Bank's account at Swiss Bank. As a result, Australian Investor ceases to have any interest in French Bank's (reduced) pool of customer securities and London Bank receives an interest in Swiss Bank's (enlarged) pool of customer securities.

Under PRIMA, the proprietary aspects of each of the three stages of this transfer process will be governed by a different law:

- Whether London Bank acquires a valid interest in Swiss Bank's pool of customer securities is a matter of Swiss law, as the law of the place of Swiss Bank, the intermediary on whose books interests in that pool are recorded.
- Whether Australian Investor's interest in French Bank's pool of customer securities is validly extinguished is a matter of French law, as the law of the place of French Bank, the intermediary on whose books Australian Investor's interest is recorded.
- Whether the appropriate proportion of French Bank's interest in European ICSD's pool of participants' securities is validly transferred to Swiss Bank is a matter of the law of the place of European ICSD, the

> intermediary on whose books French Bank's and Swiss Bank's interests are recorded.

There could be questions under French law as to whether Australian Investor's interest has been validly extinguished and under the law of the place of the European ICSD as to whether French Bank's interest has been validly transferred to Swiss Bank. However, whether any defect, under French law, in the first element of the transaction will flow through so as to impair or invalidate the second element will be a matter of the law of the place of the European ICSD. Likewise, whether any defect[128] in the second element under the law of the place of the European ICSD will flow through so as to impair or invalidate the third element will be a matter of Swiss law. This analysis has some similarities to the analysis of international cash transfers, which will typically involve transfers across accounts of one or more correspondent banks acting for the ultimate payer and payee.[129]

D. Fact Pattern 4 – Collateral provider holds through collateral taker as intermediary and collateral provided by way of pledge

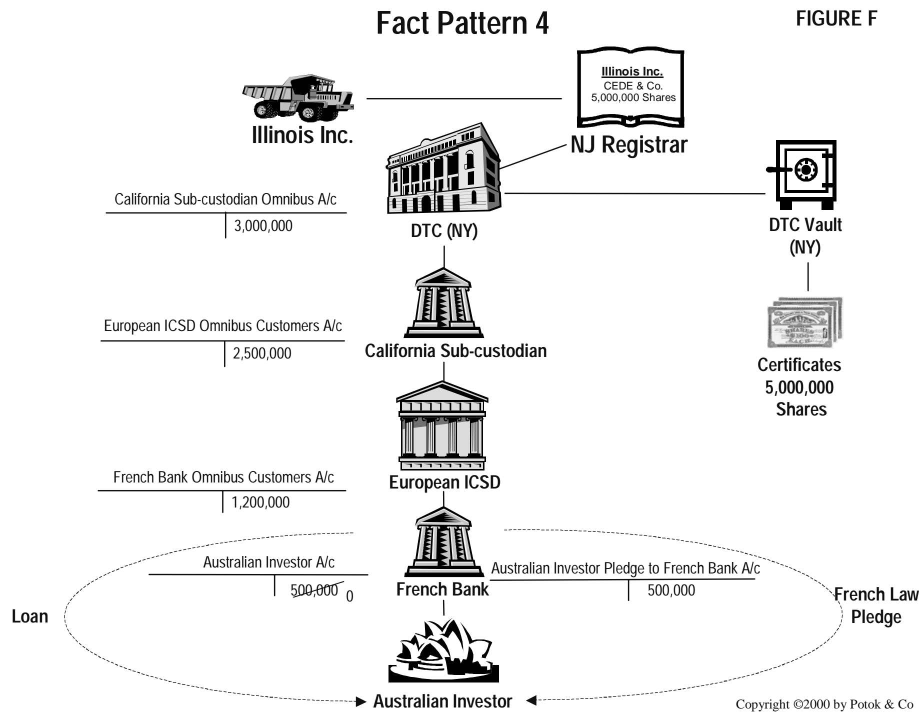
Finally, we consider the situation where Australian Investor requests that its intermediary, French Bank, make the loan in return for a pledge by Australian Investor of its interest in respect of the Illinois Inc. shares.

> Australian Investor pledges its interest in respect of 500,000 Illinois Inc. shares to French Bank under a pledge whose contractual aspects are governed by French law. As schematically depicted in FIGURE F below, the pledge is represented on the books of French Bank by a debit to the "Australian Investor Account" in respect of 500,000 Illinois Inc. shares and a corresponding credit to the "Australian Investor Pledge to French Bank Account". The pledge does not result in any change on the books of European ICSD, California Sub-custodian or DTC.

[128] Including, if applicable, a defect arising because that law recognises a defect in the first element of the transaction under French law as infecting the second element.

[129] This fact pattern was also considered by experts in the jurisdictions surveyed by the Legal Expert to the Permanent Bureau. The probable and possible answers under current law are shown in schematic form in Figure 3 (completion of transfer) and Figure 4 (priorities) in Appendix B to this Report.

The experts also considered the situation where securities are transferred by way of sale rather than as collateral. Although one would expect that the answers would be the same as to applicable law irrespective of whether the transfer is for collateral purposes or as a pure sale, this is not the case. The results are shown in schematic form in Figure 5 (completion of transfer) and Figure 6 (priorities) in Appendix B to this Report. For an example of different tests applied to title transfer for collateral purposes and outright sale, see the analysis of Swiss law, *infra*, pp. 55 *et seq.*



After executing the pledge in favour of French Bank, Australian Investor also enters into a pledge agreement in respect of the same 500,000 Illinois Inc. shares with Italian Bank. The second pledge is valid under Italian substantive law (the governing law chosen by Australian Investor and Italian Bank in their pledge agreement).

Australian Investor then enters insolvency in Australia. The liquidator asks the Australian court to rule on whether the pledges in favour of French Bank and Italian Bank should be treated as valid and, if both pledges are to be treated as valid, how they should be regarded as ranking against each other.

In this fourth fact pattern, under PRIMA, proprietary issues, such as whether French Bank obtained a perfected pledge of Australian Investor's interest in respect of the Illinois Inc. shares and whether French Bank has priority over the interest of Italian Bank, would be governed by French law, as the law of the place of French Bank, the intermediary on whose books the interest of French Bank is recorded. Note that here, because French Bank acts as both intermediary and secured party, the record of French Bank's pledge is made on its own books.[130]

[130] Superficially, it might appear that in this example PRIMA would point to the law of the place of European ICSD, the intermediary through which French Bank holds its underlying interests. However, this argument fails to focus properly on the particular interest that French Bank is here acquiring, namely, a co-proprietary interest in its own pool of customer securities – an interest which is recorded in its own books and not on the books of European ICSD.

The same analysis would apply if the transaction were a transfer of title from Australian Investor to French Bank. The interest transferred here would likewise be Australian Investor's interest in French Bank's pool of customer securities, an interest recorded on French Bank's books and not on those of European ICSD.

III. Where is the relevant intermediary located?

Once the relevant intermediary has been *identified*, one still has to determine where the relevant intermediary is *located* for purposes of PRIMA.

First, one needs to distinguish the place where the *intermediary* is located, that is, its actual office, from the place where the "*electronic data*" of the intermediary are kept. The electronic data might be kept in a computer system physically located in a different country or even in multiple places; or where an electronic *network* is being used, it might even be impossible to locate it at a single place. Hence, it seems important to ensure in the proposed Convention that an intermediary's place is *not* regarded as the place at which the technology supporting the bookkeeping within the indirect holding system is located; instead the proposed Convention's rule should refer to the law of the place where the actual office of the intermediary maintaining the investor's account is located.[131] The next question then is: where is the office of the intermediary maintaining the account located?[132] For example, if it were Swiss Bank's Dutch office that acted as immediate intermediary in the first fact situation above, where would the intermediary be located for purposes of PRIMA?

One possible method to locate the intermediary would be to look to the *account agreement* governing the relationship between an intermediary and its clients (often referred to as the custody agreement), which will indicate the address of the intermediary's office. In such a case, this address could be regarded as the authoritative location of the relevant intermediary. The obvious problem with this solution is that a third party may not have access to the account agreement to see the address.

Another possibility is that the relevant intermediary's office should be the address stated in the *most recent account statement* sent by the intermediary to its client. This answer has the advantage of being more readily accessible – a third party, like Italian Bank in our examples above, would ask to see a current account statement before taking the pledge of securities and would therefore know that its rights will be governed by the law of the address stated.

Perhaps the preferable answer, along the lines of Article 8 of the U.C.C. and the proposed EU Collateral Directive, is a cascade of answers, first looking to the address in the account agreement, and, if none is present, looking to the address in the account statement, or possibly vice versa. For the extremely rare cases in which neither the account agreement nor the most recent account statement contain an address of the intermediary, a second fall-back position needs to be established. The policy here should be to ensure that not only the intermediary and all of its clients but also third parties can look to a single, readily identifiable body of law to determine their rights and duties. Therefore, it is suggested that this second fall-back position should primarily focus on *legal* factors. The place of the intermediary could therefore be ascertained on the basis of its *statutory seat* or by referring to the law under which it has been *incorporated or*

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[131] This has rightly been emphasised at the Oxford colloquium, see POTOK, *op. cit.* (footnote 31), p. 7, footnote 15.

[132] On this issue, see also text of the proposed Directive of the European Parliament and the Council on the cross-border use of collateral, *infra,* footnote 164, and accompanying text, as well as the text of Art. 8-110(e) of revised Art. 8 U.C.C., *infra*, p. 51.

formed.[133] To what extent references to *factual* concepts such as "the central administration of the intermediary", "its principal establishment" or its "principal place of business" should be retained in the proposed Convention, will have to be examined carefully during the Experts meeting. A closely related point to be considered thoughtfully will be the situation in which the intermediary operates through a *branch office*: in such a case, should PRIMA point to the jurisdiction where the head office is located or to the jurisdiction in which the branch is located?

IV. Does PRIMA apply to all types of parties?

As the focus of PRIMA is the location of the *intermediary*, the test should apply regardless of the legal status of the pledgor / transferor or pledgee / transferee.[134] PRIMA thus avoids the complex problem of developing one or several connecting factors suitable to situations which involve a large variety of *legal entities* as well as *natural persons*.

V. Does PRIMA point to a State's substantive law or to its private international law *(renvoi)*?

There is the further question whether the reference to the law of the place of the relevant intermediary includes this jurisdiction's conflict of laws rules or is to be understood as merely designating its substantive rules. In other words, is there room for *renvoi*?

Traditionally, the Hague Conventions on the applicable law exclude any form of *renvoi*. It is argued in this Report that this should also apply to the proposed Convention. If the designation of the applicable law were to include the PRIMA jurisdiction's private international law rules, one would reintroduce an element of *uncertainty* and thereby frustrate the purpose of the proposed Convention: if, within a *renvoi* concept, the PRIMA jurisdiction's private international law rules point to the law of a State which is not a party to the proposed Convention and which in fact has adopted a different approach to the question at stake (let us assume the "*look-through approach*"), the parties to a transaction would lose all the benefits of certainty and predictability that the proposed Convention is designed to provide.[135] Hence, it is assumed that the court seized

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[133] The concept of *statutory seat* is well established in many civil law countries (although its precise meaning may vary from one country to another) but is unknown in other legal systems, in particular in *common law countries*. Hence, an alternative criterion is needed. It is suggested here that this should be the place in which the intermediary was formed. The suggestion put forward here is based on Art. 3, para. 2, of the *Preliminary Draft Convention on Jurisdiction and Foreign Judgments in Civil or Commercial Matters*, adopted in October 1999 by a Special Commission of the Hague Conference on Private International Law. For further details on Art. 3, para. 2, see the Explanatory Report on the Preliminary Draft Convention, drawn up by PETER NYGH and FAUSTO POCAR. Both the Preliminary Draft Convention and the Explanatory Report are available on the website of the Hague Conference (http://www.hcch.net), under the heading *Work in progress*.

[134] Either party might therefore be a corporation or other legal person, an association of legal persons which lacks legal personality but which is capable under the law which governs it of appearing and pleading before a court, or a natural person. There would be no special treatment for, *e.g.*, central banks, participants in settlement systems or regulated institutions.

[135] It is worth noting that of the 28 jurisdictions surveyed by the Legal Expert to the Permanent Bureau, seven would look to the conflict of laws rules of the jurisdiction that would govern proprietary issues; in one other, it is unclear how the court would decide this issue (see Appendix B, p. I).

should apply the substantive law of the PRIMA jurisdiction, without having regard to such jurisdiction's private international law rules.[136]

VI. Summary

The principal attributes of PRIMA may be summarised as follows:

- PRIMA dictates that questions of creation, perfection (rights against third parties) or completion, priorities and realisation of interests in respect of securities, be governed by the law of the place of the immediate intermediary on whose books the relevant interest is recorded;
- PRIMA situates all of an investor's interest with respect to a portfolio of securities in one single jurisdiction, even where the issuers and certificates evidencing such underlying securities are situated in many different countries;
- PRIMA applies irrespective of whether a transfer is made by way of sale or by way of a collateral transaction, and in the case of a collateral transaction, irrespective of whether the transaction takes the form of a pledge or of a transfer of title;
- PRIMA applies irrespective of the particular legal status of the collateral provider or collateral taker;
- PRIMA applies irrespective of the jurisdiction in which the collateral provider, the collateral taker or any intermediary is formed or located.

In addition, the following attributes may also be highlighted:

- Where a collateral taker acts as the collateral provider's intermediary (that is, the collateral provider holds through the collateral taker prior to the provision of collateral) and is also the secured party, the law of the relevant intermediary will be the law of the place of the collateral taker;
- The location of the relevant intermediary may be established by reference to:
  - (i) the address stated in the account agreement governing the relationship between the relevant intermediary and its client,
  - (ii) the address stated in the most recent account statement sent by the relevant intermediary to its client, or
  - (iii) in any other case, its *statutory seat* or the law under which it has been *incorporated or formed*.
- The designation of the relevant intermediary's jurisdiction through PRIMA means the substantive law of the place of the intermediary and *excludes* any form of *renvoi*;
- Under the proposed Convention, a perfected or completed interest effected through the application of PRIMA will still be subject to insolvency laws. Hence, in the case

[136] See *e.g.*, POTOK / MOSHINSKY, *op. cit.* (footnote 116), p. 15. It may be noted that in the proposed Directive of the European Parliament and the Council on the cross-border use of collateral, *renvoi* is also excluded, see *infra*, footnote 162, and accompanying text.

of an insolvency of the collateral provider, the collateral taker's interests would still be subject to the insolvency laws of the bankruptcy forum.

VII. Additional questions to be looked at during the Experts meeting

A. Definition of Securities

Among the further questions to be discussed during the *Group of Experts* meeting in January 2001, the *definition* of the term *"securities"* is of particular importance: to what kind of securities would the proposed Convention apply? The term "securities" (and the related term "security") appears to be used in a variety of contexts and therefore to have a range of possible meanings.[137] This makes it important to define the scope of the proposed Convention clearly. Subject to this, it would seem desirable for the definition of "securities" to be as broad as possible and to be flexible enough to accommodate new kinds of instruments that may be developed in the future.

Two approaches seem possible. The first would be not to attempt an exhaustive definition but to use the term "securities" with an illustrative list of examples (such as shares, bonds, depository receipts, etc.) in the expectation that the States will use the term in its ordinary sense within the context made clear by the examples.[138] The attraction of this approach is that it makes possible relatively simple wording. The risk is that it leaves scope for some unevenness in the implementation of the proposed Convention, although the risk may be regarded as acceptably small if it is thought that the term "securities" is broadly used with sufficient consistency across the markets internationally.

The second approach would be to attempt to provide a definitive definition of the term "securities". While it is true that such an approach would enhance certainty and facilitate uniform interpretation, a comprehensive definition might run counter to the need for sufficient flexibility to accommodate new types of securities.

The following paragraphs outline some suggested characteristic features and some definitions in existing legislation, by reference to which the two approaches mentioned might be analysed.

The context of the proposed Convention is clearly that of securities of the kind commonly traded on financial markets and referred to in such markets as "securities". We have therefore considered some definitions derived from similar contexts, in particular, the U.C.C.,[139] the EU Investment Services Directive and the proposed EU Collateral Directive (which draws on the EU Investment Services Directive).[140]

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[137] See BENJAMIN, *op. cit.* (footnote 79), Chapter 1; see also *supra,* p. 8, for a discussion of the meaning of the term "securities".

[138] A broad definition is also contained in Art. 1 of the *Luxembourg Grand-Ducal Degree of 1971*: "Par 'valeur mobilière' au sens du présent règlement, il faut entendre dans l'acceptation la plus large tous les titres et autres instruments financiers susceptibles de circuler de façon fongible, y compris notamment aussi les certificats de dépôt, bons de caisse et tous autres titres représentatifs de droits de propriété, de créances ou de valeurs mobilières, qu'ils soient matérialisés ou dématérialisés, transmissible par inscription en compte ou traditions, au porteur ou nominatifs, endossables ou non."

[139] Art. 8-102(a)(15) of the U.C.C.: " 'Security', except as otherwise provided in Section 8-103, means an obligation of an issuer or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer: (i) which is represented by a security certificate or bearer or registered form, or the transfer of which may be registered upon books maintained for that purpose by or on behalf of the issuer; (ii) which is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations; and (iii) which: (A) is, or is of a type, dealt in or traded on securities exchanges or securities markets; or (B) is a medium for investment and by its terms expressly provides that it is a security governed by this Article." This definition encompasses stocks and bonds, mutual fund shares, limited partnership shares, and "just about any medium which permits investment in an enterprise or

These seem to indicate that the key characteristics for securities for purposes of the proposed Convention should be the following:

(i) they are instruments representing or conferring contractual or other intangible rights of some kind;

(ii) they are instruments which either are represented by certificates or other documents of title or are evidenced by and are transferable in records or books of account maintained by or on behalf of the issuer;

(iii) they are instruments issued in fungible series such that any security or quantity of securities in a series is indistinguishable from a like security or quantity in the same series; and

(iv) they are instruments of a kind traded or tradable in a securities, investment or financial market.

These characteristics would seem to exclude in particular the following related but distinct kinds of instruments:

(a) *commodities*: physical commodities and instruments representing physical commodities (such as metal warrants and bills of lading) would be excluded as falling outside both (i) and (iii);

(b) *derivatives*: many derivatives contracts would be excluded as falling outside both (ii) and (iii).[141] While derivatives are traded on financial markets and for that purpose entered into on standard terms and by

financial participation in a business", see the summary on Art. 8 provided by the ULC (http://www.nccusl.org/uniformact_summaries/uniformacts-s-uccra8is.htm). It is for discussion whether limb (B) of this definition should be replicated in the proposed Convention. The fact that it would provide a mechanism for parties to "opt in" to the application of the proposed Convention could result in the proposed Convention applying across a range of disparate cases and contracting States might feel uncomfortable about a blanket extension of the principle of the proposed Convention to cases which, had they been specifically identified, would not have been thought appropriate. The scope for diversity conferred by an "opt-in" provision could also undermine the uniform interpretation of the proposed Convention. On the other hand, such an "opt-in" provision would confer additional flexibility to accommodate new types of instruments.

[140] For these two Directives (Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, and the proposed EU Collateral Directive, see *infra* p. 52) transferable securities mean: "shares in companies and other securities equivalent to shares in companies, bonds and other forms of securitised debt which are negotiable on the capital market and any other securities normally dealt in giving the right to acquire any such transferable securities by subscription or exchange or giving rise to a cash settlement excluding instruments of payment" (Art. 1, para. 4 of the Investment Services Directive, to which the proposed EU Collateral Directive refers).

[141] The term "derivatives" has no precise meaning and can be used in a number of different senses according to the context. It is sometimes used to include instruments, such as convertible or exchangeable bonds, warrants and transferable options to subscribe for securities, which have the characteristics of securities suggested above. The transfer of more complex derivatives of the kind commonly documented under ISDA master agreements could not generally be effected simply by entries in accounts held by the transferor and transferee: such a transfer would normally involve a tripartite contract between the transferor, the transferee and the counterparty (which under most master agreements would be entitled to refuse its consent to the transfer).

reference to standardised amounts, they are not issued in fungible series or *transferable on books maintained by an issuer*.[142]

B. Definition of intermediary

It will be necessary to agree on a definition of "intermediary", setting out what functions an intermediary must discharge in order to be regarded as an "intermediary" for purposes of the proposed Convention. By way of comparison, Article 8-102 (a)(14)of the U.C.C. defines securities intermediary as follows:

> "'Securities intermediary' means:
> (i) a clearing corporation; or
> (ii) a person, including a bank or broker, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity."

C. Should the conflict of laws rule in the proposed Convention be generally applicable?

A conflict of laws rule embodied in a convention is said to be *generally applicable* if the law designated by the rule applies irrespective of whether or not the State whose legal order has been designated is a Party to the convention.[143] The modern Hague Conventions containing provisions on the law applicable fall into the category of "generally applicable conventions".[144] It is argued in this Report that this should also be the case for the proposed Convention. In the context of collateral transactions effected in an indirect holding system, there seems to be no reason why a different approach should be taken. Thus, the provisions of the proposed Convention should apply even if the law designated under the proposed Convention is the law of a non-contracting State. This would have the considerable advantage that in States which decide to become a party to the proposed Convention, the desired certainty and predictability would be obtained instantly, without waiting for other countries to join.

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[142] The mechanism by which a derivatives contract can in practice be "sold" is by entering into an equal and opposite contract which, being made with the same counterparty (the relevant derivatives exchange or its clearing house), eliminates the first contract by a process of netting. See *supra*, footnote 60, for an explanation of netting.

[143] In French, this is often referred to as a convention *"portant loi uniforme"*; another expression is to say that the convention is applicable *erga omnes*.

[144] See *e.g.*, the *Convention of 1961 on the Protection of Minors* (Art. 1), the *Convention of 1961 on the Conflicts of Laws relating to the Forms of Testamentary Dispositions* (Art. 1), the *Convention of 1971 on the Law Applicable to Traffic Accidents* (Art. 3), the *Convention of 1973 on the Law Applicable to Maintenance Obligations* (Art. 3), the *Convention of 1978 on the Law Applicable to Agency* (Art. 4, which states explicitly that the "law specified in this Convention shall apply whether or not it is the law of a Contracting State"), the *Convention of 1989 on the Law Applicable to Succession to the Estates of Deceased Persons* (Art. 2, which states explicitly that the "Convention applies even if the applicable law is that of a non-Contracting State"), the *Convention of 1996 on Jurisdiction, Applicable Law, recognition, Enforcement and Co-operation in Respect of Parental Responsibility and Measures for the Protection of Children* (Art. 20), and, most recently, the *Convention of 2000 on the International Protection of Adults* (Art. 18). The texts of all these Conventions are available on the website of the Hague Conference (http://www.hcch.net).

D. Should the proposed Convention (PRIMA) also apply to non-fungible (transparent) accounts and mere contractual rights?

Moreover, the Experts may wish to address the question whether the proposed Convention should also apply to structures under which securities are held through *transparent or non-fungible* accounts or where the rights of account holders constitute mere contractual rights without any proprietary interest in or in respect of underlying securities.[145] At first glance, there appear to be two basic options. Before presenting these two options, however, it seems appropriate to emphasise once again that indirect holding systems operating with non-fungible accounts or on the basis of mere contractual rights are rare in practice.

The first possibility is that the proposed Convention should apply only to *fungible* accounts. This approach is consistent with the principle suggested above as the basic justification of PRIMA, namely, that the appropriate law for proprietary matters is the law of the place where the record of title is maintained and where, therefore, orders in respect of the property can be effectively enforced.[146] This approach, however, involves the complication that it becomes necessary to identify the law which determines whether a given account is fungible.

This preliminary issue may be approached in two different ways: the relevant concept of fungibility may either be provided by (i) a reference in the proposed Convention to a *national substantive law* or (ii) embodying the concept of fungibility itself in a definition in the *proposed Convention*. If reference were made to national law to determine the fungibility of an account, the relevant national law should presumably be identified in accordance with PRIMA. To justify this, one may indeed apply reasoning similar to the accepted principle that if there is a conflict between the *lex situs* and the *lex fori* as to whether a particular thing is movable or immovable, the *lex situs* must prevail, considering that in the last resort only the *lex situs* has effective control over the thing.[147]

If instead of a reference to national law, one were to prefer a *uniform* concept of fungibility, the proposed Convention would have to provide for an autonomous definition of fungibility set out in a substantive law rule. Thus, it would require all States to adopt a substantive rule defining what constitutes a fungible account. This would be a very significant extension in the scope of the proposed Convention and, given the differences in the property laws of the States, the difficulty of achieving an agreed rule could be considerable.

A further practical complication of this "fungible-only" approach is that, in a case where the account maintained by the immediate intermediary was found not to be fungible, reference would have to be made to the position of the account of the next intermediary in the holding pattern and a similar analysis conducted. In some cases, this process might be repeated several times until one either reached a fungible account with an intermediary or traced the investor's interest through to (i) the level of actual registration in the register of the issuer or (ii) possession of certificates.

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[145] See *supra*, p. 10, and pp. 19 *et seq*.

[146] See *supra*, p. 29.

[147] DICEY & MORRIS, *op. cit.* (footnote 10), Rule 111, para. 22-009.

These practical difficulties prompt the question whether to adopt an alternative approach under which the proposed Convention would apply irrespective of whether the holding pattern involves fungible accounts or not. Obviously, the main advantage of this approach is that it avoids distinguishing between fungible and non-fungible accounts and thus circumvents the difficulty of determining the law according to which one has to ascertain whether an account is fungible or not. Under this approach, PRIMA would apply irrespective of the nature of the indirect holding system involved. The simplicity thus achieved has some attraction but brings with it the difficulty that the proposed Convention may subject proprietary issues to the law of an intermediary in circumstances where the investor's title is clearly recorded at some higher level in the holding pattern (traceable property right). This, however, seems difficult to reconcile with the basic principle suggested above as underpinning PRIMA.

As regards situations in which an account holder has a mere contractual right without any proprietary interest in or in respect of underlying securities, it has been mentioned that traditional private international law principles would already lead (at least in most cases) to the application of the law of the intermediary.[148] It would therefore appear that it does not really matter whether this law is designated under the principle of the "characteristic obligation", "the most significant relationship", "the proper law" or PRIMA.

E. Mandatory rules *(lois d'application immédiate)*

As already mentioned, the proposed Convention will not interfere with a State's existing *insolvency laws*. At the meeting in January, however, the Experts may wish to consider the broader question of the impact of *mandatory rules* (*lois d'application immédiate*) of the *forum* and of third States.[149] At first glance, it would seem that the mandatory rules of the *forum* will remain applicable in addition to the provisions designated through PRIMA. It is indeed unlikely that a judge will disregard the mandatory rules of the *forum*: these rules are to be regarded as an expression of fundamental values which are so important that, as a matter of policy, the rules must apply in any action before a court of the forum, even where the issues are in principle governed by a foreign law. However, which rules would be regarded as mandatory in the context of collateral transactions

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[148] See *supra*, p. 30.

[149] We use the term *mandatory rules* in an "international sense", that is, we refer to rules which must be applied to the issue before the court regardless of any choice of law by the parties or any rule of the local private international law under which the issues would otherwise be referred to another legal system. This idea of "directly" applicable rules (in the sense that they short-cut traditional private international law mechanisms) is quite appropriately reflected in the French expression *lois d'application immédiate,* see PHOCION FRANCESCAKIS, *Quelques précisions sur les 'lois d'application immédiate' et leurs rapports avec les règles de conflits de lois*, RCDIP 1966, pp. 1 *et seq.* (the German expression "Eingriffsnormen" is equally pertinent).

By way of information, it may be added that the concept of mandatory rules has been introduced in several national private international law acts (*e.g.*, the *Swiss Statute on Private International Law of 1987*, Art. 18 [mandatory rules of the *forum*] and Art. 19 [mandatory rules of a third State], *Code Civil of Quebec*, Art. 3079 [for both mandatory rules of the *forum* and of third States], *Italian Statute on Private International Law of 1995*, Art. 17 [mandatory rules of the *forum* only], *Venezuelan Statute on Private International Law of 1998*, Art. 10 [mandatory rules of the *forum* only], as well as in several international conventions (see *e.g.*, the *Hague Convention of 1978 on the Law Applicable to Agency*, Art. 16 [for both mandatory rules of the *forum* and of third States], the *Hague Convention of 1985 on the Law Applicable to Trusts and on their Recognition*, Art. 16 [for both mandatory rules of the *forum* and of third States], the *Rome Convention of 1980 on the law applicable to contractual obligations*, Art. 7 [for both mandatory rules of the *forum* and of third States], and the *Inter-American Convention of 1994 on the Law Applicable to International Contracts*, Art. 11 [for both mandatory rules of the *forum* and of third States].

effected through an indirect securities holding system? Would, for example, a requirement that a pledge of securities issued by a corporation formed under the law of the *forum* be filed or registered in a public register fall into this category?

Another and probably more delicate question will be the impact of mandatory rules of a *third State*. This may be illustrated by way of an example: Let us assume that the securities held by an investor through an intermediary located in State Y are securities issued by a corporation formed under the laws of State X; the investor provides its interests in these securities as collateral under a pledge mechanism. Let us further assume that the law of State X requires that all pledges over securities issued by corporations incorporated in State X be filed in a public register in State X. Under this fact pattern, the question could arise as to whether the law of State X has to be taken into consideration in addition to the law of State Y which, as a result of PRIMA, governs the proprietary aspects of the collateral transaction. Any requirement to take into consideration the mandatory rules of a third State would potentially reintroduce an element of uncertainty and thus frustrate the purpose of the proposed Convention. If mandatory rules of a third State were to be considered, at least two subsequent issues would arise: (i) would the law of *any* third country be relevant or only of a country with a close and substantial connection; (ii) should the application of the mandatory law of the third country be mandatory itself or be at the discretion of the *forum*? Given the potential uncertainty that the concept might introduce, it would seem preferable not to adopt it in the proposed Convention.[150]

Section 4 — A survey of jurisdictions having adopted or considering PRIMA

The adoption of PRIMA in a *Hague Convention on the law applicable to dispositions of securities held through indirect holding systems* would sanction at an international level a solution that has already been adopted in a number of national jurisdictions and which is currently also being considered by several other jurisdictions. In other words, it would seem that by embodying PRIMA in a worldwide convention, one would indeed provide the international financial market with the certainty and predictability needed by using a connecting factor which appears to be more and more accepted.

A. Legislative developments which have already led to the enactment of PRIMA

1. At a regional level: The EU Settlement Finality Directive

The European Union first introduced an important legal framework for payment and security settlement systems in 1998, when the *Directive on Settlement Finality* was

[150] On the issue of mandatory laws in general, see *e.g.*, PETER NYGH, *The reasonable expectations of the parties as a guide to the choice of law in contract and tort*, in: Recueil des Cours – Collected courses of the Hague Academy of International Law 1995, vol. 251, pp. 376-397.

adopted (the Settlement Finality Directive).[151] This Directive applies to cross-border collateral in the context of financial transactions involving a designated securities settlement or payment system or an EU central bank. Among other things, it protects netting in settlement systems, insulates collateral given to the system operators, certain system participants and EU central banks from the effects of bankruptcy and clarifies the law applicable to dispositions of book-entry securities. The relevant provision in this respect is Article 9, paragraph 2, which reads as follows:

> "Where securities (including rights in securities) are provided as collateral security to participants and/or central banks of the Member States or the future European central bank as described in paragraph 1, and their right (or that of any nominee, agent or third party acting on their behalf) with respect to the securities is legally recorded on a register, account or centralised deposit system located in a Member State, the determination of the rights of such entities as holders of collateral security in relation to those securities shall be governed by the law of that Member State."

Although it appears that the original purpose of Article 9, paragraph 2, was to benefit only central banks, the European Central Bank and certain participants in designated systems as collateral takers, with the encouragement of the European Commission and other bodies, a number of the jurisdictions in Europe in the implementation process have extended the protection of Article 9, paragraph 2, so as to protect financial market participants more generally,[152] and some others have indicated the intention to do the same.[153, 154]

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[151] See the references in footnote 104; on the Settlement Finality Directive in general, see *e.g.*, SCHEFOLD, *op. cit.* (footnote 49), p. 472; DIEGO DEVOS, *La Directive européene du 19 mai 1998 concernant le caractère definitif du règlement dans les systèmes de paiement et de règlement des opérations sur titres*, in: EUREDIA (European Banking & Financial Law Journal), 1999, pp. 149-185; DIEGO DEVOS, *Specific Cross-Border Problems Regarding Bank Insolvencies and European Harmonization Efforts*, in: Giovanoli / Heinrich (eds.), International Bank Insolvencies – A Central Bank Perspective, 1999, p. 314.

[152] For an example of a broad implementation of Art. 9, para. 2, of the Settlement Finality Directive, see Art. 17a of the German *Depotgesetz* which reads in English as follows: "Dispositions relating to securities or holdings in collective securities deposits which have been entered with legal effect into a register or booked to an account shall be subject to the law of the country supervising the register, in which the entry with legal effect is made directly in favour of the beneficiary or in which the headquarters or branch of the custodian managing the account and crediting the beneficiary with legal effect is located." For commentary on Art. 17a, see CHRISTOPH KELLER, *Die EG-Richtlinie 98/26 vom 19.5.1988 über die Wirksamkeit von Abrechnungen in Zahlungs- sowie Wertpapierliefer- und abrechnungssystemen und ihre Umsetzung in Deutschland,* WM 2000, pp. 1269 *et seq.*; SCHEFOLD, *op. cit.* (footnote 49), pp. 473-476, with references in footnotes 77 and 79 to the implementing legislation of other States. For a more comprehensive survey of the status of the implementation of Art. 9, para. 2, in Member States, see R. POTOK, *Legal certainty for securities held as collateral,* Attachment A to Annex VI to the *Conclusions of the Special Commission of May 2000, op. cit.* (footnote 1).

[153] See *infra,* footnote 165, 166.

[154] This Directive raises the interesting question whether the *Rome Convention of 1980 on the Law Applicable to Contractual Obligations* is of any relevance for our subject matter. Suppose that an investor's interest in securities held by an intermediary is pledged as collateral for a loan. This transaction may be categorised as an assignment of the investor's interests within the scope of Art. 12 of the Rome Convention. As a result, the *contractual* obligations of this transaction would be governed by the law applicable to the contract of transfer (Art. 12, para. 1; presumably, this law will have been chosen by the parties). But does Art. 12 equally apply to the *proprietary* aspects of the transaction? Whereas the official report on the Rome Convention seems to suggest that the Convention does *not* apply to proprietary issues (GIULIANO and LAGARDE Report, OJ C282/1, *ad Art.* 1, para. 2), the Dutch Supreme Court held in 1997 that Art. 12, para. 1, of the Rome Convention *does* indeed extend to the proprietary aspects of an assignment (*Brandsma qq* v. *Hansa Chemie A.G.,* Hoge Raad, 16 May 1997; for a critical comment upon this case, see TEUN H.D. STRUYCKEN, L.M.C.L.Q. 1998, pp. 345-360). How does the Settlement Finality Directive impact on this conflict? One may legitimately argue that the Directive *supersedes* the Rome Convention. The Convention indeed states in Art. 20 that it "shall not affect the application of provisions which, in relation to particular matters, lay down choice of laws rules relating to contractual obligations and which are or will be contained in acts of the institutions of the European Communities or in national laws harmonised in implementation of such acts." It would seem that if one interprets Art. 12 broadly so as to encompass *proprietary* aspects (an interpretation which, again, is debated), one

2. At a national level (Belgium, Luxembourg, France, United States)

Countries that have set up a new legal regime for securities held through indirect holding systems may already have created a structure which effectively looks to the location of the immediate intermediary for proprietary issues. This is because the investor's interest is represented solely by book entries on the accounts of the immediate intermediary and thus is held to be located where the accounts are located. As regards Belgium and Luxembourg, this has been acknowledged by leading lawyers.[155]

As regards France, securities issued in France are no longer certificated and are solely evidenced by book entries and therefore can only be situated where the investor's title is maintained, that is, where the intermediary or the issuer with whom the investor has an immediate relationship is located.[156] The PRIMA principle has been adopted through a unilateral (as opposed to a multilateral) conflict of laws rule in Article 29 of law n° 83-1 of 3 January 1983. Article 29, which governs the pledge of securities accounts, provides that French law applies to the pledge of a securities account with an immediate intermediary in France even though there are securities issued by non-French issuers in the account.[157] It is open to debate, however, whether a French court would apply PRIMA to the situation where securities issued by non-French issuers are held though an account with an immediate intermediary *located outside France*.

As regards the United States, PRIMA has been expressly embodied in the 1994 version of Article 8-110, of the U.C.C., paragraph (b) of which reads as follows:

> "The local law of the securities intermediary's jurisdiction, as specified in subsection (e), governs:
>
> (1) acquisition of a security entitlement from the securities intermediary;

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would also have to interpret Art. 20 broadly and thus give priority to the Settlement Finality Directive, which not only is later than the Rome Convention (*lex posterior*), but which also constitutes a more specific act (*lex specialis*). Another (more radical) approach, which would also lead to the exclusion of the Rome Convention in this matter, consists in regarding a transfer by way of successive book entries not as an assignment but rather as a *novation* (to which Art. 12 does not apply). Assignment indeed presupposes that a claim is transferred from Party A to Party B as it is. In the event of a transfer by way of book entries, however, the investor waives its claim against the intermediary, which, in turn, has an obligation towards the transferee. This process may legitimately be categorised as a novation. On the question whether the Rome Convention has any bearing upon the subject matter, see FENTIMAN, *op. cit.*, (footnote 26), pp. 42-43.

155 See GUYNN, *op. cit.* (footnote 5), pp. 44-45, but see also GOODE, *op. cit.* (footnote 31), pp. 12-13, footnote 12, with further reference.

156 See ROBLOT, *La dématérialisation des valeurs mobilières,* Paris 1984, n° 185.

157 See DE VAUPLANE / MOUY, *La réforme du nantissement des titres dématérialisés,* Banque & droit, n° 48, 1996, p. 3.

(2) the rights and duties of the securities intermediary and entitlement holder arising out of a security entitlement;

(3) whether the securities intermediary owes any duties to an adverse claimant to a security entitlement; and

(4) whether an adverse claim can be asserted against a person who acquires a security entitlement from the securities intermediary or a person who purchases a security entitlement or interest therein from an entitlement holder."

And according to paragraph (e), the following rules determine a "securities intermediary's jurisdiction" for purposes of this section:

"(1) If an agreement between the securities intermediary and its entitlement holder specifies that it is governed by the law of a particular jurisdiction, that jurisdiction is the securities intermediary's jurisdiction.

(2) If an agreement between the securities intermediary and its entitlement holder does not specify the governing law as provided in paragraph (1), but expressly specifies that the securities account is maintained at an office in a particular jurisdiction, that jurisdiction is the securities intermediary's jurisdiction.

(3) If an agreement between the securities intermediary and its entitlement holder does not specify a jurisdiction as provided in paragraph (1) or (2), the securities intermediary's jurisdiction is the jurisdiction in which is located the office identified in an account statement as the office serving the entitlement holder's account.

(4) If an agreement between the securities intermediary and its entitlement holder does not specify a jurisdiction as provided in paragraph (1) or (2) and an account statement does not identify an office serving the entitlement holder's account as provided in paragraph (3), the securities intermediary's jurisdiction is the jurisdiction in which is located the chief executive office of the securities intermediary."[158]

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[158] According to Art. 8, para. (a), the local law of the *issuer's jurisdiction*, as specified in subsections (d), governs: "(1) the validity of a security; (2) the rights and duties of the issuer with respect to registration of transfer; (3) the effectiveness of registration of transfer by the issuer; (4) whether the issuer owes any duties to an adverse claimant to a security; and (5) whether an adverse claim can be asserted against a person to whom transfer of a certificated or uncertificated security is registered or a person who obtains control of an uncertificated security." According to para. (d), the "issuer's jurisdiction" means "the jurisdiction under which the issuer of the security is organised or, if permitted by the law of that jurisdiction, the law of another jurisdiction specified by the issuer. An issuer organised under the law of this State may specify the law of another jurisdiction as the law governing the matters specified in subsection (a) (2) through (5)."

According to Art. 8, para. (c), the local law of the *jurisdiction in which a security certificate is located at the time of delivery* "governs whether an adverse claim can be asserted against a person to whom the security certificate is delivered."

Paragraph (f) goes on to specify that a securities intermediary's jurisdiction is *not* determined

> "by the physical location of certificates representing financial assets, or by the jurisdiction in which is organised the issuer of the financial asset with respect to which an entitlement holder has a security entitlement, or by the location of facilities for data processing or other record keeping concerning the account."

B. Current legislative reform with a view to enacting PRIMA

It is worth mentioning that there are several legislative developments currently under consideration which, if implemented, will also lead to the adoption of PRIMA.

1. At a regional level: the proposal for a Directive of the European Parliament and the Council on the cross-border use of collateral

The proposed EU Collateral Directive builds upon the Settlement Finality Directive already mentioned and is intended further to improve the general legal framework governing the provision of collateral in the EU financial markets. It is designed to create a uniform minimum regime for the provision of securities as collateral under both pledge and title transfer structures.[159] As regards the conflict of laws treatment of book-entry securities used as collateral in a cross-border context, the proposed EU Collateral Directive intends to extend the principle adopted in Article 9, paragraph 2, of the Settlement Finality Directive (PRIMA). The relevant provision in the proposed Directive is Article 11, paragraph 2, which reads as follows:

> "For the purposes of any rule of the law of a Member State or part of a Member State relating to a choice between the laws of different countries, any question with respect to any of the matters specified in paragraph 5 arising in relation to the application of a financial collateral arrangement to any book-entry securities collateral [or cash collateral] shall be governed by the law of the country or, where appropriate, the law of the part of the country in which the relevant account is maintained, whether or not that country is a Member State."[160]

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[159] Among other things, the proposed Directive, which is due for adoption in 2003, intends to provide limited protection of collateral arrangements from some rules of insolvency law, in particular those that would inhibit the effective realisation of collateral or cast doubt on the validity of techniques such as close-out netting, the provision of top-up collateral and substitution. See Working document, *op. cit.* (footnote 31 *in fine*), p. 19.

[160] The matters specified in para. 5 are the following: "(a) the ranking or priority of any title to or interest in the book-entry securities collateral arising under financial collateral arrangement as against any competing title or interest claimed by another person; (b) any act or thing necessary to ensure that any title to or interest in the book entry securities collateral arising under the financial collateral arrangement may be asserted generally against persons who are not parties to the financial collateral arrangement; (c) the steps required for the realisation of the collateral following the occurrence of an enforcement event, including any act or thing necessary to ensure that any disposal of the collateral will be effective generally as against persons who are not parties to the financial collateral arrangement."

This provision embodies PRIMA as a general rule applicable to all situations where securities held through indirect holding systems are provided as collateral. This provision would thus put an end to the uncertainty surrounding the implementation of Article 9, paragraph 2, of the Settlement Finality Directive.[161] Finally, it may be noted that the proposed provision excludes *renvoi*,[162] does not admit the possibility of the parties *choosing the law applicable* to the proprietary aspects of the transaction,[163] and *localises* the relevant account by using the following cascade:

> "A relevant account shall be treated for the purposes of this article as maintained at any given time: (a) where an office is identified in the agreement governing the relevant account, or in the most recent statement relating to the account sent by the relevant intermediary to the holder of the account, as the office at which the account is maintained, at the office so identified; (b) in any other case, at the head office of the relevant intermediary."[164]

2. At a national level

PRIMA-like legislation is currently under consideration in various countries in Europe (the Netherlands[165] and the United Kingdom[166]), the Asia Pacific region (Japan[167] and

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[161] See *supra*, p. 49.

[162] Art. 11, para. 3, of the proposed Directive reads as follows: "The reference in paragraph 2 to the law of a country or part of a country is a reference to its domestic law, that is, to its substantive law, disregarding any rule under which, in deciding the relevant question, reference would be had to the law of another country."

[163] See SCHEFOLD, *op. cit.* (footnote 49), p. 471, with further references.

[164] Art. 11, para. 4, of the proposed Directive.

[165] The Netherlands Standing Government Committee on Private International Law has issued a Draft Bill on Conflict of Law Rules Relating to Property Law Issues. Section 14 of the Draft Bill adopts PRIMA for indirectly held securities. It is expected that the Draft Bill will come into effect in the Netherlands during the Autumn of 2001.

[166] The United Kingdom originally implemented Art. 9, para. 2, of the Settlement Finality Directive reflecting the restriction in that article. The UK Treasury has indicated that it intends to introduce further legislation which will extend the protection of Art. 9, para. 2, to financial participants more generally.

[167] In Japan, the Financial Council announced in a report released in June of 1999 that the conflict of laws issue should be resolved, and specifically referred to the PRIMA rule. The Ministry of Justice and the Financial Services Agency are working first on substantive law reform in this area and then will focus on the conflict of laws issue. It is hoped that PRIMA or a similar rule will be adopted in Japan within a few years.

Australia[168]), North America (Canada[169]) and the Caribbean (Bermuda,[170] the British Virgin Islands[171] and the Netherlands Antilles[172]).

Section 5 — The indirect holding system and the *trust* concept: an excursus

For legal systems which recognise the *trust* concept, it has been argued that the PRIMA solution could also be reached on the basis of the traditional *lex rei sitae* rule: if an investor holds an interest in respect of securities through the indirect holding system, the investor's interest is one of co-ownership in the interests held by the immediate intermediary, in the sense that the intermediary is the trustee of a trust for the benefit of the investor.[173] Under traditional conflict of laws principles, the proprietary aspect of the transfer of such an interest would be governed by the *lex rei sitae*. The question of *where* such a beneficial interest lies, depends on the precise nature of the interest: if the investor has an absolute right to ask for the delivery of the trust assets *in specie*, then the beneficial interest is situated at the place of the assets; if the investor does not hold such an absolute right, then the *situs* of the beneficial interest is the place of the residence or business of the trustee. In the case of securities held through indirect holding systems, the investor does *not* have a right to delivery of specific securities but only the right to call for delivery of a specified quantity of securities of the appropriate description. Hence, the *situs* of the beneficial interest is the place of residence or business of the trustee. Accordingly, it is the law of the place of residence or business of the investor's immediate intermediary as trustee which governs the proprietary aspects of the transfer.[174]

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[168] The Australian Government is considering the adoption of legislation embodying PRIMA principles following their endorsement by the Government's corporations advisory body.

[169] At the request of the Uniform Law Conference of Canada, Canada's provincial securities commissions have formed a task force to develop and urge their respective provincial governments to adopt a uniform (harmonised in the case of Quebec) Securities Transfer Act (STA) modelled on revised Art. 8 of the U.C.C in the U.S. In addition, pending the implementation of comprehensive STA legislation by several provinces in Canada, the Ontario Securities Commission is urging the Ontario Government to adopt an interim PRIMA-like measure in the form of an amendment to Ontario's Business Corporations Act or Personal Property Security Act.

[170] The Legislative Changes Committee of the Bermuda International Business Association has been considering the adoption of PRIMA and has indicated that it is "favourably considering the changes".

[171] The British Virgin Islands Financial Services Department is currently considering a draft bill of PRIMA legislation and it is hoped that legislation will be introduced early in 2001.

[172] The Netherlands Antilles Government is seriously considering the implementation of PRIMA in its conflict of laws legislation. This implementation may well be effected as early as 1 January 2001.

[173] It should be stressed that use of the trust analogy for the purposes of the conflict of laws analysis is entirely separate from the issue of the substantive rights and obligations of the parties. In particular, it does not imply that intermediaries (including depositories and custodians) are subject to the strict liabilities imposed on trustees; their responsibilities are likely to depend primarily on the terms of their contracts with their customers.

[174] See MARK MOSHINSKY, *Securities held through a Securities Custodian – Conflict of Laws Issues,* Oxford Colloquium on Collateral and Conflict of Laws, Special Supplement to Butterworths Journal of International Banking and Financial Law, pp. 18-21, with further references; POTOK, *op. cit.* (footnote 31), pp. 6–7, and BENJAMIN, *op. cit.* (footnote 79), pp. 79-84.

While the result of this analysis has received the support of leading trust experts, some prefer to avoid the reference to the *legal fiction* of a *situs* for intangibles such as electronic book entries. Rather, they argue for the adoption of a specific rule pointing directly to the law of the place of the investor's immediate intermediary to govern the proprietary aspect of a collateral transaction involving securities held through an indirect holding system, thus bypassing any artificial reference to the *situs*.[175]

In this context, one may also ask about the applicability of the *Hague Convention of 1 July 1985 on the law applicable to trusts and on their recognition* (the Trust Convention) to the investor-intermediary relationship within indirect holding systems. For the purposes of the Trust Convention, a trust is a legal relationship created by a person, the settlor, whose assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose (Art. 2, para. 1). Article 3 specifies that the Trust Convention applies only to trusts *created voluntarily* (and evidenced in writing), thus excluding *constructive trusts* from the Convention's scope of application.[176] Against this background, it has been argued that trusts arising from the investor-intermediary relationship are *excluded* from the scope of the Trust Convention, as these trusts are not *created* by a settlor.[177] The contrary view may, however, also be argued; the analysis may in part depend on the precise documentation and circumstances in the particular case. For purposes of the proposed Convention, the important point would seem to be to make it clear that, in cases where an indirect holding pattern is regarded as giving rise to a trust to which the Trust Convention applies, the conflict of laws rule in the proposed new Convention will prevail over that in the Trust Convention to the extent that the two are inconsistent.

Section 6 — The conflict of laws puzzle in the absence of any specific rule designed to apply to the indirect holding system: the example of Switzerland

A more detailed presentation of the situation in Switzerland appears to be interesting for two main reasons: first, Switzerland has an important financial market with considerable international ramifications; and secondly, in 1989, a modern and comprehensive Private International Law Statute entered into force. In addition, the analysis of the conflict of laws problems relating to dispositions of securities held in indirect holding systems under Swiss law reveals some particular novel features that are interesting and relevant. Somewhat surprisingly, however, this analysis appears to be rather complicated and thus generates significant uncertainty that needs to be addressed.

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[175] See in particular GOODE, *op. cit.* (footnote 31), pp. 22-23, see also POTOK, *op. cit.* (footnote 31), p. 7.

[176] See the Explanatory report on the Convention by ALFRED E. VON OVERBECK, in: Proceedings of the Fifteenth Session, Tome II, Trusts – applicable law and recognition, The Hague 1985, p. 380, para. 49.

[177] See GOODE, *op. cit.* (footnote 31), p. 23, footnote 11.

I. Certificated and uncertificated securities under Swiss law

As is the case with the substantive law of many jurisdictions, Swiss law treats certificated and uncertificated securities in very different ways.

Certificated securities deposited with the Swiss CSD, SEGAINTERSETTLE (SIS), are characterised as fungible chattel. As such, they are subject to property rights and other rights *in rem*. When buying such securities, the investor acquires a pro-rata property right as co-owner of the pool of securities deposited with SIS, and not exclusive property rights in individual securities.[178] Contract provisions of SIS provide that SIS acquires no ownership rights in the deposited securities.

In principle, the ownership of certificated securities is transferred by transfer of possession, that is, by delivery of the certificate (Art. 714 of the Swiss Civil Code, hereinafter CC). Similarly, for a pledge to be effective, transfer of possession of the securities is required, and the pledge is not perfected as long as the pledgor retains exclusive possession of the securities. In an indirect holding system, SIS has direct possession of the securities and the intermediaries and the investors have derivative (indirect) possession of the securities. In such a situation, possession can be transferred without delivery, if a third party remains in possession of the securities based on a special legal relationship, such as a contract (Art. 924 of CC). It is this alternative method of transfer which applies in the indirect holding system: SIS, as a third party, keeps direct possession of all the securities deposited with it, based on contract. Transfer of possession without delivery is thus effectuated through book entries.

Uncertificated securities, however, are characterised as mere personal or contractual rights against the issuer.[179] Consequently, these securities have to be transferred or pledged according to the provisions on the assignment and pledge of claims. Among other requirements, the assignment or pledge must be in writing.[180]

In summary, depending on the type of the securities involved, certificated or uncertificated, the legal nature of the investor's interests in respect of the securities varies: the investor will have a property right *in rem* in certificated securities and a contractual right in uncertificated securities. This distinction is crucial in determining which conflict of laws rules to apply for transactions relating to indirectly held securities.

II. The conflict of laws issues

The conflict of laws issues are governed by the federal Private International Law Statute of 1987 (hereinafter PILS). At the outset, it is important to note that no special provisions have been adopted to tackle the specific case of the indirect holding system for securities. Which of the "general" provisions applies depends on the nature of the

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[178] Even if a company issues one or more global certificates, legal doctrine and practice still assume that the investor holds a right *in rem* in the securities.

[179] See *e.g.*, D. ZOBL / C. LAMBERT, Zur Entmaterialisierung der Wertpapiere, *Schweizerische Zeitschrift für Wirtschaftsrecht/Revue suisse du droit des affaires/Swiss Review of Business Law*, 1991 vol. 3, p. 129.

[180] For the assignment of claims: Art. 164 to 174 of the Swiss Code of Obligations, hereinafter CO, with the writing requirement embodied in Art. 165 of CO; for the pledge of claims: Art. 899 to 906 of CC.

interest in the securities as well as on the type of transaction involved. There are three provisions to be considered:

- Article 100 of PILS for the *outright transfer of certificated securities*;
- Article 105 of PILS for the *pledging of certificated or uncertificated securities*; and
- Article 145 of PILS for the *outright transfer of uncertificated securities*.[181]

A. Certificated securities

1. Transfer of title / outright transfer

As mentioned, under Swiss law certificated securities are considered to be *movable property*. This being said, it should be noted that the Swiss PILS does not contain a specific provision on the transfer of title for collateral purposes (*transfert de propriété à fin de sûreté*, *Sicherungsübereignung*). Hence, one first has to ascertain whether such a transfer of title may be assimilated to an existing category of transactions. It would seem, however, that there are two different options that may legitimately be considered. As these two options lead to different results, the goal of legal certainty and predictability is not achieved.

First, one may take the view that a transfer of title for collateral purposes has to be assimilated to an *outright transfer* of full ownership of certificated securities. Accordingly, the proprietary aspects would be governed by the general rule of Article 100 of PILS on the transfer of movable goods, that is, by the *lex rei sitae*.[182] Under paragraph 1 of this Article, the transfer of rights in movable property is subject to the law of the State in which the property is located at the time of the transfer. Because the rights in certificated securities are considered to be property rights, the *situs* of the certificate, that is, the *location of the CSD or of its depository keeping the certificates in its vault,* determines the substantive law to be applied.[183]

Under the second approach, the transfer of title for collateral purposes would be likened to a *pledge*, because transfer of title is designed to secure a transaction. Accordingly, a transfer of title for collateral purposes would be governed by the law that would apply to *pledges*. The following analysis will show that if this were the case, then two forms of transfer of ownership of securities may lead to quite different results – the test to be applied to determine the law applicable to title transfer for collateral purposes would be different from that applicable to outright sale.

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[181] For the following, see in particular DIETER ZOBL, *Internationale Übertragung und Verwahrung von Wertpapieren (aus schweizerischer Sicht),* manuscript of a presentation to the Subcommittee E10 of Committee E of the IBA in Frankfurt in Fall 1999, to be published in: Schweizerische Zeitschrift für Wirtschaftsrecht / Revue suisse de droit des affaires / Swiss review of business law, 2001, vol 2; REBER, *op. cit.* (footnote 31), pp. 24-27.

[182] ZOBL, *op. cit.* (footnote 181), p. 11. Art. 100 reads as follows: "1. Acquisition and loss of real rights in movable goods are governed by the law of the country of location at the time of the event giving rise to the acquisition or loss. 2. The scope and exercise of real rights in movable goods is governed by the law at the location of the goods." The English translation is taken from P. A. KARRER / K. W. ARNOLD, *Switzerland's Private International Law Statute 1987*, Deventer 1989.

[183] Generally, the same substantive law will also apply to the scope and exercise of *in rem* rights with regard to these certificated securities (Art. 100, para. 2, of PILS).

2. Pledge

Article 105 of PILS deals, *inter alia*, with the pledging of certificated securities and is a special provision that derogates from the general principle of the *lex rei sitae* set out by Article 100 of PILS. It contains a subjective as well as an objective connecting factor. Article 105, paragraph 1, of PILS provides that the pledging of certificated securities is subject to the law chosen by the parties to the pledge; however, this choice of law may not be asserted against third parties.[184] Where third parties rights are involved then unless the third party accepts the law chosen by the parties to the pledge, the law of the place of the habitual residence of the lien creditor (collateral taker) would be the applicable rule.[185] Article 105 thus raises some significant uncertainties, as a third party may choose, at its convenience, to have its rights determined either by the law chosen by the parties to the pledge agreement or by the law of the lien creditor's habitual residence. Therefore, in order to obtain a valid interest in the securities, the lien creditor will always have to ascertain whether the formalities of both the law chosen by the parties *and* the law of the place of the habitual residence of the lien creditor have been complied with. This leaves the parties to the pledge agreement with little certainty because the crucial question is precisely whether they have an interest that is good against third parties.[186]

Absent a valid choice of law, the pledging of securities is subject to the law of the place of habitual residence of the lien creditor (collateral taker).[187]

However, it must be noted that quite often the lien creditor also will act as the intermediary and that therefore the law of the place of the intermediary's habitual residence would govern (to the extent that the choice of law made by the parties does not prevail).[188]

B. Uncertificated securities

1. Transfer of title / outright transfer

The transfer of uncertificated securities also may be regarded in two different ways. First, one may categorise it as a transfer of a *claim*, which is effected by *assignment*. Article 145 of PILS provides that such assignment of a claim is subject to the law chosen by the parties to the assignment, or absent such a choice, by the law governing the claim.[189] At first glance, this provision seems to leave ample room for an effective choice

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[184] Art. 105, para. 1, reads as follows: "The pledge of claims, securities, and other rights is governed by the law chosen by the parties. The choice of law cannot be invoked against third parties."

[185] PIUS FISCH, in: Honsell / Vogt (eds.), *Kommentar zum Schweizerischen Internationalen Privatrecht*, Basle 1996, *ad Art.* 105, note 12; ZOBL, *op. cit.* (footnote 181), p. 11.

[186] See *e.g.*, REBER, *op. cit.* (footnote 31), p. 26.

[187] Art. 105, para. 2, reads as follows: "If no choice of law has been made, the pledge of claims and securities is governed by the law of the pledgee's habitual residence; the pledge of other rights is governed by the law applicable to them."

[188] REBER, *op. cit.* (footnote 31), p. 26.

[189] Art. 145 is placed under the heading *Transfer of claims 1. By contractual agreement* and reads as follows:

"1. The contractual assignment of a claim is governed by the law chosen by the parties or, if none was chosen, by the law applicable to the claim. The choice of law has no effect on the debtor without his assent.
2. For the assignment of a claim of an employee, the choice of law is only valid to the extent permitted for the employment contract by Article 121 subsection 3.
3. The form of assignment is exclusively subject to the law governing the contract to assign.
4. Questions only concerning the relationship between assignor and assignee are subject to the law governing the legal relationship on which the assignment is based."

of law. It should be noted, however, that according to Article 145, paragraph 1, the choice of law may not be asserted against the debtor of the claim assigned. Thus, for instance, the choice of law may not be invoked against the issuer of uncertificated securities without the issuer's consent. Further, according to some views, an analogy has to be drawn to Article 105, paragraph 1, according to which the choice of law is not valid against third parties who did not consent to such a choice.[190] In the absence of a valid choice of law (possibly resulting from the objection of a third party), the law governing the claim which is being assigned would apply. In the case of equity securities this would be the law of the issuer, and in the case of debt securities, it would be the law governing the debt securities.[191]

According to a second approach, the transfer of title should be regarded as a *pledge*.

2. Pledge

The specific conflict of laws rule for uncertificated securities is to be found in Article 105 of PILS which addresses the pledging of "claims" and "other rights". As for certificated securities, the pledging of uncertificated securities, whether claims or other rights, is subject to the law chosen by the parties; here too, the choice of law may not be asserted against third parties. In the absence of a valid choice of law, the pledging of "claims" is subject to the law of the place of the lien creditor's habitual residence, whereas the pledging of "other rights" is subject to the law governing such other rights (Art. 105, para. 2 of PILS).[192] As it is disputed, whether uncertificated securities should fall within the category of "claims" or "other rights", the application of the provision poses a first major problem. In addition, the reference to the law governing "other rights" is difficult to apply in practice; it would appear that it could lead in the case of uncertificated securities, to the law of the location of the issuer.[193]

Thus in the case of a pledge of uncertificated securities there is a double uncertainty. It is not clear whether the uncertificated securities would be treated as "claims" or "other rights", and if the latter it is unclear how the test would be applied. A more detailed analysis of this issue would exceed the scope of this Report, and has so far not been conducted.[194]

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[190] For a discussion of this issue, see FELIX DASSER, in: Honsell / Vogt (eds.), *Kommentar zum Schweizerischen Internationalen Privatrecht*, Basle 1996, *ad Art.* 145, note 12 with further references.

[191] REBER, *op. cit.* (footnote 31), p. 27.

[192] See *supra,* footnote 187.

[193] See CHRISTOPH BRUNNER, *Wertrechte – nicht verurkundete Rechte mit gleicher Funktion wie Wertpapiere*, Bern 1996, pp. 108-109.

[194] See, however, R. POTOK'S forthcoming book mentioned in footnote *, which will include an analysis of this issue.

III. Conclusion

Depending on the type of securities and the kind of collateral transaction considered, there are at least *four different substantive laws* which could apply: (i) the law of the location of the physical certificates as the *lex rei sitae*, (ii) the law chosen by the parties to the transaction, (iii) the law of the lien creditor's habitual residence, (iv) the law of the issuer, or (v), with respect to debt securities, the law governing the debt securities. Such a variety of possible solutions creates great uncertainty as to which law applies to the perfection of a valid interest in securities. The present lack of fully fledged and clear legislation on this issue has been described as a true danger to the smooth functioning of the Swiss securities market.[195] Although the legal provisions of the PILS may be open to interpretations which may lead to the immediate intermediary's jurisdiction as the applicable law, the issue seems to be too important to be left to a vague possibility of a desirable interpretation. In the case of a dispute, there remains uncertainty as to which path a court will take.[196]

[195] REBER, *op. cit.* (footnote 31), p. 27.

[196] REBER, *op. cit.* (footnote 31), p. 27.

CONCLUSIONS

This Report has presented the two basic approaches which in theory might be taken to ascertain the law applicable to the proprietary aspects of a collateral transaction effected through the indirect holding system: the "look-through approach" and the "place of the relevant intermediary approach" or PRIMA. The first approach, which looks to the law of the location of the underlying securities, is highly problematic and would lead to serious practical problems. Under the second approach, where an interest in securities is provided as collateral through a book entry transfer between accounts maintained by an intermediary, the collateral taker would look to the law of that intermediary to determine the validity and priority of the collateral taker's legal entitlement as against third parties. This Report suggests that PRIMA is a sound, practical and fully appropriate answer to the problem under consideration: with respect to most indirect holding systems, the only place at which there exists any evidence of the collateral taker's interest is on the books of its immediate intermediary.

This Report goes further and concludes that PRIMA should apply not only to transactions that involve the taking of collateral but to outright sales of securities that are held through tiers of intermediaries.

PRIMA has already been adopted in a number of cases at both national and regional level. Furthermore, several legislative initiatives currently under consideration will (presumably) also lead to the enactment of PRIMA – a fact which provides a further indication of the merits of the solution envisaged for the proposed Hague Convention. It has to be stressed, though, that a worldwide convention would also be an advantage to those States which already have enacted PRIMA: the more jurisdictions that adopt this approach, the greater the predictability and certainty offered to the increasingly globalised financial market. The adoption of a uniform rule would be in the interests both of countries that already have a sophisticated financial market and of those whose markets are still developing; it would also be to the advantage of all participants in financial markets, whether lenders or borrowers.

The proposed Convention – confined as it will be to *conflict of laws issues* – will not in any way require changes to be made to domestic law as regards the nature of the interest an investor holds in securities held through indirect holding systems. It is precisely its limited scope that should allow for the proposed Convention to be adopted before the end of 2001. The further step of harmonising the *substantive* law relating to the nature of interests in respect of securities held through intermediaries is a major undertaking that may be considered by UNCITRAL or UNIDROIT in the near future.

The aim of this Report has been to give the delegates who will attend the forthcoming Experts meeting (January 2001) on the *law applicable to dispositions of securities held through indirect holding systems,* some basic information indispensable to the task of examining whether it is feasible for the Hague Conference to prepare and adopt, through a "fast-track" procedure, a new Convention on this issue, if possible before the end of 2001.

In addition to the principal question of determining the appropriate connecting factor to determine the law that should govern dispositions of securities held in indirect holding systems, the Experts may wish to examine closely the *definition of securities* (material

scope of the proposed Convention), the impact of *mandatory rules* (*lois d'application immédiate*), and the factors to be adopted to *locate geographically* the place of the relevant intermediary. Furthermore, the Experts meeting will have to discuss whether the proposed Convention should be *generally applicable* (as it is indeed suggested in this Report).

Despite the number of questions that need to be addressed, this Report suggests that the goal of adopting a convention before the end of 2001 is indeed *feasible*. As of today, financial market participants are not in a position to ascertain readily and unequivocally which law will govern the proprietary aspects of dispositions of interests in respect of securities held through indirect holding systems. The exposures involved are extremely large, as each day indirectly held securities worth hundreds of billions of dollars, euros and yen are provided as collateral under arrangements involving a cross-border element. The problem thus appears to be extremely important for the international financial markets and urgently needs to be addressed.

Appendix A

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Vogt, Nedim Peter	Bär & Karrer Seefeldstrasse 19 8024 Zürich Switzerland
Wiener, Jack	The Depository Trust Company 55 Water Street New York, NY 10041 United States of America
Woods, William	The Bermuda Stock Exchange PO Box HM 1369 Church Street Hamilton HMFX Bermuda

Appendix B

List of jurisdictions surveyed by the questionnaire

Australia
Austria*
Belgium
Brazil*
Canada (Ontario)
Canada (Quebec)
Denmark
England
Finland
France
Germany
Greece
Hong Kong*
Ireland**
Italy*
Japan
Korea
Luxembourg*
Malta
Mexico*
The Netherlands
Portugal
Singapore
South Africa
Spain*
Sweden
Switzerland
USA (New York)

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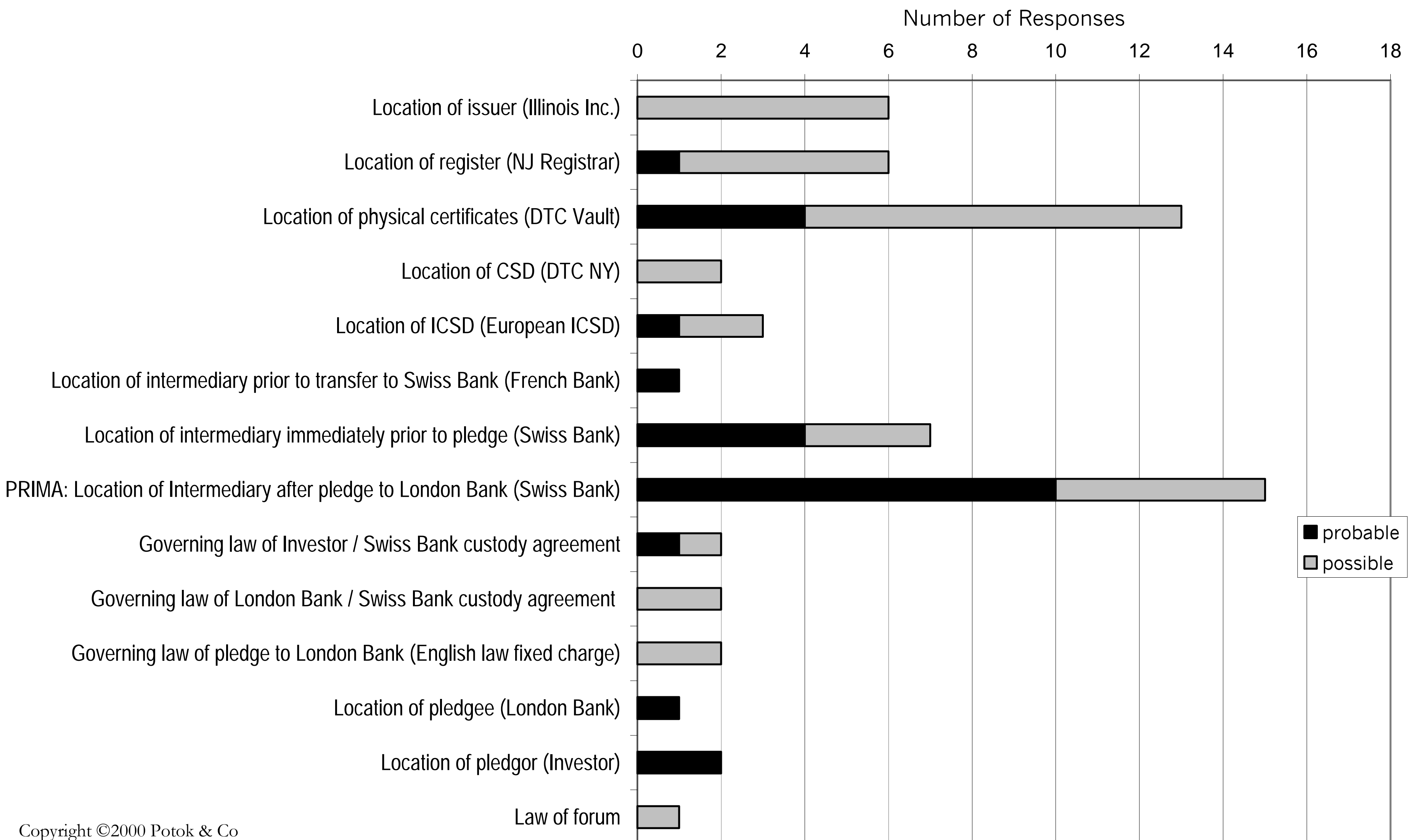
* The applicable law designated by these jurisdictions includes foreign conflicts of laws rules. Some of these jurisdictions, however, would not accept a remission to the law of a third state *("renvoi au deuxième degré)*.

** In Ireland, it is unclear whether the courts would also look to the foreign conflict of laws rules.

Pledge of Illinois Inc. Shares — Perfection

Figure 1



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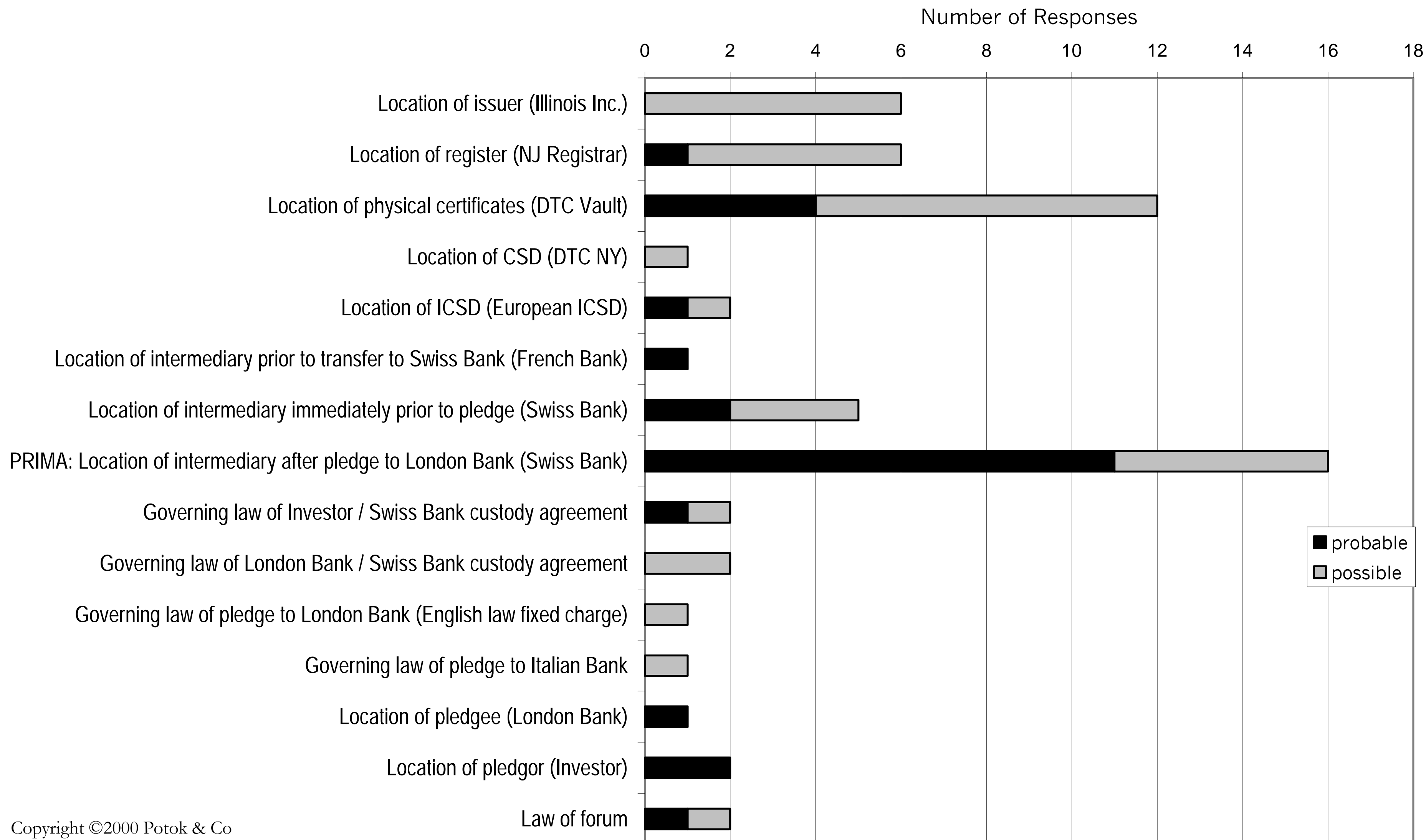
Pledge of Illinois Inc. Shares — Priorities

Figure 2



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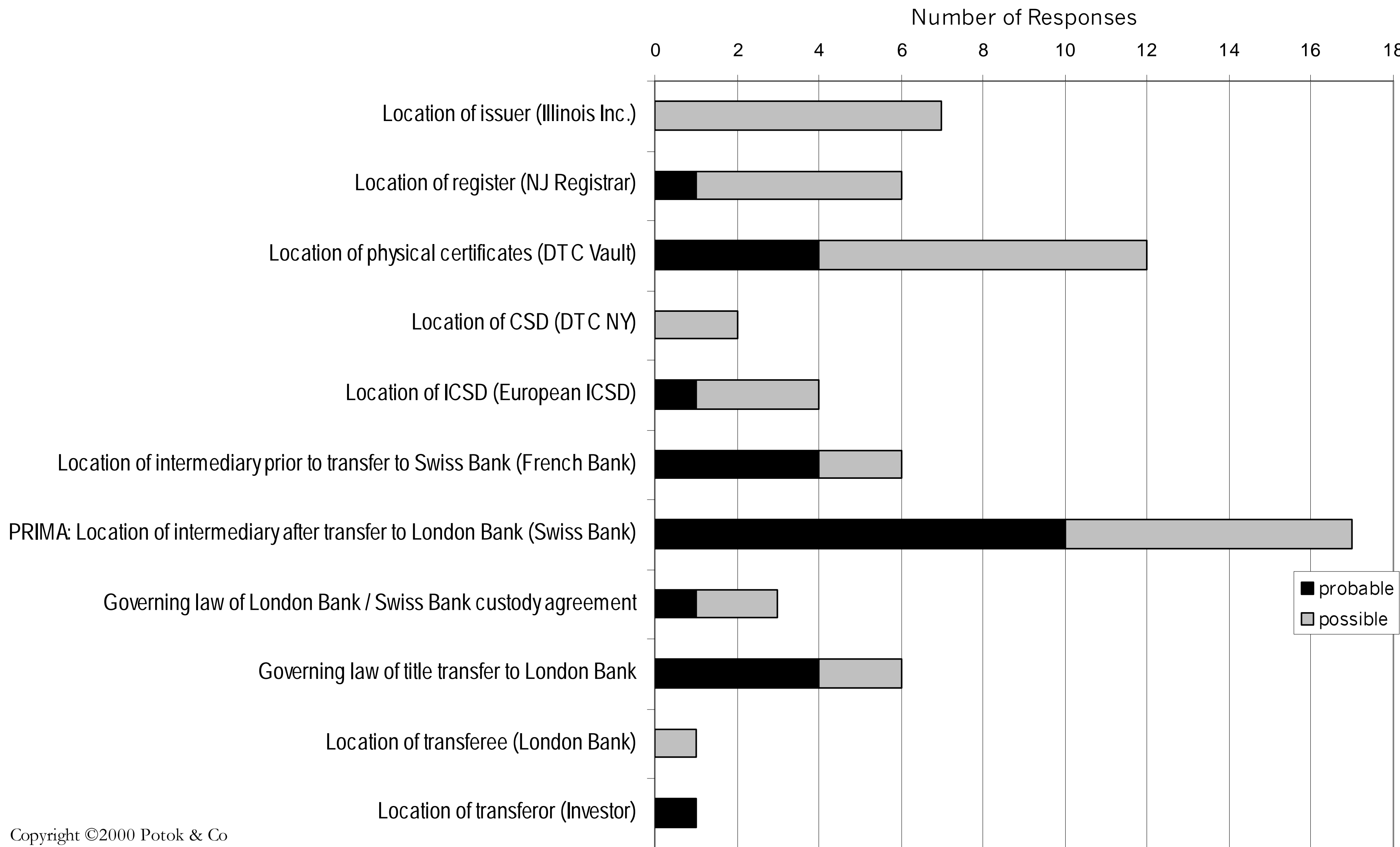
Title Transfer of Illinois Inc. Shares — Completion

Figure 3



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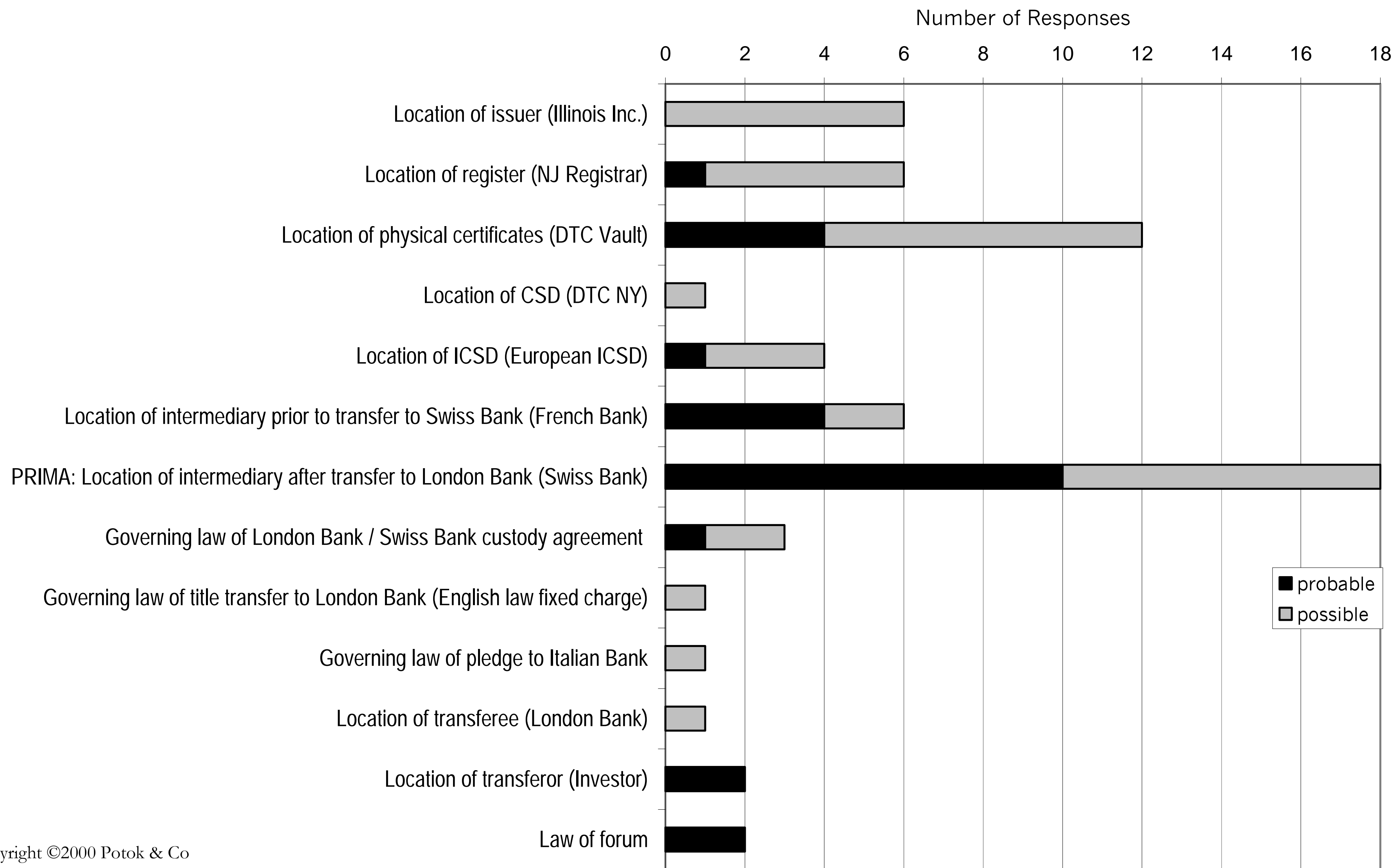
Title Transfer of Illinois Inc. Shares — Priorities

Figure 4



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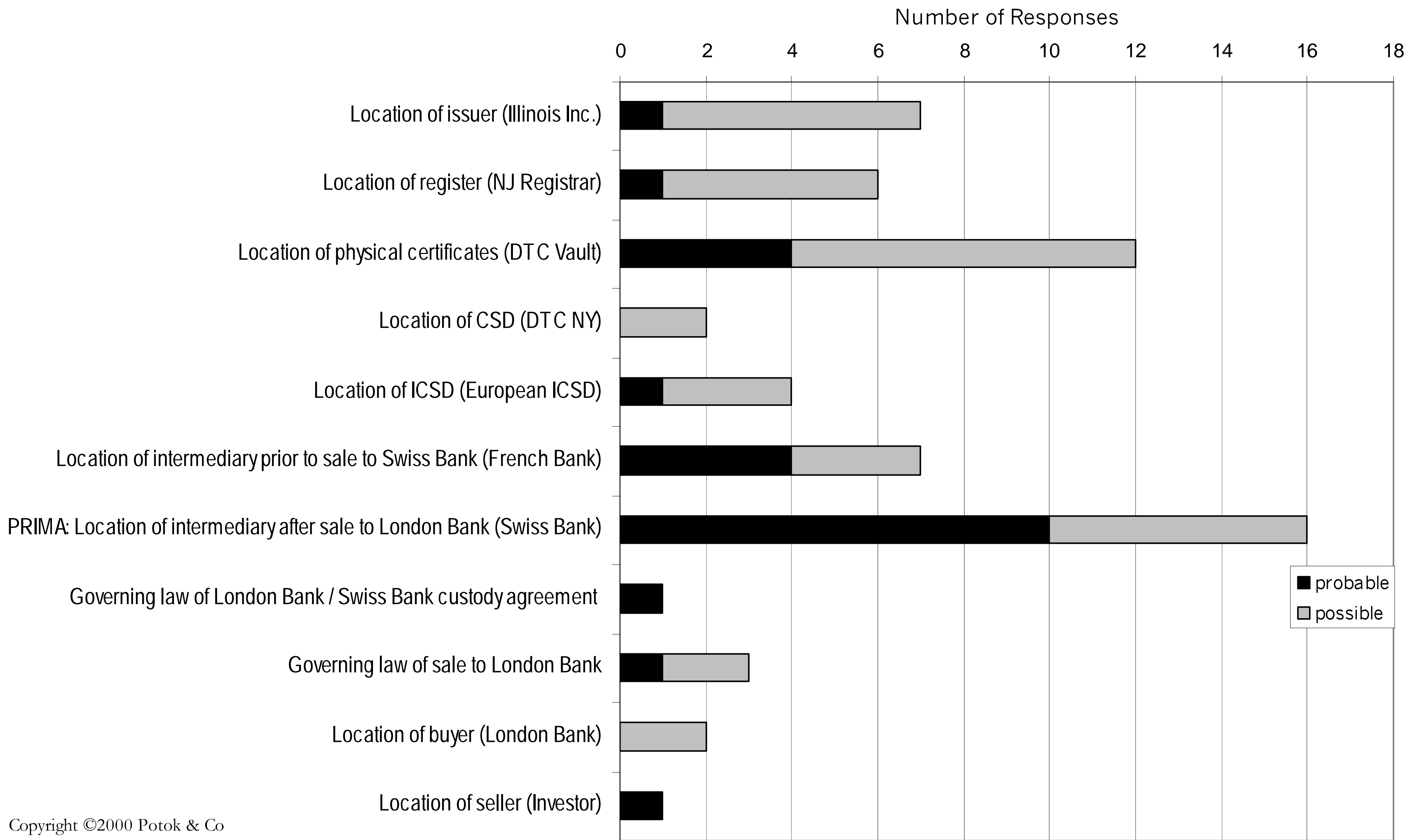
Sale of Illinois Inc. Shares — Completion

Figure 5



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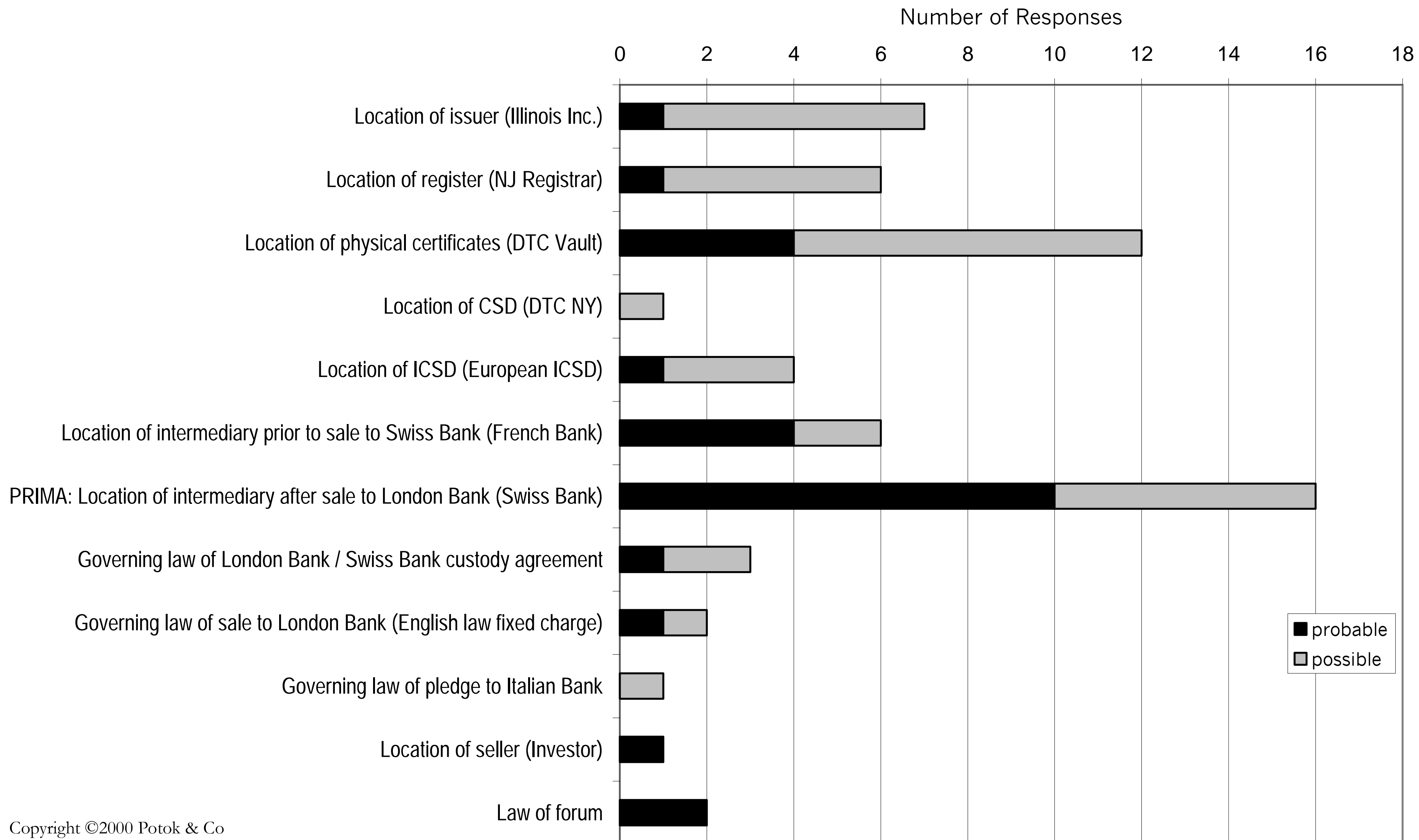
Sale of Illinois Inc. Shares — Priorities

Figure 6



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