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OBSERVATIONS SUR LES TRANSFERTS IMPLIQUANT PLUSIEURS INTERMÉDIAIRES : UNE RÉPONSE AU DOCUMENT PRÉLIMINAIRE NO 12

Soumises par la délégation du Japon

(disponibles en anglais uniquement)

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COMMENTS ON TRANSFERS INVOLVING TWO OR MORE INTERMEDIARIES: A RESPONSE TO PRELIMINARY DOCUMENT NO 12

Submitted by the Japanese delegation

(available in English only)

Document préliminaire No 14 A de mai 2002
à l'intention de la Commission spéciale sur les titres intermédiés

Preliminary Document No 14 A of May 2002
for the attention of the Special Commission on indirectly held securities

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I. Introduction

1. This Note concerns several problems relating to transfers involving two or more intermediaries and responses to Prel. Doc. No 12 submitted by the Permanent Bureau. Needless to say, the proposed convention is a private international law convention and it only concerns choice-of-law rules without touching upon substantive laws. At the same time, however, it must be borne in mind that the proposed choice-of-law rules need to be tested with reference to the existing substantive laws and in light of the possible consequences of their application to the topics to be covered by the future convention, as the proper functioning of the proposed rules in the real world is an essential element for the success of the future convention. In the hope of making the future convention acceptable to as many States as possible, this Note intends to identify the situations in which the proposed rules might create more problems than they solve, resulting, either from the structure of the proposed rules or from the interplay between the proposed rules and the existing substantive laws. In this Note, the following two specific features of the transfers involving two or more intermediaries are especially examined;

a) an applicable law to the disposition between an intermediary and its upper-tier intermediary is to be designated, which is concerned with Section III of this Note;

b) two different applicable laws could be designated to decide on the proprietary aspect of what is in substance one single right in the case, which is discussed in Sections IV and V of this Note.

2. Since the expert meeting in January 2001, many important issues have been discussed on this project. It seems that, however, much of the discussions on the choice-of-law rules in the draft convention have been more or less based upon a certain assumption that the substantive laws to be designated by the choice-of-law scheme are of the type which is often described as the "security entitlement system" or the "beneficial interest system". It might have been reasonable at the early stage of the discussions to use such assumption, as we did either consciously or unconsciously, for the purpose of building up the basic image or structure of the future convention. In the next stage, however, we have to carefully examine how the preliminary draft convention works in the real world where many States have different substantive law systems on this matter so that the future convention will become acceptable to as many States as possible.

3. From this viewpoint, the problems relating to *transfers involving two or more intermediaries* should deserve more careful examination, because, in case of *transfers involving two or more intermediaries*, the differences of the substantive laws could have more bearing on the question of how to formulate the choice-of-law rules under the future convention than in case of *transfers under the same intermediary*. Since the discussion in the past seems to have been rather focused on the latter case, we fear that some types of substantive laws, if they are designated as applicable laws, might pose serious problems in case of *transfers involving two or more intermediaries* under the choice-of-law scheme as contemplated in the present preliminary draft.

II. Two different types of systems for indirectly held securities

4. Broadly speaking, one typical image of the common law based systems on this matter could be described as follows:

First, the CSD owns all of the securities issued by the Issuer.

Second, the first-tier intermediaries own beneficial interests to the securities.

Third, the second-tier intermediaries or investors own beneficial interests to the beneficial interests of the first-tier intermediaries.

Fourth, the third-tier intermediaries or investors own beneficial interests to the beneficial interests of the second-tier intermediaries.

Fifth, ….

Under this system, each entity has its own substantive right and, even when a collateral or sales contract is concluded between two investors in the third-tier-level, the securities interests will be "transferred" from the third-tier investor to its second-tier intermediary, from the second-tier intermediary to its first-tier intermediary, from the first-tier intermediary to the CSD, from the CSD to the other first-tier intermediary, from the first-tier intermediary to the other second-tier intermediary and from the second-tier intermediary to the other investor (stage-by-stage).[1]

5. However, there is another type of system for indirectly held securities in many States.[2] Under the Japanese substantive law, for instance, only investors are regarded as real and ultimate owners of the securities issued by Issuer. While CSD, first-tier intermediaries, second-tier intermediaries and other entities operate a multi-tiers settlement mechanism, these entitles do not have their own substantive rights, the investors being still sole owners of the securities. Although intermediaries as well as the CSD perform important functions under this type of legislation to perfect the relevant right, thus playing a decisive role in determining the proprietary aspect of any transaction of indirectly held securities,[3] they are only tools for the disposition between the investors, as it were, transferring account data on behalf of the investors. When two investors make a collateral or sales contract, from the legal viewpoint, the relevant rights are deemed to be directly transferred from one investor to the other one. The intermediaries and the CSD only follow their clients' orders and co-operate to transfer the relevant account data without acquiring or losing substantive rights of their own.

6. In case of *transfers under the same intermediary*, the differences of these two types of systems do not noticeably appear under the choice-of-law scheme of the preliminary draft. In case of *transfers involving two or more intermediaries*, however, the latter type of system has to face, at least, the following difficulties under the preliminary draft.

III. Intermediaries without substantive rights

7. In the latter type of legislation, intermediaries have no substantive right. In case of *transfers under the same intermediary*, this feature does not appear under the choice-of-law scheme of the preliminary draft. However, it does appear in case of *transfers*

[1] A similar analysis has been presented in paragraph 4 of Prel. Doc. No 12.
[2] See paragraph 5 and footnote 2 of Prel. Doc. No 12.
[3] In other words, the intermediaries are not regarded as ones categorised in Article 1(4) of the preliminary draft.

involving two or more intermediaries, especially in the disposition between an intermediary and its upper-tier intermediary.

8. When the law of the State, whose legislation is of the latter type, is designated as the law applicable to the disposition between an intermediary and its upper-tier intermediary, it is most likely that the designated law has no provision for the perfection of the disposition between the intermediaries because under this type of legislation there can be no disposition of substantial rights taking place between intermediaries. The choice-of-law scheme of the preliminary draft seems to presuppose that there will always be the dispositions of substantial rights of some kind from one tier to another under any indirectly held security system, which is not the case under the latter type legislation of some jurisdictions. Some of the States of the latter type of legislation have already established their own legal systems for immobilised or dematerialised securities on the indirect holding system. Nevertheless, their substantive laws do not work well in the above circumstances, under the choice-of-law scheme of the present preliminary draft.

9. In other words, the choice-of-law mechanism of the preliminary draft is designed to fit only the former type of substantive laws: the "security entitlement system" or the "beneficial interest system". It seems that the present preliminary draft could produce undesirable effects that if the States of the latter type of legislation wish to make their substantive laws workable in practice within the framework of the choice-of-law mechanism under the future convention, they would have no choice but to adjust their substantive laws to the "security entitlement system", regardless of the fact they have already established their own legal systems. This cannot be the intention of this Hague Conference on PIL, as it must be recalled that, at the very beginning of this project, we agreed to establish a choice-of-law convention without changing each State's substantive law.

10. To remove this difficulty, the following policy options could be considered.

Option A: The preliminary draft should be maintained as it is. The States, which have to face the difficulty described above, are recommended or expected to change their substantive laws when they ratify the future convention.

Option B: The preliminary draft should be slightly modified to remove the difficulty described above.

Option C: The preliminary draft should be drastically modified to make it fit both types of legislation on this matter.

IV. Direct lawsuits between investors

11. Another difficulty occurs when one investor directly brings a lawsuit against the other investor in case of *transfers involving two or more intermediaries*. In the latter type of legislation, the proprietary aspect of the rights should be decided in a lawsuit which one investor directly brings against the other investor, because, in this type of legislation, investors are regarded as real and ultimate owners of the securities and, when two investors make a collateral or sales contract, the relevant rights are deemed to be directly transferred from one investor to the other.

12. The stage-by-stage approach adopted by the preliminary draft will sometimes lead to the situation where one investor's right is perfected under one applicable law and, at the same time, the other investor's right is also perfected under another applicable law. On

this contradictory occasion, courts must be puzzled for making decisions on such direct claims.

13. The instances of direct claims frequently appear in the latter type of legislation. However, they could occur in the former type of legislation as well. Even in the United States, for instance, there is a similar type of direct claim or direct lawsuit called as "adverse claim".[4]

14. We have not reached a consensus on whether or not there is any possibility of this type of claim under the preliminary draft and what law should be applicable to such a claim yet. At least, we need to clarify these issues to avoid unnecessary disputes which otherwise might arise once the future convention comes into operation. The following policy options could be considered.

Option A-1: A direct claim is prohibited under the preliminary draft because the draft adopts the stage-by-stage approach. It is too clear to make a provision about it in the text of the preliminary draft or to mention it in the explanatory note.

Option A-2: A direct claim is prohibited under the preliminary draft because the draft adopts the stage-by-stage approach. To avoid uncertainty, however, it should be mentioned in the explanatory note.

Option A-3: A direct claim is prohibited under the preliminary draft because the draft adopts the stage-by-stage approach. To avoid uncertainty, however, a provision about it should be made in the text of the preliminary draft.

Option B-1: A direct claim could be possible under some specific circumstances. It is unnecessary, however, to make a provision for the law applicable to the direct claim in the text of the preliminary draft or to mention it in the explanatory note.

Option B-2: A direct claim could be possible under some specific circumstances. The details of the occasions, including the structure of the law applicable to the claim, should be mentioned in the explanatory note.

Option B-3: A direct claim could be possible under some specific circumstances. A provision for the law applicable to the direct claim should be made in the text of the preliminary draft.

Option C-1: A direct claim is an issue outside of the scope of the preliminary draft. It is unnecessary to make a provision for the law applicable to the direct claim in the text of the preliminary draft or to mention it in the explanatory note.

Option C-2: A direct claim is an issue outside the scope of the preliminary draft. To obtain much certainty, however, the details of the occasions, where the claim could be recognised, including the structure of the law applicable to the claim, should be mentioned in the explanatory note.

Option C-3: A direct claim is an issue outside the scope of the preliminary draft. To obtain much certainty, however, it is necessary to make a provision for the law applicable to the direct claim in the text of the preliminary draft.

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[4] See U.C.C. §8-502 (1994).

V. The problem of "double interests"

15. The problem of "double interests" has been already addressed, as one of the issues to be examined in case of *transfers involving two or more intermediaries*, especially in paragraph 11 of Prel. Doc. No 12. At the same time, however, the Preliminary Document pointed out "similar difficulties" appearing under English law in paragraph 12.[5] It also concluded that "the analysis appears to be similar in the case of the example given above (in paragraph 11)" in paragraph 13.

16. However, the "similar difficulties" described in paragraph 12 do not appear in many other States. At least, under Japanese law, for instance, if L can legally insist that the shares be restored into his name, N can never insist on retaining his share. If N can legally insist on retaining his share, L can never insist that the shares be restored into his name any more. Many States are unfamiliar with the "double interests" problem in the context of paragraph 12.

17. Moreover, the "similar difficulties" as referred to in Prel. Doc. No 12 is not at all similar to the problem of "double interests" to be examined in the preliminary draft. The reason why the "double interests" problem appears in the context of paragraph 12 is completely different from the reason for the "double interests" problem in the preliminary draft. In the preliminary draft, "double interests" problem occurs because the preliminary draft uses two different applicable laws to decide on the proprietary aspect of what is in substance one single right. Even when neither X law nor Y law permits the "double interests" phenomena, the preliminary draft, with its structure of designating two different applicable laws, could almost inevitably produce the "double interests" problem because the conditions for perfection of the two applicable laws could be different.

18. In paragraph 13, Prel. Doc. No 12 presented a possible solution as follows: "The fact that both Investor A and Investor B have securities purportedly credited to their respective accounts does not mean that additional securities have been validly created, but it may accurately reflect the fact that both have rights against their intermediaries which in each case are valid under the applicable law. However, only one of the intermediaries can have sufficient underlying securities (or rights to securities) to back the rights of its investor (or, in practice, its investor account holders collectively). The intermediary which has insufficient securities to back validly created rights will itself need to purchase securities to eliminate the discrepancy. If it is unable to do so, the consequences of the deficiency will depend on the insolvency law applicable to the insolvency of the intermediary concerned."

19. In the context of paragraph 12, "the only solution to this difficulty" should be "for the company itself … to purchase shares from another holder and register them in the name of N". As the company did something to produce the discrepancy, we could make the company responsible to "purchase shares from another holder and register them in the name of N". However, in the context of the preliminary draft, the intermediary did nothing wrong to produce the discrepancy. The discrepancy could inevitably occur because of the

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5 Paragraph 12 explained as follows: "under English law, where –
(a) a company receives what purports to be a transfer of shares from L to M (but is in fact a forged transfer) and issues a certificate in the name of M; and
(b) N takes a transfer of the shares from M in reliance on the certificate;
then L can insist that the shares be restored into his name (because a forged transfer is invalid) while N can also insist on retaining his shares (because he is entitled to rely on the certificate issued to M). Since the "new" shares have not been validly created, the only solution to this difficulty is for the company itself (or its registrars, if they are responsible for the failure to detect the forged transfer) to purchase shares from another holder and register them in the name of N."

preliminary draft's structure of designating two different applicable laws to decide on the proprietary aspect of what is in substance no other than one single right. Why does the intermediary have to be responsible to the discrepancy?

20. In practice, the intermediary might voluntarily purchase securities to eliminate the deficiency. To avoid possible confusion, however, it should be clarified whether or not the intermediary is legally obliged to do so. It is still unclear whether or not the preliminary draft itself obliges the intermediary to eliminate the deficiency. If not, at present, we do not know each State's legislation for eliminating such a deficiency. Some States might have already established such legal countermeasures. It seems, however, that many States lack such legal countermeasures. Even if a number of States have their own countermeasures, the policies of the countermeasures of these States could more or less differ. How can we resolve this type of conflict? Should we add some provisions to the preliminary draft for the responsibility of the intermediary to resolve the problem of "double interests"?

21. We have to resolve the problem of "double interests" if we are to adopt the stage-by-stage approach in the preliminary draft. The following policy options could be considered.

Option A-1: The preliminary draft itself legally obliges the intermediary to eliminate the deficiency. It is too clear to make a provision about it in the text of the preliminary draft or to mention it in the explanatory note.

Option A-2: The preliminary draft itself legally obliges the intermediary to eliminate the deficiency. To avoid uncertainty, however, it should be mentioned in the explanatory note.

Option A-3: The preliminary draft itself legally obliges the intermediary to eliminate the deficiency. To avoid uncertainty, however, a provision about it should be made in the text of the preliminary draft.

Option B-1: The preliminary draft itself does not legally oblige the intermediary to eliminate the deficiency. It is unnecessary, however, to make a provision to resolve the problem of "double interests" in the text of the preliminary draft or to mention it in the explanatory note.

Option B-2: The preliminary draft itself does not legally oblige the intermediary to eliminate the deficiency. A desirable legal countermeasure to resolve the discrepancy should be mentioned or recommended to each State in the explanatory note.

Option B-3: The preliminary draft itself does not legally oblige the intermediary to eliminate the deficiency. A provision to resolve the discrepancy should be made in the text of the preliminary draft.

VI. "Suggested unitary solution" described in Prel. Doc. No 12

22. In case of *transfers involving two or more intermediaries*, the difficulties described above could occur under the present preliminary draft. It seems that Prel. Doc. No 12 did not sufficiently answer the concerns about these difficulties. Instead, Prel. Doc. No 12 pointed out the difficulties of the "suggested unitary solution" which was explained as the

opposing approach to the stage-by-stage approach.[6] It concluded that the stage-by-stage approach was preferable because the opposing approach had too many difficulties. At least, however, it does not mean that there is no issue to be examined in the stage-by-stage approach.

23. Moreover, the "suggested unitary solution", described and countered in Prel. Doc. No 12, is not the one actually proposed in the series of the discussions. There are two different issues in the proprietary aspect. First, what kinds of task intermediaries and CSD have to carry out for their investors' collateral or sales transactions (or lower-tier intermediaries)? Second, if the collateral or sales transactions between the investors are invalid, which investor can maintain or bring back the relevant right? The proposal actually presented in the previous meeting is that the stage-by-stage approach should be modified on the latter occasion to eliminate the difficulties mentioned above. It did not mean that a single law should govern proprietary aspects of "all" stages of a transfer between parties who use different intermediaries.[7]

VII. Conclusion

24. Prel. Doc. No 12 concluded that "the "relevant intermediary" should be assessed separately but according to a common standard (*i.e.* PRIMA) for each portion of the overall transfer and that the problem of "double interests" does not seem to generate insurmountable difficulties in the context of indirectly held securities.[8] However, as examined above, the solution for the problem of "double interests" presented by the document does not seem enough to eliminate this difficulty. In addition, at least, there are two more difficulties to be resolved. At present, we cannot easily conclude that the stage-by-stage approach should be maintained for all stages of the proprietary aspects, especially in case of *transfers involving two or more intermediaries*.

25. It would be extremely appreciated if Member States and observers could consider the problems in case of *transfers involving two or more intermediaries* in detail using the analysis and the policy options described in this Note and comment on them.

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6 See paragraphs 6-10 of Prel. Doc. No 12.

7 From this viewpoint, Working Doc. No 21 of the Special Commission of January 2002 is misleading. This document was presented only for stimulating the discussion on this matter at the moment. The "suggested unitary solution" might be deduced from literally reading the document. However, the "suggested unitary solution" is different from the intention of the presenter.

8 See paragraph 19 of Prel. Doc. No 12.