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Une Note explicative sur le fonctionnement de PRIMA dans le cadre de l'avant-projet de Convention sur la loi applicable à certains droits sur des titres détenus auprès d'un intermédiaire (« avant-projet d'avril 2002 » reproduit dans le Document préliminaire No 10)

établi par le Bureau Permanent

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An Explanatory Note on the Functioning of PRIMA within the Framework of the Preliminary Draft Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary ("April 2002 preliminary draft" reproduced in Preliminary Document No 10)

submitted by the Permanent Bureau

Document préliminaire No 12 de mai 2002
à l'intention de la Commission spéciale sur les titres intermédiés

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for the attention of the Special Commission on indirectly held securities

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[*] Cette Note explicative se fonde sur un Mémorandum préparé par Guy Morton (délégation du Royaume-Uni) ainsi que sur les commentaires portant sur la version provisoire de l'avant-projet de Convention adopté par la Commission spéciale en janvier 2002 (voir le Doc. prél. No 9). Le Mémorandum de M. Morton, de même que tous les commentaires reçus, ont été étudiés par le Comité de Rédaction lors de sa réunion de mars 2002 à Francfort.

[*] This Explanatory Note is based on a Memorandum prepared by Guy Morton (United Kingdom delegation) and on the comments made on the provisional version of the preliminary draft Convention adopted by the Special Commission in January 2002 (see Prel. Doc. No 9). Mr Morton's Memorandum as well as all the comments received were examined by the Drafting Committee at its meeting in March 2002 in Frankfurt.

I. Introduction

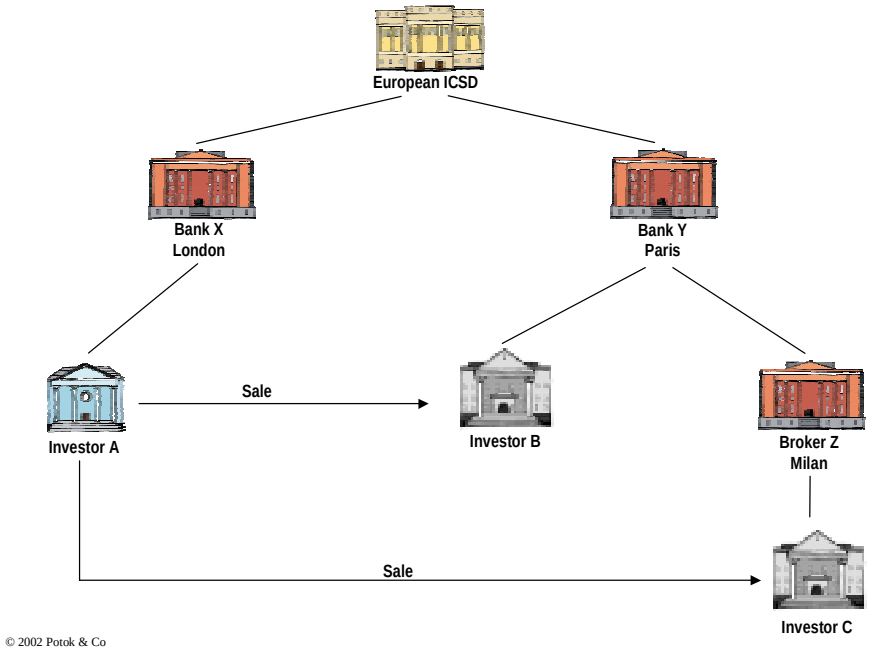
1. This Note considers two sets of issues that have been raised about the application of the PRIMA principle within the framework of the future Hague Convention on the *Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary.* The issues addressed relate to *transfers involving two or more intermediaries* and focus on two basic questions: First, is it conceivable for the same transfer to be regarded as involving two or more "relevant intermediaries" thereby leading to the application of more than one PRIMA law? Or should the proposed Convention seek to avoid this possibility, guaranteeing the application of one PRIMA law? Secondly, what are the effects of possible differences between relevant laws on the question of whether a defect in the contractual validity of a transfer impairs its effectiveness as a transfer of property? These two issues will be addressed separately in the present Note.

II. Transfers involving two or more intermediaries

2. The first set of issues may be illustrated by the following example. Suppose that –

- Investor A holds a portfolio of securities in a securities account with Bank X in London;
- Bank X in turn holds its interests in the relevant kinds of securities in an account with its intermediary, European ICSD;
- Investor A sells some of its securities to Investor B and the rest to Investor C;
- Investor B holds its interests in a securities account with Bank Y in Paris;
- Investor C holds its interests in an account with Broker Z in Milan; Broker Z in turn holds its interests in a securities account with Bank Y in Paris;
- Bank Y holds its interests in the relevant kinds of securities in an account with the same European ICSD as Bank X.

This fact pattern can schematically be depicted as follows:



A. The problem of multiple "relevant intermediaries"

3. The first problem is that of identifying who is the "relevant intermediary". For example, in relation to Investor A's transfer of securities to Investor B, is the relevant intermediary Bank X (A's intermediary) or Bank Y (B's intermediary)?

4. For legal systems which analyse the interest held in each securities account as a separate interest, this question gives rise to some complication and fragmentation of the conflict of laws analysis, but not to any insuperable difficulties. Taking the example of the transfer from Investor A to Investor B, the analysis under PRIMA would be –

- whether Investor B acquires a valid interest in Bank Y's pool of customer securities held with European ICSD is a matter of French law, as the law of the intermediary on whose books Investor B's interests in that pool are recorded;
- whether Investor A's interest in Bank X's pool of customer securities is validly extinguished is a matter of English law, as the law of the intermediary on whose books Investor A's interest in that pool are recorded;
- whether the appropriate proportion of Bank X's interest in European ICSD's pool of participant's securities is validly transferred to Bank Y is a matter of the law of the place of European ICSD, as the law of the intermediary on whose books both Bank X's and Bank Y's interests are recorded;

- whether any defects under English law or European ICSD's law in the earlier elements of the transfer would flow through so as to impair or invalidate the interest of Investor B will be a matter of French law.[1]

In other words, the answer to the question "who is the relevant intermediary?" differs depending on the portion of the overall transfer which is under consideration. Within such a framework, PRIMA will simplify the choice of law issue and improve certainty at *each individual level* of the multi-tiered holding system by substituting a single law (*i.e.* the law of PRIMA) for the multiple possibilities that must now be considered at *each* level (*e.g.* law where certificates are located, law of issuer's incorporation, law of the forum, PRIMA, etc.). For the ultimate transferee / purchaser (Investor B in the example above), the suggested approach means that he will start assessing his position by looking at one single law (French substantive law in the example above). If according to that law the transferee / purchaser can acquire a valid interest in the pool of his intermediary's pool of customer securities independently of the earlier elements of the transfer, no further assessment is needed to consider his position; if, however, the applicable law takes the position that any defect in one of the earlier elements of the transfer impairs or invalidates the transferee's / purchaser's interest, then a further assessment will be required. In other words, whether the transferee / purchaser has to retrace the steps of any previously effectuated transfer will depend on the substantive law of its intermediary.

5. However, for legal systems which regard the interest held by the transferee / purchaser as the same item of property as that originally held by the transferor / seller, this stage-by-stage analysis presents a greater problem of principle: how can two different laws apply to proprietary aspects of a transfer of a single item of property?[2]

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[1] See *Report on the Law Applicable to Dispositions of Securities Held Through Indirect Holding Systems*, prepared by Christophe Bernasconi (Prel. Doc. No 1 of November 2000 for the attention of the Working Group of January 2001), page 37, from which this analysis is taken (and from which the problem discussed is sometimes referred to as "the page 37 problem"). See also Prel. Doc. No 3 of July 2001, *Tentative Text on Key Provisions for a Future Convention on the Law Applicable to Proprietary Rights in Indirectly Held Securities – Suggestions for further amendment of the text contained in Working Document No 16 of the January 2001 experts meeting, with brief explanatory comments*, submitted by the Permanent Bureau (the "annotated July 2001 draft"), p. 5 to 6.

[2] According to some legal systems, the relevant rights are deemed to be directly transferred, from the legal point of view, from Investor A to Investor B, even if the items relating to the rights are actually transferred from Bank X to Bank Y via their mutual relevant intermediary (European ICSD). In other words, these transactions are deemed to be not four dispositions ((1) Investor A to Bank X, (2) Bank X to European ICSD, (3) European ICSD to Bank Y and (4) Bank Y to Investor B)) but only one disposition (Investor A to Investor B). This is particularly the case where only the investors are regarded as owners of the securities issued by the issuer and the "intermediaries" do not have their own substantive rights on the securities, *i.e.* where there is a direct legal relationship between the investor and the issuer. On the contrary, from the legal perspective of other States, these transactions are deemed to be not one disposition (Investor A to Investor B) but four dispositions (as described above). Underlying this step-by-step analysis is the notion that the investor has no direct legal relationship with the issuer of the securities. Instead, the investor's interest is recorded on the books of an intermediary, which in turn has its interests recorded with another intermediary, which in turn has its interest recorded with another intermediary and so on up the chain until an intermediary is the owner of the securities. These indirect holding systems, therefore, have one or more tiers of intermediaries between the issuer and investor, who each has its own

B. Suggested unitary solution

6. In response to this difficulty, some experts have suggested that, instead of following the stage-by-stage analysis presented above (in paragraph 4), the PRIMA rule for transfers involving more than one intermediary be formulated by reference to *one* single law. In other words, while these experts agree with the general PRIMA principle, they also argue that PRIMA should go further. They urge that, in the interests of clarity and simplicity, the Convention should provide that a *single* law governs proprietary aspects of *all* stages of a transfer between parties who use different intermediaries. In particular, it has been suggested that this law be the law of the State of the *recipient's* intermediary.[3] This unitary solution has also been referred to as the "Super-PRIMA" approach, as *one* single law would override *all the individual PRIMAs* at each level of the multi-tiered holding system.

7. This suggestion has the attraction of apparent simplicity. However, it appears to move the problem elsewhere, and potentially give rise to greater uncertainty than the stage-by-stage analysis.

8. In the example set out above (paragraph 2), this may be illustrated by considering the position of European ICSD. Under the stage-by-stage analysis suggested in Preliminary Document No 1 and the current structure of the Convention, European ICSD can be confident that proprietary aspects of the transfers which it is instructed to make from Bank X's account to Bank Y's account will be treated by courts of other States as governed by the law of European ICSD's own jurisdiction (the reason being that European ICSD would be the relevant intermediary for X and Y). Under the "unitary" formulation, by contrast –

- European ICSD is unlikely to know, or to be in a position to find out, whether the transfer is part of a transfer between parties using different intermediaries at another level;

- more seriously still, even if European ICSD were able to obtain the necessary information, it would discover that the single transfer across its own accounts is in fact governed by two different systems of law: in relation to the securities transferred to Investor B, by French law as the law of the intermediary on whose books Investor B's interest is recorded, and in relation to the securities transferred to Investor C, by Italian law as the law of the intermediary on whose books Investor C's interest is recorded.

9. Thus the suggested "unitary" solution does not achieve greater simplicity or clarity and does not remove the possibility of different laws being relevant to a single transfer. Its main effect appears to be to shift the burden of any uncertainty from the

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substantive right in relation to its intermediary higher up in the chain. Under this type of holding pattern, Investor A's (*i.e.* the transferor's / seller's) interest cannot be transferred directly to Investor B (*i.e.* the transferee / purchaser), since Investor A never holds an interest with the same intermediary as Investor B. See also the comments reproduced in Prel. Doc. No 9, p. 23 *et seq*.

[3] See *e.g.* Prel. Doc. No 3 of July 2001 (*op. cit.*, footnote 1), p. 5 to 6.

immediate parties to the disposition in question to intermediaries, particularly those involved in the middle stages of the transfer.

10. This result appears in principle to be erroneous. The parties to the transaction are in a position to investigate the chain of transfer if they so choose, to identify and ensure compliance with all relevant laws and to negotiate appropriate contractual provisions with each other and with the intermediaries whose services they choose to employ. They are therefore the parties best placed both to assess any risk and to protect themselves against it. By contrast, intermediaries involved in the middle stages of such a transfer are very unlikely to be able to investigate the holding patterns at other levels. Against this background, it would seem contrary to principle, and to the certainty and predictability which the Convention aims to produce, that parties in this position should be exposed to the effect of rules of property law of a jurisdiction of which they are unaware; and, even if the appropriate investigation were theoretically possible, the complications arising from any significant volume of transfers between the customer securities accounts of major banks would make it quite unrealistic in practice. Moreover, the suggestion would appear to have the result that the law governing the proprietary aspects of the earlier stages of the transfer is fixed only *retrospectively*; at the time that each stage occurs it will appear to be governed by one law, but this will be replaced by a different law when it becomes clear that an ultimate transferee holding through an intermediary in a different jurisdiction is involved. Finally, a further difficulty mentioned by the opponents of the unitary solution arises from the fact that some intermediate transfers will be *composite transfers* of securities in the course of transmission to a number of different ultimate transferees who hold through intermediaries in different jurisdictions. In such a case it may not be possible to identify which securities are attributable to which ultimate transferee, leaving the position on governing law quite unclear.

C. The problem of "double interests"

11. Commentators who are concerned about the possibility of multiple relevant intermediaries, including some who advocate a "unitary" solution, point out that one of the consequences of a system which acknowledges two or more relevant intermediaries is that there can be two "owners" of the same "securities". In the example quoted above (paragraph 2), if Bank X's debiting of investor A's interest were invalid as a matter of English law, but Bank Y's credit of securities to Investor B's account were valid as a matter of French law, both Investor A and Investor B would regard themselves as owners of the securities and both would be justified under the applicable law, but there cannot logically be enough securities to satisfy both entitlements.

12. This difficulty, real though it is, is by no means unfamiliar in the context of complex transfers of intangible property. For example, a person who acquires a negotiable instrument in good faith, for value and without notice of any defect in the title of his transferor acquires a title to the instrument which is good against all the world, but this does not mean that prior parties are deprived of all rights. In the context of securities transfers, similar difficulties can arise under the same law. To give but one example, 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.

13. The analysis appears to be similar in the case of the example given above (in paragraph 11). 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.

D. Contractual validity vs validity of 'real' transfer

14. Questions have also been raised as to the effect on the functioning of the PRIMA principle of laws which distinguish between the *contractual* agreement for a transfer and the transfer as a transfer of property (or *'real'* transfer). The legal background to this second set of issues may be portrayed as follows: In some legal systems (such as in common law systems,[4] France[5] and Japan[6]), the law provides for the passing of movable property upon the conclusion of a contract implying such transfer (such as a contract of sale). Other systems, however, require an additional term or agreement providing for the transfer of property, *i.e.* a 'real' agreement.[7] For those States which – like Germany, the Netherlands and Switzerland – distinguish between the underlying (*e.g.* sales) contract and an additional 'real' agreement transferring property to the buyer, a further issue arises: what is the relationship between the underlying contract and the 'real' agreement?

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[4] In England, for example, an agreement for the sale of specific goods identified at the time of the sale will generally operate to transfer title without any further instrument of transfer. The position for securities is different. In general, transfer of title will require an instrument of transfer separate from the agreement for sale; for bearer securities the delivery of the certificate representing the securities will be necessary to transfer title.

[5] Art. 1583 of the French Civil Code. This being said, one has to emphasise that under French law this general principle does not apply to dematerialised securities.

[6] Art. 176 of the Japanese Civil Code; see *e.g.* M. Yokoyama, *Le transfert de la propriété immobilière et son opposabilité en droit civil japonais*, Rev Int Droit Comp 1996, p. 887 *et seq.* ; Hiroshi Oda, *Japanese Law*, 2nd edition, Oxford Univerity Press, Oxford 1999, p. 189 ; Hans Peter Marutschke, *Einführung in das japanische Recht*, Beck, München 1999, p. 113.

[7] For a European comparative law analysis of the following issues, see *e.g.* Ulrich Drobnig, *Transfer of Property*, in: Hartkamp / Hesselink / Hondius / Joustra / du Perron (eds), Towards a European Civil Code, 2nd Revised and Expanded Edition, 1998 Ars Aequi Libri – Nijmegen, p. 495 *et seq*. Drobnig epitomises the alternative approaches by the catchwords 'unitary consent' or 'double consent' (p. 504).

15. The answer is obvious for an invalidity affecting the 'real' agreement only: such a defect prevents the purported performance of the seller's obligation to pass property to the buyer.[8] However, the obligation as such arising from the underlying contract of sale is not affected, and the seller remains obliged to perform the contract. The matter is quite controversial in the reverse situation where only the underlying contract is affected by an initial or a subsequent invalidity: does such an invalidity extend to the 'real' agreement, which after all, is but a "flanking" agreement? Under a first group of legal systems, the real agreement is made dependent upon the legal fate of the underlying contract as its *causa* (doctrine of *causality*); under a second group of legal systems, the validity of the 'real' agreement is determined independently (doctrine of *abstraction*). Whereas the first system is applied, for example, in the Netherlands[9] and Switzerland,[10] the second system is applied in Germany[11].

16. To put the problem in the context of indirectly held securities: what is, in a system that follows the double consent approach (*i.e.* distinguishes between contractual and 'real' transfer validity), the effect of a possible disharmony between the PRIMA law (governing the proprietary aspects of the transaction) and the *lex contractus* (governing the underlying contract)?

17. If under the relevant PRIMA law any defect in the contractual validity of the transfer agreement precludes it from having any effect as a transfer of property (doctrine of causality), the distinction creates no additional difficulties beyond those already discussed above (see II. A and II. B). In other words, for each separate portion of the overall transfer, the relevant PRIMA law determines whether the respective transferee gets a valid interest. One may merely add that this issue does not only arise in relation to a transfer implying several intermediaries, but also when A and B are holding through the same intermediary.

18. The position is a little more complicated where the PRIMA law does contemplate that a transfer may be valid as a transfer of property (a "real" transfer) even if based on an invalid contract (doctrine of abstraction). The basic result of the Convention – that the courts of the forum must determine matters of property law by reference to the PRIMA law – would continue to apply, and this would be the case even if the domestic law of the forum did not contemplate the possibility of a transfer that was effective as a transfer notwithstanding contractual problems. Where the distinction might matter is in relation to the question whether a defect at an early stage in a multiple transfer could flow through so as to impair the validity of interests purportedly acquired at a later stage. If in the case of such a transfer –

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[8] See Drobnig, *op. cit.* (footnote 7), p. 507 *et seq.*

[9] See Art. 3:84 par. 1 BW (*levering krachtens geldige titel* – delivery pursuant to a valid title).

[10] For movable property, the principle is not expressly spelled out by the Civil Code but has been established by the Swiss Supreme Court in a fundamental decision (55 II 306), which has been confirmed subsequently (96 II 150).

[11] This is not expressly spelled out by the Civil Code but is implied and is the unanimous view of both writers and the courts. The principle of abstraction may well be regarded as a general feature of German law since it permeates several fields of law. It applies to all transfers of full or limited rights in things, claims and rights.

(a) the law of the originating transferor (A in the example given at paragraph 2) recognised the validity of a transfer notwithstanding contractual defects; but

(b) the law of the ultimate recipient (say B in the example) not only did not recognise this possibility under its domestic law, but also permitted a party to an earlier transfer (A in this case) to assert that the defect gave him a right superior to B's, notwithstanding that the law which it would ordinarily regard as applicable to property issues took a different view;

then the original transferor (A) might succeed in tracing his claim through and the forum would have to recognise the resulting defect in B's title. It should be noted, however, that this result could only arise if the recipient's jurisdiction were a non-Contracting State, since, if it were a Contracting State, it would have to apply the Convention rule instead of its previous rule summarised in (b) above. If the Convention commands the level of acceptance which is hoped for, therefore, it seems questionable whether this issue will be one of great practical importance.

III. Conclusions

19. This Note suggests that in the case of transfers involving several intermediaries:

(a) 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; and

(b) possible differences among legal systems on the question whether a defect in the contractual validity of a transfer impairs its effectiveness as a transfer or property do not appear to generate any new problems which are specific to the context of indirectly held securities.

20. It goes without saying that the views expressed in this Note and the conclusions suggested above are to be attributed to the Permanent Bureau only. In order to allow the Drafting Committee to further assess the issues raised in this Note at its next meeting in London (May 2002), ***the Permanent Bureau invites Member States and observers to consider these issues in detail and to specifically comment on them in their observations on the "April 2002 preliminary draft" (which are to be submitted before Wednesday 15 May 2002, for the attention of Christophe Bernasconi, First Secretary, at the following e-mail address: cb@hcch.nl).***

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