

Intermediated Securities: Legal Problems and Practical Issues

Louise Gullifer & Jennifer Payne, eds.
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Louise Gullifer and Jennifer Payne have edited for publication a volume of essays based on presentations at an international conference on the Geneva Securities Convention, held at Oxford in March 2009. In so doing they have provided a substantial benefit to all who work with the commercial law of securities.

The commercial law of securities is an inherently complex field, due in part to the field's many intersections with other bodies of law. The core questions of commercial law as applied to securities are about ownership, outright transfer, transfer as collateral or of other partial interests, rehypothecation, the duties of intermediaries to their account holders and others, and the related conflicts of law. But the understanding of commercial transactions in securities inherently implicates numerous additional regimes as well, many of them formidable in their own right. These additional regimes range from basic provisions of property and contract law to corporate or other company organic law, regulation of securities markets, regulation of market participants including banks and broker-dealers, various insolvency regimes, and sophisticated amalgams of all of the foregoing. Because of this daunting complexity, the commercial law of securities is a lightly trodden field, with only a few academics and lawyers specializing in it — especially as compared to the tremendous volume, size and importance of the transactions involved. The commercial law of securities is a Mississippi River of commerce.

In recent decades the commercial law of securities has been outstripping its old roots in negotiable instruments law and moving into a more modern and abstract framework of intermediation.¹ Intermediation in this context refers to the

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¹ The 1994 revisions to Uniform Commercial Code Article 8 introduced one form of this modern intermediated framework to U.S. law, and later served as a model for the *Uniform Securities Transfer Act* in Canada. UCC Article 8 uses the term "indirect holding system." See generally, William D. Hawkland, James S. Rogers & Carl S. Bjerre, 7A Uniform Commercial Code Series § 8-501:01. Modern regimes in other nations employ

maintaining and transfer of property rights in securities by means of book entries in accounts maintained by brokers, banks, or other custodians acting as intermediaries, often in several tiers, between an issuer and its ultimate investors. Transactions between buyers and sellers or other commercial actors are carried out by debits and credits to the appropriate accounts, with the intermediaries themselves being linked as needed on their respective books or on those of a central securities depository.²

The Geneva Securities Convention (the "Convention") is a landmark project that harmonizes some of the most important principles of the commercial law of intermediated securities. Negotiations culminating in the Convention, more formally known as the UNIDROIT Convention on Substantive Rules for Intermediated Securities, were conducted under the auspices of UNIDROIT, the International Institute for the Unification of Private Law, which is an independent intergovernmental organization having 63 member states and initial roots dating back to the League of Nations. The term "substantive" in the Convention's title distinguishes its subject matter from the conflicts of law rules for intermediated securities (the latter being most notably dealt with by the Hague Securities Convention and Europe's Financial Collateral Directive).³ The Geneva Securities Convention has not at present been ratified by any nation, but the success of its dissemination and acceptance will need to be judged over a much longer term, and the Convention has already strongly influenced another ongoing project, the draft European Securities Directive.

The volume under review consists of nine essays of substantial length plus a handful of shorter contributions. All of the authors are abundantly well qualified in their fields, with a good mix of academics and distinguished practicing lawyers, including among others Ben McFarlane and Robert Stevens, Charles Mooney and Hideki Kanda, Eva Micheler, Gabriel Moss, Antony Zacaroli and Herbert Kronke. The remainder of this review looks more closely at some of the essays, with Part 1 focusing on conceptions of intermediated securities, Part 2 highlighting certain questions of property rights, and Part 3 serving as a conclusion.

1. THE FUNCTIONAL APPROACH AND VARYING LEGAL SYSTEMS

The Convention carries out its harmonization project by means of a so-called functional approach. Herbert Kronke, Secretary General of UNIDROIT during

a variety of nomenclature and conceptual systems, as the Gullifer & Payne volume (hereinafter "Gullifer & Payne") helps to demonstrate. In addition, many legal systems are without law directly targeting intermediated securities at all.

² The terms of art under UCC Article 8 and the *Uniform Securities Transfer Act* are "clearing corporation" and "clearing agency" respectively. See UCC § 8-102(a)(5); Ontario *Securities Transfer Act*, 2006, S.O. 2006, c. 8, s. 1(1) ("Ontario STA").

³ See Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary ("Hague Securities Convention"), online: <<http://www.hcch.net/upload/conventions/txt36en.pdf>>; Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements; amendatory directive 2009/44/EC.

most of the Convention process, explains in his remarks in this volume that the functional approach entails formulating Convention provisions in neutral or “everyday” language, specifying the intergovernmentally negotiated results directly while “rigorously refrain[ing]” from relying on any legal system’s pre-existing doctrinal or conceptual characterizations.⁴ This approach proved to be crucial to the Convention’s success, precisely because of the complexity of the commercial law of securities noted above. The varying national bodies of law concerning intermediated securities, each developed over the decades in “splendid isolation” from each other,⁵ inevitably conceptualize matters in sharply varying ways — but provided that these varying conceptualizations nonetheless converge on their central results (as they prove to have done), an international instrument can harmonize those results.

Dramatizing the importance of the functional approach, the very nature of securities themselves (intermediated or otherwise) has been subject to widely varying views across borders and over time. The Convention’s central term “intermediated securities” is defined expansively by means of two complementary or alternative formulations,⁶ because in some legal systems account holders are treated as having rights directly to the securities in their own right, while in others the intermediary rather than the account holder is the primary rights holder.⁷ Other questions touching the essential nature of securities are explored in the volume’s essays by Ben McFarlane and Robert Stevens jointly, by Gabriel Moss, and by Eva Micheler. A 2004 Financial Markets Law Committee (FMLC) report had recommended, among

⁴ Herbert Kronke, “Remarks on the Geneva Securities Convention’s Development and its Future” in Gullifer & Payne at 247. In an early essay on the then-draft Convention, which remains very valuable on the Convention’s final text, Luc Thévenoz provides a good example of the functional approach:

[T]o 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.

Luc Thévenoz, “Intermediated Securities, Legal Risk, and the International Harmonization of Commercial Law” (2007) 13 *Stan. J.L. Bus.* 384 at 414. See also Louise Gullifer, “Ownership of Securities: The Problems Caused by Intermediation” in Gullifer & Payne at 7 (“specifying the result rather than the legal reasoning used to achieve this result”).

⁵ Kronke, *supra*, n. 4 at 246.

⁶ “[I]ntermediated securities’ means securities credited to a securities account or rights and interests in securities resulting from the credit of securities to a securities account . . .” Convention art. 1(b).

⁷ Under the U.S. and Canadian systems an intermediary holds the securities for its account holders to the extent necessary to satisfy the security entitlements with respect to the particular financial asset, and the account holders’ rights may ordinarily be exercised only through the intermediary. See UCC §8-503; Ontario STA, s. 97; Hawkland, Rogers & Bjerre, *supra*, n. 1, §8-503:01 (describing the “sui generis” nature of a security entitlement).

other things,⁸ that English law clarify by statute the nature of account holders' rights, namely that account holders hold a bundle of co-proprietary and personal rights in the securities held by their intermediaries (and that accordingly account holders are not, for example, bailors or purely contractual and general creditors). The FMLC report had also recommended statutorily confirming the holding in *Hunter v. Moss*,⁹ which upholds account holders' property rights to an intermediary's unsegregated securities against trust law's traditional requirement that the trust *res* be identifiable. McFarlane and Stevens on one hand, and Moss on the other, express different perspectives on these questions, as well as others, in a valuably direct colloquy.

Eva Micheler further explores competing conceptualizations of securities. She shows that modern German and Australian law classify securities as tangibles, with an associated rule under which good faith buyers take free of adverse claims,¹⁰ but that earlier theory (before the 1871 unification of the German Empire) had regarded securities as intangibles, with an associated rule of *nemo dat qui non habet*,¹¹ and that Prussia and Austria in that era had accordingly created special freedom from adverse claim rules. Micheler's sensible conclusion is that modern law, too, can create needed exceptions to otherwise applicable property principles, justified by securities' unique nature and purpose, as with *Hunter v. Moss*.¹²

2. PROPERTY PRINCIPLES AND INTERFACE WITH NON-CONVENTION LAW

Professor Kronke also points out that the Convention takes a minimalist approach by focusing on a "carefully selected list of key issues," while explicitly

⁸ Many of the issues in the FMLC report are also the subject of Convention provisions.

⁹ *Hunter v. Moss* (1993), [1994] 1 W.L.R. 452, [1994] 3 All E.R. 215, 91(8) L.S.G. 38, 138 S.J.L.B. 25 (Eng. C.A.).

¹⁰ The issue of adverse claims is discussed below, text accompanying notes 15-16.

¹¹ "No one gives who hath not."

¹² By contrast to the divergent rules of law under discussion here, subconscious understandings of the intermediated securities system tend to be unified and highly coherent. This becomes clear when one examines the figurative language used in the field as illuminated by the cognitive theory of metaphor. See Carl S. Bjerre, *Metaphor in the Law of Securities Ownership* [unpublished, manuscript on file with author]; see also Carl S. Bjerre, "Mental Capacity as Metaphor" (2005) 18 Int'l J. for the Semiotics of Law 101 (demonstrating the metaphorical coherence of discourse in a different private law field); see generally, e.g., George Lakoff, *Women, Fire and Dangerous Things* (Chicago: University of Chicago Press, 1990). Specifically, the manuscript shows that intermediated securities are subconsciously conceptualized as flowing liquids; that it is accordingly no accident that intermediaries closer to a central securities depository are called "higher tier"; and that many other expressions such as "blocked account," "clearing," and "settlement" are all systematically consistent with the metaphorical understanding. See also Convention art. 22 (prohibiting "upper-tier" attachment). By significant contrast, the manuscript shows, the separate discourse of shareholder power under corporate as opposed to commercial law shows equity owners being conceptualized at the top rather than the bottom of a structure, consistent with the subconscious metaphor that power is up.

leaving a substantial number of related issues to the non-Convention law.¹³ Indeed the extent of the Convention's deference to non-Convention law is unique among international instruments, and is responsible for a good deal of the Convention's difficulty. Nonetheless this deference to non-Convention law is eminently sensible in light of the field's above-noted complexity. National systems inevitably vary in their sprawling detail, even while they converge on their central results.

Charles Mooney and Hideki Kanda, two of the leaders of the negotiation and drafting processes, contribute a sharply focused essay on the Convention's property-related provisions,¹⁴ highlighting the important role played by non-Convention law and spelling out the often contrasting approaches taken by the non-Convention law of the United States and Japan. Two important instances are the rules on innocent acquisition (which are derived from fundamental principles of negotiability) and the rules on priority.

Convention article 18(1) provides an innocent acquisition rule, namely that the rights of a person acquiring intermediated securities for value (whether by credit to the acquirer's account or by the alternative Article 12 methods discussed below) are not subject to the rights of another person, provided that the acquirer neither knows nor "ought to know" that the acquisition violates the other person's rights. Mooney and Kanda first discuss the essence of the ought-to-know standard and some of the dynamics that led to its adoption, and they then explore its counterparts under U.S. law (which is statutory and based on willful blindness¹⁵) and Japanese law (which is judge-made and based on good faith and the absence of gross negligence). The authors nicely show that the Convention standard is only a safe harbor, *i.e.*, that the Convention defers to non-Convention law (or more accurately "applicable" law) on the question of whether acquirers not meeting the Convention standard are nonetheless protected.¹⁶

As to priority, Convention Article 12 permits Contracting States to declare that any or all of three alternative methods, in addition to crediting a securities account, are available to make an interest in intermediated securities effective against third parties.¹⁷ The Convention generally provides that among those three

¹³ Kronke, *supra*, n. 4 at 247.

¹⁴ Charles W. Mooney, Jr. & Hideki Kanda, "Core Issues under the UNDROIT (Geneva) Convention on Intermediated Securities: Views from the United States and Japan" in Gullifer & Payne at 69.

¹⁵ See UCC §8-105(a)(2); STA §18(b).

¹⁶ Convention art. 18(4). In the authors' words, "The Convention protects qualified acquirers, but it says *nothing* about the effects of an acquirer's failure to qualify." Mooney & Kanda, *supra*, n. 14, at 104 (emphasis in original).

¹⁷ The three methods are control agreement (which may be negative or positive), designating entry (which also may be negative or positive), and grant by the account holder to its own intermediary. Convention art. 12(3), 1(k), 1(l). Other methods recognized by non-Convention law are also preserved. *Ibid.*, art. 13.

methods, first in time is first in right,¹⁸ subject to certain exceptions.¹⁹ The interests conferred by any of the Article 12 methods may be either limited (as with security interests) or full transfers of outright ownership (as with the opening leg of a repo transaction),²⁰ and this flexibility presents interesting priority questions. For example, if the first of two interests granted in the same intermediated securities is an outright transfer (and the account holder is arguably thus left with nothing to give to a second acquirer), does the *nemo dat* principle modify Article 19's otherwise applicable priority rankings? Mooney and Kanda adroitly show that the result actually depends on non-Convention law, and that the Convention provisions that seem, in isolation, to contemplate the second acquisition being effective or even having priority are not dispositive. "The Convention's priority rules should not be read to create inferences about the non-Convention law."²¹

Beyond the analysis itself, a further benefit (intended or not) of Mooney and Kanda's comparative approach is that it leads to an appreciation of the contingent and potentially flexible nature of many commercial law rules. Within its narrower scope the same is true of the paper by Antony Zacaroli,²² which provides an illuminating account of English law's floating charge as affected by rights to withdraw or substitute collateral. Zacaroli distinguishes this topic, in ways that must surely be correct, from the varying "control" provisions appearing in the Financial Collateral Directive, its U.K. implementing regulations, and the Convention. Inevitable though a given rule may seem in the context of a given system, it probably did not fall from the sky.

3. FURTHER AND CONCLUDING MATTERS

Erica Johansson's essay discusses repledge or re-use of collateral under the Financial Collateral Directive, its U.K. implementing regulations, and Convention article 34, with each of these instruments' tradeoffs between liquidity of markets and security to pledgors.²³ Maisie Ooi expresses concern about the principal rule of

¹⁸ Convention art. 19(3). This familiar principle points up a nice structural contrast with the innocent acquisition rules, under which the *last* in time can loosely be said to be first in right.

¹⁹ See *ibid.*, arts. 19(4) (subordination of intermediary's interest), 19(7) (availability of declaration that designating entry shall have priority).

²⁰ The Convention sensibly provides that the same is true of the primary means in the intermediated securities systems for making interests effective against third parties, namely the crediting of the securities account. Convention art. 11(4).

²¹ Mooney & Kanda, *supra*, n. 14, at 117.

²² Antony Zacaroli, "Taking Security over Intermediated Securities: Chapter V of the UNIDROIT (Geneva) Convention on Intermediated Securities" in Gullifer & Payne at 167.

²³ Erica Johansson, "Reuse of Financial Collateral Revisited" in Gullifer & Payne at 151. The paper also discusses recent papers from the U.K. Treasury and Financial Services Authority (FSA). For more on repledge see Erica Johansson, *Property Rights in Investment Securities and the Doctrine of Specificity* (Berlin: Springer, 2009); Thomas Keijser, *Financial Collateral Arrangements: The European Collateral Directive Considered from a Property and Insolvency Law Perspective* (Deventer: Kluwer, 2006).

the Hague Securities Convention when combined with the Geneva Securities Convention's acquisition by credit principle, and advocates for two alternative conflicts rules.²⁴ Habib Motani, Karin Wallin-Norman, and Teun Struyken provide brief views of the Convention from the United Kingdom, Sweden and the Netherlands.²⁵ Editor Jennifer Payne examines the voting of intermediated securities under U.K. law and expresses skepticism that the Convention would strengthen account holders' rights.²⁶ Editor Louise Gullifer opens the volume with an excellent overview that combines wide-ranging scope with admirable clarity of detail.

Overall this volume very usefully foregrounds practical issues as its subtitle promises, while also fitting well within the best tradition of academic essay collections. The essays are quite timely but should also prove to be of enduring value, and of course this short review cannot do justice to the richness and complexity of the matters covered. The text of the Convention, but not the detailed Official Commentary thereon, is included as an appendix.²⁷

chapter IV; Kenneth C. Kettering, "Repledge Deconstructed" (1999) 61 U. Pitt. L. Rev. 45; Kenneth C. Kettering, "Repledge and Pre-Default Sale of Securities Collateral Under Revised Article 9" (1999) 74 Chi-Kent L. Rev. 1109.

- ²⁴ Maisie Ooi, "Intermediated Securities: The Choice of a Choice of Law Rule" in Gullifer & Payne at 219. These provocative alternatives may present look-through issues reminiscent of those that helped shape the Hague Securities Convention.
- ²⁵ See Gullifer & Payne at 253, 254 and 255. For an in depth look at the Swedish law of intermediated securities see Karin Wallin-Norman, *Kontorätt: Rätt till kontoförda värdepapper* (Stockholm: Jure Förlag AB, 2009). Wallin-Norman there addresses among other things the role of metaphor in the legal system's move from directly held to intermediated securities, though without straying into the cognitive theory of metaphor addressed *supra*, n. 12.
- ²⁶ Jennifer Payne, "Intermediated Securities and the Right to Vote in the UK" in Gullifer & Payne at 187. For discussion of analogous topics under U.S. law, see Marcel Kahan & Edward B. Rock, "On Improving Shareholder Voting" in John Armour & Jennifer Payne, eds., *Rationality in Company Law: Essays in Honour of DD Prentice* (Oxford: Hart Publishing, 2009) at 259; Marcel Kahan & Edward Rock, "The Hanging Chads of Corporate Voting" (2008) 96 Georgetown L.J. 1227.
- ²⁷ The Official Commentary was in draft form at the time the volume was published, and has very recently been released in final form. See Hideki Kanda, Charles Mooney, *et al.*, *Official Commentary on the UNIDROIT Convention on Substantive Rules for Intermediated Securities* (Oxford: Oxford University Press 2012).