

UNIDROIT

**The UNIDROIT Study Group**

**on**

**Harmonised Substantive Rules Regarding Indirectly Held Securities**

Position Paper  
August 2003





**The UNIDROIT Study Group**  
**on**  
**Harmonised Substantive Rules Regarding Indirectly Held Securities**

Position Paper  
August 2003

### **Notice**

The members of the UNIDROIT Study Group, whose names are set out in the annex, are each expert in the field of financial markets law in the legal system of their country with a high degree of practical experience. However, the members of the UNIDROIT Study Group participate in the work of UNIDROIT on a strictly personal basis. The views expressed in this paper are those of the members and do not necessarily reflect those of their institutions.

Comments (in English only) may be sent by post to the *International Institute for the Unification of Private Law (UNIDROIT)*, attn. Ph. Paech, Via Panisperna, 28, I-00184 Rome (Italy) or by e-mail to [ph.paech@unidroit.org](mailto:ph.paech@unidroit.org).

Copyright © 2003 by UNIDROIT. All rights reserved. Excerpts may be reproduced or translated provided the source is stated.

UNIDROIT 2003, Study LXXVIII Doc. 8

# CONTENTS

Contents .....	1
Avant-propos .....	2
Foreword .....	3
Summary .....	5
1 Introduction .....	7
1.1 National – regional – global efforts .....	8
1.2 The Hague Convention .....	11
2 The initial discussions at UNIDROIT .....	13
2.1 Internal soundness and compatibility .....	13
2.2 Approach .....	14
2.3 The needs of principal market participants as guidelines .....	15
2.4 Scope of uniform requirements .....	16
3 The background .....	18
3.1 Upper tier attachment .....	18
3.2 Transfer formalities .....	19
3.3 Security (collateral) dispositions: rules on the creation and realisation of security .....	19
3.4 Informal dispositions .....	20
3.5 Good faith acquisition .....	21
3.6 Net settlement .....	22
3.7 Finality and irrevocability .....	22
3.8 Possibility of provisional credits .....	24
3.9 Allocation of shortfall .....	26
3.10 Insolvency protection and other issues where a uniform rule may be considered .....	27
Appendix 1 – Members of the UNIDROIT Study Group .....	29
Appendix 2 – About UNIDROIT .....	30

*The UNIDROIT project on indirectly held securities is supported by:*

Association of  
German Banks

**CAPITALIA**  
GRUPPO BANCARIO

## **AVANT-PROPOS**

In the second half of 2002, UNIDROIT embarked upon a new project entitled *Harmonised substantive rules regarding securities held with an intermediary*. The Study Group convened by the Secretary General of UNIDROIT to deal with the subject, made up of 13 leading experts in the field of the law of securities holding, held its first meeting in September 2002. The challenge it faces is to draft an international instrument capable of improving the worldwide legal framework for securities holding and transfer, with special emphasis on cross-border situations. The draft is to be submitted to the Governments of the UNIDROIT member States to serve as a basis for an intergovernmental negotiation process conducted under UNIDROIT auspices, culminating in a diplomatic Conference and, hopefully, in the signing of an international convention with respect to the legal framework concerning indirectly held securities.

The present *Position Paper* marks the first step of the work of the UNIDROIT Study Group. It outlines the Group's views on the scope of the future instrument which will be further refined until it is ready to submit a concrete proposal. The Group felt that it was important to go public at this stage, in order both to keep member States and the private financial sector concerned informed of its findings and to benefit from their response to the *Position Paper*.

Comments are, accordingly, most welcome.

## **FOREWORD**

by Sir Andrew Large, Deputy Governor, Bank of England; Chairman, Group of Thirty Global Clearing and Settlement Project

The global financial system is only as good as the infrastructure that supports it. The smooth functioning of the system – and the confidence on which it depends – will be threatened if its infrastructure is considered unreliable. This is a particular concern in cross-border trading of securities because there are very often no common or even consistent structures, standards or operational rules.

It was this concern that motivated the Group of Thirty to commission the report, *Global Clearing and Settlement: A Plan of Action*, published earlier this year. And it was the challenge of strengthening the infrastructure for global securities trading to which that report's recommendations are addressed. The report put forward a strategy with three pillars, aiming to: (1) create a strengthened, interoperable global network by implementing technical and business practice standards intended to improve the connections across borders and systems; (2) mitigate operational and legal risks by introducing a stronger risk management including a solid legal basis for clearing and settlement; and (3) improve governance of market participants by private boards supported by official supervision.

Fully realising these goals will be an ambitious undertaking, and an important part of achieving them is to identify practical steps to advance the agenda and responsible groups and organisations to undertake them. UNIDROIT is a worthy partner in this effort. The *Position Paper* that follows is dedicated to the proposition that creating a sound legal basis for internal and cross-border clearing and settlement activities in national legal systems is a matter of the utmost importance.

This approach is an essential element of the second G30 pillar and is embodied in several G30 recommendations which point to a number of key legal questions such as: contract legality and enforceability; legal certainty over rights to securities, cash, or collateral; and recognition of support and flexible valuation and closeout netting arrangements. Recommendation 15 in particular extends the call for improving legal certainty to all market participants. They should be able to determine with certainty and reasonable cost and effort what law defines and governs the rights over their assets and what those rights are. This recommendation encompasses conflict-of-law rules but extends further to substantive law that would ensure the protection of investor's assets against intermediary insolvency, provide for simple and clear rules regarding pledging and realisation procedures, and stipulate the moment when a securities disposition becomes "final"; that is, irrevocable and unconditional.

The G30 Plan of Action concludes that, ultimately, legal certainty in cross-border transactions will be fully achieved only through enactment of strong, clear, and consistent national and international laws. While efforts like last December's Hague Convention are therefore important, we also welcome the complementary, global efforts being pursued by UNIDROIT to address questions of substantive law that have

been discussed but never tackled on a global level. The present *Position Paper on harmonised substantive rules regarding indirectly held securities* pursues resolution of these legal problems and represents a major step towards the more certain and efficient clearing and settlement environment to which the G30 report aspires.

## SUMMARY

Legal certainty and economic efficiency in the global securities market suffer from inconsistencies inherent in the phenomenon of holding of securities through intermediaries. Several international initiatives, such as the *G30 Plan of Action*, the *Giovannini Report* and the *IOSCO/CPSS Recommendations*, address this problem. They identify the need for a reliable, smoothly functioning legal framework, especially in cross-border holding and transfer of securities, a need perceived by all those who participate in the capital markets, first of all the investor, but also the collateral taker, public and private issuers of securities, the securities industry, and systems for clearance and settlement of securities transactions.

Substantial work has already been undertaken to address legal uncertainty in respect of the indirect holding of securities. For example, the EU *Collateral and Settlement Finality Directives* harmonise key aspects of the laws of EU member States relevant to securities settlement systems and indirectly held securities, while the concerns relating to conflict-of-laws issues are addressed by the December 2002 *Hague Convention on indirectly held securities*.

While important progress has been made, none of these instruments are of themselves enough to cover the full spectrum of concerns identified. EU Directives operate only at the regional level, and while it is hoped that the Hague Convention will in due course extend worldwide, it is by its nature confined to conflict-of-laws issues. A clear identification of the applicable law is a huge step forward, but the law thus identified may be unsatisfactory when measured against the standards suggested by the aforementioned international initiatives.

UNIDROIT, a global legal organisation with 59 Member States whose laws include all the key systems of financial law around the world, is an ideal forum for developing a global instrument that addresses questions of substantive law in respect of indirectly held securities. A UNIDROIT project to this effect was launched when a Study Group was first convened to deal with those questions in September 2002. The Group's preliminary conclusions may be summarised as follows:

It is important to consider the modernisation and harmonisation of key aspects of substantive law relevant to the cross-border holding and transfer of securities held through intermediaries. The issues at stake can be divided into two categories –

- The first category is **internal soundness**, which comprises issues relating to the key features which any structure for the holding and transfer of securities through intermediaries must possess if it is to be regarded as sound, bearing in mind in particular the objectives of investor protection and efficiency.
- The second category is **compatibility**, which comprises issues affecting the ability of different legal systems to connect successfully where securities are held or transferred across national borders.

A harmonised rule should be regarded as appropriate if, but only if, it is clearly required to reduce legal or systemic risk or to promote market efficiency. This approach recognises that, desirable though it may be in principle to achieve harmonised rules, in practice this is a complex and difficult process that requires both technical and political consensus. The difficulty of achieving this, particularly within a reasonable timeframe, strongly argues in favour of a restrictive approach to the scope of harmonisation. Furthermore, a functional approach should be adopted, that is, one which uses language which is as neutral as possible and which formulates rules by reference to their results.

A key element of the Study Group's approach was its recognition of the central position of book entry accounts in modern indirect holding and transfer systems. Parties dealing in securities held with an intermediary need to be sure that a credit of securities to their account represents a good and effective interest. The importance of the security of book entry interests is particularly marked in the common situation where linked transfers of interests take place through different intermediaries and settlement systems, operating under different laws. Any doubt as to the effectiveness of an interest represented by a book entry credit, or about the effectiveness and finality of a transfer made through book entry debits and credits, would give rise to damaging uncertainty and systemic risk.

Against this background, the Study Group envisages an instrument the structure of which reflects, on the one hand, its resolve to concentrate on a small number of key questions that call for global uniform rules and, on the other hand, its purpose of giving guidance, in particular to those capital markets which at present only have an incomplete set of rules, in establishing a sound legal framework for indirectly held securities. Accordingly, the instrument will in all likelihood be split into a mandatory minimum convention and a non-mandatory annex intended to serve as a "benchmark".

On this basis, the preliminary conclusion regarding the scope of the project, *i.e.* the desirability of a uniform rule, encompasses the following issues:

- Preclusion of "upper tier attachment";
- Role of book entries into a securities account;
- Formalities regarding creation and realisation of collateral;
- Role of non book-entry dispositions over securities;
- Possibility of a provisional credit, which does not correspond to the total number of securities credited to accounts maintained by an intermediary;
- Good faith acquisition;
- Net settlement;
- Finality of book entry transfers and irrevocability of instructions;
- Loss allocation, *i.e.* who bears the risk of a shortfall in securities.

There are other issues where a uniform rule may be considered, especially that of the protection of the client's assets against the claims of general creditors of the (insolvent) intermediary. Here, consideration may be given either to its inclusion in a mandatory instrument, or to the formulation of "benchmark" criteria.

# 1 INTRODUCTION

It has become widely recognised in recent years that developments in the practice of holding and transferring securities have in a number of respects outrun the traditional legal framework.

The basic rules on the legal nature of securities, the rights of issuers and holders and the manner in which securities can be transferred and provided as collateral were formulated in the days when securities were transferred individually by physical delivery and when there was a direct relationship between issuers and holders. But this direct, two-party model no longer applies to the great majority of securities transferred through modern financial markets. Instead, considerations of speed, efficiency and economy of settlement have led to the evolution of a sophisticated system of intermediaries, through which securities can be held and transferred in book entry form, generally by computerised means.<sup>1</sup>

The structural and technical innovations which have made these developments possible were not everywhere matched by a corresponding level of modernisation of the law. This is not to say, of course, that the legal framework of the new arrangements has not been carefully constructed and documented; but the process has required the use of traditional tools and concepts adapted from other contexts. To take a prime example, the key concept of custody generally builds on traditional rules defining the rights and obligations that arise where the owner of a physical object deposits it with another person for safe keeping. The reason for this is that although securities were originally intangibles, they became certificated, frequently in bearer form, and acquired the legal status of *res mobilia*, which later remained unchanged in most jurisdictions, notwithstanding the fact that in modern computerised systems securities are (again) sometimes not represented or evidenced by certificates.

The application of the existing legal framework to the evolving arrangements for holding and transferring securities through intermediaries gives rise to a number of questions. Concepts such as transfer of possession, or protective procedures such as formal notification or publicity requirements, may need to be extended or adapted, sometimes with inconvenient results. More seriously, there may be doubt about whether existing legal techniques are effective when applied to indirectly held

<sup>1</sup> A.O. AUSTEN-PETERS, *Custody of investments*, Oxford University Press 2000, p. 21 *et seq.*; J. BENJAMIN / M. YATES, *The law of global custody*, 2<sup>nd</sup> ed., Butterworths 2002, p. 13 *et seq.*; Chr. BERNASCONI, *The law applicable to dispositions of securities held through indirect holding systems*, The Hague Conference of Private International Law, Nov. 2000, available at [http://www.hcch.net/e/workprog/coll\\_sec\\_pd1.pdf](http://www.hcch.net/e/workprog/coll_sec_pd1.pdf); D. EINSELE, *Wertpapierrecht als Schuldrecht*, J.C.B. Mohr 1995, p. 7 *et seq.*; F. NIZARD, *Les Titres Négociables*, Economica 2003, p. 4 *et seq.*; R. GUYNN, *Modernising securities ownership, transfer and pledging laws*, Capital markets forum of the International Bar Association, 1996, p. 28 *et seq.*; R. Potok (ed.), *Cross border collateral: legal risk and conflict of laws*, Butterworths 2002, p. 7 *et seq.*; J.St. ROGERS, "Policy perspectives on revised U.C.C. Article 8", (1996) *U.C.L.A. L. Rev.*, pp. 1431, 1435 *et seq.*

securities, or about their precise effect in the new context.<sup>2</sup> Doubts arise particularly in the case of cross-border holding and transfer of securities because, in those cases, different laws, which are sometimes even based on different legal traditions, interact. Parties need to be sure which country's law governs the various legal issues relevant to their rights, and that the applicable substantive rules are legally sound, clear and consistent (see *infra*, 1.2).

The efficient and secure transfer of securities is a matter of vital importance to financial markets. The volume and value of securities transferred, both in settlement of outright sales and as collateral, are enormous and continue to increase. Moreover, the use of securities as collateral is a key feature of the banking system, in particular underpinning arrangements for high value cash transfers. Thus, the persistence of inappropriate or outdated legal requirements represents a cost and a drag on the increase in efficiency of the markets; and any significant uncertainty is likely to give rise to systemic risks.<sup>3</sup>

### 1.1 National – regional – global efforts

At national level, some countries have in recent years revised the legal framework applicable to the indirect holding of securities in order to reflect the new market reality.

In the United States, Article 8 of the Uniform Commercial Code<sup>4</sup> underwent a fundamental revision in 1994. The previous version of U.C.C. Article 8 was based on principles of direct holding of securities. Revision was put on track after a US stock market crisis in 1987 revealed the insufficiency of the old system. The new feature was the institution of a *securities entitlement*, by virtue of which the investor has a bundle of rights and interests exclusively against his lead-intermediary instead of the traditional property right in his assets.<sup>5</sup>

In Belgium,<sup>6</sup> the investor's interest is defined as a co-proprietary right which consists of a notional portion of a pool of assets of the same type held by the intermediary for all its clients collectively. The investor's title is the book entry and not a physical or dematerialised security. The co-proprietary right is accompanied by personal rights against the intermediary. In the event of insolvency of the intermediary, the investor's interests are superior to the claims of other creditors of

<sup>2</sup> R. GUYNN, *supra* note 1, p. 25 *et seq.*; J.S. ROGERS, *supra* note 1, p. 1436.

<sup>3</sup> *I.e.*, "the risk that the inability of one institution to meet its obligations when due will cause other institutions to be unable to meet their obligations when due. Such a failure may cause significant liquidity or credit problems and, as a result, might threaten the stability of or confidence in markets", IOSCO/BIS, Recommendations for securities settlement systems, November 2001, p. 49; available at <http://www.bis.org/publ/cpss46.pdf>.

<sup>4</sup> The American Law Institute/National Conference of Commissioners on Uniform State Laws, *Uniform Commercial Code, Official Text – 2000 With Comments, Revised Article 8* (1994 Revision), p. 651 *et seq.* (hereinafter: U.C.C. Article 8).

<sup>5</sup> *Cf.* U.C.C. Art. 8, Part 5; J.S. ROGERS, *Policy perspectives on revised U.C.C. Article 8*, (1996) *U.C.L.A. L. Rev.* pp. 1431, 1456 *et seq.*

<sup>6</sup> *Cf.* Arts. 10-13 of Belgian Royal Decree No. 62 dated November 10, 1967, as amended, April 7, 1995; R. GUYNN, *supra* note 1, p. 43 *et seq.*

the intermediary; he has a so-called right of revindication, *i.e.* a claim for the return of property enforceable against anyone in possession of it.

In Luxemburg,<sup>7</sup> the law provides for a very similar framework. An investor, holding securities through an intermediary, has a right of (co-)ownership in a given pool of non-individually identified securities of the same type held by the intermediary on behalf of all owners of the same type of securities. This right of ownership can only be exercised against the direct intermediary. There is a right of revindication granted to investors in case of insolvency of the intermediary. The law precludes the attachment of securities accounts at the level of securities settlement systems. Upper tier attachments are equally precluded.

In France, securities were dematerialised in November 1984. There are no longer any certificates and securities are evidenced by book entries in accounts maintained by authorised financial intermediaries or by the issuer itself. Issuers and intermediaries in turn have an account with Euroclear France in which issued securities are evidenced by book entries. The number of securities appearing in the accounts maintained by issuers and intermediaries must correspond to the number of securities appearing in the accounts maintained by Euroclear France. If they did not, investors would lose any right to the securities that appeared in their account with the issuer or their intermediary. In other words, book entries in the accounts maintained by Euroclear France prevail over book entries in the accounts maintained by intermediaries.<sup>8</sup>

Japan revised the legal framework applicable to bonds and other debt securities, including government bonds, in 2002. The changes became effective in January 2003. The financial instruments in question can now be dematerialised; however, the investor has the position of a proprietor. Neither an intermediary nor a Central Securities Depository (CSD) has any property right in the securities in question, they are merely responsible for making book entries and maintaining accounts. The investor's right is determined by the book entry in his account with the lead intermediary. Japan will change its laws in respect of shares in the same manner by the end of 2003.

In addition, several law reform projects are currently under way. First, the Uniform Law Conference of Canada is at present preparing a draft of a uniform law on multi-tiered holding systems in Canada.<sup>9</sup> This is intended to harmonise Canadian legislation on this subject and to stay close to the modernised framework in the United States.

Second, in Switzerland, a governmental commission is reviewing a proposal for a Securities Custody Act launched by the private financial sector. The project is intended to codify the current legal framework, which works well, and to eliminate some minor inadequacies, in particular by introducing earmarking of encumbered

---

<sup>7</sup> Cf. Arts. 6, 7 and 15 of the Law of 1 August 2001 on the circulation of securities and other fungible instruments.

<sup>8</sup> Code Monétaire et Financier, Art. L. 431-2; cf. F. NIZARD, *supra* note 1, p. 217 *et seq.*

<sup>9</sup> Cf. <http://www.law.ualberta.ca/alri/ulc/current/etiered.htm>.

securities and by providing a sound legal framework for the treatment of so-called *Wertrechte* (non-tangible securities).<sup>10</sup>

Third, in the United Kingdom, a working party is developing proposals for a securities statute, clarifying the property law aspects of indirectly held securities. The aim is to build on the existing English law, and to respond to international law reform initiatives by promoting account finality in securities market dealings.<sup>11</sup>

There have also been numerous consultative initiatives in recent years aimed at drawing the attention of Governments, competent authorities, the private financial sector and the legal profession to the legal and systemic risk and insufficiencies arising from the current system.

In November 2001, the International Organisation of Securities Commissions (IOSCO) together with the Bank for International Settlements (BIS), issued nineteen Recommendations for Securities Settlement Systems.<sup>12</sup> Their main purpose is to give guidance for the reduction of legal and systemic risk in clearing and securities settlement systems. In particular, the recommendations refer to the general need for a sound legal framework for such systems, and to the imperative of protecting customers' securities against the claims of a custodian's general creditors.<sup>13</sup>

The G30 January 2003 Plan of Action<sup>14</sup> concerning global clearing and settlement endorsed these calls, especially in its Recommendations 15 and 16.<sup>15</sup> Particularly important is the fact that G30 identified the solution of conflict-of-laws problems by the Hague "PRIMA" Convention (see *infra*) as an important first step towards increased legal certainty regarding rights to securities, but the report also pointed to complementary questions of substantive law that needed to be tackled. These include the need for effective protection against the risk of losing assets in the event of the intermediary's insolvency, for reshaping pledging formalities and the realisation procedures relating to collateral, and for harmonised rules of finality of settlement.

At the European level, the second Report by the Giovannini Group<sup>16</sup> of April 2003 expressed the view that insufficiencies as to the legal framework for clearing and

<sup>10</sup> *Ibid.*, Arts. 18, 24.

<sup>11</sup> Working party of the Financial Markets Law Committee (FMLC), Chairman Sir Roy Goode, Secretariat J Benjamin; *cf.* <http://www.fmlc.org>.

<sup>12</sup> IOSCO/BIS, *Recommendations for securities settlement systems*, November 2001, available at <http://www.bis.org/publ/cpss46.pdf>.

<sup>13</sup> *Ibid.*, Recommendation 1 ("Securities settlement systems should have a well founded, clear and transparent legal basis in the relevant jurisdiction"); Recommendation 12 ("[...] It is essential that customers' securities be protected against the claims of a custodian's creditor"); Recommendation 19 ("CSDs that establish links to settle cross-border trades should design and operate such links to reduce effectively the risks associated with cross-border settlements"); and other, more detailed recommendations.

<sup>14</sup> The Group of Thirty, *Global Clearing and Settlement – A Plan of Action*, 2003; summary *cf.* <http://www.group30.org/call.htm>.

<sup>15</sup> *Ibid.*, pp. 46 *et seq.*

<sup>16</sup> The Giovannini Group, *Second Report on EU Clearing and Settlement*, Brussels, April 2003; in this second report the group addresses the question of what actions should be undertaken to eliminate barriers to the integration of the European financial market identified in its first report: The Giovannini Group, *Cross-Border Clearing and Settlement Arrangements in the*

settlement were still among the most serious obstacles to the integration of the EU financial market. The report considered that important legal differences would be removed for most purposes by the implementation of the EU Directive on financial collateral arrangements,<sup>17</sup> but that the question of the absence of a common framework for the treatment of ownership in securities remained. To tackle this question, the report advocated the creation of an EU Securities Account Certainty Project, a proposal also endorsed by the European Financial Markets Lawyers Group,<sup>18</sup> a pan-European initiative under the auspices of the European Central Bank.

## 1.2 The Hague Convention

Parties need to be sure which country's law governs the various legal issues relevant to their rights, and traditional conflict-of-laws rules do not always give a clear answer when applied to modern holding and transfer patterns.<sup>19</sup>

The adoption, in December 2002, of the Hague Convention on indirectly held securities<sup>20</sup> represented a huge step towards modernising and clarifying the law on the indirect holding and transfer of securities. The convention is based on the principle of the applicability of the "PRIMA" law.<sup>21</sup> Under Article 4 of the Convention, the law governing the main proprietary issues of indirect securities holding is the law agreed upon as governing the account agreement between the investor and his direct intermediary, provided certain factual conditions are met.

Throughout the discussions at The Hague, delegations were always aware, however, that to solve conflict-of-laws issues would not be enough. While clear identification of the applicable law does eliminate an important area of uncertainty, the substantive law thus identified may itself be unclear or unsatisfactory. Moreover,

*European Union*, Brussels, November 2001. Both reports are available under [http://europa.eu.int/comm/economy\\_finance/giovannini\\_en.htm](http://europa.eu.int/comm/economy_finance/giovannini_en.htm).

<sup>17</sup> Cf. Arts. 4, 7 and 9 of Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements ("Collateral Directive") and Arts. 3-5 and 9 of the complementary directive 98/26/EC of 19 May 1998 on settlement finality in payment and securities settlement systems; available at [http://europa.eu.int/eur-lex/en/lif/reg/en\\_register\\_1040.html](http://europa.eu.int/eur-lex/en/lif/reg/en_register_1040.html). In fact, implementation of these directives by the EU member States will lead to harmonisation with respect to the following questions: (1) Enforceability of transfer orders and netting against third parties even in case of an insolvency of the intermediary; (2) protection of a collateral taker in case of the insolvency of the collateral provider; (3) formal requirements for the provision of financial collateral; (4) the re-use of financial collateral; (5) enforcement of financial collateral by set off and close-out netting; (6) conflict of laws relating to book entry securities. Cf. K. LÖBER, "Die EG-Richtlinie über Finanzsicherheiten", *Zeitschrift für Bank- und Kapitalmarktrecht* 2002, p. 601 *et seq.*

<sup>18</sup> European Financial Markets Lawyers Group, *Harmonisation of the legal framework for rights evidenced by book-entries in respect of certain financial instruments in the European Union*, June 2003.

<sup>19</sup> For a full discussion of the conflict of laws issues, see Chr. BERNASCONI, *op. cit.*, p. 27 *et seq.*; R. Potok (ed.), *op. cit.*, p. 48 *et seq.* and the various materials there cited.

<sup>20</sup> *Convention on the Law Applicable to Certain Rights in respect of Securities Held with an Intermediary*, adopted under the auspices of The Hague Convention on Private International Law, The Hague on December 13, 2002; available at [www.hcch.net](http://www.hcch.net).

<sup>21</sup> "Place of the Relevant Intermediary Approach"; cf. Chr. BERNASCONI / R. POTOK, "PRIMA Convention brings certainty to cross-border deals", *International Financial Law Review*, 2003, pp. 11, 13.

individual laws which operate satisfactorily in isolation may fail to combine effectively in the context of the cross-border holding and transfer of securities. A number of instances have been identified where two or more national substantive laws on contract, property and dealing in securities do not properly interconnect and give rise to inefficiency or legal uncertainty.<sup>22</sup>

<sup>22</sup> They can be classified as problems arising from general legal diversity, from inconsistent or insufficient national rules or from interconnecting of (as such) internally sound systems; *cf.* Ph. PAECH, "Harmonising substantive Rules for the Use of Securities Held with Intermediaries as Collateral", *Uniform Law Review / Revue de droit uniforme*, 2002, pp. 1140, 1154 *et seq.*; available at <http://www.unidroit.org/english/workprogramme/study078/main.htm>.

## **2 THE INITIAL DISCUSSIONS AT UNIDROIT**

For the above reasons, UNIDROIT, following a request from its Member States' Governments, instituted a project entitled *Harmonised Substantive Rules Regarding Securities Held with an Intermediary*, which was given high priority. A Study Group was set up and held its first session in September 2002. The Group's thinking was refined during its March 2003 meeting and a third session will be held in November 2003. In light of more detailed consideration of the current position under a number of legal systems, it was agreed that analysis of the underlying theoretical and practical issues was required. To this end, the Study Group agreed to conduct fact-finding interviews in the interim. Such fact-finding meetings were held with groups of experts in the United Kingdom, France and Switzerland in the early part of 2003. Further missions to the United States and Canada are currently being prepared, and there are plans for other such meetings in about 10 countries in all continents.

### **2.1 Internal soundness and compatibility**

At its September 2002 meeting, the Study Group concluded that it was important to consider the modernisation and harmonisation of key aspects of substantive law relevant to the cross-border holding and transfer of securities held through intermediaries. It divided the issues into two categories.

The first category was that of issues relating to the key features which a structure for the holding and transfer of securities through intermediaries must possess if it is to be regarded as sound, taking into account in particular objectives of investor protection and efficiency. The question is whether indirect holders of securities can be confident that their interests are robust and can be dealt with under simple, clear rules and procedures for acquisition, holding, transfer (including both outright transfer and provision as collateral) and realisation.<sup>23</sup> Furthermore, it is clearly essential that the investor's interest should not be exposed to risks such as the insolvency of any intermediary or interference by unrelated parties. The Study Group termed these issues of **internal soundness**.

The second category was that of issues affecting the ability of different legal systems to connect successfully where securities are held or transferred across national borders. If the rules of two systems of law, though each achieving internal soundness, produce an unclear or unsatisfactory result in combination,<sup>24</sup> this raises issues which the Study Group termed issues of **compatibility**.

<sup>23</sup> Establishing that an interest in indirectly held securities is robust involves both legal and operational issues. Operational issues are beyond the remit of the work of the UNIDROIT Study Group.

<sup>24</sup> Such issues can arise especially when two or more national legal systems based on different concepts interconnect. One example relates to the notion of "securities": in some countries, certain financial instruments are considered securities, whereas in others they are not and therefore do not benefit from the special protection afforded securities but are treated as

## 2.2 Approach

The Study Group, at its March 2003 meeting, focussed, first, on the criteria that should govern the question of whether a particular matter needs a harmonised rule. It concluded that a rigorous approach should be adopted, and that a harmonised rule should be regarded as appropriate if, but only if, it is clearly required for the reduction of legal or systemic risk or for the promotion of market efficiency. This approach recognises that, however desirable it is in principle to achieve fully harmonised rules, this is in practice a complex and difficult process requiring both technical and political consensus. The difficulty of achieving such harmonised rules, particularly within a reasonable timeframe, strongly supports a restrictive approach to the scope of harmonisation.

The Study Group also recognised, however, that even in relation to issues where a uniform, harmonised rule was not thought to be required in accordance with the test suggested above, it might still be important to set out a clear standard to be achieved. In particular, if it were concluded that elements of the minimum requirements for internal soundness could be achieved in more than one way and that uniformity was not essential, it might still be highly desirable to promulgate standards which systems wishing to be internationally recognised as sound would need to meet.

Against this background, the Study Group now envisages an instrument, the structure of which reflects, on the one hand, the decision to concentrate on very few key questions that call for global uniform rules and, on the other hand, the desire to guide the process of establishing a sound legal framework for indirectly held securities, especially in those capital markets which at present only have an incomplete set of rules. Hence, the instrument will in all likelihood be split into a mandatory minimum convention and a non-mandatory annex intended to serve as a benchmark.

Confusion can easily arise from the different traditions and conceptual frameworks of different systems of law. This is why the Study Group concluded that it should adopt a functional approach – that is, one which uses language which is as neutral as possible and formulates rules by reference to their results. It drew in this respect on the experience of the Hague Convention, where it was found unexpectedly difficult to use even common concepts such as “property” or “proprietary interest” in a manner which would be understood in the same way in all legal systems. The Hague Convention therefore avoided such terms and used instead more neutral language such as “effects against third parties”. The same approach had previously borne fruit in developing innovative and universally acceptable rules in the UNIDROIT / ICAO Cape Town Convention on equipment financing.<sup>25</sup>

mere contractual claims. In case of insolvency of an intermediary situated in such a country, such assets are possibly not protected; *cf.* Ph. PAECH, *supra* note 22, at p. 1156.

<sup>25</sup> *Cf. infra*, Appendix 2, About UNIDROIT.

### **2.3 The needs of principal market participants as guidelines**

A key element of the Study Group's approach is its recognition of the central position of book entry securities accounts in modern indirect holding and transfer systems. In seeking to identify the nature and extent of the uniform rules that are desirable, it is useful to consider the needs of the principal participants against the background of criteria of systemic risk and market efficiency.

An **account holder** needs to be confident -

- (a) that entries in its accounts with its intermediary represent interests that are good against the intermediary and third parties, even in case of insolvency of the intermediary;
- (b) that such entries cannot be revoked or reversed once certain clearly identifiable and reasonably simple conditions have been satisfied;
- (c) that it can give instructions to its intermediary in a reasonably simple and convenient form.

An **intermediary** needs to be confident -

- (a) that it can accept instructions from its direct account holder and can ignore purported instructions or other interference from outside parties;
- (b) that, where an account holder has provided securities held in its account as collateral to the intermediary itself, the intermediary can enforce its security in accordance with its terms without the need to satisfy any additional conditions or procedural requirements;
- (c) that, where an account holder has provided securities held in its account as collateral to another party, the intermediary can accept instructions from the collateral taker in clearly specified circumstances and without the need to satisfy any additional conditions or procedural requirements;
- (d) that the instructions referred to in (a) and (c) cannot be revoked or reversed once certain clearly identifiable and reasonably simple conditions have been satisfied;
- (e) that such instructions can be given in a reasonably simple and convenient form;
- (f) that, when the intermediary is making entries in the accounts of its account holders on the basis of entries made in accounts which it maintains with a higher tier intermediary, the entries in those accounts held with the higher tier intermediary represent interests that are good against the higher tier intermediary and third parties and are not liable to be reversed or revoked;
- (g) that, to the extent that there are matching debits and credits to accounts maintained by the intermediary for different account holders (whether or not in respect of deliveries between those account holders) it can effect a net settlement of those debits and credits – that is, that it need not make precisely matching entries in accounts which it holds with an upper tier intermediary, but can simply make such entries (if any) as

are required to reflect the net overall change in the aggregate balances of its account holders taken together.

A **collateral taker** needs to be confident -

- (a) that it can obtain an interest valid against the collateral provider, the intermediary and third parties by ensuring compliance with a clear, reasonable and simple procedure;
- (b) that if it needs to enforce its security it will be able to give to the intermediary instructions on which the intermediary will be entitled and bound to act, without the need to satisfy any additional conditions or procedural requirements.

These concerns are particularly marked in the common situation where linked transfers of interests are taking place through different intermediaries and settlement systems, operating under different laws. If, for example, there were any doubt about whether an interest represented by a book entry credit made in a securities account governed by the law of one country, or a transfer made through book entry debits and credits on such a securities account, would be recognised as effective and final under the law of another country, this would give rise to damaging uncertainty and systemic risk.

#### **2.4 Scope of uniform requirements**

In the light of the above objectives, the Study Group considered a number of issues of importance to the structure and operation of arrangements for the holding and transfer of securities through intermediaries, in order to form provisional views on what substantive provisions are desirable and whether and to what extent, having regard to the criteria suggested above, those provisions should be set out in uniform rules.

The Study Group reached the preliminary view that the achievement of the objectives set out above implies uniform rules in a number of areas -

- (a) There will need to be a rule precluding "**upper tier attachment**".
- (b) Any rules imposing special formalities, other than the debiting and crediting of **book entry accounts**, as a pre-condition of a disposition of securities held with an intermediary taking full effect will have to be disapplied.
- (c) There will need to be rules on **creation and realisation of collateral**, notably regarding formalities with a view to protect the collateral taker.
- (d) There will need to be a rule governing the effects of an **informal disposition** (*i.e.* a disposition made otherwise than by entries in book entry accounts) over securities.
- (e) There will need to be a rule confirming that a person acquiring an interest in **good faith** as a result of the crediting of securities to his securities account acquires an overriding title free of the claims of any person who

may be able to challenge the effectiveness or propriety of any matching or connected debit or credit on the basis of which the credit was made.

- (f) There will need to be a rule regarding **net settlement**, confirming that book entries made by an intermediary may reflect the net overall change in the aggregate balance of its account holders taken together.
- (g) There will need to be rules confirming the **finality** of book entry transfers – *i.e.* the non-reversibility of credits to an account – that also address the irrevocability of instructions once they have been given to an intermediary.
- (h) There will need to be rules dealing clearly with the possibility of a **provisional credit**, *i.e.* a credit entered in circumstances which cause the total number of securities credited to accounts maintained by an intermediary to exceed the available underlying securities or interests in securities held by the intermediary.
- (i) There will need to be a rule about **loss allocation** which clearly defines who bears the risk of a shortfall in securities at the level of the account holder's direct or any other higher tier intermediary.

This set of issues must not be regarded as complete or definitive. The Study Group has not yet decided whether certain other issues, especially the protection of account holders from their intermediary's insolvency, require uniform legal rules.

## 3 THE BACKGROUND

### 3.1 Upper tier attachment

The phrase “upper tier attachment” is commonly used to refer to the risk that a securities account with an intermediary at a higher tier in the holding pattern may be subject to a legal claim (typically through court proceedings) to freeze or attach the account in order to enforce a claim against a person alleged to hold an interest through an intermediary at a lower tier.

The account maintained with the upper tier intermediary will generally be an “omnibus” account, that is, an account in the name of the lower tier intermediary to which are credited all the securities held for the latter, without any attempt to distinguish the interests of particular clients of the lower tier intermediary.<sup>26</sup> The use of such “omnibus” accounts is one of the key factors contributing to the efficient operation of the indirect holding system.

The fact that the higher tier intermediary has no knowledge or record of interests other than the interest of the lower tier intermediary as its immediate account holder is generally regarded as lessening the likelihood of a court’s being prepared to make a freezing or attachment order at the upper level. On the other hand, it also increases the damage that such an order, if made, would inflict on the integrity of the system, since the higher tier intermediary might have no alternative, pending clarification of the position, but to freeze the *entire* account, thereby interrupting transactions not only of the underlying investor who is party to the dispute, but of all the other account holders of the lower tier intermediary.

It is obvious therefore that there are strong reasons for making it absolutely clear that no claim for upper tier attachment should be admissible.<sup>27</sup> Given the international nature of the multi-tier holding pattern, a rule to this effect will need to be a uniform rule if it is to give the necessary assurance, not only to intermediaries who may be exposed to claims for attempted attachment, but also to other intermediaries and their account holders. Therefore, it would seem highly desirable to have a free-standing rule expressly precluding upper tier attachments. This should be the case even under legal systems where the nature of an account holder’s interest is such that it is clear that the interest exists solely at the level of the account holder’s immediate intermediary, which should logically preclude any upper tier attachment.

<sup>26</sup> The lower tier intermediary may, however, maintain an account for its own securities separate from the “omnibus” customer securities account (and in many cases this is a regulatory requirement).

<sup>27</sup> The need for such a rule was emphasised by a number of commentators on the Hague Convention on indirectly held securities (*cf. supra*, 1.2), though it was recognised that that Convention, being concerned only with conflict of laws, could not itself supply the rule.

The above discussion concentrates on the position of higher tier intermediaries. The Study Group did, however, note that the same considerations apply in relation to issuers of securities, and reached the preliminary conclusion that there should be a uniform rule protecting the issuer from adverse claims from any level in the holding system.

### **3.2 Transfer formalities**

If the indirect holding system is to operate safely and conveniently, the applicable legal rules need to make it clear that -

- (a) a disposition effected by debiting or crediting a book entry securities account is effective upon, and by virtue of, the making of the necessary book entry or entries;<sup>28</sup>
- (b) the intermediary which maintains the account is entitled to make such debits and credits on the basis of instructions in a simple and convenient form, and, in particular, that instructions in electronic form, if provided for in the terms on which the relevant accounts are operated, are sufficient.

This means that any existing rules that require additional formal steps to be taken (for example, rules making writing, signature or formal notice a necessary condition of an effective transfer) will need to be disapplied, and that, if there is any doubt about whether property interests can be created and disposed of by book entries, this will need to be confirmed.

Clearly, there are powerful arguments of market efficiency that support the desirability of such a rule; in the opinion of the Study Group, however, such a rule is also desirable on systemic grounds, given the scope for legal uncertainty that would be introduced if apparently effective debits and credits could be retrospectively impugned on formal grounds.

### **3.3 Security (collateral) dispositions: rules on the creation and realisation of security**

Special considerations apply in relation to dispositions made by way of security (collateral dispositions). Such dispositions are commonly the subject of particular procedural requirements (for example in relation to formal notice or public filing as a necessary element in the perfection of a security disposition) which have their origins in policy considerations relating to the protection of borrowers and of

<sup>28</sup> The question then arises whether the debit and credit entries are to be regarded as effecting a single transfer of a property right (in which case it may be necessary to define which entry is definitive), or whether the debit entry is analysed as extinguishing an interest, and the credit entry as creating an interest, in a manner such that the two interests need not be regarded as identical. The answer depends mainly on the analysis of the nature of the rights constituted by a credit of securities to a book entry account and will be discussed further by the Study Group (*cf. infra*, 3.9).

unsecured creditors and subsequent lenders or purchasers against being misled by a false impression of assets being unencumbered and available for the satisfaction of their claims.

There is a degree of tension between these policy considerations and the objectives referred to in paragraph 3.2 *supra*. Further discussions will be needed as to how to achieve an appropriate balance, but the Study Group has noted that a number of the regimes for security transactions that have been developed in recent years have included provisions for security disposition to be effective if made by way of book entry transfer to an account of the pledgee or by some kind of appropriation in the account of the pledgor resulting in the securities coming under the control of the pledgee, for example by appropriating the pledged securities to a “starred” or “escrow” sub-account, or by “earmarking” them. These regimes provide a promising model for a possible uniform rule; their existence also seems to the Study Group to support the view that a simplified regime for collateral transactions in relation to indirectly held securities is justified on grounds of systemic risk and market efficiency.

A similar position applies in respect of the rules on the realisation by a collateral taker of its rights upon default by the collateral provider. Many systems of law impose special restrictions on realisation, such as the requirement of advance notice, the use of a prescribed method of realisation (e.g. sale by public auction) or the conduct of the process of realisation under court supervision. Where the pledgor is or becomes subject to insolvency proceedings, special rules of insolvency law will also apply. These may include, in addition to the elements referred to above, the imposition of a moratorium on enforcement or of further procedural conditions on enforcement. They will also, of course, usually include special rules relating to the possible invalidation of the security disposition itself as constituting fraud vis-à-vis other creditors or otherwise contravening mandatory principles of insolvency law.

Further discussion is needed on the extent to which any uniform rule should impinge on such special restrictions on realisation.

### **3.4 Informal dispositions**

The Study Group has considered whether the rules contemplated in paragraphs 3.2 and 3.3 *supra* should be exhaustive – that is, whether “informal” dispositions by account holders which are not effected by book entry transfer or otherwise recorded in accordance with those rules should be devoid of any effect.

The Study Group’s preliminary view is that a provision to that effect would go further than was necessary to achieve the objectives in view, and that, accordingly, such informal dispositions should not be completely precluded, provided that it were clear that an interest arising under such a disposition would not be good against parties other than the account holder, and would therefore be liable to be defeated by a subsequent disposition by book entry transfer effected by the account holder.

### 3.5 Good faith acquisition

As mentioned above, an account holder (including a lower tier intermediary in relation to securities held by it in an account with a higher tier intermediary) needs to be confident that entries in its accounts with its intermediary represent interests that are good against the intermediary and third parties.

On the face of it, this suggests that what is required is a rule dealing with any case where a previous holder of securities credited to an account seeks to contest the disposition that results in the credit and as a result to claim a title superior to that of the “transferee” account holder – the rule being that the “transferee” account holder, if acting in good faith, will prevail.

The Study Group regards a rule protecting an account holder who receives a credit of securities in good faith as essential to the overall objectives of legal certainty and efficiency. It is, however, debatable whether a rule which focuses on the concept of a good faith *transfer* or *acquisition* is a necessary, or the most desirable, way of achieving the objective. It may well be preferable to have a rule which looks only to the credit of the securities and precludes any attempt to trace a claim by an account holder whose account has been debited into another account to which the corresponding credit has been made.

The possibility of thus tracing claims raises difficult practical and theoretical issues.<sup>29</sup> The two sets of issues are connected, since the limitations on the possibility of tracing in practice, and the random incidence of cases where tracing is possible as against those where it is not, undermine any justification of principle or fairness which might otherwise be adduced in favour of preserving a right to trace.

In the light of these difficulties, there are in the opinion of the Study Group strong grounds for the view that the position of a good faith recipient of a credit of securities will be equally well protected by the rules defining the circumstances (if any) in which credits of securities may be reversed. These will need to be complemented by corresponding rules dealing with the reversal of debits and preserving the intermediary from exposure to claims in cases where it has debited an account in good faith.

One effect of this principle of protecting good faith acquisition (or, as suggested above, good faith credits and debits), to which the Study Group has devoted considerable discussion, is that an unauthorised disposition by an intermediary of securities held by it with a higher tier intermediary (for example, a transfer or pledge of the securities to raise funds for the intermediary’s own operations) will result in the intermediary’s counter-party receiving a good interest, to the prejudice of the intermediary’s underlying account holders. This result follows from the application, at the level of the higher tier intermediary, of the principle of respecting credits and debits made in good faith. The Study Group has concluded that this result is unavoidable if the overall objectives of efficiency and legal

---

<sup>29</sup> For a characteristically lucid account of the practical difficulties, see J.S. ROGERS, “Negotiability, Property and Identity”, *Cardozo Law Review*, 1990, p. 471. For the theoretical difficulties, see Sir Roy GOODE, *Legal Problems of Credit and Security*, 3<sup>rd</sup> edition (2003), p. 42 *et seq.* and the literature there cited.

certainty are to be achieved, and that any resulting investor protection concerns will need to be addressed as a matter of regulatory policy in deciding what regulatory and disclosure requirements should be imposed on intermediaries.

### **3.6 Net settlement**

As noted above, it is important that, to the extent that there are matching debits and credits to accounts maintained by the intermediary for different account holders (whether or not in respect of deliveries between those account holders), it can effect a net settlement of those debits and credits – that is, that it need not make precisely matching entries in accounts which it holds with an upper tier intermediary, but can simply make such entries (if any) as are required to reflect the net overall change in the aggregate balances of its account holders taken together.

This point has an important bearing on the definition of the nature of the interest constituted by a credit balance on a securities account. A key issue here is whether such a balance is regarded as creating or representing a property right in particular underlying securities which directly or indirectly correspond to the credit balance. If it is so regarded, it is necessary to consider the conceptual question of how transfers of these underlying property rights can be effected on a net basis and without identification of the property subject to individual transfers. If, on the other hand, a securities account balance is not so regarded (for example because it constitutes merely a co-proprietary right or a *sui generis* securities entitlement), the analysis of net settlement appears to be somewhat simpler. These questions will need to be examined in more depth as part of the Study Group's further work and consultation.

### **3.7 Finality and irrevocability**

If arrangements for the transfer of securities through book entry accounts with intermediaries are to operate effectively -

- first, where an intermediary is instructed to credit securities to an account of its account holder on the basis of a corresponding credit made to its own account maintained with a higher tier intermediary, it needs to be confident that the credit to its own account cannot be reversed. This position arises in every case where an investor transfers securities to another investor who does not happen to maintain a securities account with the same intermediary – an extremely common situation;
- second, an intermediary needs to be confident that, once instructions to effect an entry on a securities account have been given, or input into an electronic system, those instructions cannot be reversed, either as a result of a change of mind or (probably a more serious risk in practice) as a result of the insolvency of the person giving the instructions;
- third, an account holder who receives a credit of securities to his account needs to be confident that the credit is not liable to be reversed as a result of the insolvency of another account holder from whose account a corresponding debit has been made.

These points are of systemic importance,<sup>30</sup> in particular in the context of securities clearing and settlement systems, where some delay between the receipt and execution of instructions is inevitable, and transactions are frequently effected in batches or chains of deliveries, each of which is dependent on a number of others.

Because the risks of reversal or revocation may arise under a variety of different laws,<sup>31</sup> and since it will often be very difficult for intermediaries or account holders to identify with confidence those that may be relevant, effective protection against these risks requires a uniform international rule with as wide a reach as possible.

The Study Group has therefore considered whether there should be a uniform rule relating to the irrevocability and finality of book entry debits and credits of securities. To the extent that questions of finality depend on the rules defining the moment at which an interest arises as a matter of the general law of property, they will be addressed by the rules suggested above on the effectiveness of book entry credits when made. However, questions of finality of transfer also involve issues of insolvency law, and the issue of irrevocability of instructions to an intermediary to effect debits and credits on book entry accounts involves questions both of insolvency law and of the general law of agency and custody.

The issue relevant to finality of transfer is whether insolvency law rules which would ordinarily require or permit the reversal of a transfer of securities as a result of the insolvency of the transferor, as for example in the case of a transfer made after commencement of the insolvency or within a “suspect” period leading up to the insolvency, should be disapplied. If the relevant rules continue to apply in full, account holders’ confidence in the integrity of the book entry system may be compromised.<sup>32</sup>

A clear rule in relation to revocation of instructions is important for intermediaries, in particular those which operate clearing or settlement systems, because it is extremely difficult in practice, and even if achievable extremely disruptive, for them to give effect to a purported revocation of authority to act on behalf of an account holder (whether by reason of insolvency or otherwise) while a settlement cycle is in progress.

The importance of these issues is reflected in the fact that the EU Settlement Finality Directive deals with both finality and irrevocability of instructions, and in each case

---

<sup>30</sup> See, for example, Arts. 3-5, 7, and 8 of the EU Settlement Finality Directive (*supra*, note 17), which ensure finality and irrevocability in respect of transfers of securities effected through systems that are recognised under the Directive.

<sup>31</sup> The obvious relevant laws are the law governing the account agreement, the law governing property issues in relation to interests held in the account (generally the PRIMA law, *supra* note 21) and the law governing insolvency proceedings in respect of the intermediary and account holders. The last of these will usually be the most important and is also the most difficult to identify, since different account holders will be subject to different systems of insolvency law.

<sup>32</sup> It is arguable that the possibility of reversal on insolvency law grounds as against the immediate recipient of a transfer of securities need not be disapplied, provided that there is no possibility of reversal affecting an onward transferee who acted in good faith. This argument rests on the proposition that it is reasonable for parties to bear the risk of insolvency of their immediate transferors, and that the risk does not have systemic implications if it is clear that it cannot infect subsequent transfers. This is a question that may need further discussion.

confers extensive protection against the normal operation of insolvency law rules on settlement systems that are recognised for the purposes of the directive.

### **3.8 Possibility of provisional credits**

The total of securities of a particular kind credited by an intermediary to securities accounts which it maintains for its customers might exceed the aggregate holdings of securities of that kind maintained by the intermediary, either directly<sup>33</sup> or indirectly.<sup>34</sup> Such a discrepancy may arise either because the intermediary credits securities to a client's securities account in circumstances where the credit is not matched by a corresponding increase in the underlying securities held by the intermediary or because securities are debited from the intermediary's holdings without a corresponding debit to customers' securities accounts.

The imbalance may be the result of a deliberate or inadvertent breach by the intermediary of its obligations; it may also occur in circumstances expressly permitted by the intermediary's agreements with account holders, in particular where these include provisions permitting account holders to use newly credited securities to make further deliveries at a time before an incoming credit of underlying securities to which the new credit matches has not been made or has not become final.

The Study Group considered whether there should be uniform rules of law governing the possibility of a provisional credit, *i.e.* the extent to which, and the conditions under which, the arrangements governing the operation of book entry securities accounts by intermediaries should be permitted to provide for the crediting of an account in circumstances which give rise to an aggregate over-crediting of securities.

The question of whether the arrangements under which book entry accounts are operated should be permitted to allow the creation of provisional credits is closely linked with issues of finality, with the allocation of any shortfall of available securities among account holders, and with the formulation of a rule protecting good faith acquirers.<sup>35</sup> It involves a tension between the objective of efficiency of settlement and that of security of holding. In order to facilitate efficient and speedy settlement of chains of deliveries, an intermediary, in particular if the operator of a settlement system, may wish to put in place arrangements permitting onward delivery of newly credited securities at a time when a linked delivery or payment on which the credit is dependent (for example the completion of a matching cash payment or the making of a corresponding credit of securities with a different intermediary) have not yet been satisfied.

---

<sup>33</sup> For example in the form of bearer certificates or balances registered with the issuer in the name of the intermediary or its nominee.

<sup>34</sup> Through interests held by the intermediary with a higher tier intermediary.

<sup>35</sup> The circumstances in which a credit, and in particular a credit which gives rise to such aggregate over-crediting, may be reversed, the question if and under which conditions a good faith acquisition is possible and the manner in which any *irreversible* loss resulting from over-crediting, whether or not in accordance with the applicable arrangements, should be allocated among *intermediaries and* account holders, are dealt with *infra* 3.9.

If an intermediary is permitted to reverse such an onward delivery in a case where the related conditions are not in the event satisfied, the ability and willingness of account holders and those dealing with them to rely on a book entry credit of securities will clearly be compromised, since it will often not be practicable, and may not be possible,<sup>36</sup> for them to discover whether, and for how long, a credit of securities is subject to reversal. This suggests that, while it may be possible for an intermediary to reserve the right to reverse a provisional credit of excess securities as against the relevant account holder, such a right of reversal should not affect any subsequent credit which the intermediary has allowed to be made against a matching debit of the provisional balance.

There is an analogy here with the situation where a bank allows a customer to draw on an uncleared balance of funds to make a subsequent payment. If the uncleared item has to be reversed, the customer will be liable to reimburse any unauthorised overdraft that arises as a result, but the subsequent payment will not be affected.

The risks arising from any permitted over-crediting will need to be clearly allocated. If, as the Study Group has provisionally concluded is desirable (see *infra*), the rule is that such deficiencies, where they cannot be eliminated by the intermediary because it is itself insolvent, will be borne by account holders in proportion to the credit balances on their accounts, the effect is to share the loss among the whole body of account holders.

This result can be avoided if the credit of securities in advance of the completion of a linked delivery or payment is permitted only through securities lending arrangements between the intermediary and one or more members of the system. Under these arrangements, the intermediary agrees with participating lending members that it has the right to borrow securities from them in order to finance other members' transactions. In return, the lenders are paid a financing fee and benefit from a personal undertaking by the intermediary to return equivalent securities. This arrangement has the attraction of avoiding any over-crediting of securities in the aggregate, while providing a means of financing liquidity in the system. An arrangement of this kind would have particular attractions under a substantive law analysis which was based on a concept of ownership of underlying securities and regarded over-crediting as conceptually impossible because it resulted in a "doubling" of title to the same asset. Like the arrangements described above, this solution results in some members of the system incurring a credit exposure to the intermediary which operates it. The difference is that under the first arrangement the risk is borne by the members generally. They may find it difficult to identify the risk, to assess its magnitude, and to be confident that they are being rewarded for incurring it. Under an internal lending arrangement, the credit risk falls only on certain members (those who participate as lenders), but those members will be paid

---

<sup>36</sup> In a fast-moving settlement system, a "provisional" credit of securities may be used to fund a number of separate onward transfers. Even in a system which has rules for the tracing of transfers, it may not be possible to identify which of such transfers were funded by the "provisional" credit, since a holding will lose such identity as it possesses when it is credited to an account which already includes identical securities and therefore becomes merged in a larger balance. If, therefore, two or more onward transfers are made out of the merged balance, it may be impossible to decide which of the onward transfers includes the "suspect" securities.

for incurring the risk and are likely to benefit from protections in addition to the covenant of the intermediary.<sup>37</sup>

There are, therefore, strong arguments in favour of a model under which financing to facilitate the settlement of chains of deliveries is provided through lending arrangements among account holders that do not involve any over-crediting of securities. However, it is clearly possible for the legal framework for the indirect holding and transfer of securities through book entry accounts with intermediaries to cover a less restrictive model under which the intermediary provides liquidity to the system by creating provisional credits of securities which are backed only by its own credit in securities of this type. The choice between these two models involves questions of legal and regulatory policy on which different views could reasonably be taken. Further discussion of the subject would be helpful, but the current view of the Study Group is that uniform rules establishing a common framework for the indirect holding of securities should be broad and flexible enough to accommodate both models.

### **3.9 Allocation of shortfall**

The Study Group also considered how a shortfall in the securities or interests held through an intermediary in respect of its account holders' entitlements should be allocated.

Shortfalls can arise if provisional credits are permitted and the credited amount is for whatever reason re-debited but the investor is neither still in possession of these securities nor in a position to replace them. Furthermore, even if it were decided that the deliberate creation of "excess" credits should never be allowed,<sup>38</sup> a shortfall could still arise as a result of fraud, inadvertence or accident. A rule governing the consequences of such a shortfall is therefore clearly necessary.

The Study Group came to the provisional conclusion that in the event of shortfall generally, the account holder's (lead) intermediary should be obliged to bear the risk.

If the shortfall cannot be eliminated by the intermediary, in particular when the latter is insolvent, the question arises as to who should bear the risk. The Study Group provisionally concluded that in this case, the shortfall should be borne by the account holders in proportion to the holdings of the relevant securities.

There are on the face of it attractions to a rule which traces the origin of the shortfall and, where the shortfall can be shown to arise from transactions relating to a particular account holder, shifts the loss to that account holder. Thus, if an account holder's account is credited after its intermediary's account with a higher tier intermediary is credited, and that latter credit is subsequently reversed on grounds of fraud or defect of title, it is superficially attractive to suggest that the particular recipient account holder should bear the loss.

---

<sup>37</sup> For example, members whose accounts are credited with securities in anticipation of settlement of a matching delivery may give security over their holdings generally in favour of the lending members who have financed the credit.

<sup>38</sup> Either on policy grounds or because it was conceptually impossible (*cf. supra*, 3.2).

However, closer examination shows that in many cases, the circumstances in which a shortfall may arise are far more complicated and will make it extremely difficult or impossible to trace particular accounts to which the shortfall should be attributed.<sup>39</sup> The Study Group therefore took the provisional view that there should be a uniform rule to the effect that any shortfall which is not made good by the intermediary (see *supra*) should be borne, in proportion to the balances on their accounts, by all the intermediary's account holders to whose accounts securities of the relevant description are credited.

### **3.10 Insolvency protection and other issues where a uniform rule may be considered**

The Study Group also contemplated whether a uniform rule was required for the protection of property representing account holders' interests from the claims of general creditors of the intermediary in the event of the latter's insolvency. It seems clear that such protection is required to satisfy the criterion of internal soundness and that uniformity as to the result is desirable. This does not necessarily mean, however, that there must also be uniformity as to the manner in which this is achieved. At present, for example, such protection is conferred under some systems as part of the rules of insolvency law and under others through arrangements having the effect that the underlying holdings representing account holders' entitlements form a separate *corpus* of property not regarded as belonging to the intermediary at all. The Study Group will welcome views about whether a diversity of mechanisms is acceptable provided the appropriate level of protection is conferred.

Whatever the mechanism by which account holders' interests are protected, intermediaries which are regulated institutions will often be subject to regulatory requirements regarding the separate identification and segregation of underlying property representing or corresponding to account holders' interests. The Study Group takes the view that it is not part of its mandate to suggest the scope or content of such regulatory requirements. Clearly, such requirements will need to be borne in mind in formulating suggestions on uniform rules of substantive law, and regulatory and supervisory bodies are and will continue to be among those consulted in relation to this project. The Study Group is not aware that any of its provisional conclusions are inconsistent with existing regulatory requirements.

Similar considerations apply in relation to —

- (a) whether, to what extent and subject to which conditions intermediaries should be able to use for their own purposes underlying securities or interests corresponding to account holders' interests;<sup>40</sup>
- (b) whether intermediaries can transfer other risks or costs to investors, e.g. the cost of replacing underlying assets as a result of a credit of "bad" stock.

<sup>39</sup> See paragraph 3.5 and 3.8 above and the literature cited in footnote 29.

<sup>40</sup> If it is permitted, it will be an additional source of excess credits, raising the issues discussed above.

This is because these are matters for public or regulatory policy judgement involving the balancing of considerations such as investor protection, freedom of contract and economic efficiency. Consideration may, however, be given to the formulation of “benchmark” safeguards which could be promulgated as agreed standards. This issue will be explored further by the Study Group.

Further points on which the Study Group has yet to reach a conclusion as to the need for a uniform rule include —

- (a) the perfection of security interests: whether there should be a uniform procedure for effecting and perfecting security interests in book entry securities created otherwise than by transfer to a new book entry account;
- (b) the definition of terms of such as “securities”.

## **APPENDIX 1**

### **MEMBERS OF THE UNIDROIT STUDY GROUP**

#### **Chair**

Mr B. SEN (Chairman)	Senior Advocate at the Supreme Court of India and Member of the UNIDROIT Governing Council, New Delhi, India
Mr Luc THÉVENOZ (Vice Chairman)	Professor of Law, University of Geneva, Switzerland

#### **Members**

Mr J. Michel DESCHAMPS	Partner, McCarthy Tétrault, Montreal, Canada
Mr Philippe DUPONT	Partner, Arendt & Medernach, Luxembourg
Ms Dorothee EINSELE	Professor of Law, University of Kiel, Germany
Mr Edgar I. JELONCHE	Professor of Law, Buenos Aires University, Argentina
Mr Hideki KANDA	Professor of Law, University of Tokyo, Japan
Mr LI Rui Qiang	Law Manager, China Securities Depository and Clearing Co. Ltd., Beijing, P.R. China
Mr Guy MORTON	Partner, Freshfields Bruckhaus Deringer, London, United Kingdom
Mr Frédéric NIZARD	Direction juridique, Crédit Agricole SA Paris, France
Mr Richard POTOK	Principal, Potok & Co., Darlinghurst, Australia
Mr Curtis R. REITZ	Professor of Law, University of Pennsylvania, USA
Mr WU Zhipan	Professor and Vice-President, University of Beijing, P.R. China

#### **Secretary**

Mr Philipp PAECH	UNIDROIT, Rome, Italy
------------------	-----------------------

The following intergovernmental Organisations and non-governmental Organisations are participating in their capacity as observers: *Hague Conference of Private International Law*, *United Nations Commission on International Trade Law* and *Capital Markets Working Group* (a private financial sector initiative which shall co-operate with the UNIDROIT Study Group).

## **APPENDIX 2**

### **ABOUT UNIDROIT**

The International Institute for the Unification of Private Law (UNIDROIT)<sup>\*</sup> is an independent intergovernmental organisation which has its seat in Rome. Its purpose is to study needs and methods for modernising, harmonising and co-ordinating private, and in particular commercial, law as between States and groups of States. Set up in 1926 as an auxiliary organ of the League of Nations, the Institute was, following the demise of the League, re-established in 1940 on the basis of a multilateral agreement, the UNIDROIT Statute.

UNIDROIT's 59 member States are drawn from the five continents and represent a variety of different legal, economic and political systems as well as different cultural backgrounds. These are: Argentina, Australia, Austria, Belgium, Bolivia, Brazil, Bulgaria, Canada, Chile, China, Colombia, Croatia, Cuba, Cyprus, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Germany, Greece, Holy See, Hungary, India, Iran, Iraq, Ireland, Israel, Italy, Japan, Luxembourg, Malta, Mexico, Netherlands, Nicaragua, Nigeria, Norway, Pakistan, Paraguay, Poland, Portugal, Republic of Korea, Romania, Russian Federation, San Marino, Serbia and Montenegro, Slovakia, Slovenia, South Africa, Spain, Sweden, Switzerland, Tunisia, Turkey, United Kingdom, United States of America, Uruguay, Venezuela.

UNIDROIT's basic statutory objective is to prepare modern and, where appropriate, harmonised rules of private law understood in a broad sense. However, experience has demonstrated the need for occasional incursions into public law, especially in areas of the law where hard-and-fast lines of demarcation are difficult to draw. Rules prepared by UNIDROIT are concerned with substantive law; they only include uniform conflict-of-laws rules incidentally.

UNIDROIT's independent status amongst intergovernmental Organisations has enabled it to pursue working methods which have made it a particularly suitable forum for tackling more technical and correspondingly less political issues. New technologies, commercial practices, etc. call for new solutions and, where transactions tend to be transnational by their very nature, these should be harmonised, widely acceptable solutions. Generally speaking, the eligibility of a subject for harmonisation or even unification will to a large extent be conditional on the perception of States' willingness to accept change in their municipal law rules in favour of a new international solution. Legal and other arguments advocating harmonisation must accordingly be weighed carefully against these considerations. Similar considerations will also determine the most appropriate sphere of application for such rules, that is,

<sup>\*</sup> For detailed information concerning the Institute and its Work Programme, *cf.* [www.unidroit.org](http://www.unidroit.org).

whether they should be restricted to truly cross-border situations or relations or extended to cover purely internal situations as well.

In keeping with its intergovernmental structure, the rules drawn up by UNIDROIT have traditionally tended to take the form of *international Conventions*, designed to apply automatically in preference to a State's municipal law upon completion of all the formal requirements of that State's domestic law for their entry into force. However, there are alternatives, including *model laws*, which States may take into consideration when drafting domestic legislation, or *general principles* addressed directly to judges, arbitrators and contracting parties who are, however, left free to decide whether to use them or not. Where a subject is not judged ripe for the drawing up of uniform rules, another alternative consists in the preparation of *legal guides*, typically on new business techniques designed for the use of professional parties in countries unfamiliar with the emerging contractual practice on the subject covered.

Once a subject has been included in the UNIDROIT Work Programme, the Secretariat convenes a *Study Group*, traditionally chaired by a member of the UNIDROIT Governing Council, for the preparation of a *preliminary draft Convention* or one of the alternatives mentioned above. The membership of such study groups, made up of experts acting in their personal capacity, is a matter for the Secretariat, which seeks to ensure as balanced a representation as possible of the world's different legal and economic systems and geographic regions.

A preliminary draft instrument prepared by a study group will be laid before the Governing Council for approval and advice as to the most appropriate way forward. Typically, in the case of a preliminary draft Convention, this will consist in its requesting the Secretariat to convene a *Committee of Governmental Experts* for the finalisation of a *draft Convention* capable of submission to a *diplomatic Conference* for adoption.

By reason of its expertise in the international unification of law, UNIDROIT is, moreover, at times commissioned by other Organisations to prepare comparative law studies and/or draft conventions designed to serve as the basis for the preparation and/or finalisation of international instruments by those Organisations.

UNIDROIT's ability to obtain up-to-date information on the state of the law in all the various countries is essential to the pursuit of its statutory objectives. This information is sometimes difficult to obtain and UNIDROIT therefore maintains a network of *correspondents* in both member and non-member States, who are appointed by the Governing Council amongst academic and practising lawyers.

UNIDROIT has, in the course of time, prepared over 70 studies and drafts. Many of these have resulted in international instruments, including the Institute's latest achievement, the *Convention on International Interests in Mobile Equipment* and the related *Protocol on Matters specific to Aircraft Equipment*, which were opened to signature on 16 November 2001 at a diplomatic Conference held in Cape Town under the joint auspices of UNIDROIT and the International Civil Aviation Organisation (ICAO).