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Intermediated Securities, Legal Risk, and the International Harmonisation of Commercial Law

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ABSTRACT: Investors do not physically hold their investment securities any more. Securities are held and transferred through a complex, sophisticated, and international network of financial intermediaries, including central securities depositories, investment banks, and brokers-dealers. Investors buy and sell their holdings by having book-entries made to their securities accounts; they provide collateral to secured lenders by book-entries or by control agreements. Because transfers and collateral transactions are critical to the liquidity of the financial markets and to financial stability, market participants and regulators have become increasingly concerned with the legal soundness, the internal consistency, and the international compatibility of national laws regulating the holding and transfer of securities held with an intermediary. This article examines how the international harmonisation of key rules of commercial law can contribute to the reduction of legal risk and discusses a draft convention prepared by the International Institute for the Unification of Private Law (UNIDROIT). Rather than addressing the numerous features of that draft, the author focuses on its methodology—the “functional approach”—and finds that it is possible to create effective international treaty provisions, which contracting States may implement without disrupting their property law with respect to the structure and characterisation of investors’ interests in securities. This article tests the robustness of the functional approach by examining two critical issues: the definition of intermediated securities as the building block of international substantive rules and the choice among four internationally recognised methods for the transfer of intermediated securities and for their use as collateral.

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I. Introduction

Investment securities are intangible rights against issuers. Transferring intangible rights often requires cumbersome formalities and exposes investors to significant uncertainties regarding the validity of their acquisition and the content of the rights so acquired. One of the critical innovations of modern capital markets was the incorporation of investors’ intangible rights into certificates, which could be transferred in accordance with the rules governing negotiable instruments. Transforming intangible rights into tangible property allowed investors to prove their ownership through the possession of certificates and to dispose of their investment by delivering them to purchasers or to secured lenders. By treating certificated securities as negotiable instruments, the law protected innocent subsequent investors against unknown defences of the issuer (holder in due course doctrine).
and against adverse claims (*bona fide* purchaser doctrine),\(^1\) even though residual risks—such as the risk of dealing with forged certificates—still required some degree of *caveat emptor*. The circulation of certificated securities materialised the capital flowing between investors and issuers through increasingly sophisticated intermediaries and markets.

In the mid-20\(^{th}\) century however, these flows of physical certificates outgrew the plumbing through which ever increasing stocks of financial assets were issued, re-sold, and pledged. The sheer volume, number of issues, and turnover speed made the delivery of certificated securities impractical and too costly as well as they increased the operational risk associated with the physical handling of certificates to levels not acceptable anymore. The pipes were clogged, the highways were jammed, or, as it was later described, the markets faced a “paper crunch.”\(^2\) Two innovative approaches were used, alternately or cumulatively, to unclog the pipes: *immobilisation* and *dematerialisation* of securities. Certificated securities do not need to move if they are immobilised in the custody of reliable depositories and represented by entries in securities accounts maintained by financial intermediaries for investors. When needed, immobilised securities can be transferred by way of book-entries in investors’ accounts, which substitute for their physical delivery. Where corporate law and investor preferences allow, physical individual securities can become wholly unnecessary. A whole issue can be replaced by one global certificate, or it can even be recorded in an “issue account” without the need for any certificate, against which the dematerialised securities can be credited to the securities accounts of market participants and, here again, be transferred by way of book-entries. Immobilisation and dematerialisation of securities have made the physical delivery of certificates nearly irrelevant. In just a few decades, the issuance of securities has shifted from the physical to a virtual world, to which financial intermediaries hold the key.

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\(^1\) For a criticism of the role of the holder in due course doctrine in the development of the law of negotiable instruments, see James Steven Rogers, *Negotiability as a System of Title Recognition*, 48 OHIO ST. L.J. 197 (1987) and James Steven Rogers, *The Myth of Negotiability*, 31 B.C. L. REV. 265 (1990). The Prefatory Note to the 1994 revision of U.C.C. Article 8 notes (at Section II.B *in initio*) however, that the purpose of parts 2 and 3 of that Article is “to apply to investment securities the principles of negotiable instruments law” protecting subsequent purchasers from defences asserted by the issuer and from adverse claims.

This revolution was prompted by the exponential growth of the financial markets and was made possible by dramatic improvements in information technologies. In most countries, statutory and case law took significant time to adapt and modify and when they did, they followed different approaches. In many jurisdictions of the civil law tradition, book-entries were deemed to represent, rather than to replace, the actual delivery of the physical securities. In the United Kingdom, lawyers and the courts resorted to the time-proven institution of trusts. The first legal responses to the new market reality of securities clearing, settlement, and custody were often quick fixes and ready-made solutions, with legislatures shying away from designing new legal concepts. The law of negotiable instruments and certificated securities was never easy to understand or teach and remains to this day significantly shaped by national traditions. The immobilisation and dematerialisation of securities have added another layer of complexity and heterogeneity of domestic legal doctrines and rules. In this time of rapid globalisation, where the national boundaries of capital markets are losing significance and where international investments have created enormous cross-border securities holdings, the disparity among national laws and the untested resilience of many such laws have lead to the emergence of new risks.

Over the past few years, stakeholders in the financial markets have become ever more concerned about the operational and systemic risks involved in the clearing and settlement of securities transactions. Numerous reports issued by industry groups, political authorities, regulators, and international organisations have highlighted the large spectrum of issues involved. Significant among them is the legal risk associated with the domestic and cross-

border transfer of investment securities, which are either immobilised with a custodian (often a central securities depository) or fully dematerialised. While nowadays securities almost universally circulate by way of book-entries in securities accounts, the legal effects of such entries still vary significantly across jurisdictions.

At the same time lenders have been looking for ways to reduce the legal risk involved in obtaining, perfecting, and enforcing their security interest in investment securities. The problem is particularly acute in situations where lenders take as collateral an interest in an internationally diversified portfolio of securities. Even though all the securities comprising a given portfolio can be recorded in a single securities account maintained by one intermediary (broker, bank, or other securities custodian) in one jurisdiction, the underlying ultimate assets—the immobilised certificates or the dematerialised record of the relevant issues—are most likely located with custodians in the various markets involved or, possibly, with an international central securities depository such as Euroclear Bank in Belgium\(^4\) or Clearstream Bank Luxembourg.\(^5,6\)

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\(^5\) Created in 1971 by Morgan Guaranty Trust Co. for the custody and settlement of Eurobonds and later sold out to market participants, Euroclear Bank operates an international securities settlement system (ICSD) for international bonds, equities, and investment funds. It is incorporated and licensed in Belgium and its ICSD operations are governed by Belgium’s Arrêté royal n° 62 coordonné relatif au dépôt d’instruments financiers et à la liquidation d’opérations sur ces instruments, as amended and published in the Moniteur Belge / Belgische Staatsblad of 23 Feb. 2004 at 10353. The Euroclear group also includes the central securities depositories (CSD) for Belgium, France, Ireland, the Netherlands, and the United Kingdom.

\(^6\) Clearstream Bank Luxembourg is an international central securities depository and settlement system for internationally traded bonds, equities and investment funds, as well as the central securities depository for German securities. Its ICSD operations are governed by Luxembourg’s Loi du 1er août 2001 concernant la circulation des titres et d’autres instruments fongibles, available at http://www.legilux.public.lu/leg/a/archives/2001/1063108/1063108.pdf#page=6 (last visited August 15, 2007). Now wholly owned by the Deutsche Börse Gruppe, it resulted from the merger in 2002 of Cedel International, an ICSD incorporated in Luxembourg in 1971, and the Deutsche Börse Clearing. Clearstream Bank Frankfurt is the German CSD.

\(^6\) For a clear and short description and comparison of the functions of national and international central securities depositories, see WIM HAUTEKIET & LAURENT VAN BURIK, Clearing and Settlement - Practical Aspects, in LES OPÉRATIONS BOURSIÈRES EN EUROPE: VERS UN DROIT COMMUN? 95, 105-108 (Association européenne pour le droit bancaire et financier, 2002).
A fragmented world of interconnected markets but diverse legal rules entails a significant degree of operational and systemic risks for the participants—investors, secured lenders, securities lenders and borrowers, and their intermediaries at all levels in the securities market. The need to manage and reduce these risks has prompted the utilisation of a number of different approaches, including the improvement of technology, market practices, and governance of the major systems.

This article focuses on the reduction of legal risk through the international harmonisation of key rules of the commercial law governing intermediated securities. It begins with a short description of important aspects of the legal risk associated with the ownership of securities held in the intermediated system and with their use as collateral (Section II). It follows with a discussion of the irreconcilable approaches of different legal systems as to the understanding and analysis of property interests in securities held with an intermediary (Section III). The paper then examines the “functional approach”, i.e. the methodology adopted by the International Institute for the Unification of Private Law (UNIDROIT) to develop an international convention that addresses the minimisation of legal risk through a partial harmonisation of the substantive rules governing intermediated securities (Section IV). Next, we will test the robustness of the functional approach by examining two key components of the UNIDROIT’s Preliminary Draft Convention on Substantive Rules Regarding Intermediated Securities: the definition of intermediated securities as its

7 The International Institute for the Unification of Private Law was founded in 1926 as an intergovernmental organisation and an auxiliary organ of the League of Nations. After the latter’s demise, it was re-established in 1940 on the basis of a multi-lateral agreement and has its seat in Rome. It currently comprises 61 member States from all continents and legal traditions. Its most recent outstanding achievements are the adoption of the Cape Convention on International Interests in Mobile Equipment, Nov. 16, 2001, S. Treaty Doc. No. 108-10 (2003) and two protocols in respect of aircraft equipment (2001) and railway rolling stock (2007), in partnership with the International Civil Aviation Organization and the Intergovernmental Organisation for International Carriage by Rail. UNIDROIT is also internationally recognised for its UNIDROIT Principles of International Commercial Contracts as well as its more recent ALI/ UNIDROIT Principles of Transnational Civil Procedure. Former projects address the sale of goods, agency, travel contracts, financial leasing, and factoring, and a significant 1995 Convention on Stolen or Illegally Exported Cultural Objects currently binding 28 States. UNIDROIT publishes the quarterly Uniform Law Review. See also www.unidroit.org.

8 Except otherwise stated, all references to that convention refer to the Preliminary Draft Convention on Substantive Rules Regarding Intermediated Securities as adopted by the Committee of Governmental Experts at its fourth session held in Rome in May 2007, UNIDROIT STUDY LXVIII Doc. 94 (Jul. 2007) (hereinafter UNIDROIT Draft Securities Convention), available at
subject-matter and building block (Section V) and the choice of four preferred methods for
the acquisition and disposition of intermediated securities or any interest (collateral or not)
therein (Section VI). Section VII concludes with some broader thoughts on the international
harmonisation of commercial law, its benefits and its limits.

II. Aspects of Legal Risk

Financial assets are intangible goods. Though investment securities were made into tangible
certificates for negotiability purpose, their recent immobilisation or dematerialisation has
essentially turned them back into intangible goods. Intangibles are the creation of law; their
existence, effects, and value are thus vulnerable to the risk that such a law is uncertain or
inadequate. “For a bank, therefore, legal risk, when it threatens the legal validity of an
‘intangible’ asset owned by it or exposes the bank to large claims, is somewhat akin to, say,
engineering risk for an aircraft manufacturer, maintenance risk for a railway operator, or
fire and earthquake risk for an owner of valuable real estate.”9 Over the past decade or so,
legal risk has unsurprisingly become a major concern for financial institutions and financial
market participants, as well as for regulators and supervisors.

Considered as a component of the operational risk,10 legal risk is often defined as the risk of
loss resulting either from a defective transaction or from the unexpected application of a

http://www.unidroit.org/english/workprogramme/study078/item1/main.htm (last visited June 20, 2006). For a
short history of the draft, see Section IV below.

Most documents generated in the course of this project are published on that website. For the
convenience of the reader and the legibility of the footnotes, I will cite to them by title (or abbreviated title
when preferable), document number, and date in the format: UNIDROIT STUDY LXXVIII Doc. --- . All
documents cited are also on file with the author. Except otherwise mentioned, all citations refer to the English
version of such documents.


10 The Basel Committee on Banking Supervision defines operational risk as “the risk of loss resulting from
inadequate or failed internal processes, people and systems or from external events.” See INTERNATIONAL
CONVERGENCE OF CAPITAL MEASUREMENTS AND CAPITAL STANDARDS: A FRAMEWORK, para. 644 and
footnote 90 (Basel Comm. on Banking Supervision ed. 2004), available at
http://www.bis.org/publ/bcbs107.pdf (last visited August 15, 2007). Basel II requires that capital
requirements reflect not only the credit risk and the market risks of a bank’s assets, but also its operational
risk.
law or a regulation. In a paper discussed at an October 2003 symposium, a working party of the International Bar Association offered a more refined definition:

“Legal risk is the risk of loss to an institution which is primarily caused by:

(a) a defective transaction; or
(b) a claim (including a defence to a claim or a counterclaim) being made or some other event occurring which results in a liability for the institution or other loss (for example, as a result of the termination of a contract); or
(c) failing to take appropriate measures to protect assets (for example, intellectual property) owned by the institution; or
(d) change in law.”

“The reference to a defective transaction in (a) above includes:

(i) entering into a transaction which does not allocate rights and obligations and associated risks in the manner intended;
(ii) entering into a transaction which is or may be determined to be void or unenforceable in whole or with respect to a material part (for whatever reason);
[…]
(vii) security arrangements that are, or may be, defective (for whatever reason).”

Legal risk may not be a result only from poor planning or drafting by the designers of securities clearing and settlement systems or by the parties to a securities transaction. It may also stem from inadequate legal rules:

“Legal risk might also refer to situations where the answer provided by the applicable law does not fit the market reality, or where the law unnecessarily complicates or burdens a transaction. Often, legal requirements that are rooted in traditional legal concepts and created to promote legal certainty lose their original purpose when applied to modern securities holding and transfer structures. The consequence of imposing requirements that complicate a transaction can be time-consuming and costly. Furthermore, a complicated procedure makes each process of perfection of a transaction specifically vulnerable to mistakes. On the other hand, in other cases, the law provides for legal concepts that make the use of

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11 Compare the definitions offered by the Basel Committee on Banking Supervision and the two definitions compiled by the Committee on Payment and Settlement Systems, a glossary of terms used in payment and settlement systems, January 2001, revised July 2001, available at http://www.bis.org/publ/cpss00b.pdf, at p. 23 (last visited August 15, 2007).

12 MCCORMICK, supra note 9, at 113. The IBA Working Party on Legal Risk has not yet produced a final paper. See also Hugh S. Pigott, Legal Risk, BUTTERWORTHS J. INT'L BANKING & FIN. L. 3 (2003).
specific kinds of transaction that are used in or requested by the practice impossible and thereby creates a barrier.”

On-exchange buyers and sellers of securities are generally not very concerned with the legal risks involved in their dealings, except maybe for the risk of regulatory and criminal sanctions in case of insider trading and other such market abuses. Lenders taking securities as collateral are typically significantly more exposed to and aware of these risks. In general, they will ask a lawyer to review the documentation and to advise on the appropriate steps necessary to perfect their interest. Institutional and other sophisticated investors have become more perceptive of the legal risk involved with their holding of securities across many markets and jurisdictions. Institutions offering global custody services are careful in reviewing the operational and legal arrangements of every sub-custodian they employ.

A. Uncertainty in Determining the Applicable Law

In the 1990s, market participants and their legal advisers identified conflicts of laws regarding the acquisition, perfection, priority, and enforcement of interests in securities held with an intermediary as the first problem in need of a global solution. Market participants in the United States may not appreciate the importance of the matter when considering U.S.-issued securities. The adoption of Article 8 of the U.C.C. by all 50 States has created little need for reliance, in purely domestic situations, on a conflict of law rule. However securities portfolios are increasingly diversified internationally. Conflict of law issues do not arise only in obviously international transactions, such as when a U.S. investor holding Japanese securities with a London bank grants a security interest to a London-based lender. Such issues also arise in transactions which may not be recognised immediately as having a connection to any foreign legal system, such as when a London

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15 U.C.C. § 8-110(b) (1994) determines that the legal matters discussed in this paper are governed by the “local law of the securities intermediary’s jurisdiction,” as opposed to the ones governed by the issuer’s jurisdiction in paragraph (a). Paragraph (e) mostly defers to the agreement between the intermediary and the account holder for the purpose of determining the law referred to in paragraph (b).
Based investor acquires from her London bank some eurobonds for which she is unaware that the global certificate representing the whole issue is deposited with EuroClear in Belgium.

With strong support from the industry, the Hague Conference on Private International Law prepared an international instrument to deal with that set of issues in a record two-year time period. The text of the Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary was adopted by diplomatic conference in December 2002. It provides for a uniform set of rules deciding conflicts of laws for all questions within the substantive scope of the Convention. While the project was originally conceived as promoting an objective test based on the “place of the relevant intermediary approach” (PRIMA), it developed into an approach largely based on a choice of law by the parties to the account agreement. In substance, the primary rule states that the law applicable to the acquisition of securities held with an intermediary or any interest in such securities shall be the law designated for that purpose by the parties to the account agreement or, when no such choice has been stipulated, the law chosen by the parties to govern the account agreement, provided in both cases that the intermediary maintaining that account (the so-called “relevant intermediary”) has some factual connection with the

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16 Starting in November 2000 with the publication of Christoph Bernasconi's Report on the Law Applicable to Dispositions of Securities Held through Indirect Holding Systems, supra note 14.


18 The substantive scope of the Convention is determined in its Article 2.


State whose law is designated.\textsuperscript{21} Default rules based on complex objective criteria are provided when the parties have not made a (valid) choice of law.

On July 5, 2006, the United States and Switzerland signed the Convention.\textsuperscript{22} The European Union and its Member States, which must take unanimous vote, are still debating\textsuperscript{23} whether to adopt a treaty which would require them to modify the PRIMA-rule as it now stands in

\begin{footnotesize}
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\item The actual rule is quite technical in its formulation. Article 4 (1) reads: “The law applicable to all the issues specified in Article 2(1) is the law in force in the State expressly agreed in the account agreement as the State whose law governs the account agreement or, if the account agreement expressly provides that another law is applicable to all such issues, that other law. The law designated in accordance with this provision applies only if the relevant intermediary has, at the time of the agreement, an office in that State, which – a) alone or together with other offices of the relevant intermediary or with other persons acting for the relevant intermediary in that or another State – i) effects or monitors entries to securities accounts; ii) administers payments or corporate actions relating to securities held with the intermediary; or iii) is otherwise engaged in a business or other regular activity of maintaining securities accounts; or b) is identified by an account number, bank code, or other specific means of identification as maintaining securities accounts in that State.” The qualifying office requirement is set out in Article 4 (2). Failing a valid choice of law, Article 5 provides for fall-back rules.

\item According to Hague Conference practice, its conventions are opened for signature after the diplomatic conference so that the first signature(s) assigns the formal date to a convention. This one will henceforth be known as the \textit{Convention of 5 July 2006 on the Law Applicable to Certain Rights in respect of Securities Held with an Intermediary.}

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European directives\textsuperscript{24} and is implemented by Member States, though not always in a wholly consistent manner.\textsuperscript{25}

B. \textit{Uncertain and Untested Legal Soundness of the Applicable Law}

The legal risks associated with the acquisition, the holding, and the collateral use of securities held with an intermediary do not subside once the applicable law has been designated. Indeed, the applicable law may not be entirely comprehensive, certain and sound. In emerging markets, it may be embryonic or wholly untested. In mature markets, the law may not have been fully adapted to the new operational and technological environment. For more than a century, selling or pledging bonds and shares had required the delivery of certificates and sometimes their endorsement. The “paper crunch” of the 1960s prompted a radical change of the capital markets infrastructure, driven by the needs of the industry and by efficiency reasons, not by legal considerations. In the wake of these changes, most jurisdictions strove to amend their statutes and regulations and often continued using traditional legal concepts rooted in the tangible world of movable property.\textsuperscript{26}

The briefest overview may give the reader an idea of the various degrees of legal elaboration enjoyed by intermediated securities across a handful of jurisdictions. In the United States, the 1977 revision of Article 8 of the Uniform Commercial Code did not include provisions which would take into account the development of the indirect holding

\textsuperscript{24} See supra note 19.


The 1994 revision of Article 8 stands out as a ground-breaking statute based on an entirely new property concept of “securities entitlement”. It has been ratified by all U.S. States; it governs the operation of TRADES, the clearing and settlement system for the debt issued by the U.S. Treasury; and it has strongly inspired the recent Canadian Uniform Securities Trading Act. In France, a mandatory move to full dematerialisation of investment securities was ordered by one sub-paragraph of the Finance Act for 1982 and a short regulation, later supplemented by detailed regulatory provisions enacted by the securities regulator, but without any comprehensive re-thinking of the rights of account...


28 An account holder who holds a security entitlement does not own the securities credited to her account, but has rights with respect to such securities (or other financial assets) as specified in U.C.C. § 8-501 through 511 (1994), including a property interest in financial assets held by her intermediary, § 8-503. For a very clear and understandable explanation of the notion of securities entitlement, see CARL S. BJERRE & SANDRA M. ROCKS, THE ABC OF THE UCC: ARTICLE 8, INVESTMENT SECURITIES (2nd ed., 2004). See also Section III.C below.

29 Plus the District of Columbia and U.S. Virgin Islands; see the website of the Uniform Law Commissioners (http://www.nccusl.org).


holders and investors. The possibility of issuing uncertificated securities was introduced in the United Kingdom by a 1995 regulation. This allowed for the launch of CREST, a new and efficient securities settlement system, but has not obviated the need for a more fundamental reform of the law governing property interests in investment securities, which currently relies on the legal concept of trust. Japan reformed its relevant legislation in two steps, allowing the issuance of uncertificated debt in 2001 and later providing for the mandatory issuance of uncertificated corporate shares. In Switzerland, the financial industry promptly moved to an almost complete immobilisation and extensive dematerialisation of investment securities based entirely on contractual arrangements between account holders, custodians, and the central securities depository; however, it took 30 years for market participants to request a statutory framework, prompting the Swiss government to prepare a Draft Federal Intermediated Securities Act, which is now pending before the Parliament.

While national legal reform—where it was completed—has generally reduced the legal risks associated with the custody and disposition of immobilised or dematerialised

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35 Now part of the Euroclear group.


securities, those risks remain considerably more significant than in other areas of the law. According to the Institute for the Unification of Private Law (UNIDROIT):

“The structural and technological innovations that have made the modern securities holding system possible have not been universally matched by corresponding levels of legislative modernisation. This is not to say that the legal framework has not been carefully revised to date; but the legislation often used traditional concepts adapted from other contexts. This causes a conceptual problem which rests upon the attempt to comprehend the modern system of holding through intermediaries under the terms of custody or deposit of physical objects.”

Global custodians, investment banks, and institutional investors have become aware of the risks embedded in these often non-transparent legal rules, which usually have not been extensively tested in courts. The have been reviewing the validity and enforceability of custody and collateral arrangements under the relevant domestic laws by using extensive questionnaires and legal opinions. Not all risks however can be minimized by private contracts. Mandatory legal provisions, including insolvency laws, need fixing and significant progress has been made in many jurisdictions after such risks were identified. The European Settlement Finality Directive and Collateral Directive are two noteworthy examples. However, like many legal reforms in other jurisdictions, they address discrete number of problems and fall short of creating a wholly consistent and sound set of legal provisions governing the acquisition, disposition, enforcement, and priority of rights in intermediated securities.

C. Legal Incompatibilities in Cross-Border Situations

Producing and maintaining sound legal rules governing the intermediated holding of securities in the many jurisdictions participating in the global capital market today is a tall order indeed, and it is far from being demonstrably achieved. Nonetheless even that would

39 Explanatory Notes, supra note 13, at 8.
40 See e.g., for example the parallel litigations in English and French courts resulting from the embezzlement by the late Robert Maxwell of securities held by various pension funds of the Maxwell group. With partial success, the pension funds claimed back the securities from various banks who had taken the securities as collateral for significant loans extended to Maxwell Macmillan, Inc. v. Bishopsgate Investment Trust (No. 3), [1996] 1 All E.R. 585 (C.A.) (determining that New York law applies) and MacMillan, Inc. v. Bishopsgate Investment Trust, [1998] EWCA (Civ.) 1680 (on the merits). The French case (Tribunal de commerce de Paris [court of commerce of Paris], 1e ch. A, June 12, 1995) remains unreported (on file with the author).
fall short of adequately reducing the legal risk.\textsuperscript{41} Securities holding patterns that involve more than one jurisdiction—I shall call them “cross-border holdings”—create an additional legal risk even when the law applicable for every tier (\textit{i.e.}, every intermediary in the holding chain) is clearly determined and internally sound and consistent. Holding securities across borders creates an additional risk of incompatibility, an example of which is illustrated below.

Let us assume that an investor holds, through her bank (or securities-brokers or any other financial intermediary licensed to provide that service) located in Pomerania, certificated shares issued by a Ruritanian company. Congruent with market practices, the Pomeranian bank does not physically hold the certificates, which are actually deposited with Ruritania’s central securities depository (CSD). Whether the Pomeranian bank directly holds a securities account with the Ruritanian CSD or uses the services of a Ruritanian sub-custodian, the law governing the bank’s holding with its sub-custodian (or the CSD) is unlikely to be the same as the law governing the investor’s holding with her bank. That is because, under modern rules of conflict of laws, such as provided for by the \textit{Hague Securities Convention} discussed above, Article 9 of the \textit{E.U. Collateral Directive} or U.C.C. § 8-510, the law governing the investor’s acquisition and disposition of securities through her account with her Pomeranian bank will probably be the relevant laws of Pomerania. Such is the case even if that law is determined by a choice of law made in the account agreement in accordance with either the \textit{Hague Securities Convention} or U.C.C. § 8-510.

As a matter of fact, only investors with very considerable bargaining power are able to secure their bank’s consent to apply some national law other than the one that governs virtually all other securities accounts its maintains.\textsuperscript{42} And it is unclear why those happy few investors would want to make such a choice: if they are unhappy with the law of one jurisdiction, they would more probably open their account with a bank (possibly the same

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\textsuperscript{42} The main virtue of the choice-of-law based conflict rule adopted by the U.C.C. and by the \textit{Hague Securities Convention} is not that the parties to a securities account agreement are likely to make choices according to their own preferences, but rather that the law designated in the account agreement – virtually always in the shape of a standard term – avoids ambiguities in settings where the customer relationship is handled in one country while the back office of the bank may be run in another jurisdiction and, possibly, the account statements be sent from a third country with cheaper cost of labour and postal services.
\end{quotation}
bank! in another jurisdiction more of their liking. Thus, we can safely assume that in most cases the rights that our hypothetical investor obtains through the credit of securities to her account with her Pomeranian bank are governed by the laws of Pomerania. For the same reason we may assume that the rights acquired by that bank through the credit of securities to its own account with its Ruritanian sub-custodian or directly with the Ruritanian CSD are governed by the laws of Ruritania.

The above hypothetical is a very simple and typical cross-border pattern where two different domestic laws will govern the holding and disposition of certain securities at two different tiers. Adding tiers (sub-custodians)—a very common feature in practice—only compounds the problem. Assuming that the two national laws applicable at the two tiers of this simple pattern are perfectly sound and certainly does not rule out the risk that their effects may be incompatible which could then produce an additional type of legal risk. Three examples will illustrate this point.

(i) Statutory provisions governing the acquisition and disposition of securities by way of book-entries in securities accounts typically go at great length to define which securities are eligible and they typically do so taking into account market practices and technologies available in their own jurisdiction. It is unlikely that the definition of securities is wholly consistent across borders. Mismatches typically create situations where certain types of securities issued in accordance with Ruritanian law are not recognised as securities capable of being credited to a securities account under Pomeranian law. For example, certain classes of derivatives may be deemed securities in Ruritania but not in Pomerania. Although the Pomeranian bank will have such derivatives credited to its securities account in Ruritania, crediting them to the securities account it maintains for its investor will not have the same effects as the credit of domestic securities any may have no legal effect at all.

(ii) A similar, and possibly more striking, mismatch between legal regimes arises when Ruritania has implemented a wholly dematerialised system while the laws of Pomerania still require the deposit of a physical certificate. Pomeranian banks will not be able to effectively credit uncertificated Ruritanian securities to their securities accounts without either a legal fix or a practical trick. The legal fix might include the statutory recognition of the holding of “foreign” uncertificated securities when no equivalent certificated securities are available. The practical trick—which was devised by Japanese and other banks for the purpose of investing in French securities before Japanese law was amended—requires the Ruritanian CSD, or possibly the Ruritanian sub-custodian, to issue a certificate evidencing
the otherwise uncertificated securities held by the Pomeranian bank for the account of its own account holders.

(iii) A third example of such mismatches has been faced in many jurisdictions by Depository Trust Corporation (“DTC”), 43 which not only holds most U.S.-issued securities but also offers global custodian services to U.S. banks and securities brokers through a broad international network of sub-custodians. U.C.C. Article 8 governs the accounts DTC maintains for its participants, which are mostly banks and brokers-dealers. To put it in somewhat simplified terms, DTC—through its nominee, Cede & Co.—acquires legal ownership of any securities it holds for the account of its clients and, by crediting them to its participants’ accounts, creates a “securities entitlement” as defined in U.C.C. § 8-102(17). U.S.-issued shares under DTC’s custody are registered to DTC’s nominee, Cede & Co. Obviously, DTC hold shares not for its own account, but for the account of its participants, which, in turn, may beneficially hold them for their own account or for the account of some account holders. However the issuer’s registry does not reflect the names of the actual investors, who exercise their rights through proxies. Such nominee arrangements were unknown in many jurisdictions whose corporate law governs shares issued by domestic companies for which DTC wishes to offer global custody services to its participants. The applicable corporate law, or possibly the by-laws of the issuers, may require that shareholders must be identified by the issuer, often through entries in the corporate registry, before they are allowed to vote. If the applicable corporate law or by-laws do not recognise the particular position of nominee, investors holding such shares through DTC are prevented from exercising their voting rights. A number of such jurisdictions have recognised the problem and opened up the holding of shares and other securities by nominees. Issuers may still be allowed to require the identification of individual investors as a pre-condition for voting. This creates highly complex arrangements, which DTC needs to maintain with its sub-custodians over the world.

Can the domestic rules governing the intermediated holding and settlement of securities in different jurisdictions be made compatible without a full—but completely illusory—

43 Established in 1973, DTC is a limited-purpose trust company organized under the New York Banking Law, a member of the Federal Reserve System, a “clearing corporation” within the meaning of the New York Uniform Commercial Code, and a “clearing agency” registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934. DTC holds and provides asset servicing for over two million issues of U.S. and non-U.S. equity issues, corporate and municipal debt issues, and money market instruments from over 85 countries.
unification of the core principles? To grasp the full scope of the problem, one needs an overview of how different the legal position and the rights of an account holder are characterised across jurisdictions.

### III. Legal Characterisation of Account Holder Rights: A Tale of Two Cities... and Sprawling Suburbs

Imperfect matches and more fundamental incompatibilities between different national laws applicable to different tiers of the same holding chain in respect of the same securities may not only result from different substantive rules. They may also result from different legal characterisations of an investor’s interest in securities held with an intermediary. Indeed the preparatory work which lead to the proposition of a uniform rule of conflict by the Hague Conference highlighted the existence of two radically different concepts of account holders’ and investors’ property rights (or lack thereof) in securities held with an intermediary.⁴⁴

In Dickens’ *Tale of Two Cities*, set during the years preceding and the first few years of the French Revolution, Paris and London epitomize two radically opposite responses to times of economic trouble, social unrest, and aspiration for change. The changes within the capital market, which led to the wholesale immobilisation and partial dematerialisation of investment securities, was not as dramatic as Dickens’ portrayal of the dichotomy between the French and English response to rapid economic change. However, the legal concepts used or developed in various jurisdictions to accommodate this move from the physical world of paper securities to the intangible world of book-entries show a Dickensian contrast between two different responses. On closer look, the image becomes even more complex, with each concept being an abstraction of the core property law and corporate law features of a number of legal systems which differ from each other in many other respects. Like the Dickensian Paris and London during the times of the French Revolution, each city is a conglomerate of very different neighbourhoods—and now suburbs—but nonetheless typifies two different legal approaches to the rights that an investor derives from holding securities through a chain of intermediaries.

Dividing the world between two groups over-simplifies the global legal landscape which harmonisation strives to encompass. Other distinctions are very important indeed, such as

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the distinction between systems where domestic investors are identified in the books of the relevant central securities depository (so-called transparent systems) and other systems where investors are only identified by their relevant intermediaries that are at the very bottom of the holding chain. However, the *summa divisio* discussed in this section is the key to understanding the narrow approach adopted by UNIDROIT in harmonising the substantive rules governing securities held with an intermediary.

A. Terminology

Before mapping the legal landscape we need to clarify the terminology. The word *securities* is used here to describe any financial asset a given legal system or a given securities clearing or settlement system accepts as such. For the purpose of this paper we do not need to decide where to draw the line between (certificated or uncertificated) securities and other financial assets. In the intermediated world an investor—typically, the person or institution who in the physical securities world would be deemed the legal owner of the certificate and, where applicable, whose name would appear in the share registry—acquires securities when these securities are credited to her (securities) account with her intermediary (including a bank or a broker-dealer). This book-entry is the closest thing the investor will ever get to “having” or “possessing” the securities short of obtaining the physical delivery of individual certificates. Indeed there be may no certificates at all or one global certificate representing the whole issue, in which case no single investor can request the delivery of that certificate for herself. In most cases, the certificates are not physically held by, or the dematerialised issue is not registered with, the investor’s own intermediary. In whichever certificated or uncertificated form they exist, the securities are almost always held by another intermediary sitting at the very top tier of the chain, quite often a national or international central securities depository.

45 While transparent systems all belong to the direct-ownership family described below, non-transparent systems may be founds in both families. For a discussion of transparent systems and the issues specific to them, see the *Report from the Transparent Systems Working Group*, UNIDROIT STUDY LXVIII Doc. 88 (May 2007).

46 See Kanda, *supra* note 37, at 230-1.

47 See Section IV below.

48 I am not taking a view here as to whether this book-entry is a necessary and/or sufficient element of the acquisition or whether it is purely evidentiary. Different legal systems take different views on that.
Except in purely domestic patterns where the investor holds securities through her account with a bank or a broker-dealer, which in turn has an account with the central securities depository, holding chains follow complicated patterns of cross-border and sub-custody arrangements and extend over more than the top-tier and the lowest-tier intermediaries. The typical investor does not know, and does not care, who and where the top-tier intermediary is nor which other intermediaries are being used. From operational and analytical perspectives, there is one intermediary at every tier of the holding chain maintaining a securities account in the name either of another intermediary (further down in the chain) or (for the last intermediary in the chain) of the investor. At every level in the chain, the relevant intermediary only knows the identity of the account holder. Where that account holder is a financial institution, the relevant intermediary may not be able determine whether its account holder holds some or all securities for its own account or as an intermediary for other account holders. Even if it does, it cannot practically determine who the investors are. Even though the whole intermediated system should operate for the benefit of the investors (the ultimate account holders down the pyramid) and of parties who hold an interest in securities (such as collateral lenders), most legal rules are designed to apply between any account holder and its relevant intermediary anywhere in the pyramid. Most rules and operations would be impractical if they would depend on the intermediary’s determining whether the account holder is or is not the “ultimate accountholder”, i.e. the investor in the securities.

49 Financial institutions, institutional, and other qualified investors do care and often enquire as to the qualities of the intermediaries used in respect of their holdings in various markets.

50 Typically along with one or more currency accounts.

51 Some intermediaries chose or are required to have not one, but two accounts with upper-tier intermediaries to keep their clients’ securities segregated from their own securities. In that case, the upper-tier intermediary can distinguish between “house securities” and “client securities” held by their account holder, but it cannot identify who the clients are. Except in transparent systems in purely domestic situations (see footnote 50 and relevant text), it is both a practical contingency and a paradigmatic principle that investors are not identified by any intermediary other than their own. This is the rationale for the prohibition of upper-tier attachment, i.e. the prohibition to attach, freeze, arrest, or block the securities of an investor at any other tier in the holding chain than the investor’s relevant intermediary. See Position Paper, UNIDROIT STUDY LXXVIII Doc. 8 (Aug. 2003), available at http://www.unidroit.org/english/workprogramme/study078/item1/main.htm, at 18–19 (last visited August 15, 2007).
B. “Direct Ownership”

We shall use “direct ownership” to denote the characterisation of an investor’s property rights in securities held with an intermediary which is characteristic of a number of civil law jurisdictions such as Belgium (host to EUROCLEAR), Brazil, China, France, Germany (host to CLEARSTREAM), Italy, Japan, Europe’s Nordic States, Spain, and Switzerland, but applies also to certain individual investors holding securities with United Kingdom’s securities settlement system CREST\(^\text{52}\). It relies on the notion that the deposit of securities with a financial intermediary disrupts neither the investor’s direct legal title to the securities or her rights and claims against the issuer. Like in the physical world of paper securities, intermediaries do not acquire ownership of their clients’ securities; they are mere possessors. Adding tiers of intermediaries between the investor and the pool of securities does not change that legal characterisation of her position. Intermediaries (often called depositories) are mere instrumentalities in the investor’s ownership of and control over his securities or his share in the pool. They are sometimes considered mere book-keepers or agents for investors.

“Direct ownership” jurisdictions recognise that when a custodian pools together securities of the same issue, it modifies the form of ownership, but does not change the identity of their owners, who are and remain the investors themselves. Pooled securities become fungible, transforming individual ownership of discrete securities into some form of pro rata ownership in the pool of securities. Sellers and securities lenders transfer all or part of their share in the pool to buyers and borrowers. Secured lenders obtain a security interest in an investor’s share in the pool of securities. This direct ownership in securities or in a pool of fungible securities is viewed as the key and the justification for the protection of investors and collateral takers against an intermediary’s insolvency: securities held on behalf of customers cannot be reached by the general creditors of an intermediary that is not their owner.

\(^{52}\) The CREST system, operated by Euroclear UK & Ireland Ltd. (the new legal and operating name of CRESTCo. Ltd since it became part of the EUROCLEAR GROUP) offers individual investors the possibility to opt out of the indirect holding system generally applicable in English law so as to hold uncertificated securities in their own name and be personally registered in the corporate register. See Comments of the United Kingdom representative on the draft Working Paper on Transparent Systems, UNIDROIT STUDY LXXVIII Doc. 64 (March 2007); GOODE ET AL., supra note 20, at 41-2; see also http://www.euroclear.co.uk/home/home.html#products/join_intro.html (last visited August 15, 2007). For a broader presentation of CREST, see BENJAMIN, supra note 26, at 203-21.
In “direct ownership” jurisdictions, the immobilisation of securities or their dematerialisation does not alter the contractual or corporate relationship between investors and issuers. Investors are the creditors and the shareholders of the issuers. For operational reasons, they rely on the intermediary system for exercising their rights such as obtaining payment or voting at the general assembly. Intermediaries represent investors vis-à-vis issuers.

As always in comparative law, this conceptual model exists in many different guises. For example book-entries (mostly credits and debits to securities accounts) can have a mere evidentiary value, creating some refutable appearance of the account holders’ interests in the securities, or they can be a necessary and possibly sufficient formality in their acquisition or disposition. In this same vein, we find systems where central securities depositories never possess the name of investors and others, so-called “transparent systems”, where the central securities depository maintains individual accounts for every individual investor, while brokers and other investment service providers are mostly acting as a mere conduit or managing those accounts as authorised agents on behalf of the investor. Other significant operational and legal differences distinguish most of “direct ownership” systems. For example, some of these jurisdictions still rely substantially on movable property concepts while others have fully embraced an intangible notion of property. However, “direct ownership” systems all share the tenet that investors, not intermediaries, are the legal owners of securities deposited with one or more intermediaries, pooled and represented by book-entries in the securities accounts of the investors. As a consequence, they consider that investors maintain a direct relationship with securities issuers, even though they depend on intermediaries to exercise their rights. These two core characteristics are maintained whether the securities themselves are deposited as individual certificates, are issued as one global certificate, or are fully dematerialised.

53 On closer examination, one always finds legal rules, provisions of a clearing or settlement system, or contractual provisions providing for the annulment or reversal of defective book-entries. This is typically the case where a debit of securities to an account was not authorised in any way by the account holder. I would submit that, strictly speaking, no legal system deems a book-entry to be the sufficient condition for the creation or extinction of rights.

54 See supra note 45. See further Article 5 of the UNIDROIT Draft Securities Convention, supra note 8, which treats transparent systems as a form of sharing the functions of an intermediary among two or more entities.
C. “Multi-Tiered Entitlements”

In this paper, “multi-tiered entitlement” will denote the second group of jurisdictions, including England and the United States, which bifurcates from the first group by assuming that, for an intermediary to hold securities on behalf of its customers, it is more efficient to take legal title to such securities. When an investor chooses to hold securities through one intermediary, she transfers legal title to that intermediary and shuts out any direct legal relationship with the issuer. This notion is often referred to as “indirect holding of securities,” though that term is not distinctive enough since “direct ownership” systems also result in the securities being indirectly held (in the sense of possessed or recorded) by intermediaries for the investors as owners of such securities. In these jurisdictions, the only party having a direct relationship with the issuer is the first-tier intermediary, usually through its nominee. One or more further intermediaries typically appear in the holding chain, each holding an interest in securities for its own account holder. The investor herself is the last account holder in the chain; she is beneficially entitled to the securities, but she is not the bondholder or the shareholder and is not registered as such in the books of the issuer.

The legal characterisation of an account holder’s position differs among jurisdictions in this second group. Under English law, and subject to the terms of the account agreement, the first-tier custodian at the top of the pyramid is the trustee of a pool of securities for its account holders, who are the beneficiaries of that trust. Each further intermediary is itself a trustee for its own account holders of the beneficial interest it derives from the credit of securities to its securities account with an upper-tier intermediary. At the bottom of the pyramid, the investor is the ultimate beneficiary of this chain of trusts. Because a trust fund cannot be reached by the general creditors of the trustee, the investor and all other account holders are protected from the insolvency of their relevant intermediary.

55 The UNIDROIT Study Group began by referring to “indirectly held securities,” and changed to using “securities held with an intermediary” like the Hague Securities Convention before the Committee of Governmental Experts adopted the defined term “intermediated securities.” Compare e.g. Hague Securities Convention, supra note 17, at Art. 1(f); Position Paper, UNIDROIT STUDY LXXVIII Doc. 8 (August 2003); Preliminary Draft Convention, Doc. 18 (November 2004), at Art. 1(f); and the current UNIDROIT Draft Securities Convention, supra note 8, at Art. 1(b).

56 Goode, supra note 2, at 125; Financial Market Law Committee, supra note 36, at 10. For an in-depth analysis, see Benjamin, supra note 26, at 36-59.
In the United States, the drafters of the 1994 revision of U.C.C. Article 8 chose to dispense with trust law altogether and created a whole new legal concept.\(^{57}\) A securities intermediary which credits a securities account with a financial asset under the agreement that it will treat the account holder “as entitled to exercise the rights that comprise the financial asset” creates a “securities entitlement”.\(^{58}\) The “entitlement holder” has a pro rata property interest in the financial assets held by the intermediary, which can be enforced in the intermediary’s insolvency.\(^{59}\) He exercises his rights in respect of the financial asset exclusively through the intermediary.\(^{60}\)

The common feature of all “multi-tiered entitlement” systems is that, at every tier in the same holding chain, the relevant intermediary holds some property interest in financial assets for the benefit of its own account holders and provides them with a property interest distinct from its own. Such account holders may only exercise their rights in respect of securities against the relevant intermediary. For an investor to “sell her securities”, she must require her own intermediary to extinguish her property interest and to provide the buyer with a similar property interest, either with itself or with another intermediary. From an issuer’s perspective, transactions among investors generally go unnoticed since it does not require a change of nominee in the issuer’s register.

D. **How Far Apart?**

Elucidating fully why the same constraints—which produced the immobilisation and dematerialisation of investment securities at the same time in various financial centres—prompted significantly different legal answers is not the purpose of this paper. Legal


\(^{58}\) “Entitlement holder,” “financial asset,” “securities intermediary,” “securities account,” and “securities entitlement” are all defined terms, see U.C.C. §8-102(a)(9), (14) & (17) and §8-501(a) (1994). ***

\(^{59}\) See U.C.C. §8-503(1) & (2) (1994).

\(^{60}\) See U.C.C. §8-505 to 507 (1994).
traditions and path-dependence are obvious factors. The fact that U.S. and English corporations only issue registered shares significantly favoured the nominee system, which is congruent with a “multi-tiered entitlement” approach. This was made possible because common law and equitable doctrines have long developed the possibility to distinguish legal title and beneficial interest and extensively beneficial entitlements, including against third parties. Conversely, continental European capital markets used to rely more on bearer shares, thus creating less need for holding through nominees. More importantly perhaps, in most such jurisdictions, no firm body of rules allowed for the division of legal title and beneficial interest. Creating a beneficial interest by way of a contract was not an option since it would not generally withstand the intermediary’s bankruptcy, which is the litmus-test of securities intermediation. In addition, the French legal tradition has remained diffident of nominees (“le prête-nom, c’est la simulation”).

Whatever its roots, the great divide between two opposite characterisations of investors’ and account holders’ interests in securities held with an intermediary is a major cause for incompatibilities among legal rules applicable to different tiers in international holding patterns as well as a significant conceptual obstacle to their solution. The third example discussed in the previous section dealing with incompatibilities in cross-border situations offers an excellent illustration. Nominees are necessary features of multi-tiered entitlement systems while they may be fully absent from the corporate laws in direct-ownership jurisdictions. As a consequence, the corporate law governing an issuer in the latter jurisdictions may prohibit or disable the nominee from exercising its voting rights (as registered shareholder), which it must exercise in accordance with the instructions from the beneficial shareholders. Certain jurisdictions may not allow one shareholder to cast split votes, prohibiting a nominee from complying with its instructions and duties. In others, a statutory rule or a provision of the by-laws may simply bar any shareholder from voting shares it does not hold for its own account. Enabling Cede & Co and other nominees to perform their function in compliance with their duties required statutory changes in major continental European corporations and sometimes extensive bilateral arrangements with every single issuer.

62 See Section II.C above.
However crucial this paradigmatic difference may be, it should not be over-emphasized. A
great diversity of declinations, variations, and peculiarities co-exist within each group. It
may well be that conceptual differences within each group may be as significant as the
distinction between direct ownership and multi-tiered entitlements. For example, some
might consider that distinguishing transparent systems such as in Brazil, China, Spain, and
the Nordic countries—where a domestic investor is identified not only by her direct
intermediary but also in the books of the central securities depository—from all other
systems is more relevant than the distinction discussed in this section. Furthermore, the
dividing line between direct ownership and multi-tiered entitlements does not necessarily
follow the tradition division between civil and common law systems. Luxembourg, host to
CLEARSTREAM,63 has enacted statutory provisions confirming the proprietary nature of an
investor’s interest in intermediated securities while careful avoiding the suggestion that it
confers any form of tangible property in the underlying certificates.64 Under German law,
an investor has a joint pro rata legal title to the pool of securities physically held in
Germany; however, when securities are held by a foreign sub-custodian, the German
investor has but a mere contractual claim for delivery of the securities.65 In England, while
securities are typically held by brokers in their own name as trustees for their account
holders, CREST offers individual investors the possibility to opt out of the indirect holding
system, to hold uncertificated securities in their own name and be personally registered in
the corporate register.66

Nonetheless, legal risk arises at every point where a particular holding chain crosses a
division between a direct ownership system and a multi-tiered entitlement system. The
next section of this article discusses the methodology used by UNIDROIT to design rules that
are capable of being adopted and implemented in all jurisdictions because they are

63 See supra note 5.

64 See Art. 6, 2nd para, of Luxembourg’s Loi du 12 août 2001 concernant la circulation des titres et autres
instruments fongibles (“Le déposant bénéficie, à concurrence du nombre des titres et autres instruments
financiers inscrits en son compte, d’un droit réel, de nature incorporelle, sur l’ensemble des titres et autres
instruments financiers de même nature reçus en dépôt ou tenus en compte par son dépositaire.”)

65 Einsele, supra note 26, at 409-451; Jürgen Than, The Legal Framework for Safe Custody,
Administration and Transfer of Securities in Germany, in 20 ANS DE DÉMATÉRIALISATION DES TITRES EN
FRANCE 233, 242-244 (Hubert de Vauplane ed., 2005).

66 See supra note 52.
independent from the legal characterisation of the rights derived by accounts holders and investors from the credit of securities to their securities account.

IV. Defining a Methodology: UNIDROIT’s Functional Approach

This section discusses UNIDROIT’s project to create transnational rules for the purpose of reducing the legal risks associated with the holding of securities through intermediaries. The project was launched in 2002 under the heading of *Harmonised Substantive Rules on the Use of Securities Held with an Intermediary as Collateral*. It was conceived as a follow-up to the *Hague Securities Convention* which provides contracting States with a clear and sound rule of conflict to determine the applicable law. A further international instrument should offer a limited number of substantive rules for the purpose of ascertaining the rights of investors and collateral takers, providing internationally recognised methods for the creation and perfection of such rights, determining their priority, recognising the effects of the rules of securities clearing and settlement systems, and, to the extent possible, protecting investors and collateral takers against the insolvency of intermediaries.

The project was undertaken by a “Restricted Study Group” which, in two years and in close consultation with representatives of central banks, regulators, and the financial industry, produced one *Position Paper*, various other documents and a draft convention. UNIDROIT’s Governing Council formally adopted the *Preliminary Draft Convention on Substantive Rules Regarding Intermediated Securities* and its *Explanatory Notes* and sent

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67 Another similar project is underway in the European Union where, as a follow-up to its *Communication on Clearing and Settlement of 28 April 2004*, COM(2004)312 final, the Commission set up a “Legal Certainty Group” in January 2005 to analyse the sources of legal uncertainty in respect of interests in securities and to propose solutions. The Group has issued a 667-page comparative report, MARKT/G2/MNCT D(2005), as the findings for its *Advice* of 11 August 2006. The work and products of the Legal Certainty Group are fully documented at http://ec.europa.eu/internal_market/financial-markets/clearing/certainty_en.htm (last visited August 15, 2007). While there were some concerns about the coordination and interaction between UNIDROIT’s global harmonisation project and the European Union regional process, there now seems to be a consensus that the E.U. Commission and Member States, which are active participants in the UNIDROIT project, will use its result to promote further regional harmonisation.

68 See Section II.A above.

69 Chronology of the project’s early phases in 2005 UNIF. L. REV. 112-115.

them to member States and a number of observer organisations. The draft convention has been negotiated among governmental delegates in the presence of observers during four sessions from May 2005 through May 2007. A diplomatic conference will be convening in 2008 to consider the final draft and eventually adopt the convention.

In its Position paper of August 2003, the Study Group proposed a test and a method for the harmonisation of the substantive law of intermediated securities. The test sets a high threshold as to if, on any given issue, a uniform rule is desirable:

“a rigorous approach should be adopted, and […] 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.”

Such a restrictive approach as to when uniform law is called for is consistent with recent similar and successful projects. It recognises that uniform legal rules are not an end in themselves but a means to reduce the legal risk of particular transactions in a global marketplace mostly governed by national legal systems.

71 Preliminary Draft Convention, UNIDROIT STUDY LLXVIII Doc. 18 (Nov. 2004) and Explanatory Notes to the Preliminary Draft Convention, UNIDROIT STUDY LLXVIII Doc. 19 (Dec. 2004), both and reprinted in their original English and French version at 2005 UNIF. L. Rev. 10-111.

72 All successive drafts, reports of the sessions of the Committee of Governmental Experts, and preparatory documents can be found at http://www.unidroit.org/english/workprogramme/study078/item1/main.htm (last visited August 15, 2007).


The Study Group also proposed the use of a functional approach. The Position Paper offers a weak definition of that approach, focusing on the use of neutral language and avoiding polarizing words, which is a traditional drafting technique for most international instruments. Indeed the functional approach developed into a methodology of its own, as explained notably in the Explanatory Notes to the November 2004 Draft:

“In each jurisdiction, the law governing securities holding and transfer is embedded in national legislation and integrated within several different legal areas: commercial law, corporate law, tax law, insolvency law, etc., as well as through measures carried out by the regulatory authorities. Generally, provisions in an international instrument can be either intrusive with respect to domestic legislation, or seek solutions that are compatible with the law of all contracting countries, or at least with their legal tradition. […] The preliminary draft Convention settles on an intermediate approach: it is not designed along the lines of domestic laws (and therefore ‘intrusive’), but aims at avoiding too much intrusion by formulating rules only by reference to facts. The means by which the required result is to be achieved in a concrete legal system is not decisive and remains within the national legislator’s discretion, provided it is compatible with the other rules of the preliminary draft Convention.”

The functional approach in this particular sense is a response to the finding by the Study Group that creating harmonised rules for the intermediation of securities could not possibly include a choice between the two fundamentally different characterisations of the property interest acquired by investors and secured lenders. Intense discussions with legal experts and industry representatives revealed that jurisdictions such as the United States and the United Kingdom would not consider abandoning the fundamental principle that an investor owns an interest in securities rather than the securities themselves. Conversely, “direct-ownership” jurisdictions would not consider any harmonisation if it required them to shut out an investor’s title to the securities themselves and her direct relationship with their

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75 See Position Paper, UNIDROIT STUDY LXXVIII Doc. 8 (August 2003), supra note 48, at 14: “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 Securities Convention, supra note 17, 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.”

76 Explanatory Notes to the Preliminary Draft Convention, UNIDROIT STUDY LLXVIII Doc. 19, supra note 13, at 19.
issuer. The functional approach responds to the need for discrete uniform rules compatible with and capable of implementation in a jurisdiction independent from the legal characterisation of an investor’s rights in securities held with an intermediary.

To comparative lawyers, the functional approach is strongly reminiscent of the *functional method* lying at the heart of so much scholarship. The functional method is both a controversial and an ambiguous notion and not much is said by the mere reference to functionalism. In the context of the UNIDROIT project, functionalism does not serve as a test for when a uniform rule is needed, nor does it provide criteria for the choice of the “better rule.” Rather it sets hard constraints on the type of rules that can be considered. Such rules must be strictly independent from the legal characterisation of the rights created or evidenced by book-entries in securities accounts so that they can be implemented by contracting States without requiring them to change that characterisation. Such uniform rules are likely to prescribe or prohibit certain results, but will require national lawmakers and regulators to provide for that result. For example, to provide that securities held for account holders do not form part of an intermediary’s bankruptcy and cannot be reached by its general creditors, a functional rule will avoid relying on notions such as property or trust and prefer words to the effect that the rights of account holders are effective against other creditors and an insolvency administrator.

An international instrument constrained by a restrictive test as to when a uniform rule is required and by strict neutrality regarding the characterisation of the property interests involved will, by necessity, fall short of a comprehensive regulation of the subject-matter. It cannot be mistaken with a uniform law. Parties to that instrument will need to have or put in place statutory provisions setting out the components and structure of the rights investors and secured parties acquire when securities are introduced into the intermediated system. To observers of the European Union, such an instrument is strikingly reminiscent of E.U. regulations, which are typically used for the approximation of national laws and regulations and are “binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods.” It is

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78 See *Explanatory Notes to the Preliminary Draft Convention* (December 2004), supra note 13, at 19.

likely to have the same fragmentary fabric, with sometimes detailed rules on discrete issues and gaping holes. 

In line with recent experiences in international commercial law treaties, this instrument is also likely to offer choices to Contracting States. Where different policy choices can be made by national legislatures without jeopardising the consistency of the overall project, the instrument may allow opt-ins or opt-outs and, when necessary, require that choices within a menu should be publicised by a declaration mechanism.

For all these reasons, this project is not trying to achieve the international unification of the law governing securities held with an intermediary. It promotes a degree of international harmonisation of the law that is compatible both with the need to reduce the overall legal risk in the marketplace and the realisation that it is neither feasible nor desirable at this stage to displace the diverse national legal doctrines of property rights. It also assumes that the prudential supervision of securities intermediaries is a matter for the States which they do in very different manners falling beyond the scope of any international harmonisation at this stage.

U.N.T.S. 11, 1973 Gr. Brit. T.S. No. 1 (Cmd. 5179-II) [hereinafter EEC Treaty], as amended by Single European Act, O.J. L 169/1 (1987), [1987] 2 C.M.L.R. 741 [hereinafter SEA], in Treaties Establishing the European Communities (EC Off’l Pub. Off. 1987), art. 249, ¶ 3. Different are regulations, which are so defined in then 2nd paragraph of the same Article: “A regulation shall have general application. It shall be binding in its entirety and directly applicable in all Member States.” A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods.”

However, E.U. directives are drafted differently from the UNIDROIT draft by often reiterating that “Member States shall provide…,” “ensure…,” “not require…,” etc....

However, unlike most other international commercial law conventions,82 the scope of this project is not restricted to international situations. On the facts, the cross-border holding of securities with intermediaries makes a significant and increasing proportion of all securities held: globally, estimates are that “roughly one in four debt securities and one in five equities today is owned by an investor outside the local issuing market.”83 In 2005, 15.8% of all U.S.-issued long term securities were foreign-owned, including 51.7% of marketable treasury. 84 At the end of the same year in Switzerland, a financial hub for the custody and management of private and institutional assets, 58.5% of all client securities in bank custody were held for foreign clients, while 86.3% of the banks’ own trading portfolios and financial investments were issued by foreign investors.85


85 See Swiss National Bank, 91 Banks in Switzerland 2006, tables 38a and 15, available at http://www.snb.ch/en/about/stat/statpub/bchpub/stats/banken.ch (last visited August 15, 2007). The second figure (banks’ trading portfolios and financial investments) does not include private bankers, who account for only .29% of the total sum.
Beyond these steadily growing numbers, decisive arguments have been made against restricting legal harmonisation to international (as opposed to domestic) holding of securities through intermediaries. Firstly, international holdings may be typically difficult to distinguish from purely national holdings. The location of physical securities or the registration of uncertificated securities is not readily ascertainable, particularly for international issues. Secondly, even assuming that international situations could be easily identified, the various tiers they comprise are each governed by the national law designated by rules of conflict such as the Hague Securities Convention or some other interpretation of the “Place of the Relevant Intermediary Approach.” Thus the specific problem raised by any international holding of securities is one of compatibility among the various national regimes governing the successive tiers. Thirdly, and most significantly perhaps, there are neither theoretical nor practical reasons why a purely domestic situation should be governed by rules different from the rules governing the “domestic” tier in an international holding. It is hard to imagine a policy justification for such a distinction while the co-existence of two different regimes would only add costs and legal risks for market participants. If anything, industry representatives insisted on the need that only one set of rules should govern the intermediary holding of securities in any given jurisdiction.

The next two sections of this paper test the feasibility and robustness of UNIDROIT’s functional approach in connection with two critical issues. Section V discusses the definition of “intermediated securities” as the object and building-block of the draft convention. Section VI analyses the methods provided by UNIDROIT Draft Securities Convention for acquiring and disposing of intermediated securities, including for the granting of security interests, as well as the principles governing priorities among such dispositions over intermediated securities and the protection of an innocent acquirer. This focused discussion of core elements of the draft instrument does not reflect the breadth and scope of its provisions, which this paper does not purport to cover in any comprehensive manner.86

86 Other important issues addressed by the draft Convention include: the obligation of an intermediary to hold sufficient assets in respect of the rights of its account holders; the protection of account holders’ rights in the insolvency of an intermediary and the allocation of shortfalls; the position of issuers of securities; as well as a whole optional chapter regulating security and title transfer collateral agreements, their enforcement, the right to use collateral securities, and top-up or substitution of collateral.
V. Intermediated Securities: Quest for the Building Block

The first logical challenge to the functional approach is the task of defining the very subject matter of the future convention. What are securities for the purpose of an international instrument harmonising substantive rules in respect of their holding and their transfer? Should the rules deal with the securities themselves or with the securities as and when they enter into the intermediary system and get credited to a securities account? This section discusses UNIDROIT’s choice to carry out its functional approach by designing rules focused not on the securities themselves, but on “securities in an account” through the adoption of intermediated securities as a defined term meaning, in substance, the rights and interests resulting from the credit of securities to a securities account.

Obviously securities, i.e. financial assets such as shares, bonds, and other fungible and transferable rights, form the necessary economic substance of the intermediary holding system. Determining which securities are capable of being held through intermediaries is a complex question, one not discussed in this paper. Most bonds and shares are capable of being credited to securities accounts and transferred by way of book-entries, but what about hedge funds, private equity investments, over-the-counter derivatives and tailor-made structured products? Market innovation and changing technologies create new financial assets on a continuous basis; national and international central securities depositories accept new classes of assets and thus allow their holding in the intermediary system. National legislators and regulators struggle to keep pace with financial innovation by updating different lists of eligible securities for the purpose of various domestic laws and regulations—listing rules, pension fund investment regulations, clearing and settlement systems, etc. Not all legal systems embrace new financial assets at the same speed. Setting up an international procedure for regularly supplementing a list of what qualifies as securities the purpose of a particular convention would be cumbersome and impractical. The definition of “securities” in Article 1(a) of the UNIDROIT Draft Securities Convention sets out two requirements—“capable of being credited to a securities account and of being acquired and disposed in accordance with the provision of this Convention”—and leaves to the rules governing an intermediary to decide when a financial instrument meets that requirement.87

87 Cf. Hague Securities Convention, supra note 17, at art. 1(1)(a) (“any share, bonds or other financial instruments or financial assets(other than cash), or any interest therein”) and U.C.C. § 8-104 (1994) which, in
The open-endedness of any definition of securities is not, however, the reason why the securities themselves cannot be the legal concept, or the building block, on which transnational rules can be based. The reason lies with the need to design rules that are independent from the legal characterisation of account holders and investors rights in respect of securities. In a “direct ownership” legal system, the investor and all account holders deal with the securities at the top of the chain. In “multi-tiered entitlement” legal systems however, only the intermediary at the top tier takes legal title to the securities, directly or through a nominee. Any lower-tier account holder—including the investor at the very bottom of the chain—obtains proprietary or other rights which are different from the securities themselves. In this second group of legal systems, international rules that would operate with securities would only apply to the top tier intermediary, not to the investor, to the collateral taker, nor to any other intermediary.

By requiring that rules be capable of application and implementation in any legal system, the functional approach calls for the adoption of an operational concept different from the securities themselves.

A. Identifying the Building Block

If not the securities themselves, what should be the building block of such an international instrument? The international community first dealt with this issue faced this debate at the Hague Conference in respect of conflicts of laws. From the onset, the project was meant to depart from outdated, impractical, and ineffectual connections to the place where the securities are located (lex cartae sitae) or to the law under which the securities have been issued (lex causae) and moved towards a rule connecting to the law of the relevant intermediary, i.e. the intermediary maintaining the account through which a disposition or an acquisition of securities is performed. Notoriously, the Hague Securities Convention and the E.U. directives differ in respect of the precise connecting factor. Within some limits, the

conjunction with §§ 8-103 and 8-102(a)(9), distinguishes securities from (the broader class of) financial assets.

88 See Section II.A above.

*Hague Securities Convention* gives precedence to the choice of law made by the parties to the account agreement. The current E.U. directives rely on “the law of the country in which the account is maintained,” respectively on the law of the Member State where the account recording the securities is “located.” While they differ in respect of a subjective, choice-oriented test as opposed to an objective, location-oriented test, the two rules converge in relying on the account to which the securities are credited and on the relevant intermediary who maintains that account.

Legal rules governing the intermediated holding of securities are obviously geared at conveying the economic substance, if not necessarily the legal substance, of the securities to the ultimate account holder, that is to the investor and to those who may have been granted an interest in the investor’s holding. Since the law governing that holding may vary at every tier in the holding chain, harmonisation rules purporting to decrease the legal risks entailed in such holding must be able to deal with each tier individually, whether or not they apply to other tiers because they have become part of the various laws governing these other tiers.

The choice of the approach for conflict of law purposes informs the approach for the design of substantive rules. If there is not one single law governing the holding of securities across the whole chain of intermediaries, and if the applicable law must be determined for every tier in that chain, then substantive rules must focus on each tier individually and as far as possible be independent from what happens at other tiers in the same chain. For harmonisation purposes, conflict of law rules and substantive rules must have the same focus, use the same building block. Substantive rules deal with “securities in the account” and more precisely with the rights that arise to the account holder from the fact that securities are credited to her securities account with an intermediary, not with the securities themselves. However it is called, “securities held with an intermediary” “intermediated

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90 See supra Section II.A and note 21.
91 E.U. COLLATERAL DIRECTIVE, supra note 19, Art. 9(1).
92 E.U. FINALITY DIRECTIVE, supra note 19, Art. 9(2).
93 “Direct ownership” rules confer legal rights in the securities themselves on the investor, while “multi-tiered entitlement” rules confer rights that are derived from the rights comprised in the securities.
94 As used in the *Hague Securities Convention*, supra note 17, Art. 1(f).
securities,” 95 or more blandly “book-entry rights,” 96 the building block for substantive provisions are bundles of rights.

**B. Intermediated Securities as a Bundle of Rights**

Once the “securities in the account,” represented by book-entries, have been chosen to serve as the building block, how should they be defined? Since the same choice was made in the Hague process, it only seemed natural to start the UNIDROIT project with the same concept of “securities held with an intermediary” adopted in Article 1(f) of the *Hague Securities Convention*:

“(f) ‘securities held with an intermediary’ means the rights of an account holder resulting from a credit of securities to a securities account”. 97

Unsurprisingly early drafts produced by the UNIDROIT Study Group copied the Hague definition. 98 Using the same defined term and definition for concepts which are common to both instruments would decrease the risk of mismatches and reflect the advances reached in a long and educated process involving delegates from many jurisdictions and observers from representative trade associations. 99

“Securities held with an intermediary” is a long defined term when it is used several times over just a few lines in many paragraphs. During its first meeting in March 2005, the Committee of Governmental Experts convened by UNIDROIT to consider the draft Convention sought a simplification of terminology without altering the definition itself. The preliminary draft for a Swiss Federal Intermediated Securities Act had been recently published, 100 and it coined a brand-new term of “titres intermédiaires” in French, translating

95 As in the UNIDROIT drafts following the May 2005 meeting described in the next sub-section.
96 As used in the E.U. LEGAL CERTAINTY GROUP advice of 11 August 2006, referred to in note 67.
97 See *Hague Securities Convention*, supra note 17, Art. 1(f). The equally authentic French text of the Convention defines “titres détenus auprès d’un intermédiaire” as “les droits d’un titulaire de compte résultant du crédit de titres à un compte de titres.”
99 See Explanatory Notes to the Preliminary Draft Convention (December 2004), supra note 13, at 22.
into “intermediated securities.” Even though the Swiss and UNIDROIT definitions do not coincide in substance, the brand-new term seemed convenient as a convenient shorthand replacement for the long-winded “securities held with an intermediary” terminology and was happily adopted without any change to the definition itself.\(^{101}\)

In the resulting (UNIDROIT) draft,\(^{102}\) “intermediated securities” not only appeared in Article 1(f) as the defined term replacing “securities held with an intermediary,” it was also used as the heading of a whole chapter as well as the heading of Article 4 describing more expansively the rights resulting from a credit of securities to a securities account which, subject to contrary provisions of the convention, included “such other rights as may be conferred by the domestic non-Convention law.”\(^{103}\) It is fair to say that the key concept of intermediated securities was overloaded with contents and connotations. Some critics raised the question of whether the new concept was compliant with the functional approach.\(^{104}\) They questioned its ability to serve as the building block of the convention without disrupting national legal characterisation of investors’ rights in securities. Some perceived that the balance dangerously tipped towards “multi-tiered entitlement” systems. Defining intermediated securities as “the rights resulting from the credit of securities to a securities account” might be unacceptable to “direct ownership” jurisdictions where book-entries do not create new rights for the investor but merely represent the securities owned by investor and evidenced by book-entries. Different intermediated securities—different rights

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\(^{101}\) See Art. 1(f) of the Preliminary draft Convention, May/June 2005, UNIDROIT STUDY LXVIII Doc. 24 (Jun. 2005). Contrary to what is suggested by the official comment in the Report on the 1st CGE session, revised August 2005, UNIDROIT STUDY LXVIII Doc. 23 Rev. (Aug. 2005), at 25 (para. 184), the new, shorter defined term substituted for the previous, longer one without change to the definition itself.


\(^{103}\) As defined in Article 1(m) of UNIDROIT Draft Securities Convention, supra note 8, “non-Convention law” (“domestic non-Convention law” in previous drafts) is used throughout to refer to “the law in force in the State whose law is applicable […], other than the provisions of this Convention.” A careful delineation between matters that need to be covered by a uniform rule and matters that need not explains why the defined term is used in a good three dozens times in the draft.

resulting from the credit of securities to an account—are indeed created at every tier in any holding chain. Subject to the law governing the account each account holder in the chain, and not only the investor at the bottom of the pyramid, obtains rights against its relevant intermediary. The suggestion that any account holder (including an intermediary acting in that capacity) obtains rights in respect of the underlying securities would seem contrary to a fundamental tenet of “direct ownership” legal systems where only the investor—the ultimate account holder—has ownership in the securities while all other account holders in the chain are acting as intermediaries and have no entitlement whatsoever to the securities unless they have been granted a security interest therein by a contract or by operation of law.

This section verifies that an international instrument capable of being adopted and implemented in jurisdictions with radically different legal characterisation of account holders’ rights can be designed around a building block—named intermediated securities for lack of a better word—defined as a bundle of rights resulting from the credit of securities to a securities account. Some of these account rights, such as the right to give instructions to the intermediary in respect of securities credited to the account, are common to all legal systems and must therefore be listed in the international instrument itself. Some are not because they are particular to certain jurisdictions—for example a property or co-property right in the physical securities themselves—and are therefore supplemented by the applicable law. Intermediated securities are, consequently, bundles of rights which are not identical across all States that would be adopting the instrument.

Though the recognition that an international instrument may govern property rights which it does not fully define and regulate is remarkable, it is not unique. The most recent and successful example of a similar circumstance is the Convention on International Interests in Mobile Equipment signed in Cape Town on 16 November 2001. The difference between the two is as a matter of degree rather than a matter of kind, as evidenced by the numerous references made in the current draft convention to the “non-Convention law,” the defined

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105 While the Convention, supra note 81, distinguishes between interests created by security agreements, by title reservation agreements, and by leasing agreements, each providing the creditor with different default remedies, Article 2(4) refers the characterisation of any given international interest to the (non-Convention) applicable law.
term referring to the “law in force in the State whose law is applicable… other than the provisions provided of this Convention”.

To package the bundle of Convention and non-Convention rights, it is also necessary to distinguish between the two categories of rights pertaining to securities held through intermediaries—the rights attached to the securities credited to an account and the right to dispose of the legal position resulting from such credit.

The rights attached to the securities form the economic substance of the securities. They typically include future payments, whether fixed such as a right to interest and to capital redemption or contingent such as a right to dividends. The contents and value of these rights varies with every issue of securities. Within any given issue, these rights are identical so that the securities are fungible. The rights attached to the securities are determined by the terms of the issue and are subject to the law governing the issue, which may be the law chosen to govern a debt issue or the corporate law of the issuer. They may include administrative rights such as voting rights.

There is no discussion that the rights attached to the securities accrue to the investor or, when applicable, to another person to whom the investor has granted an interest in the securities. When intermediaries receive distributions and other benefits attached to the securities, they are bound to pass them down to their own account holders so that these benefits ultimately percolate to the investor at the bottom of the holding chain. The rights attached to the securities originate from the issuer and their substance must be passed down to the investor: the intermediaries are merely the channel for the enjoyment of such rights.

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106 See UNIDROIT Draft Securities Convention, supra note 8, Art. 1(m). The instrument does not, however, purport to provide any rule of conflict of laws. Its Article 3 draft defines the sphere of application of the draft convention without taking any view as to whether there is a conflict of laws and, if so, as to the rule solving that conflict. The conflict of laws issue will be determined by the Hague Securities Convention, supra note 17, for its contracting States and by any applicable conflict rule in other forum states. For a good explanation of the origins of Articles 1(m) and 2, see “Applicable law”—Report on the Meaning and the Objectives in the Preliminary draft UNIDROIT Convention, reprinted as Appendix 6 of the Final Report on the First Session of the Committee of Governmental Experts, UNIDROIT STUDY LXVIII Doc. 23 rev. (Aug. 2005).

107 Such distinction has been extensively used by the German doctrine of negotiable instruments (Wertpapierrecht), which distinguishes Rechte aus dem Papier (rights attached to the instrument) from Rechte am Papier (rights over the instrument itself).
Intermediaries typically owe a qualified duty to facilitate the exercise of the rights attached to the securities.108

This so far is common to all jurisdictions. Legal systems differ however as to against whom an investor is directed to exercise the rights attached to the securities. Securities issued and held in “direct ownership” jurisdictions entitle the investor to exercise her rights directly against the issuer.109 Often the investor nonetheless needs the help of her intermediary to exercise her rights, if only to obtain the evidence of her holding or her registration in the issuer’s registry. Conversely, investors holding securities through intermediaries in “multi-tiered entitlement” jurisdictions have no direct rights against issuers. The issuer only knows and recognises the nominee at the top of the intermediary pyramid. Investors rely on their own intermediary to exercise the rights attached to the securities.

In sum, though arguably all legal systems converge in recognising that investors must enjoy the rights attached to securities, they differ in conveying the benefits of those rights. In an international context, direct entitlement against the issuer appears to be the exception rather than the rule. Direct ownership systems operate easily within the boundaries of a jurisdiction but are typically modified as soon as foreign investors are concerned. The direct link between an issuer and investors typically breaks up when the securities are held across borders.

Distinct from his possible right to obtain and to retain the benefits attached to the securities, the account holder can, as a matter of fact if not always as a matter of law, modify his position resulting from the credit of securities to his account by instructing the intermediary to extinguish that credit (e.g., for the purpose of transferring the position to another account holder) or to encumber his position (e.g. by creating a security interest). The account holder may actually breach some duty by disposing of the intermediated securities in his account. For example, an intermediary may not be allowed to charge securities held for the account of customers or an investor may breach a covenant to some creditors that he will not further encumber his property. Except when the relevant intermediary is aware of another person’s interest in the intermediated securities and legally bound to respect that interest, it

108 See, e.g., UNIDROIT Draft Securities Convention, supra note 8, Art. 8(1) (“An intermediary must take appropriate measures to enable its account holders to receive and exercise the rights specified in Article 7(1), but this obligation does not require the relevant intermediary to take any action that is not within its power or to establish a securities account with another intermediary.”).

109 See Section III.B above.
is neither able nor allowed to question the dispositions made by the account holder. The right, or at least the power, to dispose of intermediated securities is a necessary component of the bundle of rights comprised in intermediated securities. Any account holder is and must be able to dispose of intermediated securities by instructing his intermediary to take the appropriate steps.

This is a disturbing thought when considering that an intermediary may, by mistake or by fraud, wrongfully dispose of securities it holds for the account of its customers or disrupt their clients’ property interest. Intermediation per se exposes investors and secured lenders to an intermediary risk. As long as the relevant intermediary remains solvent it can take, or be forced to take, appropriate measures to restore the position of its account holders. This is impossible once the intermediary has become insolvent. No rule of property law or commercial law can absolutely protect account holders against fraudulent or merely erroneous dispositions made by an intermediary in breach of its duties. The proprietary nature of investors rights in securities held with an intermediary is the basis for a preferential treatment in the intermediary’s insolvency; it does eliminate the risk of a fraudulent or erroneous disposition, resulting in shortfalls that must be allocated among account holders. Regulations imposing rules of conduct, safety measures, reconciliation of accounts, etc. contribute significantly to the mitigation of the intermediary risk, at least when they are adequately supervised and enforced. Criminal provisions may deter certain egregious conducts. Investors can be protected by insurance protection schemes. But no rule of law can eliminate the intermediary risk absolutely.

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111 Art. 17 of the *UNIDROIT Draft Securities Convention*, supra note 8, states that the rights of account holders and the interests that have become effective against third parties are effective against the insolvency administrator and against any creditor of the insolvent intermediary. Article 22 allocates the securities held by the insolvent intermediary to the rights of its account holders. Article 23 provides for the *pro rata* allocation of any shortfall in any given securities issue among the account holders holding securities of that issue, but reserves any conflicting rule applicable in the insolvency proceeding.
C. Which Bundle of Rights?

At this stage, it has been established that intermediated securities, the legal concept on which the convention rules operate, ought to be defined as a bundle of rights conferred on the account holder by the credit of securities to his account. This bundle includes a core content of rights which is necessary for the purpose of the substantive provisions of the convention. This core content can be supplemented by other rights granted by the applicable non-convention law so as to accommodate different characterisations of property interests in securities held in the intermediary system.

By defining a core content of account holders’ rights, the UNIDROIT Draft Securities Convention is treading on new ground. For the purpose of establishing rules of conflicts of law, the Hague Securities Convention only needs to refer to “the rights of an account holder resulting from a credit of securities to a securities account” and may defer to the applicable law for their contents and characterisation. Unlike conflict of law provisions, substantive provisions must give substantive contents to the rights they purport to regulate. Reflecting the constraint that the UNIDROIT project must not impose any legal characterisation of the property interest of investors and account holders in securities held with an intermediary, the functional approach requires provisions which deal with intermediated securities as bundles of rights without fully defining the contents of such rights. However whenever a provision deals with intermediated securities it does apply to the whole bundle of rights, including the rights granted to the account holder by the non-convention law.

The draft convention needs to establish the core substantive contents of intermediated securities defined as a bundle of rights. It is submitted that there are only two such rights: the right of an account holder to dispose of intermediated securities credited to her account and the rights attached to the securities. Both rights are subject to some qualifications. Conversely, ownership, co-ownership, or other property rights in the securities themselves are not part of the core notion of intermediated securities, but they may be granted by the non-convention law in addition to the rights conferred by the convention.

(a) Right of disposition. The first component of this bundle is the account holder’s right to dispose of the legal position created by the credit of securities to her account. That includes a complete disposition, such as an outright sale or a donation, or a partial disposition, such as granting a security interest or another limited interest. Intermediated securities exist through entries made by intermediaries in securities accounts they maintain. An effective

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112 See Hague Securities Convention, supra note 17, Art. 7(1)(a).
disposition will thus always require the intermediary to act upon an instruction from the account holder or to enter into an agreement in respect of the securities credit to her account. As discussed in the next section, the draft convention does not purport to characterise dispositions made by the account holder. There is no need for harmonising the various security and other interests that account holders may create or transfer to other persons. This is left to the applicable law. The draft convention provides methods (debits and credits, control agreements, etc.) to effectuate dispositions and make them effective against third parties as well as rules establishing the priorities of such dispositions.

The right of an account holder to dispose of intermediated securities—which includes, when possible, the right to hold the securities otherwise than through credit to her securities account—is a necessary component of the bundle of rights accruing to the account holder. It is not and cannot be qualified by a requirement that the account holder is not acting in breach of statutory, contractual, or regulatory duties when making that disposition.

Intermediaries could not possibly verify that instructions received from an account holder comply with the duties of that account holder. Such a requirement would dramatically hinder the negotiability of intermediated securities or it would create disproportionate costs on the intermediation systems and on its customers by causing intermediaries to guarantee the conduct of their account holders towards third parties. The only limits to an account holder’s right to dispose of intermediated securities must be confined to previous interests granted to third parties which were made effective with the consent or the help of the intermediary and judicial orders enjoining an intermediary to comply with an account holder’s instruction.

(ii) Rights attached to the securities. Intermediated securities that would not convey the rights attached to the securities to the investor would be of no value. However, they are difficult to include in a way that is compatible to the functional approach. In “direct ownership” jurisdictions, the rights attached to the securities only accrue to the investor or other persons to whom he has granted in interest in the securities; intermediaries may need to assist in conveying distributions, voting instructions, and other benefits between issuers and investors, but they are acting under some sort of agency arrangement and have no

113 UNIDROIT Draft Securities Convention, supra note 8, Art. 1(k) which includes, where permitted by the non-Convention law, that a control agreement entered between the grantor and the grantee of an interest in intermediated securities need only be notified to the intermediary. This would be an effective disposition if, and only if, the law providing for this method imposes a duty upon the intermediary to abide by the control agreement to which it did not consent.
entitlement to the benefits themselves. The opposite is true in “multi-tiered entitlement”
systems, where each account holder has a right to obtain from its own intermediary any
benefits accruing from the securities subject—subject, when the account holder is itself
acting in the capacity of an intermediary, to transmit such benefits to its own account
holders.

The common ground, on which a uniform rule may be based, is that “direct ownership” and
“multi-tiered entitlement” systems equally provide for the investor to ultimately benefit
from the rights attached to the securities. Providing, at a minimum, that investors are
entitled “to receive and exercise the rights attached to the securities” raises practical
questions. The investor may not be an account holder. The ultimate account holder at the
bottom of the pyramid may not be the investor, but may hold securities for the benefit of
another person or his rights may be subject to the interests of other persons. The rule
determining when an account holder must have the benefit of the rights attached to the
securities cannot rely on a substantive test as to whether that person is actually the investor.
Actually, there would probably be no international consensus as to who qualifies as
investors. The test must therefore address formal features that are easily established in the
securities intermediation system. Article 7(1) of the UNIDROIT Draft Securities Convention
now provides that:

“The credit of securities to a securities account confers on the account holder:
(a) the right to receive and exercise the rights attached to the securities,
including in particular dividends, other distributions and voting rights:
(i) where the account holder is not an intermediary or is an intermediary
acting for its own account; and,
(ii) in any other case, if provided by the non-Convention law; [...]”

That provision illustrates two significant features resulting from the functional approach.
Firstly, explicit allowance must be made for the non-Convention law to supplement the
rights of account holders. This compromises the uniformity of the law among contracting
States by maintaining significant divergences, but it must not impact the operation of the
provisions of the convention which lay down major features that should be common to all
these States. Secondly, the convention must operate with as little extrinsic elements as
possible. In this example, it cannot and should not take any view as to, for example,
whether an “account holder who is not an intermediary” is or is not the actual investor and

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114 How intermediaries are compensated for their service is a matter for the agreement governing the
account and is not relevant to the harmonisation process.
whether some provisions of law other than the convention impose on him a duty to receive and exercise these rights in the name or for the account of another person.

(iii) Ownership, co-ownership, and other property rights in the (underlying) securities. As discussed in Section III.B, “direct ownership” legal systems confer on the investor a property interest in the securities held or registered by the top-tier intermediary, often a co-ownership right in the fungible pool of securities of the same issue held by that intermediary. The functional approach postulates that this property right should neither be displaced nor imposed on contracting States. It is an additional component of intermediated securities that may be provided for by the non-convention law and, in these jurisdictions, will become part of the bundle of rights resulting from a credit of securities to a securities account.

D. Evaluating the Current Draft

The choice of a defined term is important from an iconic and a pragmatic perspective. It must be short enough to avoid lengthy circumlocutions. The image it conveys should avoid carrying misleading connotations. Translation in the official language of the instrument (French and English) and into other languages should be easy. The Hague Securities Convention uses “securities held with an intermediary” as a defined term, which is neutral and comprehensive enough. UNIDROIT’s choice of “intermediated securities” as a defined term has the additional advantage of being shorter to be used in the drafting of provisions where precision often requires several repetitions in the same paragraph. It is also new enough and lacks national roots which means it can be adopted free of legal baggage and misleading connotations.

Different terms should not create the impression that the Hague Securities Convention and the UNIDROIT Draft Securities Convention do not operate on the same object. Indeed, Rome’s “intermediated securities” are Hague’s “securities held with an intermediary.” Because UNIDROIT deals with substantive provisions, it goes further and outlines the substantive rights comprised in intermediated securities. Some of these rights exist in all systems and are thus listed in the instrument; all others are incorporated into it by referring to the non-Convention law.115 Nonetheless, whatever rights are contained in UNIDROIT’s

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115 See UNIDROIT Draft Securities Convention, supra note 8, Art. 7(1).
intermediated securities are “the rights of an account holder resulting from a credit of securities to a securities account” for the purpose of the Hague Securities Convention.\(^\text{116}\)

In November 2006, however, during their third session, the governmental experts convened by UNIDROIT made one further step to assuage the concerns of delegates from “direct ownership” jurisdictions. They altered the definition to reflect prominently that, under certain legal systems, the rights arising from the credit of securities to a securities account may include the securities themselves or some interest therein. The definition now reads:

\[\text{“(b) ‘intermediated securities’ means securities credited to a securities account or rights or interests in securities resulting from the credit of securities to a securities account”}\]

This definition indicates that intermediated securities may be nothing else but the securities when they are credited to a securities account. The addition of “securities credited to a securities account” at the beginning of the definition is very unfortunate. Not only do these words disrupt the consistency of the UNIDROIT definition with the Hague definition,\(^\text{118}\) their use calls into question whether “intermediated securities” are synonymous with “securities held with an intermediary” and creates tension between the two definitions used by the international instruments. Moreover, it departs from the functional approach by bringing to forefront (“means securities credited to a securities account”) the notion that having intermediated securities is equal to having the securities themselves, a characteristic of “direct ownership” systems which is totally alien to “multi-tiered entitlement” systems. Only the second part of the definition (“or interests in securities resulting from the credit of securities to a securities account”) is truly common to all legal systems. To make the matter worse, the French language—which, in the practice of UNIDROIT, is equally authentic as the English version of an international convention—knows of only one word (droits) to render the “rights or interests” part of the English definition. Intermediated securities are now defined in French as “des titres portés au crédit d’un compte de titres ou tous droits sur des titres qui résultent du crédit [...]”, blurring the distinction between the rights attached to

\(^{116}\) See Hague Securities Convention, supra notes 17, Art. 1(f).

\(^{117}\) UNIDROIT Draft Securities Convention, supra note 8, Art. 1(b). The addition to the Hague definition has been italicised.

\(^{118}\) Unless one argues that “securities credited to a securities account” merely means an account holder proprietary interest—if he has any—in the securities themselves, which falls within “the rights of an account holder resulting from a credit of securities to a securities account” under Art. 1(f) of the Hague Securities Convention, supra notes 17.
the securities and the right to dispose of intermediated securities and raising further ambiguities as to whether intermediated securities are not merely securities under disguise.

Though it is technically correct, the current definition of “intermediated securities” carries the wrong message. It overemphasises the securities themselves—a characteristic particular to the “direct ownership” systems—while shrouding the actual building block of the whole draft Convention, correctly described in Article 7 as the bundle of rights that an account holder derives from having securities credit to his account.

To avoid a misleading reification of the legal concept on which the whole draft Convention is based, the drafter should reinstate an unadulterated copy of the Hague definition (“the rights of an account holder resulting from a credit of securities to a securities account”). The possibility that national law may include ownership interests in these rights should not be part of the definition. At most, if an acknowledgment of the “direct-ownership” systems is needed in the definition itself, the order of the elements should be reversed and the language of the Hague Securities Convention should be supplemented by some language such as “including, where applicable, ownership and other rights in the securities.”

VI. Disposition of Intermediated Securities: A Menu Approach

Parties to a transaction in intermediated securities are chiefly concerned with three questions: How can an account holder transfer to another person whole or part of his interests in intermediated securities? When is that disposition effective against other the relevant intermediary, its creditors, and all other parties? What priority does the disposition enjoy in respect to prior and subsequent dispositions? If intermediated securities are the building block of the draft Convention, then methods for their disposition are its toolbox. As we shall see, the draft Convention recognises that debits and credits are the universally recognised method for disposing of intermediated securities, which must be available in the laws of all contracting States. It offers contracting States a choice between three additional methods which enjoy wide international recognition, namely earmarking, control agreements, and self-perfection of dispositions in favour of the relevant intermediary. Contracting States may choose to implement in their national provisions one, two, three or none of them.119

119 Contracting States might even retain other methods to make interests effective against other parties, but, in priority conflicts, such methods would only enjoy a subordinate position and rank below any prior or
A. Credits and Debits, the Gold Standard

The immobilisation and dematerialisation of securities have substituted credits (and debits) in securities accounts for their physical possession and delivery. More than an accounting mechanism, book-entries are the “gold standard” of dispositions in intermediated securities, the universally acknowledged method through which intermediated securities are acquired and disposed of. In many jurisdictions, credits and debits may also be used to transfer a partial interest such a security interest in intermediated securities, for example by having them credited to a “pledge account” in the name of the collateral taker. Given the paramount importance of dispositions by credit and debit, one would have expected an international harmonisation project to produce some universal standard for the validity and effectiveness of credits and debits. The actual outcome is far more nuanced and illustrates both the ambition and the limits of the enterprise.

Credits of securities lie at the core of the UNIDROIT Draft Securities Convention, as outlined by their mention two different but related purposes:

- Article 1(b) refers to a credit of securities to define intermediated securities, the building block of the whole Convention. Article 7(1) gives substantive contents to the defined term by listing the rights such a credit confers upon an account holder.

- Unsurprisingly, Article 9(1) dealing with the acquisition of intermediated securities confirms that they “are acquired by an account holder by the credit of securities to that account holder’s securities account.”

There is a strong element of circularity in defining intermediated securities through the rights resulting from a book-entry and then by providing that they are acquired by that very book-entry. This reflects the narrow constraints resulting from the methodology adopted. Since the functional approach forbids that the subject-matter of the convention be fully substantively defined, intermediated securities are characterised in a somewhat descriptive manner as whatever an account holder acquires when securities are credited to his account.

Two significant questions affect the value of credits in securities accounts. Are credits the necessary and/or the sufficient condition for the acquisition of intermediated securities? In particular, is there any legal connection between a credit to the transferee’s account and the subsequent disposition effected in accordance with one of the four methods provided for in the Convention.

See UNIDROIT Draft Securities Convention, supra note 8, Arts. 11 and 15(2).

120 Id. at Art. 9(3), which states the correlative proposition that “intermediated securities are disposed of by an account holder by the debit of securities to that account holder’s securities account.”
relevant debit in the transferor’s account? The current draft does not provide a full answer to either and leaves room for the non-convention law. The key statement that intermediated securities are “acquired by the credit of securities” is qualified in two respects. The language in Article 9(1) is subject to the provisions of Article 13 regarding “Invalidity and Reversal.” Article 9(2) states that “[n]o further step is necessary, or may be required by the non-Convention law, to render the acquisition […] effective against third parties.”

The two paragraphs combined provide harmonisation in respect of the effects of credits—and debits—against third parties, but their effectiveness between an account holder and his intermediary can be (and actually is) subject to additional requirements and conditions. At first glance, this would seem a disappointing result. Short of full harmonisation, it nonetheless provides a firm and sensible foundation.

The first reason for this limited ambition lies with the initial policy choice that the future instrument cannot require contracting States to modify their legal characterisation of property interests created or represented by credits to securities accounts. Unlike other disposition methods discussed in the next section, credits and debits are tightly connected with legal characterisation issues. In a straight sale of securities, for example, “direct ownership” jurisdictions construe the disposition as a transfer from the seller to the buyer of a discrete ownership interest in securities or in a fungible pool of securities. The seller relinquishes her interest when and only when the buyer acquires it. The property interest acquired by the buyer is nothing but the seller’s interest transferred, untouched and unmodified, through one or more intermediaries. Acquisition and disposition are not only simultaneous; they are co-dependent as a matter of law because no buyer can acquire legal title to securities without the former title-holder relinquishing it.

At the opposite end, “multi-tiered entitlement” jurisdictions characterise an account holder’s position as some sort of interest in his intermediary’s holding of the same issue. Even where the intermediary maintains an account for both parties to a sale of securities, the sale does not, legally speaking, result in a transfer of the seller’s interest to the buyer. The seller’s interest is extinguished by the debit to her account. The credit to the buyer’s account creates a new interest. Both interests relate to the same holding of the same

121 Emphasis added.

122 Art. 9(3) of the UNIDROIT Draft Securities Convention, supra note 8, follows the pattern of Article 9(1) by providing that intermediated securities are disposed of by way of debit subject to Article 13 on effectiveness and reversal.
intermediary, but they are not legally connected in such a way that the validity of the debit is a condition for the validity of the credit or conversely. In these jurisdictions, credits and debits are not co-dependent. These legal systems are more comfortable with netting processes, where instructions from and for various account holders or various participants in a securities settlement system are offset so that settlement in regard of one issue results in one debit or one credit for each account holder rather than a series of credits and debits in each account.\footnote{Id. at Art. 9(5), which does not require that Contracting States allow the netting of debits and credits (“Nothing in this Convention limits the effectiveness of debits and credits to securities accounts which are effected on a net basis in respect of securities of the same description.”)}

The fact that, because of the very structure of property interests in securities, certain jurisdictions rely extensively on a legal connect between credits and debits while others do not is the most significant reason why it is impossible to unify the rules governing the validity of debits and credits without unifying the legal characterisation of investors’ and account holders’ interests in securities held through intermediaries.

There is an additional and more pragmatic reason for this limitation to the extent of harmonisation in respect of credits and debits. Moving securities by way of book-entries entails a degree of risk arising from possible human errors, technical failures, and fraudulent behaviours (operational risk). However desirable the absolute irreversibility of book-entries would appear to be from a legal certainty viewpoint, the integrity of the intermediary system requires that defective book-entries should be corrected and that, at any given time, the sum of all book-entries relating to an issue of securities always represents the totality of the issue, no less and no more. All jurisdictions provide for general or specific rules determining when a book-entry is valid or when it is ineffective or must be reversed. Very specific provisions dealing with various circumstances are to be found in account agreements and, most importantly, in rules of clearing and settlement systems. They may provide, for example:

\begin{itemize}
  \item that a debit to a securities account is null and void or must be cancelled when it has not been caused by the account holder or when it is not covered by actual, apparent, or statutory authority from him and when it was ordered by an account holder lacking the capacity to do so;
  \item that a credit must be reversed when it was made against the delivery of certificated securities that are later determined to be forged;
\end{itemize}
that a book-entry must be corrected when the securities identified, their number, or the account affected do not match the instructions upon which the intermediary was acting;

that a credit of securities given before the actual settlement of the transaction may be reversed if the settlement fails; etc.

The exact description of the circumstances mandating or allowing correction of book-entries and the particular effects of such corrections vary widely not only from one jurisdiction to another, but from a clearing or settlement system to another. Arguably they could be abstracted and categorised in such a manner as to establish a significant degree of convergence. But the technical rules themselves depend heavily on market usage, existing information technologies, operational arrangements, etc. It would be illusory to pursue their unification and there is no need for it. At present, Article 13(1) of the draft Convention states the only universal principle that a debit to a securities account should not be allowed to stand if it was not authorised by the account holder.¹²⁴ Consistently with the notorious difficulty of harmonising rules on agency,¹²⁵ the current draft Convention wisely refers the authorisation issue to the applicable law.¹²⁶ Article 13(2) refers all other potential cases of invalidity and reversal of book-entries to the non-Convention law, the account agreement, and the rules of a securities settlement system.

The value of harmonisation does not reside in achieving uniform conditions for the validity of book-entries in securities accounts, but in regulating adequately their effectiveness against third parties. An account holder is generally not in danger of relying to his detriment on credits and debits to his accounts that are later annulled, cancelled, or reversed. This is because he can appreciate whether a debit or a credit was properly entered, whether it is defective and should be corrected, and whether it is subject to conditions

¹²⁴ *Id.* at Art. 13(1).

¹²⁵ By long practice, international conventions for the unification of private law do not deal with agency issues and refer the matter, usually implicitly, to the applicable law. The 1983 UNIDROIT Convention on *Agency in the International Sale of Goods* never entered into force. Unifying the relevant conflict of law rules is no less a challenge, as evidenced by the paltry number of parties, only four, to the 1978 *U.N. Convention on the Law Applicable to Agency*. See, however, the relevant provisions in the 2004 *UNIDROIT Principles of International Commercial Contracts*, obviously a non-binding instrument.

¹²⁶ *See UNIDROIT Draft Securities Convention*, *supra* note 8, Art. 13(1)(b).
subsequent such as, for example, the settlement of the transaction. The real risk falls upon third parties to whom intermediated securities have been transferred and who are at risk that the credit to their own account could be invalidated because the credit in their transferor’s account must be reversed. A short illustration may be helpful in understanding why there is a need to protect the so-called “onward-transferee”.

Acting on behalf of A Inc., B instructs Intermediary-1 to transfer 100 X shares to the account of C as a security for a loan granted to A. C then sells his holding in X-shares to D and has them credited to D’s account with Intermediary-2 against full payment. A Inc. challenges the validity of the debit to its account and can prove that B had no real, apparent, or statutory authority to take the loan and grant collateral on its behalf.

It is worth noting here that credits do not necessarily convey full ownership in intermediated securities. “Pledge” or “collateral” accounts in the name of the collateral taker are used in many jurisdictions to grant a security interest. Other limited interests such as usufructs or life interests can be conferred in the same way. The draft Convention confirms that credits can be used for any sort of dispositions, thus relying on the transaction (generally a contract) between the transferor and the transferee to determine the interest acquired by the transferee.

Returning to the illustration, the draft Convention provides that the unauthorised debit of shares from A Inc.’s account must be reversed so that the account holder is made whole. The Convention does not however determine the fate of the credit to C’s account with Intermediary-1 and of the credit to D’s account with Intermediary-2. The status of these two credits is governed by the non-Convention law governing each account, which may

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127 “Provisional credits,” i.e. credits subject to a legal or contractual condition subsequent, are used in many jurisdictions to allow credit securities to the transferee’s account before the transaction is actually settled. When settlement fails, the credit is reversed. If the account holder was allowed to make further dispositions before the credit became final, he becomes liable to return or procure an equivalent quantity of securities of the same issue to the relevant intermediary.

128 Art. 9(4) of UNIDROIT Draft Securities Convention, supra note 8, reads: “A security interest, or a limited interest other than a security interest, in intermediated securities may be acquired and disposed of by debit and credit of securities to securities accounts under this Article.”

129 Id. at Art. 13(1).

130 Id. at Art. 13(2).
be two different national laws potentially inconsistent with each other. Assuming that under the applicable law the credit to C’s account must be reversed—which is a probable rule in most jurisdictions because of the fraudulent behaviour of C—so that, after reversal, C’s securities account shows a negative position of C towards Intermediary-1 in respect of X-shares, is D exposed to a reversal of her own credit in her own account with Intermediary-2? Alternately, is D exposed to a potential claim (by C or by Intermediary-1) to return the 100 X-shares credited to her account?

The common sense answer, which is probably supported by existing rules in most jurisdictions, is that if D was not aware of the defective position of her seller C, the credit to her securities account should stand and she should be protected from a claim for restitution. Bona fide market participants should generally be protected against the defects and uncertainties in respect of prior transactions to which they are not parties, of which they have no knowledge, and which may be governed by some law they are unable to ascertain. A uniform rule is necessary here because the provisions of non-Convention law and account agreements applicable to the various accounts used in this illustration are not harmonised and may lead to inconsistent and unfair results. The protection of innocent acquirers is a necessary part of the reduction of legal risks affecting intermediated securities and therefore, a necessary component of any harmonisation project. The conditions and effects of defective credits and debits as between account holders and intermediaries cannot be harmonised but their effects against innocent or bona fide third parties must be.

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131 Assuming that the Hague Securities Convention applies to the conflict of laws, whether the credit to C’s account should be maintained would be governed by the law designated in C’s account agreement while D’s account agreement would determine the law governing the fate of the credit to D’s account.

132 The protection of innocent acquirers is an important feature to ensure the negotiability of (certificated) securities. How it translates into the dematerialised world of intermediated securities remains discussed in many jurisdictions. See BENJAMIN, supra note 26, at 75-78, and ROGERS, supra note 26, at 695-696. For a discussion of specific jurisdictions, see Einsele, supra note 26, at 97-114 and 172-198 (critical of the present German law construct) and FRÉDÉRIC NIZARD, LES TITRES NÉGOCIABLES 253-293 (2003). See Maxwell cases, supra note 40.

133 The use of words such as “innocent” or “in good faith” remained controversial after the last meeting of the Committee of Governmental Experts (May 2007) so that the current language—setting out a test based on either actual knowledge or “knowledge of facts sufficient to indicate that there is a significant probability that the interest or fact exists and [the relevant person] deliberately avoids information that would establish that this is the case”—has been placed between square brackets. See UNIDROIT Draft Securities Convention, supra note 8, Art. 14(4)(b); see also the Working Paper on the Good Faith Concept in the UNIDROIT Project.
In short, the degree of international harmonisation that can be reached in respect of credits and debits in securities accounts is limited. What can and should be achieved at a minimum is protecting innocent third parties from potential ripple effects of prior invalid book-entries. The draft Convention meets that minimum but fails to promote further harmonisation of debits and credits.

B. A Choice among Three Other Methods

Crediting securities to the transferee’s account—and debiting them from the transferor’s account—is not the only method used to confer an interest, and particularly a security interest, in intermediated securities. It has some significant drawbacks for certain collateral transactions. It gives exclusive control to the collateral taker who, as the account holder to whose account the securities are credited, can fully dispose of them while the collateral provider has no access whatsoever. This is sometimes the desired result, but not always. The parties may wish to grant fewer powers to the secured lender or may agree that the collateral provider should retain the power to modify the portfolio given as security. They need to be able to more finely tune the respective powers of the collateral taker and collateral providers. In addition, transferring intermediated securities out of the account of the collateral provider is not necessary when the collateral taker is the intermediary itself, as is most regularly the case when the latter finances a purchase of securities by the account holder.

Most legal systems make more than one method available for the creation and the perfection of security interests and other limited interests in securities held through intermediaries. The securities may be allowed remain in the account of the collateral provider provided it is made effective against third parties (“perfected”) in one of several ways: filing a public notice, having the interest registered, designating (“earmarking”) the securities in the account, entering into a control agreement, or simply relying on the intermediary’s inherent control in respect of its own interests in customer assets. Does international harmonisation mean that all jurisdictions should implement all such methods or retain a choice? What should be the status of national methods that do not enjoy international recognition?


134 See id. at Art. 14(2).
Additional methods for granting interest in securities are mostly relevant for collateral interest. Intermediated securities are very important assets for asset-financing. Promoting efficient collateral use of intermediated securities should take into consideration three basic criteria on which there is a broad consensus.\(^{135}\)

1. Efficient use of the full value of the collateral implies that it should be possible to create multiple security interests in the same assets. This requires that the parties to successive collateral transactions be able to predict with the highest degree of certainty the priority among their respective interests.

2. The rights of the collateral taker must be fully recognised in the insolvency of the collateral provider and his remedies must remain available notwithstanding the institution of insolvency proceedings.

3. The value of the security interest to the collateral taker is higher (and therefore the cost of credit for the collateral provider is lower) when the former can enforce his rights speedily and efficiently in case of default. Self-help remedies such as the right to sell the collateral without prior approval by a court are particularly efficient when the market for such assets is liquid and the prices volatile.

Not all of these concerns are capable of the same degree of international harmonisation. Notably national bankruptcy laws embed strongly diverging policy choices regarding the balance of the interests of secured lenders and other creditors in bankruptcy. All jurisdictions provide remedies against fraudulent transfers by bankrupt debtors, but no one has yet attempted at unifying such rules. Self-help remedies are deemed in many jurisdictions to go against public policy, especially when consumers are parties to the

The draft *UNIDROIT Convention* deals in different manners with those three concerns.

The first two concerns lie at the very core of the *UNIDROIT Draft Securities Convention*, whose Article 10 recognises that an account holder may grant one or more interests in securities credited to her account by entering into an agreement with the grantee of each interest. Such interests may become effective against third parties in one of the three methods listed in Article 10(2), namely:

- (a) …the person to whom the interest is granted is the relevant intermediary;
- (b) …a designating entry in favour of that person has been made;\(^{137}\)
- (c) …a control agreement in favour of that person applies.\(^{138}\)

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\(^{136}\) Articles 4, 6 and 7 of the E.U. COLLATERAL DIRECTIVE, supra note 19, mandate the availability of self-help remedies for secured transactions among qualifying participants such as financial institutions. A recent evaluation report by the European Commission shows that some Member States have taken this opportunity to extend such remedies to a larger class of transactions, while others have not. The Commission concludes that this is not an area where further harmonisation within the EU is feasible or even desirable. *See* Evaluation Report on the Financial Collateral Arrangements Directive (2002/47/EC), COM(2006) 833 final at 8–9.

\(^{137}\) *UNIDROIT Draft Securities Convention*, supra note 8, Art. 1(l) defines a designating entry as “an entry in a securities account made in favour of a person other than the account holder in respect of intermediated securities, which, under the account agreement, a control agreement, the uniform rules of a securities settlement system or the non-Convention law, has either or both of the following effects:

(i) that the relevant intermediary is not permitted to comply with any instructions given by the account holder in respect of the intermediated securities in relation to which the entry is made without having received the consent of that other person;

(ii) that the relevant intermediary is obliged to comply with any instructions given by that other person in respect of the intermediated securities in respect of which the entry is made in such circumstances and as to such matters as may be provided by the account agreement, a control agreement, the uniform rules of a securities settlement system or the non-Convention law, without any further consent of the account holder.”

\(^{138}\) *Id.* at Art.1(k) defines a control agreement as “an agreement between an account holder, the relevant intermediary and another person, or, if so permitted by the non-Convention law, an agreement between an account holder and another person of which notice is given to the relevant intermediary, which relates to intermediated securities and includes either or both of the following provisions:

(i) that the relevant intermediary is not permitted to comply with any instructions given by the account holder in respect of the intermediated securities to which the agreement relates without having received the consent of that other person;

(ii) that the relevant intermediary is obliged to comply with any instructions given by that other person in respect of the intermediated securities to which the agreement relates in such circumstances and as to such
Contracting States are not required to adopt all three methods and may possibly choose none, though that seems quite hypothetical; to improve international transparency, contracting States are required to declare the methods they have adopted. 139

The draft Convention does not distinguish between the creation (inter partes) and the perfection (erga omnes) 140 of an interest. The collateral agreement and, when necessary, the designating entry or the control agreement together are required to create an interest in intermediated securities and to make it effective against third parties. The value of the harmonisation here is that “no further step is necessary, or may be required by the non-Convention law, to render the interest effective against third parties.” 141 The value of the provision also lies in the recognition that many perfection mechanisms on which most jurisdictions rely for traditional assets such as cars, inventory, real estate, or intellectual property do not fit the needs of the participants to the intermediated securities systems. Intermediated securities are given as collateral in much the same way as money deposits with banks (cash accounts). The reasons for this similarity are factual and compelling. Securities in a securities account, like money in a bank account, can only be identified by looking into an account which is not publicly accessible. The party maintaining the account, a regulated and supervised financial intermediary, is the gatekeeper to the assets in the account: not only does it keep track of what comes in and goes out, but it is in the position of controlling such movement for the benefit of other parties interested in the account. A potential secured lender has no other way of assessing the existence, value, and availability of the assets in the accounts than to rely on information disclosed by the bank or intermediary with the consent of the account holder.

Rendering interests in the account effective against third parties ought not to be based on publicity requirements, but rather on the capacity of the secured party to protect the collateral from unauthorised disposition by the collateral provider. The element common to all three alternatives listed above is the control enjoyed by the collateral taker—whether it

 matters as may be provided by the agreement or the non-Convention law, without any further consent of the account holder.”

139 Id. at Art. 10(4)(a).

140 Unlike the Hague Securities Convention, supra note 17, which defines “perfection” in Article 1(i) as the “completion of any steps necessary to render a disposition effective against persons who are not parties to that disposition,” the UNIDROIT Draft Securities Convention, supra note 8, uses the words “effective against third parties” to avoid a term of art which carries strong connotations, see inter alia at Arts. 10 & 15.

141 UNIDROIT Draft Securities Convention, supra note 8, Art. 10(1) in fine.
is the relevant intermediary itself or another party exercising that control through the relevant intermediary. Whether through a control agreement or a designating entry, or because it is itself the relevant intermediary, the secured party enjoys either a *positive control*—the intermediary will implement the instructions of the secured party without further consent of the account holder—142—or a *negative control*—the intermediary will not implement instructions from the account holder without consent from the secured party—143—or possibly both.

Creating multiple interests in the same asset is of little value to the beneficiaries unless they can ascertain easily, in advance, and without ambiguity the relative rank of their respective interests enjoy. Article 15 of the draft Convention determines the priority among competing interests in the same intermediated securities. Interests granted in compliance with one of the three internationally recognised methods listed in Article 10(2) rank among themselves according to the time they were made effective against third parties. Interests created by operation of law (“non-consensual interests”), which are entirely governed by the non-Convention law,144 enjoy the priority afforded to them by that law. It is worth noting that the Convention does not purport to preclude contracting States from providing other methods for granting (voluntary) interests in intermediated securities. Such non-internationally recognised are perfectly valid but the interest so created rank below any interest granted in accordance with an internationally recognised method.145

As noted above, efficient collateral transactions require that the collateral taker can easily and speedily enforce her rights when the debtor defaults. Self-help remedies are particularly important when the collateral is made of highly liquid and volatile financial assets.

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142 I use “positive control” to describe the situation where, according to the language in Article 1(k-l) of the *UNIDROIT Draft Securities Convention*, common to control agreements and designating entries, “the relevant intermediary is obliged to comply with any instructions given by [the holder of the interest] in respect of the intermediated securities [to which it applies] in such circumstances and as to such matters as may be provided by the account agreement, a control agreement, the uniform rules of a securities settlement system or the non-Convention law, without any further consent of the account holder.”

143 I use “negative control” to describe the situation where, according to the language in Article 1(k-l) of *UNIDROIT Draft Securities Convention*, common to control agreements and designating entries, “the relevant intermediary is not permitted to comply with any instructions given by the account holder in respect of the intermediated securities [to which it applies] without having received the consent of that other person.”

144 See *UNIDROIT Draft Securities Convention*, supra note 8, Art. 10(7).

145 See supra note 119.
However, a number of jurisdictions traditionally take a restrictive approach to self-help remedies for public policy reasons and may often not distinguish financial from other assets. To promote such remedies in respect of intermediated securities without compromising the international acceptance of an international instrument which must remain focused, the drafters have opted to deal with enforcement remedies in a separate chapter. Under the heading “Special Provisions with Respect to Collateral Transactions,” it is substantially modelled after the European Financial Collateral Directive.\textsuperscript{146} Contracting States would significantly improve the value of collateral transactions by adhering to that chapter. Nonetheless they may, by declaration, opt-out of it completely or restrict the application of its provisions to certain categories of parties, to exchange traded securities and/or to collateral transactions securing certain categories of obligations. This very open menu reflects two rationales. Improving the national rules governing the enforcement of security interests is highly desirable but it is not such an indispensable feature that its absence would deprive the future convention of any value and meaning. This opt-out also reflects that harmonising these rules touches upon public policy choices that are not specific to securities or intermediated securities so that contracting States may have significant reason not to reform their law in that respect while at the same time the wish to adopt the others parts of the convention.

\textbf{C. Similarities and Differences}

Arguably the provisions setting out the methods for disposing of intermediated securities form the very core of the draft convention. They provide the basic toolbox for the global intermediary system. However, the two key provisions, Articles 9 and 10, are structured quite differently.

Article 9 makes credits and debits available to all account holders under the law of all contracting States. It prominently proclaims that “[n]o further step is necessary, or may be required by the non-Convention law,” to render the acquisition or disposition “effective against third parties.” The draft Convention does not regulate the conditions under which book-entries are invalid or must or can be reversed. Except for the invalidity of unauthorised debits,\textsuperscript{147} the matter is left for the non-Convention law and, to the extent the

\textsuperscript{146} \textit{See supra} note 136.

\textsuperscript{147} \textit{See UNIDROIT Draft Securities Convention, supra} note 8, Art. 13(1).
latter allows, to the account agreement or the rules of a securities settlement system. To minimise the impact of ineffective credits, the draft Convention provides protection to innocent “onward transferees,” i.e. subsequent transferees whose acquisition could be challenged because of a defective entry at a prior stage.

Article 10 sets out three alternative methods, any one or more of which contracting States may elect to implement in their law. The resulting harmonisation is only partial. The validity, extent, and robustness of any interest so created or transferred depend on the validity and the provisions of the particular contract on which the interest is based. However, the effectiveness of such interest against third parties, including against an insolvency administrator, and its priority in respect of other interests in the same intermediated securities are fully harmonised.

As indicated throughout the paper, the functional approach, a sine qua non condition to the success of the future Convention, imposes significant constraints on the degree of harmonisation it can achieve. However, it also yields interesting and sometimes surprising results both from a theoretical and a practical viewpoint. One of them is a common feature of Articles 9 and 10: each one of the four methods (credit to a securities account, control agreement, designating entry, and agreement with and in favour of the relevant intermediary) can be used either to fully transfer intermediated securities or to grant any sort of limited interest in the same. Whether the parties have done one or the other and which particular interest has been granted is a matter for the terms of the agreement among the parties subject to the applicable law. The draft Convention provides the plumbing; the applicable law determines the substance that flows between the parties.

Credits to securities accounts are widely used to perform straight sales and repurchase agreements (Repos). Control agreements, designating entries, and self-perfection for the

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148 See id. at Art. 13(2).
149 See id. at Art. 14(2).
150 See id. at Art. 9(4) (credits and debits can also be used to acquire of dispose of a “security interest, or a limited interest other than a security interest”) and Art. 10(1) (account holder may grant any “interest in intermediated securities, including a security interest or a limited interest other than a security interest”).
151 Repurchase agreements (or repos) are transactions whereby securities are exchanged against cash under terms that, upon termination, the reverse exchange will take place along with an additional payment (repo interest). The cash provider is compensated by the cash receiver through a difference between the initial payment and the final payment (repo interest). Economically, repos are fully-secured loans widely used in the
relevant intermediary are typically employed to create security interests. Parties to a particular transaction may nonetheless see benefits and efficiencies in achieving the same result by any of the methods available. Central banks maintaining securities accounts for commercial banks and securities firms may choose to rely on the self-perfection method to take their account holders securities in overnight Repos without the bother of debiting the securities on day one at 17:00 and re-crediting them on the next day at 9:00. Secured lenders in a pledge transaction may choose to insist on obtaining absolute control of the collateral by having the securities credited to their accounts or they may be satisfied with negotiating a control agreement that leaves the collateral provider with some benefits from and power over the securities credit to his account. The fundamentally open-nature of the disposition methods offered by the draft create interesting possibilities that will certainly be explored and tested by market participants. It also requires a clear delineation between two of the most important sets of rules in the future convention: the priority of competing interests created by successive dispositions versus the protection of innocent acquirers.

D. Priorities and Innocent Acquisition: First-in-Time vs. Last-in-Time

An effective framework for secured transactions requires *inter alia* a clear and predictable rule governing the priority of competing interests in the same assets.152 The draft Convention adopts a first-in-time, first-in-right principle for all interests in the same intermediated securities which become effective against third parties in accordance to one of the three methods offered in Article 10 (control agreement, designating entry, and agreement with and in favour of the relevant intermediary).153 Other consensual interests—interests created by agreement between the parties and made effective against third parties in accordance with a method not regulated by the Convention—enjoy the rank set out by the non-Convention law but are always subordinated to interests perfected in accordance with the Convention.154 Non-consensual interests, *i.e.* interests arising by operation of law, may be provided for by the non-Convention law which then determines their priority against any other interest.155

money markets generally and by central banks to implement their monetary policy. Legally, they enjoy the benefit of being immune to the bankruptcy of either party.

152 *See supra* Section VI.B and note 135.

153 *See UNIDROIT Draft Securities Convention, supra* note 8, Art. 15(1) & (3).

154 *See id.* at Art. 11 and 15(2).

155 *See id.* at Arts. 10(7) and 15(5).
An effective title system for negotiable assets also requires protecting *bona fide* acquirers against competing claims by previous holders. ¹⁵⁶ What is true in the physical world of certificated securities is also needed in the intangible world of intermediated securities, which are massively traded in the near total anonymity of regulated exchanges. One cannot forget however, that intermediated securities are also the subject-matter of complex and highly-customised transactions among sophisticated parties supported by extensive due diligence. The on-exchange buyer of stock, the lender taking bonds as collateral, as well as the purchaser of a controlling interest in a corporation should all be eligible for protection; however, obviously they cannot be expected to apply the same standard of diligence in enquiring about the entitlement of their seller or collateral provider in the respect of the securities. A difficult balance must be reached between security of title and security of transfer. ¹⁵⁷ Given the highly fungible nature of intermediated securities and the reliance of all parties on actions taken by intermediaries, which are typically highly regulated and supervised entities, ¹⁵⁸ the draft Convention sets out a standard of an “innocent person” based on actual knowledge or what one may be termed “wilful blindness.”¹⁵⁹

When drafting priority rules and innocent acquisition rules, it is easy to forget they are exact opposites. A priority rule promotes title security by protecting incumbent holders of interest against subsequent or subordinated interests in the same assets. Typical instances are first-in-time rules, though other criteria may be taken into consideration. ¹⁶⁰ Conversely, an innocent acquisition rule fosters transactional security by protecting the acquirer of an interest against prior interest in the same assets—a last-in-time priority. Obviously first-in-time and last-in-time rules contradict each other. Both may be necessary, as we find in most property systems, but their respective scope must be carefully designed so that they are never applied at the same time.

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¹⁵⁶ See *supra* note 132.

¹⁵⁷ As clearly and concisely expressed by BENJAMIN, *supra* note 26, at 75-6.

¹⁵⁸ The draft Convention does not require governmental regulation, supervision, or oversight of intermediaries. All regulatory issues fall beyond the scope and purposes of the Convention.

¹⁵⁹ See *supra* note 133 on the pending controversy over the test for innocent acquisition.

¹⁶⁰ *Id.* at Art. 15, which combines a time-priority principle between interests perfected in accordance with one of three preferred methods with a time-unrelated preference of such internationally recognised methods over domestic ones.
The purpose of this paper is not to address in any depth the numerous features of the draft Convention. Its focus is on the methodology of a particular international harmonisation project, specifically the functional approach, which reflects the choice that any provision should be capable of being implemented by any contracting State without the need to change the domestic characterisation of interests in securities held with an intermediary. The delimitation between the priority and the innocent acquisition rules provide a successful example of finding a solution by adhering strictly to the functional approach.

Prima facie one might think that innocent acquisition should apply to full ownership while priorities apply to limited interests in the same property.\textsuperscript{161} This would not be sensible, however, since collateral takers must be able to protect their interest not only against subsequent collateral takers, but also against subsequent buyers of the same assets. At a more fundamental level, in an instrument which takes no view on the legal characterisation of the interests acquired, transferred, or granted, but leaves that question entirely to the non-Convention law, relying on such characterisation for the purpose of defining the respective scopes of international rules increases rather than it decreases legal risks. Many jurisdictions allow collateral transactions involving the transfer of full ownership to the collateral taker while others do not. Some jurisdictions distinguish between outright transfers such as in repurchase operations from ownership-based security interests. Attaching the trigger of uniform priority and innocent acquisition rules to the legal characterisation of the competing interests under non-Convention law would vastly undermine the predictability which the Convention is meant to promote.

The draft Convention provides methods for transferring intermediated securities and for granting interests without choosing sides as to the exact contents of the rights so transferred or granted. A consistent implementation of the functional approach suggests that distinguishing the respective scope of the priority and innocent acquisition rules should rely on the method used to create or transfer an interest instead rather than on its legal characterisation.

1) The priority rule must regulate competing interests granted in the same securities credited to the same securities account. Securities accounts lie at the core of the

\textsuperscript{161} This may have been the principle underlying the \textit{March 2006 Draft of the Convention}, UNIDROIT STUDY LXVIII Doc. 42 (Mar. 2006), where Article 6 dealt with “priority among competing security interests” and Article 7 protected innocent acquirers to whose securities accounts securities were credited. Article 4 could be read as limiting the use of credits and debits to the acquisition of full ownership in intermediated securities.
intermediated world. Book-entries and other records maintained by the intermediary maintaining the account must allow all parties interested in an account—namely the account holder and any person who was granted an interest in the securities in that account—to ascertain their respective position. Indeed, all such parties rely on the intermediary to keep accurate records and (when authorised by the account holder) to provide reliable information on existing interests in intermediated securities. All parties interested in the same account are exposed to the same intermediary risk, including the risk that it overlooks the rights of one party or fraudulently defeats them.

2) A buyer of intermediated securities or of an interest therein who wants to take her interest free of competing claims she is not aware of should have the securities credited to her own account. As noted before, credits are the gold standard of intermediated securities. It follows that a 

*bonda fide*

acquirer must be able to rely on such credits to her securities account. Obviously if the securities to be debited from the account of the seller or collateral provider are encumbered by other interests, which were made effective against third parties, the intermediary should not allow the securities to be debited from the transferor’s account. The intermediary may waive its own interests; the debit is not effective in respect of other interest holders who have not consented because it is not properly authorised. In such cases, the innocent acquisition rule protects a 

*bonda fide*

transferee from the defects in the debit entry. Provided she meets whatever test chosen for that purpose, the account holder to whose account securities are credited takes intermediated securities—or such interest therein as provided under her contract with the transferor and the applicable law—free of any previous interest she was not aware of at the time of the acquisition.

In compliance with the functional approach the draft Convention delimits the respective scopes of the provision on priorities and of the innocent acquisition provisions by limiting the former to the credit of securities to a securities account and the latter to the use of any of the three other methods for making an interest effective against third parties.

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163 Compare Articles 14 and 15 with Articles 9 and 10 of the *Unidroit Draft Securities Convention*.

164 The draft Convention does not however determine the priority conflict the account holders of an intermediary and the collateral takers to whom that intermediated has granted an interest in the securities of its
VII. Conclusion

Long gone are the dreams of a world where comparative legal scholarship and multilateral diplomacy would join forces to create a better world by promoting the international convergence of commercial laws. 165 Even though the International Institute for the Unification of Private Law is unlikely to change its name any time soon, the unification of private law for its own sake is neither achievable nor even desirable. 166 Studies, mostly in respect of corporate law, have highlighted the existence and benefits of a market for legal systems in the context of a federal State or among sovereign States. Drawing substantially on economic and political sciences, they support the promotion of competition among jurisdictions by empowering private actors to choose the rules they want to govern their venture or transaction. 167

The law governing securities held through intermediaries is very much a case in point. Even though it deals with a global and competitive market place, the law is notable for its stark national differences in the legal characterisation of the property right of investors and strong public policy choices regarding the protection of investors, the regulation of intermediaries, and the flexibility of secured transactions. The Hague Securities Convention addresses conflicts of laws by substantially promoting the choice of the applicable law by account holders, see UNIDROIT Draft Securities Convention, supra note 8, Art. 16. Whether the collateral takers should win so as to foster the overall liquidity, as they do under U.C.C. §8–511 (1994), or the property rights of account holders should be protected except when collateral takers meet the test of an innocent acquisition, is a highly controversial policy issue on which contracting States are unlikely to agree. For a discussion of the policy in the U.S., see Charles W. Mooney, Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries, 12 CARDOZO L. REV. 307, 379-412 (1990); Russell A. Hakes, UCC Article 8: Will the Indirect Holding of Securities Survive the Light of Day?, 35 LOY. L.A. L. REV. 661, 772-783 (2002).


an account holder and the relevant intermediary. But property rights need to be clearly defined and allocated and they must be recognised and enforced in domestic as well as in international situations. Even before the ink had dried in the Hague, a substantive discussion had begun on whether, how, and to what extent another international instrument should promote the soundness of national laws and reduce the legal risk resulting from their partial incompatibility.

This paper has discussed the international harmonisation of substantive rules governing intermediated securities and the *UNIDROIT Draft Securities Convention*, which will likely be submitted to a diplomatic conference in June 2008. It has set a particular emphasis on the functional approach adopted by its drafters to overcome what appears to be the central objection to any harmonisation in that area of the law—the fact that the rights of investors in respect of securities held through intermediaries are structured and characterised in radically different ways under the domestic laws of the nations interested in the project and the lack of any need to displace that diversity. In Sections V and VI, we confirmed the validity of this approach in respect of several core issues, although we criticised the current definition of intermediated securities which does not adhere strictly with the functional approach.

The draft convention does not contain an exhaustive regulation for the holding and disposition of intermediated securities. Rather than being a comprehensive, self-contained international instrument meant to replace national laws, it regulates a limited number of key issues. Its implementation requires the support of national statutory and regulatory provisions regulating the much larger number of issues entailed in any modern intermediary system for the holding and transfer of securities. Numerous references to the “non-Consortium law”169 in the draft convention testifies to its necessary incorporation into the fabric of domestic provisions.

Even in the matters directly addressed by the draft convention, a number of choices must or may be made by contracting States. We have particularly discussed the menu of disposition methods other than debits and credits (control agreement, designating entry, and agreement with and in favour of the relevant intermediary) among which every contracting State may

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168 *See* above section II.B.

169 *See supra* note 103.
choose, subject to a declaration mechanism promoting the international transparency of that choice. 170

The *UNIDROIT Draft Securities Convention* confirms the dominant traits of most recent international harmonisation projects in the area of commercial law, *i.e.* a disciplined and transparent reasoning regarding when and where uniform rules are necessary; a functional approach concerning how such rules must be devised; a strong dialog between governments, international organisations, and the relevant constituencies, including State (central banks, regulators, etc.) and non-State (investors, industry representatives, etc.) actors; and the recognition that domestic policy concerns may be addressed by making choices and “menus” available to contracting States to the extent compatible with the purposes of the particular project. These traits add to, rather than subtract from, the complexity of any such project. They have, however, become an integral feature of the international harmonisation of commercial law where, more often than not, less is more.

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170 See Section VI.B. above.