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Law and Systems for Intermediated Securities and the Relationship of Private Property Law to Securities Clearance and Settlement: United States, Japan, and the UNIDROIT Draft Convention

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Abstract

This paper compares the private law of the United States and Japan that applies to the holding of securities through intermediaries, such as securities firms and banks. In particular, it focuses on Articles 8 and 9 of the United States Uniform Commercial Code and the Japanese Book-Entry Transfer Act. That act is now in effect in Japan for most securities other than equity securities and it will become operative for equities in January 2009. The paper also examines the proposed UNIDROIT Draft Convention on Substantive Rules regarding Intermediated Securities. The Convention will be discussed at a diplomatic conference to be held in Geneva in September 2008, with the goal of adopting a final text. It considers the Convention on alternative assumptions that the non-Convention law is the law of the United States or the law of Japan. It generally concludes that the functional approach (*i.e.*, result-oriented, as opposed to doctrine- or theory-oriented) adopted by the Convention is successful and appropriate. Finally, the paper considers differences between United States law and Japanese law in the context of similarities and differences in the principal systems and practices for clearance and settlement of securities transactions in the United States and Japan.

Keywords: book-entry; central securities depository; intermediary; securities; securities account; security interest; settlement

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LAW AND SYSTEMS FOR INTERMEDIATED SECURITIES AND THE RELATIONSHIP OF PRIVATE PROPERTY LAW TO SECURITIES CLEARANCE AND SETTLEMENT: UNITED STATES, JAPAN, AND THE UNIDROIT DRAFT CONVENTION

I. INTRODUCTION

This paper is the first product of research that I conducted with the support of the Bank of Japan's Institute for Monetary and Economic Studies (IMES) while I was a Visiting Scholar in Tokyo. The assistance of the staff of the IMES, other staff of the Bank of Japan, and other professionals in Tokyo was essential to my completion of this project—if any such project ever is actually "completed." Indeed, my hope is that the initial fruits of my research will not represent an "end," but the beginning of continuing conversations and intellectual exchanges among financial market professionals, regulators, and academics in Japan, the United States, and around the world.

This part of the paper introduces the subject of intermediated securities and provides background. Part II provides an overview of the relevant United States and Japanese legal regimes and the proposed regime under the UNIDROIT Draft Convention on Substantive Rules Regarding Intermediated Securities.[1] (For convenience, references

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[1] In 2001 the Governing Council and General Assembly of the International Institute for the Unification of Private Law (UNIDROIT) authorized work on a project on "Harmonised Substantive Rules regarding Securities Held with an Intermediary." UNIDROIT 2004, Study LXXVIII – Doc. 19, Explanatory Notes to the Preliminary Draft Convention (December 2004) at 1, *available at* http://unidroit.org/english/documents/2004/study78/s-78-019-e.pdf. Beginning in 2002 and continuing through 2004, a UNIDROIT study group, which met in five sessions, developed the draft text of an instrument and the UNIDROIT Secretariat prepared Explanatory Notes. *Id.* at 1-4. Beginning in 2005, UNIDROIT has held four meetings of a committee of governmental experts to develop further the text of the draft Convention. I served as a member of the United States delegation at these four meetings in Rome (May 2005, March 2006, November 2006, and May 2007). For the text of the draft Convention as it emerged from the fourth session, see UNIDROIT 2008, CONF. 11 – Doc. 34, Draft Convention on Substantive Rules regarding Intermediated Securities, *available at* http://unidroit.org/english/conventions/2008intermediatedsecurities/conference2008/conferencedocuments/conf11-003-e.pdf (citations to the Convention herein are to "Conv. Art. _"; unless otherwise noted, all UNIDROIT documents cited herein are available at http://unidroit.org/english/workprogramme/study078/item1/preparatorywork.htm). The draft text of the Convention is supplemented and explained by the Report of the fourth session and by the Explanatory Report prepared for the diplomatic conference mentioned below. *See* UNIDROIT 2007, Study LXXVIII – Doc. 95, Report of the UNIDROIT Committee of Governmental Experts on its fourth session, held in Rome, 21-25 May 2007 (hereinafter, "Fourth Session Report"); UNIDROIT 2008 CONF. 11 – Doc. 4, Explanatory Report to the Draft Convention on Substantive Rules regarding Intermediated Securities. The views expressed in this paper do not necessarily reflect the position of the United States or any other member of the United States delegation. A diplomatic Conference under the auspices of UNIDROIT and hosted by the government of Switzerland will be held in Geneva, September 1-13, 2008. *See* Diplomatic Conference to adopt a Convention on Substantive Rules regarding Intermediated

here are to the "Convention," although it presently is only a draft convention.) Following that overview, Part II then examines several transactional patterns and settings under United States and Japanese Law and the Convention regime. Part III then briefly considers certain aspects of clearance and settlement in the United States and Japanese securities markets, including the relationship of the relevant applicable private law to the clearance and settlement processes. Part IV concludes the paper.

A word about terminology may be useful. In general I adopt the terminology employed under the Convention (such as "intermediary," "securities account," and "account holder").[2]

A. Intermediated Securities Holding: A Brief Primer

In developed financial markets the control of securities[3] by financial intermediaries (such as a central securities depository (hereinafter, "CSD"), a securities firm, or a bank) for the benefit of investors—account holders—is ubiquitous. Most investors in securities in these markets know this. But most investors (much less non-investors) probably have not given much thought to the common practice of maintaining one's financial investments in an account with an intermediary. This brief preliminary discussion seeks to make more accessible to those other than the specialists a topic that is highly technical as to the applicable legal regimes as well as the market structures and systems. Even this effort is challenging inasmuch as systems vary so much from country to country and from market to market within a given country.

In many (probably almost all) legal regimes and securities market systems this phenomenon of intermediation necessarily imposes at least some risk on account holders. This risk is over and above the risk that the investor intends to assume, the *issuer* risk that the issuer of the securities will enjoy success or failure, that the value of securities will rise or fall, or that debt securities will or will not be paid when due. Specifically, the additional risk is *intermediary* risk as opposed to issuer risk. This includes the risk that the intermediary will become financially distressed and, in addition, the risk that the intermediary will not have available sufficient securities to satisfy its account holders

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Securities (Geneva, 1-13 September 2008), *available at* http://unidroit.org/english/workprogramme/study078/item1/conference2008/main.htm.

[2] Exceptions are made, in particular with respect to United States law, when discussing particular defined terms and texts of statutes that use such terms.

[3] Except as otherwise indicated, this paper uses the term "securities" not in any particular technical sense or context but to refer generally to financial assets (such as shares of company stock and debt instruments such as bonds and debentures) that are routinely credited by intermediaries to securities accounts for the benefit of account holders. Some of these financial assets are represented by certificates and some are not.

who hold those securities in their securities accounts with the intermediary.[4] It also includes the risk that an intermediary may make errors of omission and commission that work to the detriment of one or more of its account holders.

Given this intermediary risk, the pattern of intermediated securities holding raises a preliminary question: Why does this pattern of intermediation persist (indeed flourish)? Consider a simple example. Misako Jones wishes to buy 100 shares of ABC Corporation common stock (which is traded on a public market). Now, it is conceivable that Misako might know that a neighbor down the street owns ABC stock and might be willing to sell 100 shares to her, but that would be highly unusual. Misako almost certainly will seek to buy the stock in the public market on an exchange. If Misako marches to the Tokyo Stock Exchange or the New York Stock Exchange, where ABC is traded, she might enjoy a guided tour and a view of the "action," but she could not buy the stock. To buy the stock she must establish a securities account with an intermediary, such as a securities firm in Japan or a securities broker-dealer in the United States. These intermediaries are regulated by law and are licensed to trade on the relevant exchanges on behalf of others. Misako's "buying" broker then would buy securities on the exchange (a "trade") from a "selling" broker. An investor's need to retain the services of an intermediary for this purpose, trading on an exchange, should be obvious even to the uninitiated.[5]

A second question then arises. What happens next *after* a trade is made on the exchange between the two brokers (to continue with our simplified example). This may not be so obvious. A system must exist to verify between the brokers that the trade was in fact made on the exchange and that they agree on the terms (*e.g.*, the particular issue of securities, the price, and number of units); this is the "clearance" function. Next, on a given day (which varies from market to market) following the trade date (or, for some transactions in some markets, even on the trade date) the selling broker must "deliver" (i.e., make available) the stock to the buying broker and the buying broker must pay the selling broker; this is the "settlement" function of a system. The days when the selling broker would physically hand over a stock certificate to the buying broker in good form

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[4] This discussion passes over, for now, insurance-like programs in some jurisdictions that provide limited protection against this risk for non-institutional, "retail" investors. As to such programs in the United States and Japan, see II.A.4., *infra* (United States); II.B.4., *infra* (Japan); II.D.2., *infra* (United States and Japan). It also does not address additional risks that arise in connection with clearance and settlement, discussed in Part III.

[5] However, for institutional investors in some markets this world has undergone significant changes. *See, e.g.*, Wikipedia, Direct Market Access, *available at* http://en.wikipedia.org/wiki/Direct_Market_Access ("Direct Market Access (DMA) refers to electronic facilities that allow buy side firms to more directly access liquidity for financial securities they may wish to buy or sell. Using DMA, the firms still use the infrastructure of sell side firms but take over more of the control over the way a transaction ("trade") is executed.").

to transfer ownership, and the buying broker would simultaneously directly pay the selling broker, have passed from memory.

We may reasonably assume that these brokers (along with many others) engaged in many exchange transactions in ABC stock on the relevant trade date. Indeed, on the trade date the selling broker may have bought more ABC stock for its customers than it sold on behalf of other customers, entitling it to receive (in some systems) ABC stock on a "netted basis" on the relevant settlement date without having to "deliver" any ABC stock on that day. The buying broker may be in an analogous situation. It may have sold more ABC stock than it bought and will be a net transferor of ABC stock without receiving any ABC stock on the settlement date. Some aspects of clearance and settlement systems are considered in more detail in Part III. For now, the straightforward point is that securities must be "in the system" (whatever the details of the particular system's structure) for transactions to be settled.

Whether the buying broker is a net transferor or a net recipient of ABC stock on the settlement date, it will credit Misako's account for the 100 shares. What happens next is up to Misako. Perhaps she is a "day trader" who immediately orders her broker to sell the securities. Under some legal regimes Misako may elect to withdraw from the intermediated system altogether by requesting that she be placed in a direct relationship with the issuer, ending any further involvement with the intermediary.[6] In other regimes, she must continue to hold the securities in her account with her intermediary (or another intermediary of her choosing).[7]

Even if Misako has the right to withdraw her securities from the intermediated system, like many other investors she may choose to continue to maintain the securities credited to her account with her intermediary. There are a variety of reasons that she may do so. She may not appreciate the existence of intermediary risk or she may believe that the risk is so slight as to be immaterial. Convenience also figures into the analysis. Recall that securities must be "in the system" for settlement to take place. If she withdraws securities from the system she will have to experience some delay and transaction costs to reintroduce them should she wish to sell the securities. Moreover, at least with paper, certificated securities, withdrawal poses additional risks. Paper can be lost, stolen, or destroyed. For present purposes, however, it is sufficient to note that *in fact* many investors choose to maintain securities in securities accounts with intermediaries even when they have the option not to do so.

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[6] In the United States, for example, for many types of securities she could request the intermediary to request the issuer to issue a security certificate in her name as the registered owner.

[7] As noted below, some "direct" or "transparent" systems discussed in connection with the Convention *do* involve holding through intermediaries but *also* afford the account holder a (more or less) direct relationship with the issuer. *See* text at notes 13-14, *infra*; I.C.; II.C.4.b., *infra*.

B. Scope and Goals

This paper is a comparative study of two general subjects. First, and primarily, it examines the Japanese, United States, and Convention private law legal regimes for the transfer of interests (including security interests) in securities by a credit to accounts maintained with securities intermediaries. In particular, and perhaps more precisely, it considers certain of the characteristics of the rights and property that arise upon the credit to an account by an intermediary for the benefit of its account holder. The paper refers to that bundle of rights and property as "intermediated securities." It also addresses the transfer of interests, including security interests, in intermediated securities other than by a credit to a securities account. Second, it examines (in considerably less detail) certain attributes of Japanese and United States systems for clearance and settlement of securities market transactions. These are the systems (the "back office) that allow for the transfer of and payment for securities that are bought and sold through trading on the securities markets (the "front office").

This study is informed by developments in law reform and clearance and settlement systems around the world. In particular, the Japanese and United States legal regimes are considered and compared to the Convention regime. In this connection, this paper gives a particular emphasis to issues relating to the creation and priority of security interests in securities credited to securities accounts with intermediaries.

As with any comparative legal study, the paper aspires to increase and deepen knowledge and understanding of the aspects of the respective Japanese and United States legal regimes and systems covered here. It also seeks to evaluate related aspects of the Convention. Finally, the paper addresses the interrelationship among the private law relating to intermediated securities (including priorities among competing claims and the rights of investors in an insolvency proceeding of a securities intermediary) and securities clearance and settlement systems.

C. Approach

It is useful and important to include a few words in this introduction about the general approach of the paper. Particularly important to note is its approach to the description, analysis, and evaluation of the private law governing rights and property arising from intermediated securities in Japan and the United States and as it would exist under the Convention. The paper takes pains to identify—and then avoid—the analytical traps and slippery slopes of conclusory doctrinal reasoning that have continually arisen during the formal and informal meetings and discussions in connection with the Convention. Delegations have continually (and sometimes continuously) talked past each other during these sessions.

Ground zero of the problem has been the characterization of the legal results that follow from an effective credit to a securities account of an account holder and the results presumed to follow from that characterization. Admirably, most delegations generally have consistently claimed to subscribe to the idea that the Convention should adopt a so-called "functional approach."[8] This is the idea that the Convention should specify the operative economic results that arise in transactions and settings within its scope, but should not attempt to override (and harmonize among states) the underlying domestic legal doctrine that is the vehicle for producing those results. For example, Article 7 of the Convention spells out the rights that are conferred on an account holder by the credit of securities to a securities account. However, it leaves the legal characterization of those rights—such as the nature of any property interest acquired by the account holder—to the non-Convention law.[9]

The following example provides a hypothetical setting that will be considered further in Part II.

EXAMPLE 1

Intermediary 1 ("IM-1") is a CSD (more on CSDs below, but for the present discussion it is merely an intermediary).[10] As to the various issues of securities credited by IM-1 to its account holders, IM-1's position appears on the books of the issuers of the securities. IM-2 is one of many other intermediaries, each of which is an account holder having a securities account with IM-1. AH-1 is one of many account holders who have securities accounts with IM-2. Similarly, IM-3 is another account holder of IM-1 and Bank is one of many account holders who have securities accounts with IM-3.

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[8] For an excellent analysis of many provisions of the Convention and an examination of the Convention's functional approach, see Luc Thévenoz, *Intermediated Securities, Legal Risk, and the International Harmonisation of Commercial Law*, 13 Stan. J. L., Bus. & Fin. ___ (2007).

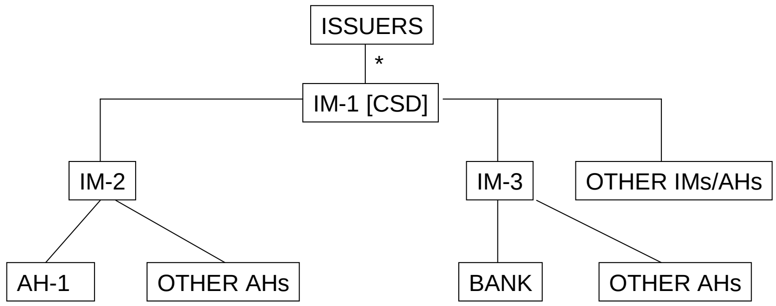
[9] "Non-Convention law" is defined to mean "the law in force in the State whose law is applicable under Article 3, other than the provisions of this Convention." Conv. Art. 1(m).

[10] See generally III., infra.

The following diagram illustrates this pattern of intermediated securities holding.

EXAMPLE 1

Basic fact pattern



*** CSD is registered owner on issuers' books, provider of information re: ultimate account holders, or both**

Under some legal regimes there could be many more tiers of intermediaries below IM-2 and IM-3 and the other intermediaries who are account holders of IM-1. Under some market structures the issuers will know IM-1 but will not know about or have any relationship with anyone else on the diagram and IM-1 will know IM-2 and IM-3 but not AH-1 or the other account holders of IM-2 and IM-3.[11] In other systems the issuers and IM-1 will know all of the players, including AH-1 and the other account holders who have accounts with IM-2 and IM-3.[12] Under some legal regimes AH-1 is the owner of the underlying securities credited to its account and neither IM-1 nor IM-2 has any property interest in those securities. Under other regimes, the account holders of an intermediary have proportionate property interests in securities of any given issue and an intermediary does not have a property interest vis-a-vis those account holders to the

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[11] This is an attribute of the so-called "indirect" holding system.

[12] This is an attribute of a so-called "direct" holding system. This terminology should not be confounded with the "direct" holding system as it is referred to in the United States, in which the security holder holds directly on the books of the issuer or has physical possession of a security certificate that has been transferred to it and in which no intermediary is involved. Discussions around the Convention have demonstrated that there probably is no pure indirect or direct system and that systems that are characterized as either direct or indirect differ substantially from others similarly classified. The dichotomy often is not useful except in the most general and colloquial context. A more useful and accurate reference is to "transparent" systems, discussed below. *See* note 7, *supra*.

extent that the securities of that issue are necessary to satisfy the account holders' interests. Under those regimes, everyone on the diagram below the issuer could have a property interest.

So-called "transparent" systems have in common the attribute that information about the interests of account holders is available at the "upper-tier" intermediary, which normally is a CSD, such as IM-1.[13] Indeed, in some transparent systems the CSD is the *only* intermediary. Moreover, in some systems some of the intermediary functions contemplated by the Convention are performed by other persons (sometimes referred to as "account operators" or "middle entities") who are not, however, themselves acting in the capacity of an intermediary.[14]

These sorts of differences among legal regimes and market structures are artifacts of market practice, legal systems and traditions, and in some cases practical political considerations. They need not be harmonized (nor is it realistic to believe that they could be). On a conceptual level, however, these differences may seem enormous. To note that AH-1 has a property interest in securities credited to his account may invoke the entire panoply of attributes of "property" under a given legal system. It is that mindset that must be overcome if the Convention is to be successful. One can only hope that the fog is beginning to lift.[15]

Under the functional approach contemplated by the Convention, however, these differences among legal regimes and market structures need not be rationalized. What are important are the *results* that the Convention would dictate in any given setting. Consider three illustrations. First, the Convention may specify the economic benefits that are conferred by an effective credit to the securities account of an account holder, such as the right to dispose of the securities, the right to dividends, and the right to vote. But, as

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[13] Deliberations at the fourth session of the committee of governmental experts benefited greatly from a report generated by an intersessional working group (chaired by Colombia and Finland) concerning adaptation of the Convention's structure to embrace these transparent systems. *See* UNIDROIT 2007, Study LXXVIII – Doc. 88, Report of the Transparent Systems Working Group (prepared by Chairs of the Working Group) 2-6 (May 2007) (hereinafter, "Transparent Systems Report").

[14] *See* II.C.3.b. (discussing adaptations of the Convention to accommodate transparent systems).

[15] For example, the Convention text now contains coherent and consistent provisions on innocent acquisition (*i.e.*, good faith purchase, but the test of innocence for this purpose remains open) and the priority of security interests and other interests acquired other than by a credit. The draft produced by the study committee and discussed at the first session of the committee of governmental experts in May 2005, however, contained provisions on each of these issues that applied generally, with the result that a last-in-time (innocent acquisition) rule and a first-in-time (priority) rule could apply to the same transaction—obviously, an untenable result.

mentioned above, it need not specify the nature of the account holder's property interest, if any, in the underlying securities. Nor would it override any of the other examples of differences among legal regimes and market structures noted above. It follows that the Convention would harmonize the package of economic benefits that are conferred on an account holder, but would not harmonize the doctrinal and structural methods employed by a state so as to provide those benefits in fact.[16]

Now, assume that under the applicable legal regime an account holder has a property interest in the underlying securities credited to its account and that intermediaries in the chain do not. Nonetheless, intermediaries in the chain might have the *power* to transfer the account holder's property to a third person free of the account holders' interest (even if the exercise of that power were wrongful as to the account holder). Or, the intermediaries might be empowered to give a security interest on their own behalf that would be senior in priority to the claim of the account holder (again, even if wrongful). Moreover, if the intermediaries did not have these powers under the applicable domestic law, the Convention itself might override the domestic law and confer that power. Having a "property" interest is not synonymous with having an interest that is absolute and inviolate.[17] Under the functional approach, locating who has the "property" often will not be useful or necessary.

Assume now that under the applicable legal regime an account holder never received a property interest and that its rights are limited to the intermediary's legal duties and contractual obligations. If the intermediary remains solvent and provides the entire package of economic benefits of ownership, the absence of property is a distinction without a difference. If the account holder wishes to sell the securities, the intermediary will acquire the securities, sell them, and remit the proceeds to the account holder. If the issuer declares a dividend, the intermediary will remit the appropriate amount to the account holder. If the account holder wishes to vote the shares, the intermediary will acquire securities that will afford the account holder its voting privileges.

This paper adopts the functional approach in comparing and evaluating the Japanese and United States legal systems and in comparing each to the Convention. It will test these regimes by the use of hypothetical settings to examine differences in practical results. It will investigate which of the differences in regimes may produce functional economic results that differ and which distinctions in doctrine and structure may have little or no impact. Distinctions without different economic results may be interesting, but are of little practical moment.

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[16] While the statement in the text is correct in general and reflects the aspirations of the Convention, there are some situations where the Convention must cede different results based on differing domestic laws.

[17] Lawrence Lessig has made this point elegantly in another context, acknowledging that while intellectual property such as a copyright is indeed property it is not effective against all persons, in all circumstances, and for all time. LAWRENCE LESSIG, FREE CULTURE 116-24 (2004).

II. INTERMEDIATED SECURITIES: CREATION, CHARACTERISTICS, INNOCENT ACQUISITION, SECURITY INTERESTS AND OTHER LIMITED INTERESTS, AND PRIORITIES

Part II addresses the private law of intermediated securities, including the rights and interests of account holders, the acquisition and disposition of intermediated securities, the duties of intermediaries, pertinent rules applicable in the insolvency of an intermediary, innocent acquisition and immunity rules, and priority rules applicable to security interests and other interests. Subparts A, B, and C provide, in turn, a brief overview of the relevant laws of the United States and Japan as well as the Convention regime. Subpart D, then, applies the applicable rules under the three regimes to significant hypothetical transactional patterns and settings.

A. United States

1. Overview and Background

United States law relating to intermediated securities is both federal law and the laws of the various states. The principal relevant federal laws deal with (i) securities regulation (largely related, directly or indirectly, to investor protection),[18] (ii) insolvency proceedings of intermediaries (both banks and securities firms),[19] and (iii) United States federal government debt securities and debt securities issued by federal agencies.[20] The principal relevant state law consists of Articles 8 (Investment Securities) and 9 (Secured Transactions) of the Uniform Commercial Code (hereinafter, "UCC").[21] The focus here is primarily on the UCC. The federal regulations for United States government and agency securities follow essentially the same rules.[22]

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[18] *See, e.g.*, Securities Exchange Act of 1934, 15 U.S.C. §§ 78A *et seq.*

[19] *See* Bankruptcy Code Subchapter III (stockbroker liquidation), 11 U.S.C. §§ 741 *et seq.*; Securities Investor Protection Act, 15 U.S.C. §§ 78aaa *et seq.*

[20] *See, e.g.*, 12 C.F.R. Part 615, Subpart O (Farm Credit System securities); 31 C.F.R. Part 357, Subpart B (United States Treasury securities).

[21] The UCC is a "uniform law" promulgated in a joint venture between the National Conference of Commissioners on Uniform State Laws and The American Law Institute. Actually, it is not a "law" at all, but simply a model promulgated with the expectation that the various states of the United States will enact it. Like any uniform law, it must be adopted by a state before it becomes law. Articles 8 and 9 have been adopted by every state in substantially uniform form.

[22] *See* note 20, *supra*.

UCC Article 8 and related provisions in Article 9 were revised in 1994, following several years of study and drafting.[23] The revision process was in part a response to the proposals by the United States Department of Treasury to revise the regulations that then governed the transfer of, and security interests in, book-entry United States government securities. Those proposals, in turn, had been prompted by uncertainties demonstrated by litigation arising out of the failure of some government securities dealers in the United States. The chief innovation in the revision was the comprehensive codification of a regime for securities controlled by intermediaries (*i.e.*, securities held in the "indirect" system, to use the informal terminology used in the United States).

In an earlier study, I had proposed major reforms of the law relating to securities held in the indirect system and the revision of Article 8 embraced the results that I advocated in all material respects.[24] The revisions recognized that the attributes of receiving a credit in an account with an intermediary—holding in the indirect system—differ considerably from having a possessory interest in a security evidenced by a certificate and from an interest that is recorded directly on the books of the issuer of a security (holding in the "direct" system, generally without the involvement of an intermediary).[25]

2. Security Entitlements: Basic Attributes

UCC Article 8 is grounded on a package of carefully defined terminology. The conceptual foundation for Article 8's indirect system is the "securities account."[26] The

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[23] For an intellectual history of the background and process resulting in the Article 8 revisions, see Charles W. Mooney, Jr., *The Roles of Individuals in UCC Reform: Is The Uniform Law Process a Potted Plant? The Case of Revised UCC Article 8*, 27 Okla. City U. L. Rev. 553 (2002). A revised Article 9 was promulgated in 1998 and was in force in every state of the United States by 2002. Revised Article 9 reorganized and revised some provisions that were adopted in connection with the 1994 Article 8 revisions, but with little change in substance.

[24] Charles W. Mooney, Jr., *Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries*, 12 Cardozo L. Rev. 305 (1990). Much of the intellectual foundation of that article was developed during the period when I was conducting comparative research at the Bank of Japan, IMES, during September to December, 1988.

[25] For a brief overview of the Article 8 revisions, see Charles W. Mooney, Jr., Sandra M. Rocks, & Robert S. Schwartz, *An Introduction to the Revised U.C.C. Article 8 and Review of Other Recent Developments with Investment Securities*, 49 Bus. Law. 1891, 1891-1902 (1994).

[26] UCC § 8-501(a) defines "securities account" as "an account to which a financial asset is or may be credited in accordance with an agreement under which the person

person that maintains a securities account for entitlement holders in the regular course of its business is a "securities intermediary."[27] The account holder is an "entitlement holder"[28] under Article 8 and the entitlement holder's rights and interest in respect of a securities account is a "security entitlement."[29] An asset carried in a securities account is a "financial asset,"[30] which may be a "security."[31]

Article 8, Part 5 deals with security entitlements. It provides a general codification of the rights and duties of entitlement holders and securities intermediaries. One acquires intermediated securities—*i.e.*, one becomes an entitlement holder and acquires a security entitlement with respect to a securities account—by a book entry indicating that a financial asset has been credited to a securities account.[32] This is not surprising, of course. Under certain circumstances one can become an entitlement holder and acquire a securities entitlement even in the absence of a book entry. If the securities intermediary receives a financial asset from a person or acquires a financial asset for the person, and if intermediary accepts the financial asset for credit to that person's account, the person acquires a security entitlement in the financial asset.[33] Moreover, a person will also acquire a security entitlement if the securities intermediary "becomes obligated under other law [*i.e.*, under law other than UCC Article 8], regulation, or rule to credit a financial asset to the person's securities account."[34] For example, if an entitlement holder instructs an intermediary to buy a particular financial asset and pays (or authorizes the intermediary to charge its account to cover) the cost of the financial asset, the entitlement holder may acquire a security entitlement in the financial asset *even if the intermediary does not acquire the financial asset*.[35]

What is the nature of an entitlement holder's interest in a security entitlement in a particular financial asset? Contrary to the possible implication of the term "entitlement,"

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maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset."

[27] UCC § 8-102(a)(14) (defining "securities intermediary").

[28] UCC § 8-102(a)(7) (defining "entitlement holder").

[29] UCC § 8-102(a)(17) (defining "security entitlement").

[30] UCC § 8-102(a)(9) (defining "financial asset").

[31] UCC § 8-102(a)(15) (defining "security").

[32] UCC § 8-501(b)(1).

[33] UCC § 8-501(b)(2).

[34] UCC § 8-501(b)(3).

[35] The effect of the absence of a credit in this setting is raised by Example 4, discussed in II.D.3., *infra*.

the entitlement holder acquires a present property interest. It is a property interest in all financial assets of the relevant type held by the securities intermediary and it is a pro rata property interest held with all other entitlement holders with respect to that type of financial asset.[36] The pro rata property interest is calculated, moreover, "without regard to the time the entitlement holder acquired the security entitlement or the time the securities intermediary acquired the interest in that financial asset."[37] To the extent necessary to satisfy its entitlement holders' security entitlements to a particular financial asset, all financial assets of that type held by the intermediary are held for the entitlement holders, "are not property of the securities intermediary, and are not subject to claims of creditors of the securities intermediary."[38] The pro rata property interest of an intermediary's entitlement holders is a clear and convenient means of ensuring that financial assets will not become subject to the claims of the intermediary's general creditors. Aside from that situation, however, their property interest plays a very minor role in sorting out competing claims of entitlement holders and third parties.[39]

3. Duties of Securities Intermediary

A securities intermediary generally is obligated to maintain sufficient financial assets to cover its entitlement holders' security entitlements.[40] For registered broker-dealers, however, the principal requirement—and exceptions—are found in regulations issued by the Securities and Exchange Commission (hereinafter, "SEC") under the Securities Exchange Act of 1934.[41] UCC section 8-504, Comment 5, provides a brief description:

> 5. This section necessarily states the duty of a securities intermediary to obtain and maintain financial assets only at the very general and abstract level. For the most part, these matters are specified in

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[36] UCC § 8-503(b). To the extent necessary to satisfy entitlement holder claims the pro rata interest would extend not only to financial assets carried by the intermediary with another intermediary in an account that indicates that the financial assets are those of the intermediary's entitlement holders (*i.e.*, in a so-called "segregated" account) but also to any financial assets that the intermediary holds (in whatever form) for its own account.

[37] *Id.*

[38] UCC § 8-503(a). Section 8-503(a) is subject to an exception in section 8-511, discussed below. *See* II.D.8., *infra.*

[39] *See* II.A.5., II.D.1., 6.-8. *infra* (discussing innocent acquisition and immunity rules and priority rules).

[40] UCC § 8-504(a).

[41] *See generally* EGON GUTTMAN, MODERN SECURITIES TRANSFERS § 4.10 (3d ed. 2004) (hereinafter, "GUTTMAN, SECURITIES").

> great detail by regulatory law. Broker-dealers registered under the federal securities laws are subject to detailed regulation concerning the safeguarding of customer securities. See 17 C.F.R. § 240.15c3-3. Section 8-509(a) provides explicitly that if a securities intermediary complies with such regulatory law, its compliance also constitutes compliance with Section 8-504. In certain circumstances, these rules permit a firm to be in a position where it temporarily lacks a sufficient quantity of financial assets to satisfy all customer claims. For example, if another firm has failed to make a delivery to the firm in settlement of a trade, the firm is permitted a certain period of time to clear up the problem before it is obligated to obtain the necessary securities from some other source.

As the quoted passage indicates, shortfalls routinely occur in the normal operation of the back offices of broker-dealers. Clearance and settlement systems provide additional protections in these situations for system participants and, in effect, for entitlement holders as well.[42]

A corollary provision of the UCC prohibits an intermediary from creating a security interest in the financial assets it is required to maintain for entitlement holders, except with the agreement of the relevant entitlement holders.[43] Such agreements with entitlement holders are common, however, inasmuch as intermediaries often need to use financial assets held on behalf of entitlement holders as collateral for borrowings of funds in order to fund loans by intermediaries to their entitlement holders (often called "margin" loans).[44] Such a loan by an intermediary to its entitlement holder normally is secured by the borrower's security entitlements. Federal regulations also regulate and restrict the creation of security interests by broker-dealers.[45]

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[42] *See generally* III.A., B., supra.

[43] UCC § 8-504(b). There is an exception to the generally applicable rule of section 8-504(b) when a secured party is in possession or has control of collateral. UCC section 9-207(c)(3) provides that in such circumstances "a secured party . . . may create a security interest in the collateral." In some such cases when the original secured party is the debtor it agrees that its secured party may dispose of the collateral even in the absence of default. A similar situation may exist in securities lending transactions. The puzzling aspects of the "missing *res*" (*i.e.*, the collateral is gone and in its place a secured party's duty to provide like collateral) are beyond the scope of this paper. *See generally* Kenneth C. Kettering, *Repledge and Pre-Default Sale of Securities Collateral under Revised Article 9*, 74 Chi.-Kent L. Rev. 1109 (1999).

[44] UCC § 8-504, Comment 2. The "margin loan" terminology derives from Federal Reserve Board regulations that restrict the amount of borrowing for the purpose of purchasing or carrying margin securities. The regulations applicable to broker-dealers are found in Regulation T. 12 C.F.R. Part 220.

[45] *See generally* GUTTMAN, SECURITIES, *supra* note 41, § 4.10.

There are additional, complementary obligations imposed on intermediaries as well. For example, an intermediary must obtain and pass on to an entitlement holder payments and distributions made by an issuer of a financial asset,[46] exercise rights with respect to financial assets if directed by the entitlement holder,[47] comply with its entitlement holders' entitlement orders,[48] reestablish a security entitlement if the intermediary transfers a financial asset under an ineffective entitlement order,[49] and obey directions of its entitlement holders to convert security entitlements to other forms of holding, such as a certificated security or a securities entitlement with another intermediary.[50]

There are exceptions to these UCC duties, however. In general, an intermediary satisfies these duties if it acts in accordance with its agreement with the entitlement holder or if, in the absence of such an agreement, the intermediary acts with "due care in accordance with reasonable commercial standards."[51] Moreover, as mentioned in the excerpt from Section 8-504, Comment 5, quoted above, compliance with analogous regulatory law that addresses "the substance of a duty imposed upon a securities intermediary by Sections 8-504 through 8-508" constitutes compliance with the duty.[52]

4. Shortfall and Intermediary Insolvency

Return to the possibility that there exists a shortfall in an issue of financial assets held by a securities intermediary—*i.e.*, the intermediary holds fewer units than is necessary to satisfy the security entitlements of its entitlement holders in respect of that issue of financial asset. Posit that a shortfall exists and further that the intermediary is insolvent and the subject of an insolvency proceeding. The details of the laws applicable to insolvency proceedings of entities acting as securities intermediaries are beyond the scope of this paper. The focus here is limited for the most part to the treatment of entitlement holder claims in the face of a shortfall of the relevant financial assets. How will the applicable laws deal with the entitlement holder claims?

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[46] UCC § 8-505(a).

[47] UCC § 8-506.

[48] UCC § 8-507(a).

[49] UCC § 8-507(b).

[50] UCC § 8-508.

[51] UCC §§ 8-504(c); 8-505(a); 8-506; 8-507(a); 8-508.

[52] UCC § 8-509(a).

Under United States law, the Securities Investor Protection Act (hereinafter, "SIPA") specifically protects eligible non-institutional account holders of insolvent registered broker-dealers against losses up to $ 500,000.[53] SIPA does not apply to banks and their entitlement holders, however.[54] Under SIPA, the value of all financial assets of types claimed by a firm's entitlement holders are pooled for the benefit of all account holders based on the aggregate value of all such financial assets.[55] The value of each entitlement holder's claim is equal to the value of the financial assets that are *or should be* credited to its account, and the aggregate value of the financial assets is allocated proportionately among the entitlement holders.[56] Under this formulation, the fortuity that there may be a shortfall in X securities but not in Y securities does not result in a windfall for Y securities entitlement holders and the X securities account holders do not bear the entire burden of the shortfall. Similarly, the risk that a firm improperly (and almost certainly fortuitously) failed to acquire securities for, or to credit securities to, any particular entitlement holder's account is not borne by that account holder alone. Under this formulation for distribution and eligibility for participation as an entitlement holder, each entitlement holder has a higher likelihood of a lower potential loss.

In the insolvency of a bank intermediary under United States law there are no special distributional rules applicable to securities account holders. Instead, the applicable property law would apply to the claims of entitlement holders. The entitlement holders would share their pro rata property interests, explained above, in the pool of financial assets of any issue as to which a shortfall existed. Also as noted above, there is no special fund or other protection under United States law for entitlement holders who suffer loss as a result of a shortfall in financial assets in the insolvency of a bank intermediary.

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[53] 15 U.S.C. § 78fff-3(a).

[54] 15 U.S.C. § 78eee(a) (protection of customers of broker or dealer subject to regulation by the SEC under the Securities Exchange Act of 1934).

[55] There is a distributional system similar to the SIPA system under Subchapter III of the Bankruptcy Code, which would apply in lieu of the SIPA regime in the case of the bankruptcy of an intrastate broker that is not subject to the registration requirements of the Securities Exchange Act and which, consequently, is not subject to the SIPA investor protection regime.

[56] Actually the calculation is a bit more complicated, inasmuch as each customer's "net equity" must be calculated by taking into account indebtedness of the customer to the debtor on margin loans. 15 U.S.C. § 78fff-2(b) (claims based on "net equity"); *lll*(11) (defining "net equity"). The discussion in text is sufficient for present purposes, however.

5. Competing Interests in Financial Assets and Security Entitlements

Article 8 has two sets of rules that address competing or conflicting interests in financial assets or security entitlements in respect of financial assets. The first set, roughly speaking, occupies the roles traditionally played by the concept of good faith purchase. I will refer to this set of rules as "innocent acquisition rules" and to their beneficiaries as those entitled to "innocent acquisition protection."[57] In general, qualifying beneficiaries of the innocent acquisition rules are protected completely from those who assert claims based on competing property interests. A second set of rules are found in Article 8 and, for security interests, in Article 9 of the UCC. These are "priority" rules that provide for a rank-ordering of competing interests. Under these priority rules, depending on the value of the relevant financial asset or security entitlement, a junior interest may be fully protected or there may be insufficient value to satisfy (or even to provide any benefit at all) to the holder of the junior interest.

a. Innocent Acquisition and Immunity from Liability.

Consider first the innocent acquisition rules.[58] Section 8-502 provides: "An action based on an adverse claim to a financial asset, whether framed in conversion, replevin, constructive trust, equitable lien, or other theory, may not be asserted against a person who acquires a security entitlement under Section 8-501 for value and without notice of the adverse claim."[59] UCC section 8-105(a) explains when one has "notice of an adverse claim." Under that section, a person has notice if the "person knows of the adverse claim"—*i.e.*, has "actual knowledge" of the adverse claim.[60] Even in the absence

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[57] I adopt this convenient referential convention mindful that the operation of one of these rules, section 8-115, protects an intermediary who does not necessarily acquire anything but instead acts on the instructions of an entitlement holder.

[58] The application of the innocent acquisition rules is addressed in somewhat more detail in connection with the examples discussed in subpart D., and in particular in Examples 2 and 7.

[59] UCC § 8-502. "A person gives value for rights if the person acquires them . . . in return for any consideration sufficient to support a simple contract." UCC § 1-204(4). Section 8-116 provides additional rules on when value is given in the context of the indirect holding system, which are discussed in connection with Example 2, in subpart D.

[60] UCC §§ 8-105(a)(1); 1-202(b)("'Knowledge' means actual knowledge. 'Knows' has a corresponding meaning."). "Adverse claim" is defined to mean "a claim that a claimant has a property interest in a financial asset and that it is violation of the rights of the claimant for another person to hold, transfer, or deal with the financial asset." UCC § 8-102(a)(1). Note that UCC section 8-502 protects only those who acquire a security entitlement "for value."

of actual knowledge, a person who "deliberately avoids information" about an adverse claim while aware of suspicious circumstances, or a person who has a statutory or regulatory duty to investigate but fails to do so also may obtain the requisite notice.[61]

Another innocent acquisition rule, similar to section 8-502, is found in section 8-510. It provides immunity from liability to "a person who purchases a security entitlement or any interest therein, from an entitlement holder."[62] A typical example of such a purchaser is a person who obtains a security interest in a security entitlement under Article 9 (discussed in more detail below in connection with priority rules). Note that the person protected under section 8-510 need not be an entitlement holder itself, but must be a "purchaser from an entitlement holder"; entitlement holders generally are protected by a similar rule under section 8-502, discussed above.[63] The purchaser may be a buyer or one who acquires a security interest.[64] The immunity provided by section 8-510(a) is available only "if the purchaser gives value, does not have notice of the adverse claim, and obtains control."[65]

"Control" of a security entitlement typically is achieved when "the securities intermediary has agreed that it will comply with entitlement orders originated by the purchaser without further consent by the entitlement holder" (a "control agreement," to use common terminology).[66] Of course, the intermediary would act at its peril if it made such an agreement without the consent or permission of the entitlement holder. Finally, if the transferor-entitlement holder itself is protected from an adverse claim under section

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[61] "A person has notice of an adverse claim if: . . . (2) the person is aware of facts sufficient to indicate that there is a significant probability that the adverse claim exists and deliberately avoids information that would establish the adverse claim; or (3) the person has a duty, imposed by statute or regulation, to investigate whether an adverse claim exists, and the investigation so required would establish the existence of the adverse claim." UCC§ 8-105(a)(2), (3).

[62] UCC § 8-510(a).

[63] *Id*.

[64] UCC § 1-201(a)(29) (defining "purchase" as "taking by sale, lease, discount, negotiation, mortgage, pledge, lien, security interest, issue or reissue, gift, or any other voluntary transaction creating an interest in property"); (30) (defining "purchaser" as "a person that takes by purchase"). Note that the innocent acquisition rule of section 8-510(a) applies only when otherwise applicable temporal (*i.e.*, first-in-time) priority rules are not applicable. *See* II.A.5.b., II.D.5., *infra*.

[65] UCC § 8-510(a).

[66] UCC § 8-106(d)(2). Control also may be obtained if the purchaser itself becomes the entitlement holder or if another person who has control "acknowledges that it has control on behalf of the purchaser." UCC § 8-106(d)(1), (3).

8-502, a purchaser from the entitlement holder is likewise immune from liability to the adverse claimant under a version of the "shelter" principle.[67]

A third provision for innocent acquisition-related is section 8-503(e), which provides immunity from liability to an entitlement holder based on the entitlement holder's pro rata property interest. The immunity is granted to "any purchaser of a financial asset or interest therein who gives value, obtains control, and does not act in collusion with the securities intermediary in violating the securities intermediary's obligations under Section 8-504" (*i.e.*, the obligation, *inter alia*, to maintain sufficient financial assets to cover an intermediary's entitlement holder claims to security entitlements). By making it so difficult for an entitlement holder to base a claim on its property interest, the statute recognizes *de facto* that in most cases it is virtually impossible for an entitlement holder to trace its interest to the hands of a purchaser of a financial asset.

A final innocent acquisition-related rule is *sui generis*. Section 8-115 provides immunity from liability to an adverse claimant for an intermediary that transfers a financial asset in response to an effective entitlement order.[68] Section 8-115 contains three exceptions from the otherwise applicable immunity. The first applies when the intermediary acts after it has received judicial process, such as a court order, restraining its act and after it has had a reasonable time to act on the process.[69] The second applies when the intermediary acts "in collusion with the wrongdoer" to violate the rights of the adverse claimant.[70] The third applies to the limited case of a stolen security certificate when the intermediary acts with notice of an adverse claim.[71]

Note that sections 8-502 and 8-510 incorporate the "notice of adverse claim" test that is similar to traditional notions of good faith purchase, although the term "good faith" is not used.[72] Sections 8-503 and 8-115, on the other hand, contain the more protective (for the person asserting immunity) standard of "collusion" with a wrongdoer. And note that these innocent acquisition rules provide immunity from liability and do not provide that an acquirer "takes free" of a competing claim. As stated in the UCC official

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[67] UCC § 8-510(b).

[68] An "entitlement order" is a notification by an entitlement holder to its securities intermediary which directs the disposition or redemption of a financial asset. UCC §8-102(a)(8).

[69] UCC § 8-115(1).

[70] UCC § 8-115(2).

[71] UCC § 8-115(3).

[72] This is the same standard incorporated into the test for "protected purchaser" status in the case of a purchaser of a certificated or uncertificated security. UCC § 8-303(a).

comments, "[t]his section [8-502] does not use the locution 'takes free from adverse claims' because that could be confusing as applied to the indirect holding system."[73]

b. Priority Rules.

UCC Article 9 provides a comprehensive legal framework for security interests in personal property, including "investment property,"[74] which consists of "a security, whether certificated or uncertificated, security entitlement, securities account, commodity contract, or commodity account."[75] Certain formal requisites must be met for the enforceability and "attachment" of a security interest to "collateral."[76] Enforceability and attachment require that "value has been given," and that "the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party."[77] In addition, in the case of certain collateral, including investment property, enforceability and attachment also require that either "the debtor has authenticated a security agreement that provides a description of the collateral" or the secured party has "control."[78]

The priority rules of Article 9 turn largely on the *time* that a security interest is "perfected," the *manner* of perfection, or *both the time and manner* of perfection.[79] The three principal methods of perfection of a security interest in investment property are "control,"[80] filing a financing statement in the proper filing office,[81] and, in the case of a certificated security, delivery of the security certificate to the secured party.[82] In general,

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[73] UCC § 8-502, comment 1; *see also* UCC § 8-503, comment 2 (to similar effect).

[74] UCC § 9-102(a)(49) (defining "investment property").

[75] *See* notes 26-31, *supra* (citations to selected Article 8 definitions); UCC § 9-102(a)(15) (defining "commodity contract"), (14) (defining "commodity account").

[76] UCC § 9-203(a), (b).

[77] *Id.*

[78] A person has control of a security or security entitlement if the person has control under section 8-106. UCC §§ 9-106; 8-106. *See* note 66 and accompanying text, *supra*.

[79] Perfection takes place when a security interest has attached and all applicable requirements under sections 9-310 through 9-316 have been satisfied. UCC § 9-308(a).

[80] UCC § 9-314(a); *see* note 66 and accompanying text *supra* ("control" in context of "security entitlement").

[81] The Article 9 filing regime is contained in Part 5. UCC §§ 9-501 *et seq.*

[82] UCC § 9-313(a). "Temporary" perfection for 20 days also is a method of perfection for certificated securities in certain circumstances. UCC § 9-312(e), (g). In addition, a security interest in investment property that is created by a broker or securities

a security interest has priority over the interest of a "lien creditor"[83] only if the security interest is perfected at the time the lien creditor acquires its rights.[84] Under the United States federal Bankruptcy Code, a trustee in bankruptcy has the rights of a lien creditor and can use that power to avoid (invalidate) a security interest that is unperfected.[85]

The baseline priority rule for competing security interests is the so-called "first-to-file-or-perfect" rule.[86] For example, if secured party 1 (SP-1) files on day 1, secured party 2 (SP-2) perfects (*e.g.*, by possession, giving value, and obtaining an adequate security agreement) on day 2, SP-2 has the only security interest and SP-1 has no interest as yet. But if SP-1 acquires a security interest on day 3, SP-1 has priority as the first to file. If the timing is reversed and SP-2 acquires its perfected security interest on day 1, SP-1 files on day 2, and SP-1 acquires its interest on day 3, SP-2 has priority as the first to perfect (although it did not file). Under a companion priority rule, a perfected security interest has priority over an unperfected security interest.[87]

A security interest perfected by control has priority over a security interest perfected by any other method (such as filing, in the case of collateral consisting of a

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intermediary is perfected upon attachment, *i.e.*, is automatically perfected. UCC § 9-309(10). Consideration of the priority of automatically perfected security interests is deferred to the discussion of Example 9. *See* II.D.8., *infra.*

[83] UCC section 9-102(a)(52) defines "lien creditor" as:

(A) a creditor that has acquired a lien on the property involved by attachment, levy, or the like;

(B) an assignee for benefit of creditors from the time of assignment;

(C) a trustee in bankruptcy from the date of the filing of the petition; or

(D) a receiver in equity from the time of appointment.

[84] The rights of a lien creditor are subordinate to a perfected security interest. UCC § 9-317(a)(2)(A). There is a minor exception when a secured party has filed a financing statement and one of the conditions in section 9-203(1)(b) has been satisfied at the time a lien creditor becomes such. In that case, when the security interest becomes perfected upon attachment, it will have priority over the intervening lien creditor's interest even though it was unperfected at the time the lien creditor became such.

[85] 11 U.S.C. § 544(a)(1).

[86] UCC § 9-322(a)(1).

[87] UCC § 9-322(a)(2).

security entitlement).[88] With one important exception, security interests in security entitlements perfected by control rank in priority according to the time that control was obtained.[89] The exception applies when the secured party is the securities intermediary with which the security entitlement is maintained. In such a case the secured party-intermediary has control automatically[90] and its security interest has priority over any other security interest.[91] (As explained above, control also may afford innocent acquisition protection.[92]) Consistent with the generally applicable temporal (*i.e.*, first-in-time) priority rule for security interests perfected by control, as among the holders of such security interests the innocent acquisition protection of section 8-510(a) does not apply.[93]

Outside of the context of the priority of competing security interests (and certain other competing interests[94]) with respect to the securities entitlements, however, section 8-510(a) does provide innocent acquisition protection for purchasers (including secured parties) who acquire control.[95] For example, suppose that a security entitlement could be traced to the deposit of stolen securities and the real owner were to assert an adverse claim. In the absence of notice of the adverse claim at the relevant time of acquisition, a secured party perfected by control would not be liable to the owner.

Consider next the purchase of an interest in a security entitlement from an entitlement holder in which the interest purchased is either a full ownership interest or a limited interest *other than a security interest* in the relevant securities. For example, the purchaser could obtain control of a security entitlement to financial assets, but the interest transferred as between the parties could be more limited. Or, the purchaser could buy outright the entitlement holder's interest as the first step in a repurchase transaction (or "repo") in which the entitlement holder is obligated to repurchase the relevant financial assets at a later time.[96]

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[88] UCC § 9-328(1). A control-perfected security interest also would have priority over a security interest that is temporarily perfected or automatically perfected. *Id.*

[89] UCC § 9-328(2)(B).

[90] UCC §§ 8-106(e); 9-106.

[91] UCC § 9-328(3).

[92] *See* notes 62-67, *supra* (discussing innocent acquisition under UCC § 8-510(a)).

[93] UCC § 8-510(a).

[94] *See* notes 97-98, *infra* (discussing priorities under UCC § 8-510(c)).

[95] *See* notes 62-67, *supra* (discussing innocent acquisition under UCC § 8-510(a)).

[96] *See generally* DAVID M. WEISS, AFTER THE TRADE IS MADE 345-52 (2006) (hereinafter, "WEISS, TRADE") (discussing repos as financing devices).

The concept of control in this context is agnostic as to whether the interest in a security entitlement is a security interest, another form of limited interest, or the full ownership interest. However, the concept of "perfection"—an important concept in the operation of UCC Article 9—plays no role outside of the realm of security interests. The principal attribute of perfection of a security interest, as we have seen, is that it affords the perfected security interest protection against judicial lien creditors of the debtor and in the debtor's insolvency proceedings. But the purchase of an interest other than a security interest in a security entitlement need not be perfected in order to achieve such status. To the extent that the interest has been effectively transferred to the purchaser, the interest is no longer property of the transferor and there is nothing for a creditor to reach or an insolvency administrator to administer. That said, there are nonetheless compelling reasons under United States law or the Convention for a purchaser other than a secured party to obtain control over the relevant security entitlement.

Control of a security entitlement affords two important benefits to a purchaser of an interest other than a security interest. First, under section 8-510(c), a purchaser with control has priority over purchasers who do not have control and purchasers with control rank in priority according to the time control is obtained.[97] This priority rule is analogous to the UCC section 9-328(2)(B) rule for security interests and applies to the interests of purchasers who do not hold security interests. Second, control confers eligibility on the purchaser for the innocent acquisition protection against the holders of adverse claims.[98]

The foregoing brief overview of priority rules relating to security entitlements is necessarily incomplete. A more detailed consideration is left for the hypothetical transactions addressed in subpart D.

6. Creditor's Legal Process (*e.g.,* Attachment)

A creditor of a debtor-entitlement holder may reach the debtor's interest in a security entitlement only by legal process against the intermediary that maintains the debtor's securities account.[99] Colloquially this limitation is referred to as a prohibition of "upper-tier" attachment. For example, if an entitlement holder holds through its intermediary and the intermediary, in turn, holds through another intermediary (such as a CSD), legal process cannot be served against the other intermediary. In the United States intermediated system, the other intermediary normally would not maintain or have access to the records necessary to determine the indirect holdings of "lower-tier" entitlement holders.

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[97] UCC § 8-510(c).

[98] *See* notes 62-67, *supra* (discussing innocent acquisition under UCC § 8-510(a)).

[99] UCC § 8-112(c).

7. Clearing Corporation Rules

The rules of a "clearing corporation" are effective even in the event of a conflict with the UCC and, moreover, those rules are effective even against non-consenting persons.[100] The definition of "clearing corporation" includes a "clearing agency" registered under the federal securities laws,[101] a federal reserve bank, or any other person that "provides clearance or settlement services with respect to financial assets" that is subject to federal or state regulation and that would be a clearing agency "but for an exclusion or exemption from the registration requirement."[102]

Clearing corporations include entities that perform clearance or settlement services (or both). The overriding nature of clearing corporation rules provides a structure that can impose necessary protections against systemic risk as well as promote efficient operations without the necessity of amending federal or state law.

8: Relationships with Issuers: Capturing the Benefits of Ownership for Entitlement Holders in the Indirect Holding System

In the indirect holding system in the United States the entitlement holders do not have a direct relationship with the issuer. In the indirect system, typically the registered owner of securities (other than United States government securities or United States government agency securities)[103] and the holder of security certificates (if applicable) is a nominee of The Depository Trust Company (hereinafter, "DTC"), the principal CSD in the United States.[104] Consider the following excerpt from the Prefatory Note to UCC Article 8:

> [T]he DTC depository system for corporate equity and debt securities can be described as an "indirect holding" system, that is, the issuer's records do not show the identity of all of the beneficial owners. Instead, a large portion of the outstanding securities of any given issue are recorded on the issuer's records as belonging to a depository. The depository's records in

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[100] UCC § 8-111.

[101] Securities Exchange Act of 1934, § 3a.23, 15 U.S.C. § 78c(a)(23) (defining "clearing agency").

[102] UCC § 8-111.

[103] *See generally* III.B., *infra* (discussing real-time gross settlement).

[104] DTC and its sister company, National Securities Clearing Corporation (hereinafter, "NSCC") are subsidiaries of The Depository Trust and Clearing Corporation (hereinafter, "DTCC"), which is a holding company formed in 1999 to combine DTC and NSCC. *See* http://www.dtcc.com/about/history/.

> turn show the identity of the banks or brokers who are its members, and the records of those securities intermediaries show the identity of their customers.[105]

Because issuers have no direct relationship with the beneficial owners (entitlement holders) in the indirect system, special structures are necessary to confer the benefits of ownership on the entitlement holders, such as the receipt of payments of dividends and principal and interest on debt securities and the exercise of voting rights. Payments of funds are relatively straightforward. Issuers pay the registered owner, DTC, which credits the accounts of its participants, who, in turn, credit their entitlement holders, and so on down the tiers of intermediaries and entitlement holders. The treatment of voting rights in the indirect system is more complex.[106]

The voting process in the indirect system begins when an issuer transmits an inquiry to DTC requesting a list of DTC participants who held the relevant security issue on the record date. The issuer then asks the participants how many sets of voting materials (such as proxies and informational materials) they require. After the bank and broker participants respond, the issuer sends the materials to the participants and, for entitlement holders of the participants who are intermediaries, the issuer repeats the process by sending inquiries to those participants. The completed proxies or instructions on voting are distributed to a tabulator that acts on behalf of the issuer to verify the validity of the proxies, count the votes, and ensure that the votes correspond to the number of securities that DTC reports is on its books and credited to its participants. Much of the actual work in this process is performed on behalf of the participants by ADP North America, Inc., to which the work is outsourced. However, the issuers are responsible for paying the costs of the participants and other intermediaries, including the fees of ADP.

The process of voting in the indirect system has resulted in relatively few problems, but these results are largely attributable to the fact that many beneficial owners do not choose to vote and the fact that voting on most matters is not close. But the system likely would yield unsatisfactory results if seriously tested. For example, the practice of securities lending can result in a larger number of entitlement holders who *believe* they are entitled to vote than the number that *actually* is entitled to vote. A full description and critique of this aspect of the indirect holding system is beyond the scope of this paper. Suffice it to say that the protection of the entitlement holders' property and economic interests in the indirect holding system in the United States has proven more successful than the current state of protection for their voting rights.

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[105] UCC Article 8, Prefatory Note, ¶ I.D.

[106] The brief description of the voting process that follows is drawn primarily from Marcel Kahan & Edward Rock, The Hanging Chads of Corporate Voting (August 13, 2007) (unpublished manuscript, U. of Penn., Inst. for Law & Econ. Research Paper No. 07-18, *available at* SSRN: http://ssrn.com/abstract=1007065).

It appears that the SEC recently has begun to take an interest in the concerns that have been expressed about voting.[107] There is some indication that it may be considering some actions to improve and rationalize the situation.[108]

9. Choice of Law

The choice of law rules for the indirect system in the United States represent one of the most innovative aspects of the 1994 revisions to the UCC. Most matters relating to security entitlements are governed by the "local law of the securities intermediary's jurisdiction."[109] These matters include the acquisition of a security entitlement from the intermediary, the rights and duties of the intermediary and the entitlement holder, duties of the intermediary to an adverse claimant to a security entitlement, and whether an

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[107] Press Release, SEC, SEC Announces Agendas and Panelists for Final Roundtables on the Proxy Process (May 23, 2007) *available at* http://www.sec.gov/news/press/2007/2007-99.htm.

[108] The Director of the SEC's Division of Market Regulation recently suggested in a speech that one approach would be disclosures by brokers to their customers concerning voting procedures. Erik R. Sirri, Director of Market Regulation, SEC, Address to the Securities Industry and Financial Markets Association (October 16, 2007) *available at* http://sec.gov/news/speech/2007/spch101607ers.htm:

> I am thinking about a number of disclosure options, such as the following:
>
> - That a customer's ability to vote is subject to the terms of the customer's account agreement signed with its broker;
> - The reasons why the customer may not be allowed to vote some or all of the securities positions credited to its account, which should include an explanation that brokers may rehypothecate shares held in a margin account and that *a customer's* [sic] *may not be able to vote some or all of its securities due to the securities being out on loan*;
> - A description of the process used by brokers to allocate votes among customers and proprietary positions when the broker has an imbalance; and
> - A description of the alternative steps a customer could take to retain the ability to vote shares represented by the securities position credited to its account.

Emphasis added.

[109] UCC § 8-110(b).

adverse claim can be asserted against an entitlement holder or against a person with an interest in a security entitlement.[110]

The reference to "local law" is a reference "to the law of a jurisdiction other than its conflict of laws rules."[111] Determination of the "securities intermediary's jurisdiction" is governed by a cascading series of rules.[112] The first rule permits the intermediary and the entitlement holder to agree as to the securities intermediary's jurisdiction in an "agreement . . . governing the securities account" (*i.e.*, in an account agreement).[113] If the first rule does not apply (*i.e.*, if there was no such agreement as to the jurisdiction) but those parties have agreed that the account agreement is governed by a particular jurisdiction's law, then "that jurisdiction is the securities intermediary's jurisdiction."[114] If the first two rules do not apply but the account agreement "expressly" provides that the securities account "is maintained at an office in a particular jurisdiction, that jurisdiction is the securities intermediary's jurisdiction."[115] In similar fashion, the remaining rules look to the jurisdiction in which an office identified in an account statement is located and, finally, to the jurisdiction in which the securities intermediary's "chief executive office" is located.

At first blush it might appear odd to honor the choice of applicable law by two parties in a bilateral, private agreement, especially because the applicable law implicates the rights of third parties, such as a creditor of an entitlement holder. But, on reflection, any interested third party *necessarily* must take account of private information dealing with such matters as whether a securities account exists, the intermediary with which it is maintained, and the financial assets that are credited to the account (*i.e.*, the nature of the security entitlements). The applicable law is just one more significant attribute. Indeed, the Hague Securities Convention takes a quite similar approach.[116]

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[110] *Id.*

[111] UCC § 8-110, comment 1.

[112] UCC § 8-110(e).

[113] UCC § 8-110(e)(1).

[114] UCC § 8-110(e)(2).

[115] UCC § 8-110(e)(3).

[116] *See* Hague Conference on Private International Law, *Convention on the Law applicable to certain rights with respect to securities held with an intermediary* (hereinafter, "Hague Securities Convention" or "HSC"), Art. 4. The Hague Securities Convention is not yet in effect, although it has been signed by the United States and Switzerland.

B. Japan

1. Overview and Background

Legislation enacted in Japan during the past few years promises substantial reforms of the legal regime for securities held through intermediaries. The Act for Book Transfers of Bonds, Shares and other Securities ("Book-Entry Transfer Act"),[117] when fully effective, will provide a unified regime for all types of securities in the Japanese intermediated system. As originally enacted in 2001, the Book-Entry Transfer Act applied only to short term corporate debt (*i.e.*, commercial paper). Amendments enacted in 2002 extended its scope to cover all debt securities, including corporate bonds and Japanese Government Bonds (hereinafter, "JGBs").[118] These amendments became effective on January 6, 2003, with an implementation deadline of 2008.[119] However, the Bank of Japan (hereinafter, "BOJ") implemented the Book-Entry Transfer Act for JGBs in January 2003[120] and the Japan Securities Depository Center, Inc. (hereinafter, "JASDEC") began operation of its new system under the Act for corporate debt securities in January 2006.[121]

Additional amendments enacted in 2004 extended the application of the Act to equity securities.[122] The 2004 amendments must be implemented by June 8, 2009, although it has been announced that the new book-entry system will be operational for equity securities in January 2009.[123]

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[117] Act 75 of 2001, as amended in 2002 (Act 65 of 2002), 2004 (Act 88 of 2004), 2006 (Act 109 of 2006), and 2007 (Act 74 of 2007). The amendment enacted in 2006 extended the scope of the act to cover beneficiary certificates in investment trusts.

[118] Act 65 of 2002.

[119] *Id.*, Supplemental Provision 1, § 2.

[120] Bank of Japan, Press Release, Start of Operations of the New JGB Book-entry System Based on the Transfer of Corporate Debt Securities Law at 3 (January 27, 2003), *available at* http://www.boj.or.jp/en/type/release/zuiji/kako03/set0301c.htm.

[121] JASDEC, Book-Entry Transfer System for "Corporate Bonds," *available at* http://www.jasdec.com/en/sb/index.html.

[122] Act 88 of 2004.

[123] Reform Promotion Center for Securities Clearing and Settlement System, Japan Securities Dealers Association, The Transition to the Dematerialization of Stock Certificates in Japan (Sept. 2004) (hereinafter, "Transition to Dematerialization"), *available at* http://www.kessaicenter.com/kisha/stock_e.pdf (dates of effectiveness and required implementation); http://www.kessaicenter.com/kokuai/touitu-kiji0525.pdf (operational date for equity securities).

Enactment of reforms under the Book-Entry Transfer Act resulted from the convergence of several influences, not from any particular significant event or market development. First, the Book-Entry Transfer Act represents yet another step in Japan's efforts to adapt its legal system to developments in information technology. For example, in 2000 a law governing electronic signatures was passed.[124] Also in 2000, provision was made for public companies to make electronic filings[125] and in 2004 provision was made for such firms to communicate with shareholders electronically.[126]

Second, there was increasing dissatisfaction with the structure and substance of the existing book-entry regime for equity securities. That system was established by the 1984 enactment of the Act for Custody and Book Transfers of Shares ("Custody Act").[127] The Custody Act will continue to apply until January 2009, when the Book-Entry Transfer Act will be implemented for equity securities. For example, the Custody Act recognized, unrealistically, only two tiers of intermediaries: JASDEC, the CSD, and the intermediaries that are direct participants of JASDEC, securities firms that maintain accounts for their account holders. Although informal means of accommodating additional tiers were devised, this created some uncertainties. Any entries in the business records relating to claimants below the account holder of an intermediary would not be book entries within the system.

Also unrealistic was the core assumption of the Custody Act that all shares would be represented by certificates, which would create an awkward structure were shares to be dematerialized (*i.e.*, to be uncertificated securities).[128] The Custody Act contemplates a "co-ownership" by an account holder and its intermediary of securities credited to a securities account.[129] It also imposes strict liability on JASDEC and *all* intermediary

[124] Act 102 of 2000 (enforced in April 2001).

[125] Act 96 of 2000 (enforced in 2000).

[126] Act 87 of 2004 (enforced in 2004).

[127] Act 30 of 1984.

[128] Dematerialization of shares generally was not contemplated by the rules on corporations in the Japanese Commercial Code (SHŌHŌ) (Act 48 of 1899), but was made possible by amendments to the SHŌHŌ (Act 88 of 2004) for a corporation that chooses to issue dematerialized shares in its certificate of incorporation. The amendments to the Book-Entry Transfer Act (Act 88 of 2004) provided the legal mechanism for a book-entry system for transactions relating to dematerialized shares. Subsequently, the issuance of dematerialized shares was made the default rule under a new Corporation Law of Japan (Act 86 of 2005), which became effective in May 2006. Corporation Law, Art. 121.

[129] Custody Act, Art. 27.

participants for losses arising out of any intermediary's failure to hold sufficient securities with JASDEC so as to match (*i.e.*, cover) credits in favor of account holders on the books of the intermediary.[130]

Third, there were deficiencies in, and corresponding criticisms of, the registration system for holding corporate bonds, which were outside the scope of the Custody Act.[131] Corporate bonds were held through an intermediated registration system involving commercial banks.[132] Consistent with the prohibition on the involvement of commercial banks in underwriting, brokering, and carrying accounts for securities (other than JGBs), banks were excluded from the JASDEC system covered by the Custody Act.

Fourth, there was a general consensus that the Japanese systems for clearance and settlement should be improved so as to conform to generally accepted international standards.[133]

When fully implemented, the new system under the Book-Entry Transfer Act will address these deficiencies in the earlier systems that it will replace. It will feature an integrated system involving a single CSD, JASDEC,[134] for shares of stock and other equity securities, corporate bonds, corporate commercial paper, and investment funds (*i.e.*, mutual funds as they are known in the United States). The Bank of Japan will remain the CSD for JGBs.[135] The name of the Book-Entry Transfer Act itself suggests an important feature of the new system: All of the securities in the system will be dematerialized and will be transferred and pledged by book entries exclusively.[136]

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130 Custody Act, Art. 25.

131 *See* Act 11 of 1942.

132 *See generally* SECURITIES MARKET IN JAPAN 2006 (hereinafter, "SMJ 2006") at 99.

133 *See generally, e.g.*, Committee on Payment and Settlement Systems, Bank for International Settlements & Technical Committee, International Organization of Securities Commissions, *Recommendations for Securities Settlement Systems* (2001) (hereinafter, 2001 CPSS-IOSCO *Recommendations*"); Group of Thirty, *Clearance and Settlement Systems in the World's Securities Markets* (1989).

134 The Book-Entry Transfer Act does not mandate a single CSD. Book-Entry Transfer Act, Art. 3-43. JASDEC is expected to serve as such, however, for securities other than JGBs.

135 Book-Entry Transfer Act, Art. 47-50 (permissible for BOJ to act as CSD for JGBs and related special provisions).

136 This will eliminate the need for JASDEC to return share certificates for registration in the names of the beneficial owners before each issuer's record date. *See* T. Shimizu, Settlement System of Tokyo Stock Exchange, 1-5 (1988) (unpublished manuscript).

(Indeed, it seems anomalous to refer to a "central securities *depository*" in a dematerialized world, although the term has become an accepted term of art in the industry.)

Before turning to details of the private law matters addressed by the Book-Entry Transfer Act, two overarching observations are in order concerning the legislative approach taken by the Act. First, it addresses specific matters within its purview, but does not purport to be a comprehensive codification. For example, it originally left many regulatory and customer protection issues to the Securities and Exchange Law (hereinafter, "SEL")[137] and now leaves these matters to the Financial Instruments and Exchange Law (hereinafter, "FIEL").[138] Second, it leaves many operational details to be addressed by contract among the relevant parties as well as under the operational regulations of the market, such as those relating to the maintaining of the shareholder registers of issuers of equity securities and the clearance and settlement systems.

As mentioned, the new system under the Book-Entry Transfer Act will apply only to dematerialized securities. To date the Act has been implemented for commercial paper, corporate debt securities, and dematerialized JGBs. Since January 2003, when the new system was first applied to JGBs, those securities have been issued only in paperless form and almost 100% of the outstanding JGBs are now in the new book-entry system.[139]

Corporate debt securities must likewise be issued or converted to dematerialized form in order to become subject to the new system.[140] Most physical bonds were changed to book-entry in April through November 2006, and most registered bonds were changed to book-entry beginning in November 2006 through April 2007 (although some were changed from November 2006 to October 2007).[141] The process of conversion required the issuer to apply to JASDEC for conversion and also the consent of bondholders; some bondholders of an issue may consent and some may retain the

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[137] Act 25 of 1948, Art 24 (disclosure of annual securities report); Art. 24-5 (disclosure of semiannual and extraordinary reports); 24-4-7 (disclosure of quarterly report); Art. 31 (business name restriction); Art 32 (restrictions on holding concurrent posts with parent and subsidiary companies); Art 33 (good faith obligation); Art. 35 (prohibition on name lending); Art. 42 (prohibition of unfair trading); Art. 42-2 (prohibition of compensation of losses).

[138] The SEL has been superseded by the FIEL, Act. 65 of 2006, which became effective on September 30, 2007.

[139] In January 2008, 99.97% of JGBs were included in the book-entry system. http://www.boj.or.jp/en/type/stat/dlong/fin_stat/short/cdab1510.csv (data upon which percentage calculation is based).

[140] Book-Entry Transfer Act, Art. 67 & supplementary provisions.

[141] SMJ 2006, *supra* note 132, at 101.

registered or physical bonds.[142] Bonds that were not converted prior to year-end 2007, however, may not be converted thereafter.[143] Consequently, bondholders had a strong incentive to convert to book-entry form in timely fashion, inasmuch as preferential tax treatment applies only to book-entry bonds that were converted before January 6, 2008.[144]

As noted above, under the 2005 amendments to the Shōhō and subsequent enactment of the Corporation Law of Japan, corporations now need not issue share certificates.[145] However, upon implementation of the Book-Entry Transfer Act for equity securities, publicly traded shares will automatically become dematerialized as a matter of law, without going through the process of amending articles of incorporation and making corresponding entries in the issuer's register.[146]

In addition to the role of JASDEC as the "top-tier" (CSD) institution, the Book-Entry Transfer Act recognizes the role of account management institutions (*i.e.*, intermediaries) and investors (*i.e.*, account holders). As is currently the case for equities under the Custody Act, the intermediaries will have accounts with JASDEC (as "direct participants" of JASDEC) and the account holders will have accounts with the intermediaries. Unlike the current system for equities, however, the Book-Entry Transfer Act expressly recognizes the possibility of additional "tiers" of intermediaries. For example intermediary 1(IM-1) could be a direct participant, having an account with JASDEC, intermediary 2 (IM-2) could be an "indirect participant" having an account with IM-1, and account holder could have an account with IM-2.[147] Securities firms, commercial banks, and certain other types of financial institutions may act in the capacity of an intermediary, subject to a licensing requirement.[148]

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[142] Various interviews and email exchanges with Katsuya Sakaba, Hideki Tomita, Takeshi Sano, and Yuji Sato, JASDEC, October-December 2006, and interviews with Takehiro Hosomura and Takahiko Kaneko, JSCC, and Takeshi Hirano and Makoto Minoguchi, Tokyo Stock Exchange, October 2006, (hereinafter, collectively, "Tokyo Interviews").

[143] *Id*.

[144] Income Tax Act, Act 33 of 1965, Arts. 10, 11 (amended 2002) & related supplementary provisions; Special Taxation Measures Act, Act 26 of 1957, Arts. 4, 4-2, 4-3, & 8 (amended 2002) & related supplementary provisions.

[145] *See* note 128, *supra*.

[146] Transition to Dematerialization, *supra* note 123, at 5-6.

[147] The Book-Entry Transfer Act does not put any limit on the number of "tiers."

[148] Although a commercial bank is permitted to act as an intermediary for equity securities, under the SEL and, now, under the FIEL, banks cannot engage in equity

The acquisition of securities under the Book-Entry Transfer Act can be made only by book entries in the transfer account register of an intermediary, *i.e.*, by a debit to a transferor's account and a credit to a transferee's account.[149] An intermediary normally will carry at least two separate accounts with JASDEC or other upper-tier intermediary.[150] One would be its "proprietary" account, to which securities owned by the intermediary (and not maintained for its account holders) will be credited.[151] The other will be its "customer" account, to which securities it manages for its account holders will be credited.[152]

The new system contemplates a strictly "matched book" under which the number of units of securities of each issue credited by an intermediary on its books to its account holders must be strictly matched to the identical number of units of that issue in the intermediary's customer account on the books of JASDEC or other upper-tier intermediary. However, the customer account normally will not reflect the individual holdings of each of intermediary's account holders but, instead, will be held in an aggregated "omnibus" account maintained for all account holders.

Consider an example in the context of corporate equity securities traded on a stock exchange. Assume that IM-1 has a customer account on the books of JASDEC. It executes a buy order for an account holder (AH-1). On the settlement date for that trade IM-1 will credit the number of units of the relevant issue of security to AH-1's account. After that credit (and all of the other credits and debits to the accounts of IM-1's account holders), the aggregate balance of units of the relevant security in IM-1's customer account at JASDEC must equal the aggregate amount of credits of that security issue on IM-1's books for all of its account holders. That does not necessarily mean that there will be a corresponding credit to IM-1's customer account on that date. As a result of

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securities transactions for clients. SEL, Art. 65; FIEL, Art. 33. So a bank would be an unlikely intermediary for an account holder who engages in trading equity securities.

[149] Book-Entry Transfer Act, Arts. 73 (corporate debt securities); 98 (JGBs); 140 (corporate equity securities).

[150]Book-Entry Transfer Act, Arts. 68 (corporate debt securities); 91 (JGBs); 129 (corporate equity securities).

[151] An intermediary also may maintain a proprietary account denominated as a pledge account, discussed below.

[152] This form of "segregation" of account holder securities is required by the Book-Entry Transfer Act Arts. 68 (corporate debt securities); 91 (JGBs); 129 (corporate equity securities). Segregation of "assets" also is required by the FIEL. FIEL, Art. 43 § 2**.** Funds held by an intermediary on behalf of account holders (for example, as proceeds of securities sold by account holders and not yet reinvested) must in the aggregate be "segregated" as well in a bank account held in trust for the account holders. FIEL, Art. 43 § 2.2.

"netting" in the clearance and settlement process, IM-1 might actually be a net transferor of the relevant securities from its customer account on that date.[153] But the offsetting credits and debits to the accounts of IM-1's account holders must *result* in a balance that is matched by the securities held by IM-1 in its upper-tier customer account.

The same analysis applies in the context of JGBs for which the BOJ serves as the CSD. Most book entries made in the BOJ book-entry system are debits and credits made to participants' accounts who are the actual parties to a transaction (sometimes on behalf of their own account holders, of course) and are made on "delivery against payment" (hereinafter, "DVP") terms.[154] Some entries, however, reflect the results of transactions that are netted in the clearing system operated by Japan Government Bond Clearing Corporation (hereinafter, "JGBCC"), and to that extent the clearance and settlement operations resemble those for equity securities.[155]

2. Securities Held Through Intermediaries under the Book-Entry Transfer Act: Basic Attributes

The account holders to whom securities are credited are presumed to hold ownership of the securities.[156] That ownership confers on them the right to the payment of principal and interest on debt securities and the rights to receive dividends, vote, and exercise other rights in the case of equity securities. In that sense the new system is a form of "direct" holding. Within the book-entry system itself, the Act is consistent with the principles of possessory rights under the general principles of the Civil Code of Japan (the Minpō), including a presumption of the rights exercised—here, ownership (or pledge, discussed below).[157] JASDEC and other intermediaries in the chain of tiers function as keepers of accounts but have no ownership interest in securities credited to their account

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[153] *See generally* III.B., infra.

[154] *See id.*

[155] For example, in December 2007 61.5% of the volume of BOJ book-entry transactions for buy/sell transactions arose from netted transactions in the JGBCC system. JGBCC Monthly Statistics Report December 2007 I, *Analysis 1, Comparing with the entire JGB Market* (volume at the Bank of Japan) (January 25, 2008) *available at* http://www.jgbcc.co.jp/english/stastics/stastics.php.

[156] Book-Entry Transfer Act, Arts. 76 (corporate debt securities); 101 (JGBs); 143 (corporate equity securities).

[157] MINPŌ Art. 188-189; Book-Entry Transfer Act, Arts. 76 (presumption that account holder is the owner of corporate debt securities), 101 (same for JGBs); 143 (same for corporate equity securities).

holders.[158] This differs from the system for equities under the Custody Act, under which account holders and intermediaries held a *sui generis* "co-ownership" of the fungible pool of security certificates.[159]

Whether and the extent to which this change in property concepts affects outcomes, and the nature of any such changes in outcomes, are addressed in subpart D, below, in connection with the analysis of hypothetical transactional patterns. For now, however, note that an intermediary's lack of a property interest in its account holders' securities does not deprive it of the power to transfer the property interests of its account holders.[160]

The Book-Entry Transfer Act supersedes provisions of the Minpō that deal with the acquisition of possessory rights.[161] Rights in dematerialized securities in the book-entry system are acquired only by credit to an account with JASDEC, the BOJ, or another intermediary.[162] It follows that an account holder cannot itself confer ownership or possessory rights on another except by means of a book entry in the system. Of course, an account holder could hold, and acknowledge that it holds, securities credited to its account in the capacity of a nominee or agent for another. But, that would not confer any property rights in the person on whose behalf the account holder is acting. That person would have only personal, contractual rights against the account holder and the securities credited to the account holder's account would be subject to the claims of the account holder's creditors.

3. Duties of Securities Intermediary

The Book-Entry Transfer Act does not by its terms impose a "duty," as such, on an intermediary to maintain a matched book for its account holders, but it reaches that result implicitly and practically by imposing strict liability. If for any reason any intermediary fails to hold securities in its customer account on the books of JASDEC or the books of another upper-tier intermediary sufficient to cover the credits it has made to

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[158] For convenience this paper sometimes refers, for example, to an intermediary that "holds" securities in its upper-tier customer account. This formulation should not be understood to conflict with the legal conclusion that the property interest is presumed to reside in the account holders (including intermediaries holding in their proprietary accounts), but not in the intermediaries acting as such.

[159] Custody Act, Art. 23.

[160] *See* II.D.1, *infra* (analysis of Example 2).

[161] *See* MINPŌ Arts. 180-187.

[162] Book-Entry Transfer Act, Arts. 73 (corporate debt securities); 98 (JGBs); 140 (corporate equity securities).

its account holders, the intermediary is required to rectify the shortfall.[163] Stated from another perspective, the aggregate units credited to underlying owners in the book-entry system (including credits to the proprietary accounts of intermediaries) should not exceed the total number of units issued by the issuer.

If an imbalance occurs (a "shortfall" from the perspective of the intermediary or an "overbooking" from the perspective of the issuer's books) the intermediary might cause the books to match by purchasing securities from account holders or acquiring additional securities in the market for credit to its upper-tier customer account (or in the case of JASDEC, for credit to its participants). JASDEC or an intermediary that has suffered the shortfall or overbooking is primarily liable. In addition, any lower-tier intermediary in the chain, including the intermediary that maintains an account with an account holder who has been damaged, is a guarantor of that liability.[164] This "partitioned" strict liability differs from the generally applicable strict liability under the Custody Act, which imposes liability on JASDEC and all of JASDEC's participants, even those not in the chain of holding in which a shortfall has occurred.[165]

During the period of time that any shortfall exists, the affected account holders have a pro rata property interest in the securities of the relevant issue that are properly credited to a customer account for their benefit. This is consistent with another important feature of the Book-Entry Transfer Act system. Issuers of securities in the book-entry system will not be adversely affected by any errors resulting in shortfalls or overbookings caused by JASDEC or any other intermediary. For example, an issuer is liable on a finite amount of debt securities or has issued a finite number of shares of stock. Any "inflation" in the book-entry system arising from too many credits to account holders will not impose any additional liability or duties on the issuer.

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[163] Book-Entry Transfer Act, Arts. 78, 79 (corporate debt securities); 103, 104 (JGBs); 145, 146 (corporate equity securities). It should be obvious that such shortfalls should not happen in the absence of mistake, fraud, or the like. The hypothetical transactions addressed below in subpart D and the discussion of clearance and settlement in Part III explore in more detail how a shortfall might occur in practice.

[164] Book-Entry Transfer Act, Art. 11, Sec. 2 (CSD must have regulations requiring a guaranty of payment of damages for upper-tier overbooking in the contract between an intermediary and its account holder). Both the JASDEC and BOJ regulations impose this requirement. Business Regulations Relating to Corporate Bonds, Etc. [Provisional Translation] ("Bond Regulations"), Art. 26(1)(5); *available at* http://www.jasdec.com/en/download/sb/10.pdf; Bank of Japan Regulations concerning the JGB Book-entry System, Art 20(1)(12), (13), *available at* http://www.boj.or.jp/en/type/law/furiketsu/fyoryo01.htm.

[165] Custody Act, Art. 25.

4. Shortfall and Intermediary Insolvency

Consider next the application of the Book-Entry Transfer Act system in the event of the insolvency of an intermediary. In the relatively few insolvency proceedings involving securities firms in Japan, proceedings have been brought under the general bankruptcy law, the Hasan Hō.[166] In recent years bank insolvencies generally have been subject to administrative proceedings under the Special Law on Emergency Measures ("Special Law"),[167] overseen by the Financial Supervisory Agency (now, Financial Services Agency; hereinafter "FSA") without judicial supervision.[168]

If there is no shortfall (overbooking) in respect of an issue of securities credited to an insolvent intermediary's customer account with JASDEC or another upper-tier intermediary, the insolvent intermediary's account holders will be protected fully. As noted above, account holders holding for their own account (and not as an intermediary) hold the property interest in the securities.[169] In a securities firm bankruptcy under the Hasan Hō, the firm's securities account holders have a right of recovery based on their property claims under nonbankruptcy law.[170] The account holders' interests similarly would be respected in the insolvency of a bank. In recovering its securities held under the Book-Entry Transfer Act, presumably an account holder's securities would be transferred to another intermediary of its choice. The insolvency proceeding of the intermediary cannot deprive them of their interests. If an intermediary has a customer account with the insolvent intermediary, the former intermediary's customers will be fully protected for the same reason if there is no shortfall in the customer account.

If a shortfall does exist in the customer account of the insolvent intermediary on the books of JASDEC or another intermediary, securities account holders of a securities firm or bank will be entitled to the benefit of their nonbankruptcy property rights—a proportionate interest in the relevant securities.[171] The account holders claiming securities of the relevant issue would share pro rata based on their nonbankruptcy property interests. However, under Japanese law the account holders would share only in

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[166] Act 75 of 2004.

[167] Act 132 of 1998.

[168] Banks also could file for reorganization under the Special Treatment of Reorganization Procedures for Financial Institutions, Act 95 of 1996, but that would require the appointment of a trustee.

[169] *See* II.B.2., *supra*.

[170] HASAN HŌ Article 62.

[171] No such shortfalls have occurred in bank insolvencies, however, and the norm has been for the Japanese government (through nationalization, the BOJ, or otherwise) to provide protections against losses from bank insolvencies.

the securities credited to the intermediary's customer account, not those that might be credited to its proprietary account.[172]

While neither the Hasan Hō nor administrative procedures under the Special Law provide any special distributional rules for account holders facing a shortfall in an intermediary insolvency, additional protections are available for account holders of securities firms. An account holder of a lower-tier intermediary would have that intermediary's guaranty of the insolvent upper-tier intermediary's obligations to remedy and be liable for the shortfall.[173] Moreover, amendments to the Securities and Exchange Law in 1998 established an Investor Protection Fund.[174] That fund protected (non-institutional) investors holding accounts with a bankrupt securities firm for losses up to ¥ ten million. These protections are carried forward in the FIEL.[175] The Book-Entry Transfer Act establishes another Investor Protection Fund that applies to securities credited to accounts in the book-entry transfer system and which also covers losses of non-institutional investors up to ¥ ten million.[176] Unlike the fund applicable to account holders of securities firms under the FIEL, the protections of the fund under the Book-Entry Transfer Act extend to account holders of all intermediaries—*i.e.*, those of banks as well as securities firms.[177]

5. Competing Interests in Securities

a. Innocent Acquisition and Good Faith Purchase

The Book-Entry Transfer Act provides that an innocent acquirer of securities by an account holder acquires complete ownership, *i.e.*, will take free of competing property claims.[178] To qualify, the account holder receiving the credit must do so in good faith and without gross negligence.[179] Under the Act, however, the only *method* of transfer or delivery that is effective to qualify a purchaser as an innocent acquirer is a credit on the

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[172] Book-Entry Transfer Act, Arts. 68 (corporate debt securities), 91 (JGBs), 129 (corporate equity securities); *see also* FIEL Art. 43-2.

[173] Book-Entry Transfer Act, Art. 11, Sec. 2.

[174] SEL Arts. 79-20 to 79-80.

[175] FIEL Arts. 79-20 to 79-80.

[176] Book-Entry Transfer Act, Art. 51 to 65-2.

[177] In the event of a securities firm insolvency securities credited to an account governed by the Book-Entry Transfer Act would be subject to the fund established by that law.

[178] Book-Entry Transfer Act, Arts. 77 (good faith purchase of corporate debt securities), 102 (same for JGBs); 144 (same for corporate equity securities).

[179] *Id.*

books of JASDEC or another intermediary.[180] Because a credit to an account holder's account presumptively confers ownership and because one who satisfies the test for innocence under Japanese law (good faith and absence of gross negligence) would incur no liability in tort or otherwise, there is no need to provide an immunity for account holders, unlike under United States law. The hypothetical transactions discussed in subpart D provide further explanation and analysis of innocent acquisition of dematerialized securities under Japanese law.

b. Priority Rules

The Book-Entry Transfer Act also addresses pledges of securities credited to a securities account.[181] Credit to the account of a secured party also can effect a security interests by way of outright assignment (*jouto tanpo*).[182] The credit to the pledge account of a creditor on the books of the creditor's intermediary (which may be JASDEC) is both a necessary and sufficient step to render the pledge effective against other creditors of a debtor and in the insolvency of the debtor (*i.e.*, to render the pledge "perfected," borrowing UCC Article 9 terminology).[183] The same is true for a credit to the proprietary account of a creditor in the case of *jouto tanpo*.[184] In either case the credit is effective as a perfection step. In its effect, the credit is recognized as the precise analogue of the delivery of a discrete security certificate.

A creditor has the option of choosing to have a pledge of shares of stock notified to the issuer or choosing to remain anonymous (except, of course, as to its debtor and the intermediary involved in the transaction) in a non-registered pledge (*ryakushiki jichi*).[185] An assignee creditor in a *jouto tanpo* transaction has a similar choice.[186]

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[180] Book-Entry Transfer Act, Arts. 73 (corporate debt securities); 98 (JGBs); 140 (corporate equity securities).

[181] Book-Entry Transfer Act, Arts. 74 (corporate debt securities); 99 (JGBs); 141 (corporate equity securities).

[182] Transition to Dematerialization**,** *supra* note 123, at 5.

[183] Book-Entry Transfer Act, Arts. 74 (corporate debt securities); 99 (JGBs); 141 (corporate equity securities). The use of pledge accounts is traditional and also serves as a weak form of public notice that the securities are pledged to the account holder and not the proprietary asset of the account holder.

[184] Transition to Dematerialization**,** *supra* note 123, at 5.

[185] *Id.*

[186] *Id.*

Inasmuch as the Act contemplates a credit to a single creditor, it leaves no room on its face for a priority contest among competing secured creditors. Were a pledgee or an assignee by way of *jouto tanpo* in actual physical possession of a security certificate, acting in part as a representative, it could declare that it holds for its own behalf as well as for another, junior creditor under the applicable provisions of the Minpō relating to possessory rights.[187] However, if the pledgee or assignee were the recipient of a credit in the book-entry system, the Act does not by its terms recognize those methods of creating possessory interests outside of the book-entry system.[188] On the other hand, one acting as a trustee under a trust arrangement can receive a credit in the book-entry system in that capacity for the benefit of its trust beneficiary.[189]

6. Creditor's Legal Process (*e.g.*, Attachment)

An attaching creditor of an account holder can reach securities credited to the account holder's account only by legal process against the intermediary that maintains that account holder's account.[190] As under United States law, so-called "upper-tier attachment" is not permitted under Japanese law.

7. System Rules

The Book-Entry Transfer Act does not contain a statutory deference to the rules of a clearance or settlement system.[191] It follows that the rules of such systems in Japan

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[187] *See* MINPŌ Arts. 181-182.

[188] *See* II.B.2., *supra*.

[189] Book-Entry Transfer Act, Art 142; *see* Bond Regulations, Art. 18(3) (provision for "Trust Account").

[190] The conclusion stated in the text is implicit, but not explicit, in the Book-Entry Transfer Act, inasmuch as an account holder has a direct property interest effective against the issuer as reflected solely by the book entry in its favor on the books of its intermediary and upper-tier intermediaries have no property interest whatsoever that could be attached. II.B.2., *supra*. The Book-Entry Transfer Act delegates to Supreme Court rule the details of legal process against securities credited to securities accounts, and Rules of Civil Execution, Supreme Court rule 5 of 1979 addresses attachment on an upper tier. *See* Book-Entry Transfer Act, Art. 130 (on and after the effective date of the 2004 amendments, Art. 280); Rules of Civil Execution, Art. 150-6 to 150-11.

[191] FIEL Art. 156-11 provides a clearing corporation with a priority over repayments from its clearing deposits in the case of a system participant's default. FIEL Art. 156-11-2 provides that, in an insolvency proceeding of a participant, the unsettled obligations and posted collateral shall be dealt with according to the relevant provisions set out in the business rules of the clearing corporation, which is subject to authorization by the competent regulatory authority (the FSA).

must conform to the Act. On the other hand, the Act does not provide rules as detailed as those of the UCC, which means that the possibility of a conflict is remote.

8. Relationships with Issuers: Capturing the Benefits of Ownership for Security Holders under the Book-Entry Transfer Act

The foregoing provides an overview of the pertinent aspects of the Book-Entry Transfer Act which deal with "property interests" or "real rights" in securities held through intermediaries. The centerpiece of the structure is the feature that an account holder acquires ownership of securities through a credit on the books of its intermediary. But acquiring that interest by a credit does not itself address the mechanism by which the account holder actually realizes the economic benefits of ownership. An obvious economic benefit is the right to sell the securities in the market and to receive the proceeds of the sale. This is accomplished largely through the book-entry system. An account holder may place a sell order with its intermediary, who executes the order in the market. On the settlement date the intermediary either remits the proceeds to the account holder through normal banking channels (*i.e.*, by check or funds transfer) or, if so agreed, retains the proceeds for the account of the account holder.[192]

Economic benefits other than proceeds of a disposition also accrue to the account holders who retain the book-entry ownership of their securities. Debt securities accrue interest payable by the issuer and provide for the issuer's full or partial redemption, repayment, or prepayment of principal. Equity securities likewise give rise to rights to payment, such as dividends or payments in full or partial redemption. Equities may afford other rights as well, such as the voting rights of shareholders. Realization by account holders of these economic attributes of securities ownership poses a challenge for the new system under the Book-Entry Transfer Act. This is so because an account holder's intermediary knows the account holder's identity, contact information, and securities holdings, but JASDEC and other upper-tier intermediaries see only customer accounts that do not identify the underlying account holders. And this system of book-entry holding does not, without more, allow the issuer to know who to pay or who is entitled to vote on a day-to-day basis as debits and credits are made to the accounts of account holders on the books of direct and indirect participants.

Consider first payments made by issuers of debt securities.[193] Corporate bonds that are not held in the new book-entry system are subject to the Law Concerning the Registration of Corporate Bonds ("Bond Registration Act").[194] This law permits bondholders to register their ownership and transfer bonds on the books of banking

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[192] *See* note 152, *supra*, (discussing funds held by intermediary for benefit of account holders).

[193] The following discussion is based largely on the Tokyo Interviews, *supra* note 142.

[194] Act 11 of 1942.

institutions without the issuance of a bond certificate. The system was simplified substantially by the establishment of a bond settlement network, JB-Net, which began operations in 1997. This system of registration provides issuers with the information necessary to make payments to the bondholders. Issuers make payments directly to bondholders through normal banking channels.[195] The Bond Registration Act was repealed effective January 4, 2008, except that bonds held in the registration system and not converted to the new book-entry system may be held thereafter in the registration system (or in physical form).

Bonds held under the new book-entry system will be paid within that system.[196] On the business day before a payment is due indirect or direct participants will send payment requests for the amount due to JASDEC and JASDEC, in turn, will send a payment request on behalf of each direct participant to the paying agent for the issuer on each issue of bonds on which payment will become due. For example, an indirect participant would notify its direct participant of the amount due to it (including amounts due to the indirect participant for its own account as well as amounts due to the indirect participant's account holders). The direct participant in turn would notify JASDEC of the amount due to the direct participant and JASDEC would notify each paying agent of the amount due to each direct participant. Payments are then made by the paying agents directly to each direct participant (*not* through JASDEC). The direct participant would retain the portion of a payment due to it and would remit to its indirect participants the amounts due to them. Each indirect participant, similarly, would retain the portion of the payment due to it and remit to its account holders the amounts due to them.

Note that data on the individual bondholders is not communicated up through the tiers; only the aggregate payments due (on account of proprietary and account holder bondholdings) are the subject of the payment requests.

Payments of principal and interest on JGBs are even more straightforward. The Japanese government makes payments to the BOJ, the CSD, for the benefit of all holders of JGBs. The BOJ then passes the appropriate payment amounts to each of its direct participants, which, in turn, pass the payments on through the chain of intermediaries to the ultimate bondholders on the books of intermediaries.

The current system for publicly held equity securities under the Custody Act involves semi-annual notifications by JASDEC to the Issuers (or transfer agents) of the identity of the beneficial shareholders. JASDEC obtains this information on account

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[195] Payments on bonds held by bondholders in physical form are made based on presentation of interest coupons or the bonds.

[196] For a description of the payment procedures for corporate bonds, see *Treatment of Redemption and Interest Payment (Annex) available at* http://www.jasdec.com/en/download/sb/02.pdf.

holders from the intermediaries.[197] The Issuers (or transfer agents) use the list of beneficial shareholders, together with the list of shareholder who holds shares directly (outside JASDEC system) for purposes of both the payments of dividends directly to shareholders as well as to communicate with shareholders concerning the exercise of voting and other rights.

The structure for voting and the exercise of shareholder rights will be similar under the Book-Entry Transfer Act when it is implemented for equity securities in 2009. One difference, however, will be the elimination of the beneficial shareholder's list. Because *all* publicly traded equity securities will be dematerialized, the identity of shareholders notified by the intermediaries to JASDEC and by JASDEC to the Issuers (or transfer agents) will be the sole, official list of shareholders. Under the new book-entry system the procedures for payments to equity security holders will change. Under the current system payments of dividends and other amounts are made directly by the issuers to shareholders through normal banking channels based on the official list of shareholders and the list of beneficial shareholders provided by JASDEC (based on information provided by direct participants). Under the new system, however, the payment procedures will be similar to the procedures for payments on corporate debt securities, described above, and will be based on requests for payment passed up the chain to JASDEC and by JASDEC to paying agents.[198]

It is important to note that a significant feature of the Japanese system before implementation of the Book-Entry Transfer Act has been that payments to and the exercise of rights by account holders take place outside of the tiered JASDEC-intermediary system for securities holding, which is the focus of this paper. Under the new book-entry system, however, the tiered system of direct and indirect participants will play a significant role in the procedures for payments on corporate debt securities as well as equity securities.

9. Choice of Law.

Neither the Book-Entry Transfer Act nor any other Japanese law provides special choice of law rules for securities held through intermediaries. The general principles of conflicts of laws rules must be applied to the book-entry system. Those principles and rules are beyond the scope of this paper.

C. UNIDROIT Draft Convention

1. Overview, Background, and Scope

The UNIDROIT Secretariat has described the rationale and goals of the Convention as follows:

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[197] Custody Act, Art. 31.

[198] Tokyo Interviews, *supra* note 142.

> This study was undertaken in order to create an international instrument capable of improving the legal framework for securities holding and transfer, with a special emphasis on cross-border situations.
>
> During the last fifty years, the practice of holding and disposition of investment securities has changed considerably: departing from the traditional concept of custody or deposit of physical certificates, for reasons of efficiency, operational certainty and speed, a system of holding through intermediaries has been developed. In this system, the greatest part of securities is immobilised with a CSD. The investor holds securities through a chain of intermediaries that are ultimately connected to the CSD. Acquisition and disposition of securities, including the creation of security interests, are in practice effected on the basis of book entries to the accounts concerned. The securities themselves are no longer physically moved.
>
> However, the legal framework which underlies this modern system of holding through intermediaries in many countries still relies on traditional legal concepts first developed for the traditional method of holding and disposition, i.e. for the physical custody of tangible assets. Because of this, the legal risk in the area of securities holding and disposition is particularly high. This legal uncertainty is multiplied by the fact that securities are increasingly held and transferred across borders, since domestic legal frameworks are not necessarily compatible with each other. Legal risk can, in times of "stress", even trigger systemic effects. Additionally, persistent legal risk affects the efficiency of the markets, as is easily illustrated by the example of increased transaction costs.
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> . . . .
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> Consequently, a framework that comprehensively addresses issues of substantive law in the problem areas identified above is still needed, particularly on a global level. Such a framework would be a necessary complement to the Hague [Securities] Convention and the EU harmonisation efforts.
>
> The future UNIDROIT Convention on Substantive Rules regarding Intermediated Securities is intended to fill this gap.[199]

The Convention applies if "the applicable conflict of laws rules designate the law in force in a Contracting State as the applicable law"[200] or if "the circumstances do not

[199] UNIDROIT, Substantive Rules Regarding Intermediated Securities (Study 78), Overview, *available at* http://www.unidroit.org/english/workprogramme/study078/item1/overview.htm.

involve a choice in favour of any law other than the law of a Contracting State."[201] The Convention does not contain a traditional provision on "scope."[202] But its provisions deal primarily with "intermediated securities,"[203] which are "securities"[204] that are credited to a "securities account"[205] maintained with an "intermediary"[206] in the name of an "account holder."[207]

The Convention does not generally exclude from its coverage relationships with the issuers of securities, but there are very few provisions that affect issuers.[208] However, it does contain an express exclusion for certain relationships between a CSD (and other persons) and issuers. Article 4 provides: "This Convention does not apply to the activity

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200 Conv. Art. 3(a). Of course, even when the Convention is completed it will not actually apply until it comes into force following adoption by the requisite number of states (a number not yet discussed in the process, much less determined, that must await discussion at the diplomatic conference).

201 Conv. Art. 3(b). Article 3(b) would appear to be superfluous as the same result would obtain under Article 3(a), but Article 3(b) probably does no harm except to the dignity of the drafters.

202 *See, e.g.*, Art. 2, Convention on International Interests in Mobile Equipment (Cape Town 2001) (hereinafter, "Cape Town Convention," and cited as "Cape Town Conv. Art. ___") *available at* http://www.unidroit.org/english/conventions/mobile-equipment/mobile-equipment.pdf.

203 Conv. Art. 1(b).

204 "Securities" is defined broadly to mean "any shares, bonds or other financial instruments or financial assets (other than cash) which are capable of being credited to a securities account and of being acquired and disposed of in accordance with the provisions of this Convention." Conv. Art. 1(a).

205 A "securities account" is "an account maintained by an intermediary to which securities may be credited or debited." Conv. Art. 1(c).

206 "Intermediary" is defined as "a person that in the course of a business or other regular activity maintains securities accounts for others or both for others and for its own account and is acting in that capacity and includes a central securities depository if and to the extent that it acts in that capacity." Conv. Art. 1(d).

207 An "account holder" is "a person in whose name an intermediary maintains a securities account, whether that person is acting for its own account or for others (including in the capacity of intermediary)." Conv. Art. 1(e).

208 *See* Conv. Arts. 26, ("Position of issuers of securities"); 27 ("Set-off").

of creation, recording or reconciliation of securities conducted by central securities depositories or other persons *vis-à-vis* the issuer of those securities."[209]

2. Intermediated Securities: Basic Attributes

Article 7 illuminates and specifies the core attributes of intermediated securities. It spells out what it is that is conferred on an account holder by the credit of securities to a securities account. Article 7(1)(a) first provides that the account holder receives "the right to receive and exercise the rights attached to the securities, including in particular dividends, other distributions and voting rights."[210] But an account holder that is an intermediary receives these economic benefits only if it "is acting for its own account"[211] or if "provided by the non-Convention law."[212]

Article 7(1)(a) illustrates well two significant characteristics of the Convention. First, it reflects the Convention's "functional" approach of providing for results that are not imbedded in any particular non-Convention legal doctrine or concept. Second, it is an example of the many provisions in the Convention which defer to the non-Convention law, usually because a consensus emerged that harmonization is either unnecessary or impossible to achieve. In this case, for example, Article 7(1)(a) accommodates Japanese law, which provides that only the account holder has a property interest (and the only property interest) in the underlying securities,[213] as well as United States law, which recognizes that all entitlement holders, even an intermediary acting its capacity as such and not for its own account, acquire a pro rata property interest vis-a-vis other account holders of the same intermediary.[214] The account holder also receives the right to instruct its intermediary to dispose of or transfer an interest in intermediated securities[215] and to instruct the intermediary to cause the holding of securities other than through a securities account.[216]

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[209] Conv. Art. 4.

[210] Conv. Art. 7(1) (a).

[211] Conv. Art. 7(1) (a)(i).

[212] Conv. Art. 7(1) (a)(ii).

[213] *See* II.B.2., *supra*.

[214] *See* II.A.2., *supra*.

[215] Conv. Art. 7(1) (b).

[216] Conv. Art. 7(1) (c). This right is provided only if "permitted under the law under which the securities are constituted, the terms of the securities, the non-Convention law and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system. *Id.*

Finally, Article 7(1)(d) provides that a credit to an account holder's securities account confers "such other rights, *including rights and interests in securities*, as may be conferred by the non-Convention law."[217] The emphasized text corresponds to similar language in the definition of "intermediated securities," which are defined as "securities credited to a securities account or *rights or interests in securities* resulting from the credit of securities to a securities account."[218] These two provisions as currently drafted offer a consensus compromise between two starkly competing visions of intermediated securities, based on non-Convention law, which proved to be highly controversial in the meetings of the committee of governmental experts.

One doctrinal approach views an account holder as *the* owner of a property interest in the underlying securities with attributes of ownership essentially similar to those of owning securities directly, without the participation of an intermediary. Japanese law may be so classified.[219] Another doctrinal approach views securities holding through an intermediary as a *sui generis* form of holding that is quite distinguishable from direct, non-intermediated holding. United States law fits this category. An entitlement holder does acquire a pro rata property interest in a fungible bulk of financial assets under United States law.[220] But the only significant role of the property interest is to insulate the financial assets from the claims of an intermediary's general creditors to the extent necessary to satisfy entitlement holder claims.[221] Other legal regimes may not fit nicely into either category. The upshot of the current formulation is to defer to the non-Convention law with respect to both the nature and extent of the account holder's property interest.

Article 17 also bears on the rights of an account holder under Article 7. Article 17(1) provides that an account holder's rights under Article 7(1) and interests in intermediated securities that have become effective under Article 10[222] generally are effective in an insolvency proceeding of the relevant intermediary.[223] The United States

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217 Conv. Art. 7(1)(d) (emphasis added). These rights are conferred "unless otherwise provided in this Convention." *Id.*

218 Conv. Art. 1(b) (emphasis added).

219 *See* II.B.2., *supra*.

220 *See* II.A.2., *supra*.

221 *See id.*

222 *See* II.C.5.b., *infra* (discussing Article 10).

223 Conv. Art. 17(1). The "relevant intermediary" is "with respect to a securities account, the intermediary that maintains the securities account for the account holder." Conv. Art. 1(g). Article 17(2) provides that the Convention does not impair the effectiveness of an

delegation for the Convention has proposed that Article 17(1) be expanded to provide that such rights and interests are effective in any insolvency proceeding and that it not be limited to insolvency proceedings of the relevant intermediary.[224] As the United States comments explain:

> The insolvency proceedings that most often will test the effectiveness of the rights and interests mentioned in Article 17(1) are not the insolvency proceedings of relevant intermediaries. Such proceedings are relatively rare. . . .
>
> The more significant insolvency proceedings affecting intermediated securities normally will be those of *transferors*, such as sellers, lenders, and debtors granting security interests, or the insolvency proceedings of an account holder—*not* those of relevant intermediaries.[225]

3. Duties of Intermediary

a. In General

Article 7(1) provides the package of rights conferred on an account holder by a credit and Article 7(2) (subject to limitations discussed below) then provides that these rights may be exercised (by the account holder, implicitly) against the "relevant intermediary."[226] The rights specified in paragraph (1)(a) (*i.e.*, "rights attached to the securities, including in particular dividends, other distributions and voting rights") also may be exercised against the issuer or both the intermediary and the issuer, but in each case only "in accordance with this Convention, the terms of the securities and the law

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interest in intermediated securities as against an insolvency administrator or creditors if that interest is effective under the non-Convention law. Conv. Art. 17(2). Article 17(2) derives from Article 30(2) of the Cape Town Convention. Cape Town Conv. Art. 30(2).

[224] *See* UNIDROIT 2008, Study LXXVIII – Doc. 113, Informal Working Group on Insolvency-related Issues, Comments on the Paper of the Chairman (Doc. 97) submitted by the delegation of the United States of America at 2-3 (January 2008) (hereinafter, "U.S. Insolvency Comments"). Consistent with the new Article 5, added to accommodate transparent systems, Article 17(1) also applies to an insolvency proceeding "in respect of any other person responsible for the performance of a function of the relevant intermediary under Article 5. *See* II.C.3.b., *infra* (discussing transparent systems and Article 5).

[225] U.S. Insolvency Comments, *supra* note 224, at 2.

[226] Conv. Art. 7(2)(b), (c); s*ee* II.C.3.b., *infra* (discussing determination of the relevant intermediary and the roles of account operators or middle entities in certain transparent systems). Article 7(2)(a) provides that "the rights referred to in paragraph 1 are effective against third parties."

under which the securities are constituted."[227] The rights specified in paragraphs (1)(b) (right to instruct intermediary to dispose or grant interest) and (1)(c) (right to cause securities to be held other than through a securities account), however, may be exercised only against the intermediary.[228] Article 8 reflects the mirror image of Article 7(1); it imposes on an intermediary, with exceptions, the obligation to "take appropriate measures to enable its account holders to receive and exercise the rights specified in Article 7(1)."[229]

Subject to several exceptions, "[a]n intermediary is neither bound nor entitled to give effect to any instructions with respect to intermediated securities" given by any person other than its account holder in respect of those intermediated securities.[230] Stated otherwise and subject to the exceptions, the intermediary must obey its account holder's instructions and is prohibited from acting on another person's instructions.

An intermediary must hold sufficient securities and intermediated securities of each description sufficient to cover securities of that description credited to its account holders' accounts.[231] If the intermediary at any time does not hold sufficient securities and intermediated securities, it must take actions necessary to cause it to hold sufficient securities and intermediated securities.[232] It must take these actions "within the time provided by the non-Convention law."[233] Moreover, under Article 21(4), these

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[227] Conv. Art. 7(2)(b).

[228] Conv. Art. 7(2)(c).

[229] Conv. Art. 8(1). Exceptions to the intermediary's obligations specified in Art. 8(1) are for actions not within the intermediary's power and for the establishment by the intermediary of a securities account with another intermediary. *See also* Conv. Art. 25 (obligations of intermediary and liability for obligation subject to non-Convention law; intermediary's compliance with obligation under non-Convention law constitutes compliance with analogous Convention obligation).

[230] Conv. Art. 20(1). Exceptions are provided for variation by agreement, holders of effective security interests, judgments and the like, rules of the non-Convention law, and rules of a securities settlement system (if the intermediary is the operator of the system).

[231] Conv. Art 21(1). However, this allocation does not include securities that an intermediary holds for itself (*i.e.*, credited to an account in the intermediary's own name). *Id.*

[232] Conv. Art. 21(3). Concerning the methods by which an intermediary may "hold" securities for this purpose, see II.C.3.b., *infra*.

[233] *Id.* Earlier drafts of the Convention provided two alternatives set out in square brackets: "[immediately] [promptly]." Discussions in the plenary as well as informal consultations revealed not so much a disagreement of substance but differing

obligations do not override non-Convention law or (to the extent permitted by that law) provisions of securities settlement system uniform rules[234] or of an "account agreement"[235] dealing with the method of compliance with those obligations, the allocation of costs of compliance, or otherwise with respect to the consequences of noncompliance with those requirements.[236]

Consistent with an intermediary's duties under Article 21, securities held by an intermediary (directly or through another intermediary) must be allocated to its account holders as necessary to comply with Article 21(1) (*i.e.*, so as to cover securities credited to its account holders' accounts).[237] Securities allocated to an intermediary's account holders are not property available to be reached by creditors of the intermediary.[238] The allocation is to be effected by the non-Convention law "and, to the extent required or permitted by the non-Convention law, by arrangements made by the intermediary."[239] These arrangements may include an intermediary's holding "securities and intermediated securities in segregated form" for "account holders generally" or for "particular account holders or groups of account holders."[240] A Contracting State may declare that the allocation under Article 22 applies only to securities that an intermediary holds in segregated accounts for its account holders.[241] The effect of such a declaration normally would be that securities not segregated for account holders (*i.e.*, held by the intermediary for its own account) would be available for the intermediary's general creditors, even in the face of a shortfall in securities segregated for account holders.[242]

Article 25 provides an important—even crucial—limitation on the obligations of intermediaries under the Convention. The first sentence of that article provides:

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interpretations of "immediately." English speaking delegations tended to believe that "immediately" means "now." Other delegations read "immediately" to incorporate a more forgiving time-frame than "now."

[234] These rules are discussed at II.C.7., *infra*.

[235] An "account agreement" is defined as "in relation to a securities account, the agreement between the account holder and the relevant intermediary governing that securities account."

[236] Conv. Art. 21(4).

[237] Conv. Art. 22(1).

[238] Conv. Art. 22(2).

[239] Conv. Art. 22(3).

[240] Conv. Art. 22(4).

[241] Conv. Art. 22(5).

[242] *See* II.A.2. (United States law); II.B.4. (Japanese law).

> The obligations of an intermediary under this Convention and the extent of the liability of an intermediary in respect of those obligations are subject to any applicable provision of the non-Convention law and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system.

Article 25 (first sentence) is intended to provide a safety-valve for the obligations imposed by the Convention on intermediaries.[243] Consider, in particular, the provisions of Article 7, which might be read to impose absolute or strict liability on an intermediary for its account holders' receipt of all rights and benefits associated with intermediated securities. However, Article 25 (first sentence) recognizes that the intermediary obligations under the Convention must be tempered by non-Convention law and permissible variations pursuant to an account agreement. Otherwise, the Convention is not likely to garner widespread support.

Modern securities markets must afford participants and regulators the flexibility to adjust the obligations of intermediaries to fit various circumstances. For example it is not unusual for an intermediary to disclaim responsibility for risks attendant to holding through foreign intermediaries. Also, the regulatory structures in some jurisdictions permit mismatches in securities credited to an intermediary's account holders and securities held by the intermediary in the case, for example, of "fails to deliver" in the settlement system.[244]

It is fair, of course, to question whether the first sentence of Article 25 achieves its intended purposes. Some readers, including counsel and judges, may find that providing that the Convention obligations are "subject to" non-Convention law and the account agreement is less than clear. For this reason, at the fourth session of the committee of governmental experts, the United States proposed a complementary and supplementary formulation to the effect that if an intermediary complies with non-Convention law and the account agreement, as they may relate to a Convention obligation, such compliance also satisfies that Convention obligation. Stated otherwise, if the intermediary is in compliance with its duties under the non-Convention law (including regulatory constraints) and the account agreement, the analogous Convention rules should defer to that law and agreement. The plenary accepted the United States proposal, which is now included as the second sentence of Article 25.[245]

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[243] Predecessor provisions of the first sentence of Article 25 were proposed by the United States delegation in the course of the drafting process.

[244] *See generally* III.B, *infra* (discussing fails to deliver in settlement systems).

[245] *See* UNIDROIT 2007, Study LXXVIII – Doc. 91 (May 2007), Observations on Transparent Systems submitted by the delegation of the United States of America (hereinafter, "U.S. Observations on Transparent Systems"), proposing a new Article 20(1*bis*):

It also is fair to question the value of the Convention based on such broad deference to non-Convention law concerning important aspects of the intermediary-account holder relationships. There are several responses to this critique. First, adoption of binding and uniform rules on intermediary obligations and duties probably is not feasible. Discussions at meetings of the committee of governmental experts to date suggest that reaching a consensus on such rules is highly unlikely. This no doubt results from the very different legal and regulatory regimes around the world. There is, nonetheless, material value in a set of "default" rules, especially for states without clear, specific laws addressing these issues. But absent additional benefits from the Convention, its treatment of intermediary obligations and duties alone probably would not justify the project. Other provisions, however, do illustrate the value of the Convention as a whole, in particular the rules on innocent acquisition and immunity and the priority rules.

b. Adaptations for Transparent Systems

Application of the Convention's provisions on intermediary obligations necessarily requires a determination of when a person is (or is not) acting in the capacity of an intermediary. In this connection, the Transparent Systems Report urged consideration of the adoption of provisions along the lines of Article 1, paragraphs (3), (4), and (5) of the Hague Securities Convention.[246] Those "provisions . . . are designed to clarify whether certain persons (including certain systems and their participants) should be regarded as intermediaries for the purposes of the [Hague Securities] Convention."[247]

Article 1(4) of the Hague Securities Convention makes it clear that a person acting as a CSD (a term not defined in the Convention or the Hague Securities Convention) may be considered an intermediary. The Convention's definition of "intermediary" was expanded during the fourth session of the committee of governmental experts so as to achieve the same clarification.[248] Hague Securities Convention Article

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> If the substance of an obligation of an intermediary under this Convention is the subject of any provision of the non-Convention law or, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system, compliance with that provision satisfies that obligation.

The language of Article 25 is identical.

[246] Transparent Systems Report, *supra* note 13, at 7-8, 12.

[247] Roy Goode, Hideki Kanda, & Karl Kreuzer, Explanatory Report on the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary 40 (2005) (hereinafter, "HSC Explanatory Report").

[248] The words "and includes a central securities depository if and to the extent that it acts in that capacity" were added to the definition of "intermediary." Conv. Art. 1((d).

1(5) permits a contracting state to declare that operators of certain systems are not to be considered as intermediaries.[249] Article 2 of the Convention, which also was added at the fourth session, is based on and closely follows Hague Securities Convention Article 1(5).

As explained in the Explanatory Report to the Hague Securities Convention, Article 1(3) of that convention:

> makes it clear that a person is not an intermediary merely because it acts as registrar or transfer agent for an issuer of securities (Art. 1(3)(a)), or records in its books details of securities credited to securities accounts maintained by an intermediary in the names of account holders for which the person acts as manager or agent or otherwise in a purely administrative capacity (Art. 1(3)(b)).[250]

Article 4 of the Convention echoes some of what Hague Securities Convention Article 1(3) seeks to clarify, inasmuch as Article 4 makes it clear that the activity of a CSD or another person with respect to securities "*vis-à-vis* the issuer of those securities" is not within the scope of the Convention. [251]

Article 5 of the Convention, another provision added at the fourth session, addresses more fundamentally the application of the Convention to some transparent systems. In these systems, persons who are not intermediaries (*i.e.*, are not acting in that capacity) nonetheless perform some functions of intermediaries (such as receiving instructions from account holders[252]). In some systems, for example, a CSD is the *only* intermediary although its intermediary functions are shared with "middle entities" (or "account operators") that perform some intermediary functions.[253] In other systems, the middle entities are intermediaries acting as such. Article 5 provides a permissive declaration mechanism under which a Contracting State may declare specified details of that state's intermediated holding system. This approach will allow a Contracting State to explain how the Convention regime should be applied when that state's law is the non-

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[249] Article 1(5) was drafted primarily to accommodate the United Kingdom's CREST system. HSC EXPLANATORY REPORT, supra note 247, at 40-41.

[250] HSC EXPLANATORY REPORT, *supra* note 247, at 40.

[251] The Convention does not address the problem addressed by Article 1(3)(a) of the Hague Securities Convention with respect to transfer agents. This omission should be considered and rectified at the diplomatic conference for the Convention.

[252] *See* Conv. Art. 20(1).

[253] *See* Transparent Systems Report, *supra* note 13, at 7.

Convention law. It also will provide transparency by ensuring that the relevant information is included in a public record in accordance with the declaration process.[254]

Article 21 also presented a problem of interpretation and application for some transparent systems. In these systems the CSD may act not only in the capacity of an intermediary but also, separately, as the transfer agent or registrar for issuers of securities. These systems presented the question of how, in its intermediary capacity, the CSD could "hold securities and intermediated securities" for the benefit of its account holders within the meaning of former Article 19(1) of the draft Convention that emerged from the third session of the committee of governmental experts in November 2006.[255]

During the fourth session this question was addressed by revisions to former Article 19(1), now numbered 21(1), and a new Article 21(2). Article 21(1) now provides that "[a]n intermediary must . . . hold or have available for the benefit of its account holders" sufficient securities to cover credits made to its account holders' securities accounts. Article 21(2), then, specifies the methods by which an intermediary may comply with its Article 21(1) obligations, which include the intermediary causing securities to be registered in the names of its account holders on the issuer's books.[256]

4. Shortfall and Intermediary Insolvency

The Convention addresses, but only to a limited extent, the matter of a shortfall in account holder securities and the treatment of account holders in an intermediary

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[254] The approach embraced by Article 5 follows a proposal made by the United States delegation. *See* U.S. Observations on Transparent Systems, *supra* note 245 (proposing two new articles to address the sharing of intermediary functions by non-intermediaries).

[255] *See* UNIDROIT 2006, Study LXXVIII – Doc. 57, Preliminary Draft Convention on Substantive Rules Regarding Intermediated Securities (November 2006), Art. 19(1) ("An intermediary must . . . hold securities and intermediated securities . . .").

[256] Article 21(2) provides:

> 2. - An intermediary may comply with paragraph 1 –
>
> (a) by procuring that securities are held on the register of the issuer in the name, or for the account, of its account holders;
>
> (b) by holding securities as the registered holder on the register of the issuer;
>
> (c) by possession of certificates or other documents of title;
>
> (d) by holding intermediated securities with another intermediary; or
>
> (e) by any other appropriate method.

insolvency proceeding. For the most part it leaves these matters to the non-Convention law.

Article 23 provides a pro rata sharing rule for account holders on an issue-by-issue basis that is not unlike those applicable under Japanese and United States law.[257] However, unlike the Japanese and United States sharing rules, Article 23 applies *only* in an intermediary's insolvency proceeding.[258] It is not a generally applicable property rule. That approach generally is consistent with the Convention's approach of leaving the characteristics and nature of an account holder's property interest to the non-Convention law.[259] Moreover, even in an intermediary's insolvency proceeding, the Convention's loss sharing rule applies "unless otherwise provided by any conflicting rule applicable in that [intermediary's] proceeding."[260] Note the careful wording of the carve-out: "applicable in that proceeding." The point is that the conflicting rule need not be a part of any insolvency law *per se*. For example, in Japan and in the United States (for banks), non-insolvency law property law principles (*i.e.*, the pro rata sharing rules) are "applicable in" insolvency proceedings.

5. Competing Interests in Securities and Intermediated Securities

The Convention, like United States law, provides two sets of rules that address competing interests in securities and intermediated securities. One set contains the innocent acquisition and immunity rules and the other set provides priority rules for security interests and other interests. As discussed below, however, the Convention's rules deviate from those provided by United States law in some important, and largely problematic, respects.

a. Innocent Acquisition and Immunity from Liability

(i) Innocent Acquisition

Article 14 of the Convention protects an account holder who acquires intermediated securities by a credit to the account holder's securities account.[261] In this

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[257] Conv. Art. 23(2)(b); *see* II.A.2., *supra* (United States law); II.B.4., *supra* (Japanese law). Where securities of an issue are allocated to only one account holder, however, that account holder bears the shortfall. Conv. Art. 23(2)(a).

[258] Conv. Art. 23(1).

[259] *See* II.C.2., *supra*.

[260] Conv. Art. 23(1).

[261] The United States has proposed a limited extension of the innocent acquisition protections to persons who acquire interests other than by a credit. The proposal is discussed below. *See* II.C.5.b., *infra.*

respect it is similar to UCC section 8-502.[262] The protections are provided in two analogous but different circumstances.

First, Article 14(1) protects an account holder from competing claims of another person. It applies if, at the time of the credit, "the account holder does not know that another person has an interest in securities or intermediated securities and that the credit violates the rights of that other person with respect to that interest."[263] (For convenience, I sometimes refer to the other person as an "adverse claimant" and the person's interest as an "adverse claim," although neither term is defined or even used in the Convention.) Article 14(1) provides three forms of protection to a qualifying account holder. First, the account holder's interest in intermediated securities credited to its account "is not subject to" the adverse claim.[264] In addition, "the account holder is not liable to" the adverse claimant (*i.e.*, a provision for immunity from liability). Finally, "the credit is not invalid or liable to be reversed" based on an earlier debit or credit being invalid or reversible by virtue of the adverse claim.[265] There is one further condition to protection under Article 14(1). It is inapplicable to an acquisition "made by way of gift or otherwise gratuitously" unless the account holder is acquiring a security interest by way of the credit.[266]

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[262] *See* II.A.5.a., *supra*.

[263] Conv. Art. 14(1).

[264] Conv. Art. 14(1)(a). This is the clear import of sub-paragraph (a), but the text is somewhat less felicitous. It provides that "the account holder is not subject to" the adverse claim. *Id.*

[265] Conv. Art. 14(1)(c). Note that subparagraph (1)(c) identifies only one ground of several possible grounds that the other person might assert as the basis for invalidity or reversibility. In advance of the fourth session the United States proposed to broaden subparagraph (1)(c) to read "the credit is not invalid or liable to be reversed as a result of the interest or rights of that other person." *See* UNIDROIT 2007, Study LXXVIII – Doc. 74, Observations on Innocent Acquisition and Immunity submitted by the Delegation of the United States of America (April 2007) at 3 (hereinafter, "U.S. Observations on Innocent Acquisition"). Time did not permit a full discussion of this proposal at the fourth session. Section 8-502 of the UCC appears to cover the circumstances addressed by each of the three subparagraphs of Article 14(1) inasmuch as section 8-502 prohibits the assertion of "[a]n action based on an adverse claim" under any theory.

[266] Conv. Art. 14(3). This curious exception for gratuitous security interests was thought necessary to avoid an inadvertent denial of protection in the case of security interests granted by one corporate affiliate to secure the obligations of another affiliate. In advance of the fourth session the United States proposed a clarification to ensure that when an intermediary receives a credit on the books of another intermediary and, in turn, the first intermediary credits the account of its account holder, the first intermediary does not acquire its interest gratuitously. *See* U.S. Observations on Innocent Acquisition,

Second, Article 14(2) offers protection to account holders from risks attendant to a "defective entry" (a term defined in Article 14(4), discussed below).[267] Article 14(2) addresses the concern that a credit on the books of an intermediary[268] in favor of an account holder may be rendered invalid or reversible by virtue of an earlier defective entry. As a simplified example, an intermediary might debit the account of A and credit the account of B. If the debit were not valid and if the intermediary were entitled to reverse it, 14(2) would, if B qualifies, protect the credit to B's account that was valid in all other respects. The test of innocence under Article 14(2) is similar to Article 14(1). B would qualify for protection if at the time of the credit to B's account B "does not know of an earlier defective entry."[269] If B qualifies, the credit would not be invalid, ineffective, or reversible as a consequence of the defective entry[270] and B would not be "liable to anyone who would benefit from the invalidity or reversal of . . . [the] defective entry."[271] Article 14(5) provides a limitation on Article 14(2): "To the extent permitted by the non-Convention law, paragraph 2 is subject to any provision of the uniform rules of a securities settlement system or of the account agreement."[272]

A "defective entry" is defined as "a credit of securities or designating entry which is invalid or liable to be reversed, including a conditional credit or designating entry which becomes invalid or liable to be reversed by reason of the operation or non-fulfilment of the condition."[273] Pursuant to Article 13(2), the non-Convention law determines whether an entry in a securities account is valid or liable to be reversed, whether an entry may be made conditionally, and the effects of a conditional entry.[274]

The protections afforded (or not) by both paragraphs (1) and (2) of Article 14 depend on whether the beneficiary of an entry "does not know" of an interest or fact.

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supra note 265, at 2. Time did not permit a full discussion of this proposal at the fourth session.

267 Conv. Art. 14(2).

268 In addition to credits, Article 14(2) (but not Article 14(1)) protects the transferee of an interest under Article 10 whose interest becomes effective against third parties other than by means of a credit. Article 10 is discussed below. *See* II.C.5.b., *infra*.

269 Conv. Art. 14(2).

270 Conv. Art. 14(2)(a).

271 Conv. Art. 14(2)(b).

272 Conv. Art. 14(5); *see* II.C.7., *infra* (discussing uniform rules of securities settlement systems and securities clearing systems).

273 Conv. Art. 14(4)(a).

274 Conv. Art. 13(2).

Article 14(4)(b) and (c) (now in square brackets) address the issue of knowledge.[275] A person knows of an interest or fact if the person has "actual knowledge."[276] In addition, a person has knowledge if the person "has knowledge of facts sufficient to indicate that there is a significant probability that the interest or fact exists and deliberately avoids information that would establish that this is the case."[277] This is the so-called "willful blindness" test applicable when a person "deliberately" (*i.e.*, intentionally) avoids actual knowledge. Subparagraph (c) deals with the circumstances in which an "organisation" (not a defined term) knows of an interest or fact. An organisation "knows of an interest or fact from the time when the interest or fact is or ought reasonably to have been brought to the attention of the individual responsible for the matter to which the interest or fact is relevant."[278]

There is much to commend the current text of subparagraphs 4(b) and (c), which is similar to the test under United States law (UCC sections 8-105(a)(2) and 8-502).[279] Although the test necessarily is soft, it nonetheless would provide considerable concrete guidance to the finder of fact in a case before a court. Consider, for example, the application of section 8-105(a)(2), the so-called "willful blindness" test.[280] A court must

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[275] As explained below, subparagraphs (4)(b) and (c) were placed in square brackets at the fourth session of the committee of governmental experts in order to indicate the absence of a consensus as to the appropriate test for knowledge of an interest or fact.

[276] Conv. Art. 14(4)(b)(i).

[277] Conv. Art. 12(4)(b)(ii).

[278] Conv. Art. 12(4)(c).

[279] *See* II.A.5.a., *supra*.

[280] *See, e.g.*, Decker v. Yorkton Securities, Inc., 106 Cal.App.4th 1315, 1322-24, 50 UCC Rep. Serv.2d 271, 277-78 (2003):

> [W]e conclude that the first part of section 8105, subdivision (a)(2), sets forth a subjective standard. In the first place, the plain meaning of the subdivision compels this result. The second part of the test in section 8105, subdivision (a)(2), pertaining to deliberate avoidance of further information that would establish the claim's existence, indicates a decision by the broker to avoid facts that would have confirmed the claim it suspected. Only a broker with a subjective belief in the probability of the claim could "deliberately" avoid the information confirming its existence.
>
> Second, comment 1 to section 8105 provides that "notice" in section 8105 is not merely inquiry notice or constructive notice. . . .
>
> Third, comment 4 to section 8105 advises that subdivision (a)(2) codifies the "willful blindness" test, and confirms the test has a subjective component.

determine first the "facts" of which a person is "aware." Next, the court must hear evidence and determine whether those facts are "sufficient to indicate that there is a significant probability that the adverse claim exists." Whether facts are "sufficient" and whether the indication is probable (*i.e.*, more likely than not) may require expert testimony concerning the market involved. Then the court must determine whether the acquirer "deliberately avoids information that would establish the existence of the adverse claim." If the acquirer was merely careless but did not "deliberately" avoid information, the test is not satisfied. This makes it clear that the test is not one of prudence but one of culpability. Absent this guidance, a court might erroneously conclude, for example, that an acquirer's failure to follow customary practice in the market could be notice of an adverse claim.

This analysis and suggested result may be more problematic for Japanese law because the standard of gross negligence clearly is one of prudence.[281] But that standard

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> Comment 4 to section 8105 explains: "Paragraph (a)(2) provides that a person has notice of an adverse claim if the person *is aware of* a significant probability that an adverse claim exists and deliberately avoids information that might establish the existence of the adverse claim. This is intended to codify the 'willful blindness' test that has been applied in such cases." . . . (§ 8105, com. 4, italics added.)
>
> Comment 4 to section 8105 continues: "The first prong of the willful blindness test of paragraph (a)(2) turns on whether the person is aware [of] facts sufficient to indicate that there is a significant probability that an adverse claim exists. The 'awareness' aspect necessarily turns on the actor's state of mind. Whether facts known to a person *make the person aware of* a 'significant probability' that an adverse claim exists turns on facts about the world and the conclusions that would be drawn from those facts, taking account of the experience and position of the person in question." (§ 8105, com. 4, [¶] 2, italics added.) . . .
>
> Finally, the last paragraph of comment 4 to section 8105 reads: "The second prong of the willful blindness test of paragraph (a)(2) turns on whether the person 'deliberately avoids information' that would establish the existence of the adverse claim. The test is the character of the person's response to the information the person has. The question is whether the person deliberately failed to seek further information *because of concern that suspicions* would be confirmed." (§ 8105, com. 4, [¶] 3, italics added.) The reference to "suspicions" presupposes a subjective awareness of the significant probability of an adverse claim. Comment 4 thus makes clear that a broker does not have notice of an adverse claim, within the meaning of section 8105, subdivision (a)(2), and section 8115, subdivision (3), unless the facts known to the broker actually made it "aware of a significant probability that an adverse claim exists," or created a "suspicion[ ]" of an adverse claim.

281 *See* II.B.5.a., *supra*.

also bears some similarity to the "willful blindness" test under the United States and Convention regimes, inasmuch as gross negligence can arise out of the failure to investigate in the face of suspicious circumstances.[282]

The delegation of France submitted a proposal concerning innocent acquisition on the penultimate day of plenary discussion at the fourth session of the committee of governmental experts.[283] The French delegation expressed concern that the approach of subparagraphs (4)(b) and (c) could give rise to "a substantial level of uncertainty" and "may . . . be inconsistent with the functional approach."[284] The French proposed to retain the wrongful knowledge standard but to substitute for subparagraph (4)(b) a deference to the non-Convention law for the determination of when a person has such knowledge.[285] After a lengthy discussion, the chair of the committee concluded that no consensus existed on the proper test for knowledge and further that for the time being subparagraphs (4)(b) and (c) should be placed in square brackets so as to reflect this absence of a consensus.

During the discussion of the French proposal the United States and some other delegations argued that it is important for the Convention to embrace a harmonized standard on innocence instead of a mere deference to non-Convention law.[286] France and some other delegations expressed a vaguely described dissatisfaction with the current text.[287] It is difficult to evaluate these critiques on the merits because of the non-substantive nature of the comments. (For example, France made much of the similarity between subparagraph (4)(b) and UCC section 8-105(a), which explains when a person has notice of an adverse claim, as evidence that the test under subparagraph (4)(b) was not "neutral.") At the conclusion of the discussion the chair announced the formation of

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[282] *See* Judgment of Saikō Saibansho [Supreme Court of Japan], 873 HANJI 97, 533 KINHAN 13 (June 20, 1977) (purchaser of promissory notes from a person that purchaser knew had previously issued a forged check in the name of the payee of the notes; held that purchaser should have been suspicious and was grossly negligent in not checking with the payee or paying bank because purchaser had a duty of care to do so).

[283] *See* UNIDROIT 2007, C.G.E./Securities/4/WP.3 (May 2007).

[284] *Id.* at 2.

[285] *Id.* at 6. Under the French proposal, subparagraph (b) would read: "a person knows of an interest or fact as required by the non convention law." *Id.*

[286] Indeed, it is plausible that no such test for knowledge of an interest or fact in this context may even exist under the non-Convention law of some (perhaps many) states.

[287] As discussed above, subparagraph (4)(b) provides ample and precise guidance to a court in the determination of knowledge. *See* text at note 277 and following (discussing "willful blindness" test).

a postsessional working group, to be chaired by Spain, which would be asked to explore the appropriate test for innocent acquisition.

Following the fourth session, the chair of the working group submitted a Preliminary Note that summarized the state of play on innocent acquisition and included a questionnaire seeking input from delegations.[288] Responses of delegations to date demonstrate substantial support for a Convention test of innocence for purposes of Article 14 and little support for merely relying on national tests under the non-Convention law (one of the alternatives posed by France).[289] More recently, the chair submitted a comprehensive report that presents the issues that must be addressed at the diplomatic conference.[290] The United States delegation has continued to press for a harmonized Convention standard (even if that standard is not mandatory) and to support the present text (now in square brackets) that embraces the willful blindness standard.[291]

(ii) Immunity from Liability

As it emerged from the third session of the committee of governmental experts, former Article 20(2) provided a limited, albeit very important, immunity from liability for intermediaries that make entries in securities accounts.[292] The limitation on liability would apply only to claims by "a third party who has an interest in intermediated securities and whose rights are violated by the entry [made by an intermediary to a securities account]." Moreover, it would not apply if either of the conditions specified in former Article 20(2)(a) or (b) exists, *i.e.*, if the entry is made after the intermediary has

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[288] UNIDROIT 2007, Study LXXVIII – Doc. 96, Working Group on Article 14 Preliminary Note (November 2007).

[289] All of the responses by delegations are available at http://unidroit.org/english/workprogramme/study078/item1/preparatorywork.htm.

[290] *See* UNIDROIT 2008, CONF. 11 – Doc. 8, Informal Working Group on Article 14 of the Draft Convention, Summary Report, *available at* http://unidroit.org/english/conventions/2008intermediatedsecurities/conference2008/conferencedocuments/conf11-008-e.pdf.

[291] UNIDROIT 2008, Study LXXVIII – Doc. 112, Informal Working Group on Article 14 of the draft Convention, Comments on the Preliminary Note and response to the questionnaire concerning acquisition by an innocent person submitted by the delegation of the United States of America (January 2008) (hereinafter, "U.S. Comments on Article 14").

[292] *See* UNIDROIT 2006, Study LXXVIII – Doc. 57, Preliminary Draft Convention on Substantive Rules Regarding Intermediated Securities (November 2006), Art. 20. As explained below, at the fourth session of the committee of governmental experts, paragraphs (2), (3), and (4) of former Article 20 were deleted, notwithstanding support for those provisions by the United States, Canada, and Luxembourg.

been served with legal process restraining the intermediary's entry or if the intermediary "acts wrongfully and in concert with another person to violate the rights of [a] . . . third party."[293] Finally, former Article 20(3) made it clear that the limitation of liability would not apply to liabilities to the relevant account holder or a transferee of an effective interest under [former] Article 8 [now, 10] or to any entry that the intermediary "is not entitled to make under [former] Article 18 [now, 20]."

As reflected by the square brackets that appeared in former Article 20(2) and (3), at its third session the committee of governmental experts failed to reach a consensus on the intermediaries that should be covered by the limited immunity. One view, and that taken by the United States delegation, is that the immunity should apply to all intermediaries, including securities settlement systems, and to securities clearing systems as well. Under this view, the immunity should not be limited to securities settlement systems and securities clearing systems. An alternative view is that it should apply only to the operators of securities settlement systems and securities clearing systems.[294]

Consideration of the appropriate beneficiaries of this limitation on liability requires an examination of its underlying purposes. The principal purpose of the limitation on liability is to protect the interests of account holders. The limitation is intended to induce intermediaries to make proper entries in securities accounts. Absent legal process served on an intermediary or the intermediary's wrongful behavior,[295] a third party's assertion that it has an interest in affected intermediated securities and that an (otherwise rightful) entry would violate its rights should not be allowed to dissuade an intermediary from making a proper entry. Otherwise, such an assertion, if credible, could force a prudent intermediary to block the account (with respect to the relevant intermediated securities) pending the ultimate resolution of the matter. This not only would disrupt the liquidity that is the goal of a system of intermediated securities but also could work a considerable hardship on the affected account holder.

At the conclusion of the third session there did not appear to be any disagreement that an assertion by a third party of an interest and of a potential violation of its rights should not have an adverse effect on the operations of a securities settlement system or securities clearing system[296] and, accordingly, that the operator of such a system should be protected by the former Article 20 limitation on liability. However, the potential for serious market disruptions, and even systemic risk, is not limited to disruptions in such

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[293] Former Conv. Art. 20(2)(a), (b).

[294] Former Article 20(4) also provided immunity for securities settlement systems and securities clearing systems that make book entries when they meet the specified test of innocence.

[295] *See* Former Conv. Art. 20(2)(a), (b).

[296] Former Article 20(4) provided a limited immunity for operators of securities clearing systems that was similar to that provided for intermediaries under former Article 20(2).

systems. For example, the clearing operations of clearing banks in the United States government and government agency securities markets are central to the operations of those markets.[297] But these banks do not meet the definition of a securities settlement system or securities clearing system as narrowly and carefully defined in the Convention. In sum, the immunity provided by former Article 20(2) is necessary for the protection of all account holders of all intermediaries. Its application should not be limited to situations that implicate securities clearing or settlement and systemic risk. Moreover, disruption of intermediaries other than securities settlement systems also may pose systemic risk.

Notwithstanding this background and these arguments, at the fourth session of the committee of governmental experts former Article 20(2), (3), and (4) were deleted—thereby eliminating the immunity even for settlement and clearing systems. Prior to the fourth session only the Italian delegation had submitted written observations opposing these immunity provisions[298] Italy expressed the view that these immunity provisions were unnecessary because the purposes of the Convention are limited to harmonizing substantive rules and preservation of the integrity of the system.[299] Italy also expressed concern that the provisions may conflict with national legislation on tort liability.[300] But neither Italy's submission nor interventions by delegations in opposition to these provisions directly confronted the policy arguments described here.

Many interventions were at best misguided (perhaps based on a misunderstanding of the application and import of the provisions) and at worst politically motivated.[301] The most plausible objections made by delegations appeared to be based on the idea that immunity is not necessary under the Convention because an intermediary qualifying for immunity would not be liable under the non-Convention law of the states represented by those delegations. But this reasoning demonstrates that the Convention immunity would be at worst harmless but useless under those states' laws. And it is presumptuous with respect to the potential liability of intermediaries under the non-Convention law of other jurisdictions.

One appropriate concern that may underlie these objections to the immunity provisions relates to the desire to preserve the liability of an intermediary that behaves in

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[297] *See* U.S. Observations on Innocent Acquisition, *supra* note 265, Addendum, at 5.

[298] UNIDROIT 2007, Study LXXVIII – Doc. 93, Comments submitted by the Government of Italy (May 2007).

[299] *Id.*

[300] *Id.*

[301] More than one delegation apparently agreed with Italy that the proposed immunities "could undermine national legislation." On what principles could such observations be based? Absent any analysis of the policy arguments, one is left wondering.

a manner so as to incur liability in tort to a third party under the non-Convention law. This, of course, was the intended effect of the former Article 20(2)(b), providing that the immunity does not apply when one acts wrongfully in concert with another to violate a third party's rights. Perhaps the disagreement boils down to whether the immunity should extend to negligent behavior. But, at least in a system of tort liability like that of the United States, the potential for liability based on negligence could prove quite disruptive. For example, if a third party asserts an interest in securities or intermediated securities, an intermediary is in a position to know whether it is itself acting wrongfully in making further entries to a securities account. But it could be enormously difficult to predict whether, after the fact, the intermediary might be held liable in negligence before a jury because, for example, it did not undertake an investigation of facts based on the assertions of a stranger.

(iii) Conclusions on Innocent Acquisition and Immunity

What more can be said as to these unfortunate results concerning innocent acquisition and intermediary immunity? First, the United States will continue to press for a harmonized test for innocent acquisition (as observed above) and for a broad intermediary immunity (even if the best achievable result were to be that neither approach would be mandatory under the Convention).

Second, it is important to emphasize the relationship between the Convention rules on innocent acquisition and immunity and analogous provisions under the non-Convention law.[302] While the discussion of the innocent acquisition test for knowledge at the fourth session was relatively superficial, it may be that the French proposal and some of the support expressed for it were based on a misunderstanding of this relationship. In particular, it was suggested that the non-"neutral" formulation in the text was motivated in part by a desire to maintain conformity with the United States approach. It also was suggested that the test could render inapplicable other, possibly more protective, approaches under the non-Convention law (such as the traditional "good faith" standard).

Neither of these concerns makes sense. If an acquirer receives a credit but does not qualify for innocent acquisition protection under the Convention test (whatever that may turn out to be), the Convention does *not* provide that the acquirer receives its interest *subject* to a conflicting claim. Nor does it provide for any liability of the acquirer to a conflicting claimant.[303] If the acquirer is protected under the French doctrine of good

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[302] The United States delegation has made the analysis that follows abundantly clear in its response to the Preliminary Note submitted by the chair of the working group. U.S. Comments on Article 14, *supra* note 291, at 1-2.

[303] To reduce the point to one of simple logic, "if X [innocence under the Convention], then Y [does not take subject to other interest and no liability]" does not mean "if not X [not innocent under the Convention], then not Y [does take subject to other interest and is

faith purchase or the United States doctrine relating to the absence of wrongful knowledge, for example, nothing in the Convention renders inapplicable or impairs those protections under the non-Convention law. On the other hand, if the non-Convention law would not afford protection to an acquirer but the Convention test would protect the innocent acquirer, the acquirer would benefit from the more protective Convention test.

A similar point can be made concerning the intermediary immunity that was provided by the now-deleted paragraphs (2), (3), and (4) of former Article 20. If under the non-Convention law an intermediary would not be liable to an adverse claimant (because, under the non-Convention law, no cause of action existed or by virtue of a specific immunity provision under the non-Convention law), the absence of an immunity rule in the Convention would have no effect. For example, when United States law is the non-Convention law, the applicable immunity provisions under United States law[304] would apply even if there were no immunity provisions in the Convention. The goal of including immunity provisions in the Convention, then, is not to preserve non-Convention law of a Contracting State that is based on sound policies; the Convention will have no effect on that law. Instead, the goal should be to override non-Convention law that might impose intermediary liability in situations in which sound policy would dictate immunity from liability.

In sum, Contracting States should be given the opportunity to adopt harmonized Convention tests for innocent acquisition and intermediary immunity. At a minimum, Contracting States should have the option of selecting Convention protections for market participants who might not otherwise be protected under the non-Convention law of those states.

b. Priority Rules

Article 15 contains the basic priority rules for competing interests in intermediated securities. It applies only to interests acquired *other* than by way of a credit to a securities account, *i.e.*, interests that "become effective against third parties under Article 10 (hereinafter, "Article 10 interests").[305] Appropriately, moreover, Article 15 applies only to competing "interests in the same intermediated securities," *i.e.*, intermediated securities credited to the same securities account. Interests become effective against third parties under Article 10 based on a "control agreement,"[306]

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liability]. This recognizes the point that one asserting a property claim or a claim for liability must do so under the non-Convention law. The Convention has nothing to say about those who receive a credit and do not qualify as innocent acquirers.

[304] *See* II.A.5.a., *supra*.

[305] Conv. Art. 15(1). Article 15 also applies to interests that are effective against third parties under the non-Convention law, which are not invalidated by the Convention. *Id.*; Conv. Art. 11.

[306] Conv. Art. 1(k) (defining "control agreement").

“designating entry,”[307] or the acquisition of the interest by the relevant intermediary, provided that the relevant Contracting State has made an appropriate declaration.[308]

Article 15(3) contains the Convention’s first-in-time priority rule. It provides that Article 10 interests “rank among themselves according to the time of occurrence of the following events.”[309] It then specifies the time that an agreement is entered into granting an interest to the relevant intermediary, the time that a designating entry is made, and the time that a control agreement is entered into.[310] It follows that priority rankings are based on the times that the steps are taken for causing Article 10 interests to become effective against third parties under Article 10.[311]

Article 15(4) provides an exception to the first-in-time priority rule of Article 15(3). It deals with an intermediary that acquires an interest in intermediated securities as to which the intermediary is the relevant intermediary (*i.e.*, an interest in its own account holder’s intermediated securities). Under paragraph (4) the interest of such an intermediary is subordinated to any other Article 10 interest that becomes effective by way of a designating entry or control agreement. The rationale behind this priority rule is the subordinated intermediary’s direct participation in the designating entry or control agreement for the benefit of the other Article 10 interest holder, who would have no way of knowing about the intermediary’s interest absent full disclosure. This is precisely the opposite approach of UCC section 9-328(3), which affords priority to the intermediary, even over the beneficiary of an *earlier*-in-time control agreement.[312] Under the Convention regime the burden is on the intermediary to bargain for a subordination of a competing interest; that burden is on the competing interest holder under the United States regime.

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[307] Conv. Art. 1(*l*) (defining “designating entry”).

[308] Conv. Art. 10(4).

[309] Conv. Art. 15(3). However, interests that are effective against third parties under the non-Convention law, but not under Article 10, are subordinated to Article 10 interests. Conv. Art. 15(2).

[310] *Id.*

[311] Because Article 15(3) addresses “[i]nterests that become effective against third parties under Article 10,” it contemplates that application of the priority rule is to be made only in situations in which Article 10(1)(a) has been satisfied, *i.e.*, in which the account holder and the transferee of the interest have entered into an agreement relating to the interest involved. However, once that agreement exists, even if entered into after, for example, a control agreement, it is the timing of the specified events, not the timing of the effectiveness of the agreement, that satisfies Article 10(1)(a), that determines priority.

[312] *See* II.A.5.b., *supra*. When the UCC Article 9 priority rules do not apply, section 8-510(d) provides a rule consistent with section 9-328(3).

The United States has proposed a limited extension of the Article 14(1) innocent acquisition protections to interests acquired under Article 10 as well as those acquired by a credit under Article 9.[313] The proposed extension would apply only in circumstances in which Article 15 does not apply to competing claims—*i.e.*, when the contest does not relate to intermediated securities credited to the same securities account. As explained in the United States proposal:

> Consider . . . an adverse claim not associated with competing Article 8 [now, 10] interests in the same intermediated securities, which are governed by Article 13 [now, 15]. For example, a third party might assert that the intermediated securities can be traced to securities that were lost or stolen. There is no principled reason why an Article 8 [now, 10] acquirer should be denied innocent acquisition protection under Article 12 [now, 14] in this setting merely because it did not receive a credit entry. The Convention should be revised accordingly.[314]

6. Creditor's Legal Process (*e.g.*, Attachment)

Former Article 17(1) of the draft Convention, as it emerged from the third session of the committee of governmental experts,[315] strictly prohibited attachment of an account holder's intermediated securities against an issuer or against any intermediary other than the relevant intermediary (*i.e.*, the intermediary that maintains the account holder's securities account).[316] The same is true of its predecessor provisions found in earlier drafts. This prohibition is of enormous importance in many systems in which an issuer or an intermediary other than the relevant intermediary (such as a CSD) would have no knowledge or means of determining whether and to what extent a debtor in question might have intermediated securities credited to its account on the books of the relevant intermediary. Similarly, the relevant intermediary would have no means of knowing that an attachment has been made if the attachment is served on another person. However, taking into account the Transparent Systems Report, a proposal made by the United States delegation, and further discussion during the fourth session, the committee found it necessary to make certain adjustments to former Article 17 that now are reflected in Convention Article 19.

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313 *See* U.S. Observations on Innocent Acquisition, *supra* note 265, at 3.

314 *Id.*

315 UNIDROIT 2006, Study LXXVIII – Doc. 57, Preliminary Draft Convention on Substantive Rules Regarding Intermediated Securities (November 2006), Art. 17(1).

316 Former Conv. Art. 17(1) ; *see* Conv. Art. 1(g) (defining "relevant intermediary," quoted in note 223, *supra*).

The strict prohibition on upper-tier attachment is problematic for some (although not all) transparent systems in which all of the relevant account-holding information is found at the level of the CSD but in which the CSD itself is not the relevant intermediary.[317] To address these concerns, the United States proposed a permissive declaration mechanism under which a Contracting State could declare that a legal process could be served on a person other than the relevant intermediary if permitted by that state's non-Convention law.[318] New Article 19(3) now provides:

> A Contracting State may declare that under its non-Convention law an attachment of intermediated securities of an account holder made against or so as to affect a person other than the relevant intermediary has effect also against the relevant intermediary. Any such declaration shall identify that other person by name or description and shall specify the time at which such an attachment becomes effective against the relevant intermediary.

Discussion during the fourth session also revealed that in some jurisdictions an attachment is made not against an intermediary or a CSD but against the debtor (account holder) or against the securities account. Accordingly, Article 19(1) now reflects a more neutral approach that accommodates (hopefully) all systems.[319] Finally, "attachment of intermediated securities of an account holder" is broadly defined to include any type of "judicial, administrative or other act or process" for enforcement.[320]

7. Securities Settlement System Uniform Rules and Securities Clearing System Uniform Rules

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[317] *See generally* Transparent Systems Report *supra* note 13, at 15-17.

[318] U.S. Observations on Transparent Systems, *supra* note 245, at 3.

[319] Article 19(1) now provides:

> 1. - Subject to paragraph 3, no attachment of intermediated securities of an account holder shall be made against, or so as to affect:
>
> (a) a securities account of any person other than that account holder;
>
> (b) the issuer of any securities credited to a securities account of that account holder; or
>
> (c) a person other than the account holder and the relevant intermediary.

[320] Conv. Art. 19(2). Various refinements and improvements were made to the text of paragraph (2) during the course of the fourth session.

In several provisions the Convention defers to the "uniform rules"[321] of a "securities settlement system."[322] Another provision defers to the uniform rules of a "securities clearing system."[323] Most of these provisions also defer to non-Convention law and the account agreement. For example, an account holder's right under Article

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[321] "[U]niform rules" is defined to mean "in relation to a securities settlement system or securities clearing system, rules of that system (including system rules constituted by the non-Convention law) which are common to the participants or to a class of participants and are publicly accessible." Conv. Art. 1(p).

[322] *See* Conv. Arts. 7(1)(c); 13(2); 14(5); 20(2)(e); 21(3); 23(3); 24(1); 25. "[S]ecurities settlement system" is defined to mean:

> a system which-
>
> (i) settles, or clears and settles, securities transactions;
>
> (ii) is operated by a central bank or central banks or is subject to regulation, supervision or oversight by a governmental or public authority in respect of its rules; and
>
> (iii) has been notified, on the ground of the reduction of risk to the stability of the financial system, as a securities settlement system in a declaration by the Contracting State the law of which governs the rules of the system.

Conv. Art. 1(n).

[323] *See* Conv. Art. 24(1)(a). "[S]ecurities clearing system" is defined to mean:

> a system which –
>
> (i) clears, but does not settle, securities transactions through a central counterparty or otherwise;
>
> (ii) is operated by a central bank or central banks or is subject to regulation, supervision or oversight by a governmental or public authority in respect of its rules; and
>
> (iii) has been notified, on the ground of the reduction of risk to the stability of the financial system, as a securities clearing system in a declaration by the Contracting State the law of which governs the rules of the system.

Conv. Art. 1(o).

7(1)(c) to instruct its intermediary "to cause securities to be held other than through a securities account" is qualified by the phrase "to the extent permitted by the law under which the securities are constituted, the terms of the securities, the non-Convention law and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system."[324] Article 13(2), relating to validity and reversibility of entries, takes a somewhat different approach. It makes validity and reversibility "[s]ubject to . . . the non-Convention law and, to the extent permitted by the non-Convention law, an account agreement or the uniform rules of a securities settlement system.[325]

This deference to these uniform rules may evoke criticism such as that addressed to the Convention's substantial deference to the non-Convention law, discussed above.[326] And the same responses to such criticism apply as well to the deference to uniform rules.[327]

8. Relationships with Issuers: Capturing the Benefits of Ownership for Account Holders under the Convention

The Convention does not, with few exceptions, address the relationship (if any) between an issuer of securities and an account holder. Article 7 is instructive. Article 7(1)(a) confers on an account holder the rights associated with the securities, such as dividends, distributions, and voting rights.[328] Although Article 7(2)(b) provides that these rights may be enforced against the issuer or the relevant intermediary (or both), it contains an important limitation. Enforcement must be "in accordance with this Convention, the terms of the securities and the law under which the securities are constituted."[329] It follows that, if under the terms of the securities and the law applicable to the securities, an account holder is not permitted to exercise rights directly against the issuer, the Convention defers to that result. Moreover, the other rights conferred on

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[324] Conv. Art. 7(1)(c).

[325] Conv. Art. 13(2).

[326] *See* II.C.2., *supra*.

[327] During the fourth session of the committee of governmental experts, the chair of the committee announced the formation of a postsessional working group, chaired by the United States and the European Commission, to consider whether similar deference should be given to the uniform rules of a CSD under circumstances in which a CSD is not acting in the capacity of a securities settlement system or a securities clearing system.

[328] Conv. Art. 7(1)(a).

[329] Conv. Art. 7(1)(b).

account holders under Article 7(1) "may be exercised only against the relevant intermediary."[330]

9. Choice of Law

The Convention does not contain any rules governing choice of law, conflicts of laws, or private international law. Resort must be had to the generally applicable principles. The inadequacy of these principles for intermediated securities prompted the project resulting in the Hague Securities Convention.[331]

10. Transition Rules

The committee of governmental experts took up the issue of transition rules at its fourth session. The discussion was guided by a report prepared by the chair of an informal working group and a presentation by the group's chair to the plenary.[332] The discussion focused on three general alternatives: (i) complete preservation of the effectiveness and priority of pre-Convention interests in intermediated securities as against post-Convention interests made effective under the Convention, (ii) preservation of pre-Convention interests during a grace period, and (iii) deference to each Contracting State to establish the relevant rules.[333] The discussion reached no consensus,[334] but there appeared to be the most support for the complete "grandfathering" approach for pre-Convention interests. An apparent consensus did emerge, however, that the Convention's innocent acquisition rules should apply from the outset of the Convention's effectiveness as against both pre- and post-Convention interests and claims.[335] Resolution of the transition rules must await the diplomatic conference.

D. Resolution of Hypothetical Transactions

Having presented an overview of the United States, Japanese, and Convention regimes for intermediated securities holdings, this subpart applies the three systems to several hypothetical settings and transactions. This exercise provides a functional test and takes account of the differences and similarities in results.

1. Debit and Credit Resulting in Shortfall in Account Holder

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[330] Conv. Art. 7(2)(c).

[331] *See generally* HSC EXPLANATORY REPORT, *supra* note 247.

[332] UNIDROIT 2007, Study LXXVIII – Doc. 84, Report on transitional rules (May 2007).

[333] *Id.* at 17.

[334] Fourth Session Report, *supra* note 1, at 17.

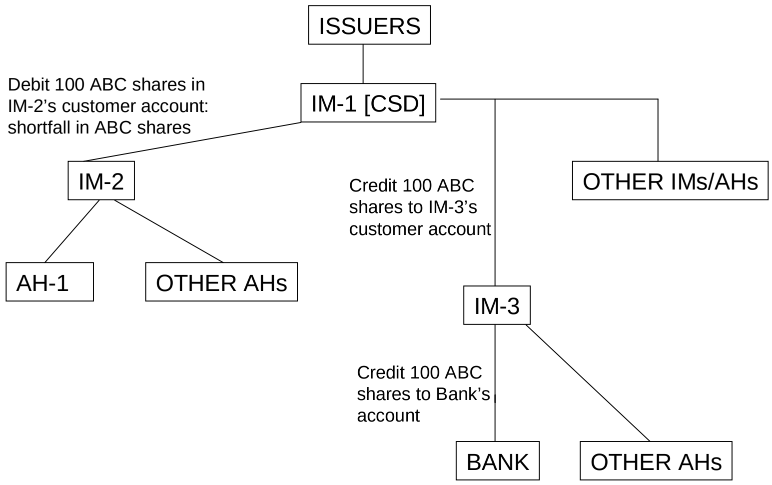
[335] *Id.* at 16.

Securities (*Herein* of Innocent Acquisition and Immunity)

Return now to Example 1 and the diagram presented in Part I, as modified by the following diagram and as explained below.

EXAMPLE 2

Debit and credits resulting in shortfall in account holder securities (*herein* of innocent acquisition and immunity)



Assume that IM-2 instructs IM-1 to transfer 100 shares of ABC Corporation common stock to Bank, by crediting IM-3, another account holder of IM-1, for the benefit of Bank, an account holder of IM-3. IM-1 complies by debiting IM-2's account and crediting IM-3's account for the 100 shares and IM-3, in turn, credits Bank's account for the 100 shares. Bank may have bought the securities outright or taken title under a repo agreement. Or, Bank may have loaned funds or securities to IM-2 and taken a transfer of the 100 shares as collateral to secure IM-2's obligations. Following the transfer, in the absence of the 100 shares debited to IM-2's account and credited to Bank's account with IM-3, IM-2 does not have sufficient shares of ABC to cover all of the credits made to its account holders.[336]

Let us freeze the action in Example 2 at this point in order to examine the legal positions of IM-2, IM-2's ABC account holders, IM-1, IM-3, and Bank under the three legal regimes. For purposes of considering Japanese law, unless otherwise noted the discussion assumes that the Japanese Book-Entry Transfer Act applies.

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[336] To be even more explicit, the total of ABC shares credited to IM-2 on the books of IM-1, together with ABC shares held by IM-2 in any other manner (*e.g.*, on the books of another intermediary, registered to IM-2 on the books of the issuer (ABC), in physical certificates in IM-2's name or indorsed in blank, etc.), are less than the aggregate credit balances for ABC shares in favor of IM-2's account holders.

As explained above, under United States law IM-2 generally is obligated to maintain sufficient financial assets to cover its entitlement holders' security entitlements and (subject to exceptions) is prohibited from creating a security interest in the financial assets required to be maintained for entitlement holders without the consent of the relevant entitlement holders.[337] For purposes of Example 2 we shall assume that the transfer by IM-2 in favor of IM-3 was not a permissible transaction under the applicable law or by an agreement of the parties. The resulting shortfall means that IM-2's ABC entitlement holders share in a proportionate property interest in the fungible bulk of the ABC securities held by IM-2, whether nominally for its entitlement holders or for its own account.[338]

Under Japanese law, IM-2 also would be obliged to rectify the shortfall on pain of becoming liable in damages to the ABC account holders.[339] And, as with United States law, Japanese law would also confer a proportionate property interest in the ABC securities held for IM-2's account holders.[340] Unlike United States law, however, Japanese law would allocate to the account holders only the ABC shares credited to IM-2's customer account on the books of the CSD (IM-1), not those that might be credited to its proprietary account.[341]

The Convention imposes a direct duty on IM-2 to remedy the shortfall.[342] However, the Convention is silent as to the nature and extent of the ABC account holders' interests during the period in which a shortfall persists, leaving the matter to the domestic non-Convention law.[343] It follows that the Convention accommodates both the United States and Japanese approaches to the effect of a shortfall on the interests of account holders.

Even assuming that IM-2's instructions to IM-1 to debit IM-2's account and credit IM-3's account for the benefit of Bank were wrongful as to IM-2's ABC account holders, if IM-2 resolves the resulting shortfall in accordance with United States and Japanese law

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[337] UCC § 8-504(a), (b).

[338] *See* II.A.2., *supra.*

[339] *See* II.B.2., 3, *supra*.

[340] *See* II.B.4., *supra.*

[341] *See id.*

[342] *See* II.C.3.a.

[343] *See* II.C.4.

and the Convention, IM-2's ABC account holders would suffer no loss.[344] In that case, the credit to the account of IM-3 on the books of IM-1 and the credit to the account of Bank on the books of IM-3 would be insulated from attack. In routine cases, these shortfalls are invisible to an intermediary's account holders and the account holders suffer no adverse consequences.

Now assume instead that IM-2's ABC entitlement holders have not been made whole and have suffered a loss by virtue of the shortfall created by the transfer to Bank. Assume further that an ABC entitlement holder (or IM-2's insolvency representative[345]) sues IM-1, IM-3, and Bank to recover the wrongfully transferred ABC shares or to obtain compensatory damages.

IM-1, IM-3, and Bank no doubt would assert defenses to these claims. Under United States law IM-3 and Bank may have a defense under UCC section 8-502, inasmuch as they received credits to their respective accounts "for value and without notice of the adverse claim[s]."[346] Nothing in Example 2 suggests that either IM-3 or bank had notice of an adverse claim. They both may have known that IM-2 initiated the transaction by instructions to IM-1 and that IM-2 acts as an intermediary for its account holders, but knowledge that the transaction *might* wrongfully create a shortfall is far from sufficient.[347] But IM-1, as well as IM-3 and Bank, each has another, even more protective defense.

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[344] Compliance normally would be achieved by IM-2's acquisition of ABC securities in the market so as to make up the shortfall. IM-2 might be subject to regulatory sanctions, however.

[345] In the United States an intermediary such as a broker-dealer or bank that could not satisfy its entitlement holders' claims almost certainly would become the subject of an insolvency proceeding in short order. However, the insolvency representative might or might not have grounds to bring an action to recover financial assets transferred by the intermediary, even if the transfer had been wrongful. The treatment of shortfalls in insolvency proceedings is considered below in connection with Example 3.

[346] UCC § 8-502; *see* II.A.5.a., *supra.* IM-3 acquired its security entitlement when IM-1 credited its account. IM-3 acquired the security entitlement "for value" because IM-3 then credited the account of Bank. UCC § 8-116.

[347] *See* UCC § 8-105(b):

Having knowledge that a financial asset or interest therein is or has been transferred by a representative imposes no duty of inquiry into the rightfulness of a transaction and is not notice of an adverse claim. However, a person who knows that a representative has transferred a financial asset or interest therein in a transaction that is, or whose proceeds are being used, for the individual benefit of the representative or otherwise in breach of duty has notice of an adverse claim.

Because the claims of IM-2's ABC entitlement holders (or an insolvency representative on their behalf) are based on the entitlement holders' property interests in the underlying financial assets, all three parties may raise a defense under section 8-503(e). Recall that section 8-503(e) prohibits the assertion of a claim based on such property interests "against any purchaser of a financial asset or interest therein who gives value, obtains control, and does not act in collusion with the securities intermediary in violating the securities intermediary's obligations under Section 8-504."[348]

Presumably, IM-1 has taken delivery of the ABC shares and also has obtained control by virtue of indorsements on certificates or becoming the registered owner of the shares on the books of the issuer.[349] Also, IM-3 and Bank each are in control of security entitlements that give rise to an interest in financial assets—the ABC shares—by virtue of having become entitlement holders of IM-1 and IM-3, respectively.[350] All three parties are purchasers, having obtained a property interest in the ABC shares under voluntary transactions.[351] IM-1 and IM-3 have given value by virtue of credits to IM-3 and Bank, respectively,[352] and it may be assumed that Bank gave value in connection with its transaction with IM-2. The facts presented in Example 2 do not suggest that any of the three parties acted in collusion with IM-2 to violate IM-2's duties under section 8-504 to maintain sufficient ABC shares for its entitlement holders. It follows that under section 8-503(e) IM-1, IM-3, and Bank should be protected from liability based on IM-2's ABC entitlement holders' claims.

Under Japanese law Bank could assert the defense that it is an innocent acquirer who was not grossly negligent, qualifying for protection under the Book-Entry Transfer Act. Again, there are no facts in Example 2 that suggest that Bank would not qualify. Unlike under UCC section 8-502, however, Japanese law contains no express protection for IM-3. Although IM-3 did receive a credit to its customer securities account on the CSD's books, under the Book-Entry Transfer Act it did not receive a property interest at all, much less one that is protected.[353] Moreover, as explained above, under the partitioned strict liability scheme of the Book-Entry Transfer Act, IM-3 is not strictly liable for IM-2's shortfall of ABC shares.[354]

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[348] UCC § 8-503(e); *see* II.A.5.a., *supra*.

[349] As the CSD, presumably IM-1 has possession of indorsed security certificates or has become the registered owner of the ABC shares on the books of ABC Corporation.

[350] UCC § 8-106(d)(1).

[351] UCC § 1-201(29) (defining "purchase"), (30) (defining "purchaser").

[352] UCC § 8-116.

[353] *See* II.B.1., 2., 5.a., *supra.*

[354] *See* II.B.3., *supra.*

A claim might be asserted against IM-3 under a tort theory of negligence, however. Or, the aggrieved account holders might also allege that they are indirect beneficiaries of IM-3's agreement (express or implied) with its account holders to act with reasonable care and in accordance with industry standards. But, having received a credit for the benefit of its account holder, Bank, under Japanese law, it is unlikely that IM-3 would be liable unless it had knowingly and actively participated in IM-2's wrongful conduct as to IM-2's ABC account holders. As was indicated concerning the United States test of notice of adverse claim, the facts of Example 2 do not suggest that IM-3's behavior would render it liable on any theory under Japanese law.

Under the Convention, IM-3 and Bank also could assert defenses equivalent to those available under UCC section 8-502. The credit to IM-3's account with IM-1 and the credit to Bank's account with IM-3 would make IM-3 and Bank eligible for protection under Article 14(1), properly applied and interpreted.[355] Under Article 14(1) an account holder qualifies for protection if it receives a credit to its securities account and does not possess wrongful knowledge. But what constitutes knowledge currently is an open issue under the Convention in the absence of a consensus (resulting in Article 14(4)(b) and (c) being placed in square brackets).[356] Assuming that neither IM-3 nor Bank had such wrongful knowledge, Article 14(1) not only provides that IM-3 and Bank would not take subject to an adverse claim but also provides immunity from liability to one that holds an adverse claim.[357] Note that the defense under Article 14(1) would be available to IM-3 under the Convention even if the domestic non-Convention law were the law of Japan, under which IM-3 would receive no property interest by virtue of the credit. Although protection under Article 14(1) is not available in a gratuitous transaction, IM-3's receipt of the credit on the books of IM-1 was immediately followed by its credit to the account of Bank. Properly construed, the credit to IM-3's account was not gratuitous.[358]

From the facts mentioned in Example 2 it appears that neither IM-3 nor Bank would be exposed to liability to IM-2's ABC account holders.[359] Consider next some

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355 *See* II.C.5.a., *supra.*

356 *Id.*

357 Conv. Art. 14(1)(b).

358 As noted above, the United States delegation has proposed a clarification that would ensure that a credit to IM-3's account in this setting would not be gratuitous. *See* II.A.5.a., *supra.*

359 The same can be said for IM-1 under United States law, as indicated in the foregoing discussion of UCC section 8-503(e). The position of IM-1 under the Japanese and Convention regimes is discussed below.

variations of these facts as presented in the following scenarios and whether they would affect the positions of IM-3 and Bank in this context.[360]

(i) Bank or IM-3 had knowledge that IM-2 had been fined by its securities regulator in the recent past for failing to maintain sufficient securities to cover the claims of its account holders.

(ii) Bank or IM-3 had knowledge, instead, that IM-2 was insolvent or nearly so.

(iii) Shortly before the debit and credits were made, an officer of Bank, who works in the department of Bank that handled the transaction between Bank and IM-2, read in the *Financial Times* that X Corp., the holding company that owns all of the shares of IM-2, recently received a large distribution of cash and securities from IM-2. The article also mentioned that X Corp. was close to a default under its public bond indentures.

(iv) Alternatively, assume in scenario (iii) that the officer of Bank who read the article worked in the trust department and had no personal knowledge of the Bank-IM-2 transaction.

(v) Shortly before the debit and credits were made, Bank undertook a routine credit check on IM-2 with a credit reporting agency. IM-2's credit report revealed that IM-2 has been sued by a former employee who was discharged (it was alleged) because the employee notified the securities regulator that IM-2 routinely has substantial shortfalls in securities credited to its account holders' accounts. Assume alternatively that: (x) an investigation of these allegations by IM-2's securities regulator is pending (and might continue for several months) or (x) the investigation by the securities regulator has been completed with no finding of wrongdoing.

(vi) In the transaction documents presented by Bank to IM-2, Bank requested (according to its routine procedures) IM-2 to represent and warrant in writing that: (x) IM-2 is solvent and (ii) the securities to be credited to Bank's account would not create an account holder shortfall. IM-2 refused, for the stated reason that Bank should rely on the applicable law and IM-2's securities regulator to protect the account holders. Bank went forward with the transaction without receiving the requested representations and warranties.

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[360] These examples were derived in part from a submission of the United States government to the third session of the Unidroit committee of governmental experts for the Convention. *See* UNIDROIT 2006 – Study LXXVIII – Doc. 45(e).

Few, perhaps none, of these additional scenarios would change the results and deprive IM-3 or Bank of the protections described above under United States or Japanese law or under the Convention, but it is not necessary to analyze these scenarios in detail here. These scenarios illustrate two points. First, the protection for innocent acquirers under all three regimes is far from a bright-line, sharp rule. The protections are highly sensitive to the facts of a particular case and predicting the judicial resolution on a given set of facts can be quite difficult.

None of the UCC, the Book-Entry Transfer Act, or the Convention specifies generally the consequences of a credit to an account holder who does *not* qualify for protection under UCC section 8-502, as a good faith purchaser under Japanese law, or under Convention Article 14(1).[361] The UCC and the Book-Entry Transfer Act leave the matter to other domestic law and the Convention leaves it to the domestic non-Convention law. Significantly, none of these regimes positively imposes liability or a remedy against a person who receives a credit merely because the person does not qualify for the relevant protection. Presumably, the adverse claimant would be required to trace securities to the credited account as a condition to recovering under any theory under the applicable law.[362] A court might order money damages, for example, or it might order the person receiving a credit to transfer the relevant securities to the adverse claimant in an appropriate case.

The aggrieved ABC entitlement holders of IM-2 also might sue IM-1 on the grounds that by debiting IM-2's account IM-1 was the direct cause of the shortfall and that IM-1's action was inconsistent with their ownership interests.

Japanese law (including the Book-Entry Transfer Act) does not expressly address this situation either by providing immunity for an intermediary who makes entries in an account or otherwise. On the other hand, absent IM-1's wrongful or grossly negligent conduct (which does not appear to be the case in Example 2), IM-1 presumably would not be liable. Consequently, the need for an express immunity does not seem necessary to Japanese legal experts.

Under United States law, IM-1 no doubt would invoke UCC section 8-115 (in addition to raising section 8-503(e), discussed above).[363] Section 8-115 provides

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[361] United States law does make specific provision for the recipient of a credit if the recipient also holds an automatically perfected security interest. *See* II.D.8., *infra*.

[362] For example, the adverse claimant might state a claim in conversion, a common law tort, under Unites States law. Under Japanese law the general principle that an owner is entitled to recover its property wrongfully held by another would be sufficient to establish a claim against the person who is not protected as an innocent acquirer. *See, e.g.*, MINPŌ Art. 200 (action for recovery of possession).

[363] *See* II.A.5.a., *supra*. UCC section 8-115 provides, in relevant part:

immunity from liability on claims by the holder of an adverse claim for an intermediary that acts on an effective entitlement order by an entitlement holder. This is precisely the action taken by IM-1 upon IM-2's instruction to debit its account and credit IM-3's account with IM-1. IM-1 would not appear to be subject to any of the three exceptions to the applicability of immunity under section 8-115.[364]

Even as the operator of a securities settlement system, IM-1 would not have an analogous potential defense under the Convention. As explained above, former Article 20(2), (3), and (4) were removed from the draft Convention during the fourth session of the committee of governmental experts.[365]

Now assume that IM-2 maintains two accounts with IM-1—one for financial assets that it holds for its entitlement holders (the "customer account") and one for financial assets that it holds for its own account (the "proprietary account"). Assume further that in Example 2 IM-2 instructed IM-1 to transfer securities from IM-2's customer account to IM-3 on behalf of Bank. This would create a shortfall under United States law only if the aggregate remaining *combined* balances of the customer account *and* the proprietary account were insufficient to cover IM-2's ABC entitlement holders.[366] Under Japanese law, however, the ABC account holders would not have any special rights to have their claims satisfied from securities credited to IM-2's proprietary account.[367] Assuming a shortfall did exist, only if IM-1 somehow had actual knowledge that the transfer created a shortfall for IM-2's ABC entitlement holders would there be an argument that IM-1 acted in "collusion" with IM-2 to violate their rights, thereby eliminating the immunity otherwise provided by section 8-115. Moreover, even with

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> A securities intermediary that has transferred a financial asset pursuant to an effective entitlement order . . . is not liable to a person having an adverse claim to the financial asset, unless the securities intermediary . . .:
>
> (1) took the action after it had been served with an injunction, restraining order, or other legal process enjoining it from doing so, issued by a court of competent jurisdiction, and had a reasonable opportunity to act on the injunction, restraining order, or other legal process;
>
> (2) acted in collusion with the wrongdoer in violating the rights of the adverse claimant; or
>
> (3) in the case of a security certificated that has been stolen, acted with notice of the adverse claim.

[364] *See id.*

[365] *See* II.C.5.a.(ii), *supra.*

[366] UCC § 8-503(1); *see* II.A.2., *supra.*

[367] *See* II.B.4, *supra.*

such knowledge, IM-1 may have believed, for example, that IM-2 was lawfully creating a security interest in the entitlement holders' financial assets.

After IM-1 and IM-3 have been made aware of the claims of IM-2's ABC entitlement holders, suppose that Bank instructs IM-3 to sell the ABC shares credited to its account in Example 2. The shares are then sold on an exchange the following day and Bank's securities account with IM-3 is debited and IM-3's account with IM-1 reflects the reduction in ABC shares arising out of Bank's sell order. Do these events expose IM-1 or IM-3 to liability under United States law? Clearly, each acted with notice of an adverse claim. But, because they did not act in collusion or in concert with IM-2 (or any other wrongdoer), section 8-115 provides them with immunity and section 8-503(e) deprives IM-2's ABC entitlement holders from pursuing an action against them. This illustrates how the "collusion" standard is more protective than the "notice of an adverse claim" standard.

The Convention does not explicitly provide for immunity from liability that would protect IM-1 and IM-3. However, assuming that IM-3 received the credit on the books of IM-1 without knowledge of the adverse claims, IM-3 should be protected by Article 14(1) (properly construed), even if Japanese law were the non-Convention law.[368] Arguably the fact that IM-3 made a subsequent entry in Bank's account at Bank's instruction, even without the protection of a provision for immunity under the Convention or the non-Convention law, should not work to penalize IM-3. But faced with a demand from IM-2's aggrieved ABC account holders, IM-3 plausibly (probably, in some jurisdictions) could refuse to act on Bank's instructions in the absence of immunity under the Convention or the non-Convention law. As explained above, providing immunity to all intermediaries would provide needed protection not only to intermediaries who make entries *but to their account holders* who otherwise could be harmed by the loss of liquidity.[369]

IM-1, who may have received its interest on the books of the issuer with the benefit of an analogous protection from adverse claims under the non-Convention law,[370] might also be protected in respect of subsequent entries over the objections of IM-2's ABC account holders. Under the Japanese Book-Entry Transfer Act law, however, IM-1 would not receive any property interest in the underlying ABC shares and therefore

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368 *See* II.C.5.a.(i), *supra.*

369 *Id.*

370 *See, e.g.*, UCC § 8-303(b) ("protected purchaser . . . acquires its interest in the security free of any adverse claim"). A purchaser for value may be a "protected purchaser," for example, if it obtains "control" of a "certificated security" and "control" can be achieved by "delivery" of the security to the purchaser along with a proper indorsement of the "security certificate.". UCC § 8-106(b)(1) ("control"); 8-301(a)(1) ("delivery").

would not benefit as an innocent acquirer under the (Japanese) non-Convention law.[371] And, as the CSD, IM-1 also did not receive a credit to a securities account so as to achieve protection under Article 12(1). This illustrates the benefits of a broad immunity for securities settlement systems as well as intermediaries generally beyond that provided by or built on the innocent acquisition protections under Article 14(1) or the non-Convention law.

Finally, note that Example 2 presented a simplified transaction in which a single debit to IM-2's account with IM-1 resulted in a shortfall of ABC shares for IM-2's ABC entitlement holders. Moreover, the credits to IM-3 and Bank resulted directly from the debit to IM-2's account. Stated otherwise, the IM-2 ABC entitlement holders could "trace" to IM-3 and Bank the entitlement holders' shares. In the real world, however, this may be impossible. Multiple debits and credits in a clearance and settlement system that employs netting in both the delivery of financial assets and payment obligations may make such tracing impossible. But it does not follow that the immunity rules of UCC sections 8-502 and 8-115 or the restrictions on entitlement holder claims under UCC section 8-503(e) are insignificant even when tracing is unlikely. Experience in the United States has shown that in the absence of such immunity even a plausible *allegation* that securities can be traced to a securities account may be sufficient to force expensive settlements of lawsuits.

2. Shortfall in Account Holder Securities: Treatment in Intermediary's Insolvency Proceeding

The details of the United States and Japanese laws applicable to insolvency proceedings of entities acting as securities intermediaries are beyond the scope of this paper. The focus here is limited for the most part to the treatment of account holder claims in the face of a shortfall of the relevant securities. Example 3 presents this scenario.

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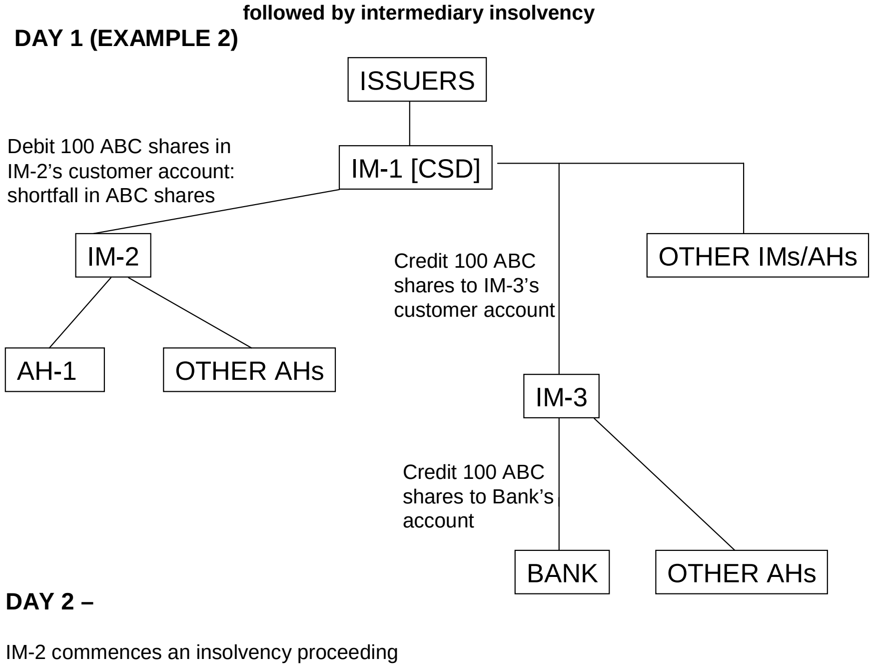
[371] *See* II.B.1., 2., *supra.*

EXAMPLE 3

Debit and credits resulting in shortfall in account holder securities followed by intermediary insolvency



Following the transactions reflected in Example 2, assume now that IM-2 became the subject of an insolvency proceeding. Assume further that after the exercise of all appropriate rights and remedies against Bank, IM-1, and IM-3, there remains a shortfall in the ABC shares held by IM-2 for its ABC account holders. How will the applicable laws deal with the ABC account holder claims?

Consider first the application of Japanese law to Example 3. As explained above, IM-2's ABC account holders will share pro rata in the ABC shares.[372] This is so whether IM-2 is a securities firm or a bank. Under the Book-Entry Transfer Act, the Investor Protection Fund will protect eligible non-institutional account holders for claims

[372] *See* II.B.4., *supra.*

against an insolvent intermediary, securities firm or bank, up to ¥10 million.[373] For equities not yet governed by the Act, the Investor Protection Fund established under the FIEL will protect the claims of eligible non-institutional account holders of IM-2 if it is a securities firm (but not if IM-2 is a bank) up to ¥10 million.[374]

Under United States law, as explained above, if IM-2 is a registered broker-dealer (securities firm) the ABC customers will be protected under SIPA for losses up to $500,000.[375] Their claims will be calculated based on the sharing formula among all customers (including those for whom no shortfall exists as to securities credited to their accounts). If IM-2 is a bank, however, the ABC entitlement holders would share pro rata in the available *ABC shares only* (*i.e.*, on an issue-by-issue basis) under the formulation in UCC section 8-503(a) and (b) and they would not be protected by any special fund or otherwise beyond the available shares.[376]

Example 3A illustrates and compares the SIPA sharing formulation with that of the pro rata sharing approach.

EXAMPLE 3A

Calculation of Account Holder Claims in Intermediary Insolvency Proceeding under Issue by Issue Pro Rata Sharing and under U.S. S.I.P.A. Sharing Formula

ABC AHs = 200 shares X 10 (value) = 2,000
Actual ABC shares = 150 X 10 = 1,500
Shortfall = 500

XYZ AHs = 100 shares X 10 = 1,000
Actual XYZ shares = 100 shares X 10 = 1,000

Issue by Issue Pro Rata Sharing:

ABC AHs = $\frac{1,500}{2,000}$ = 75% = 1,500

XYZ AHs = $\frac{1,000}{1,000}$ = 100% = 1,000

S.I.P.A Formula Sharing:

ABC + XYZ AHs = 2,000 + 1,000 = 3,000
Assets – 1,500 + 1,000 = 2,500

$\frac{2,500}{3,000}$ = 83.33 % = ABC AHs = 1,666
XYZ AHs = 833

[373] *See id.*

[374] *Id.*

[375] *See* II.A.4.

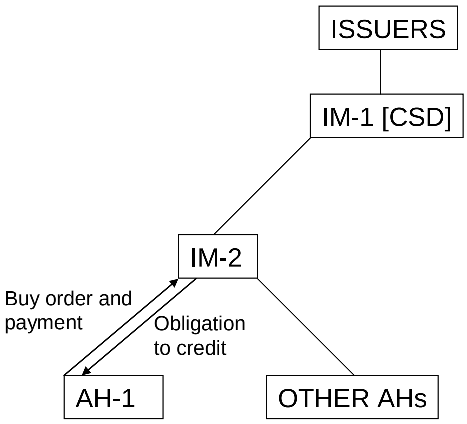
[376] *Id.*

Under the Convention a pro rata formulation similar to the UCC approach applies in insolvency proceedings only. However, the Convention expressly defers to any conflicting approach under the non-Convention law, such as the SIPA formulation.[377]

3. Account Holder Places Buy Order and Makes Payment to Intermediary, but Does Not Receive a Credit

EXAMPLE 4

Account holder places buy order and pays intermediary, but intermediary does not credit account holder's account



(i) AH-1 places buy order
(ii) IM-2 becomes obligated to credit AH-1's account, but no credit is made
(iii) AH-1 pays IM-2
(iv) IM-2 commences an insolvency proceeding

Example 4 builds on and refines Example 3. Example 4 posits that AH-1 placed a buy order for securities with IM-2 and paid IM-2, that IM-2 is obliged (under the applicable law and the account agreement) to credit AH-1's account, but that IM-2 fails to enter the credit. IM-2 may or may not have bought securities on AH-1's behalf.

Under Japanese law, in the absence of a credit to AH-1's account, AH-1 would not acquire any property interest in securities—even if IM-2 had bought securities on behalf of AH-1, as agreed.[378] IM-2's obligation to enter the credit would not be sufficient to trigger the acquisition of property.

Like Japanese law, under the Convention it is the credit of securities to a securities account that triggers an account holder's acquisition of rights with respect to securities as specified in Article 7—including property rights in the underlying securities

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[377] *Id.*

[378] *See* II.B.1., 2., *supra.*

to the extent conferred by the non-Convention law.[379] But note that this does not necessarily produce the same result as the one under Japanese law. The Convention does not provide that a person can obtain an interest in intermediated securities *only* by a credit. Indeed, Article 11 preserves methods of acquisition provided by the non-Convention law.[380]

Under Japanese law AH-1 would not share in the pool of the relevant securities unless it possessed a property claim under non-insolvency law.[381] AH-1 could assert only an unsecured claim for damages, such as for the value of the securities that were to be credited or for the return of the purchase price. The Convention is essentially consistent with Japanese law in this respect. In the absence of the acquisition of rights by virtue of a credit, AH-1 would not participate in the sharing provisions for an insolvent intermediary's account holders under Article 22.

As noted in connection with Example 3, the Convention does not override conflicting rules of law applicable in an insolvency proceeding of an intermediary, such as the more expansive sharing formula in the United States under SIPA.[382] Moreover, under SIPA a customer's right to share in the pool of customer securities is not dependent on a credit having been made to a customer's account.[383] It follows that AH-1 in Example 4 would be entitled to participate in the sharing formula in IM-2's insolvency were IM-2 a broker-dealer. The UCC takes a similar approach.[384] It follows that AH-1 also would share pro rata in the ABC shares if IM-2 were a bank.[385]

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[379] *See* II.C.2., *supra.*

[380] *See* II.C.5.b., *supra.*

[381] *See* II.B.4., *supra.*

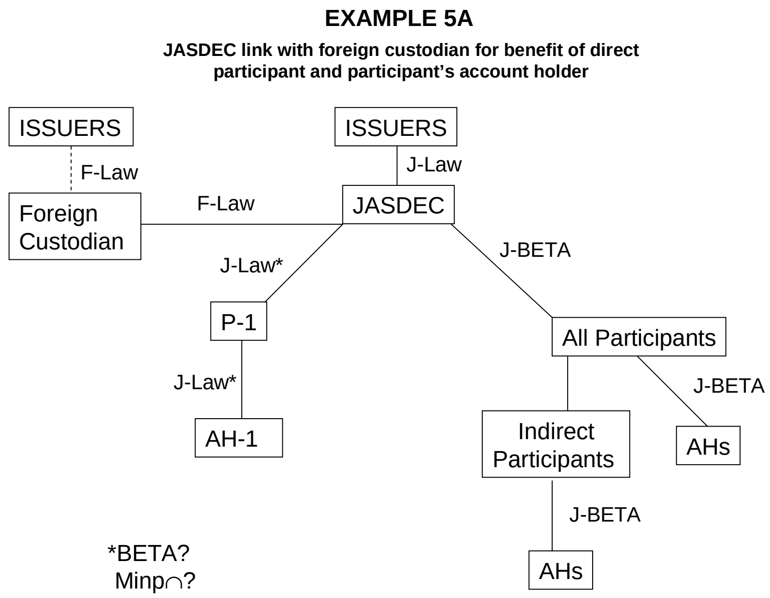
[382] *See* II.A.4., D.2., *supra.*

[383] *See* II.A.4., *supra.*

[384] *See* UCC § 8-501(b).

[385] *See* II.A.4., *supra.*

4. Cross-Border Linkages of Intermediated Securities Systems



Example 5A reflects an arrangement between JASDEC and a "foreign custodian" on behalf of a direct participant (account holder) of JASDEC, P-1, or on behalf of P-1 and P-1's account holder, AH-1. The foreign custody arrangement could take a variety of forms, such as a securities account with an intermediary governed by foreign law, with JASDEC as the account holder, or as an account with a foreign CSD. For present purposes, what is significant is that the bundle of rights and the nature of property that JASDEC acquires through the custody arrangement are governed by the law of a jurisdiction other than Japan.

Example 5A also reflects the relationships between JASDEC and P-1, P-1 and AH-1, and (if any) JASDEC and AH-1. Example 5A assumes that, under the applicable choice of law rule, these relationships are governed by Japanese law. But the applicable Japanese law may not be the Book-Entry Transfer Act. The Book-Entry Transfer Act applies to the intermediated chain from a Japanese securities issuer to the lowest-tier account holder under a securities account governed by the Book-Entry Transfer Act. It also applies to foreign debt securities (*i.e.*, debt securities issued under law other than Japanese law). However, it does not directly apply by its terms to foreign equity securities, such as corporate shares. There currently is a debate as to whether the "property law" provisions of the act would (or should) be applied to foreign equities by analogy. If the act does not apply, then the Japanese law applicable to these relationships would be the general law relating to interests in movables under the MINPŌ.[386] An

[386] For a discussion of intermediated securities transactions under the MINPŌ, see generally Charles W. Mooney, Jr. & Atsushi Kinami, *Transfer, Pledge, Clearance and*

analysis of that body of law is beyond the scope of this paper. But it is reasonable to presume that the origins of the Custody Act and subsequently the Book-Entry Transfer Act reflect the dissatisfaction with the general law applicable to movables in the context of modern intermediated securities markets. If this is so, it may be worth exploring whether the Book-Entry Transfer Act could be clarified so as to cover explicitly all securities, including foreign equities, carried in securities accounts to which Japanese law applies.

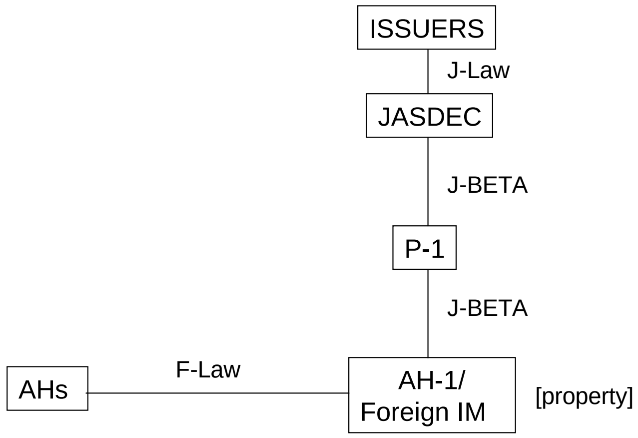
Such a clarification would reflect sound policy. The Book-Entry Transfer Act reflects a legal regime for dealing with property rights in an intermediated system. The nature of the property that is the subject of the regime—securities—consists of a set of interests, rights, and benefits under the applicable law (Japanese or foreign law), including the terms of the relevant securities. But much of the system governed by the Book-Entry Transfer Act, in particular those aspects unrelated to the rights and duties of issuers and the relationship between account holders and issuers, such as those dealing with book entries in the system, need not turn on the law applicable to the underlying securities. *Whatever it is* that JASDEC receives by virtue of the foreign custody arrangement could be transferred and held in the system provided by the Book-Entry Transfer Act. The act might require some adaptation for foreign equity securities (relating to dividends and voting, for example[387]), but including all securities within its scope would have the advantage of permitting these foreign-law interests to be addressed within a unified book-entry regime.

Settlement in the Japanese and United States Government Securities Markets, 12 U. Penn J. Int'l Bus. L. 517 (1991) (hereinafter, "Mooney & Kinami, *Transfer*").

[387] As noted above, the argument for application by analogy extends only to the "property law" related provisions of the act, not to regulatory provisions. Presumably an amendment of the act to include explicitly foreign equity securities would make this distinction clear.

EXAMPLE 5B

Foreign intermediary as lowest tier account holder in Japanese BETS

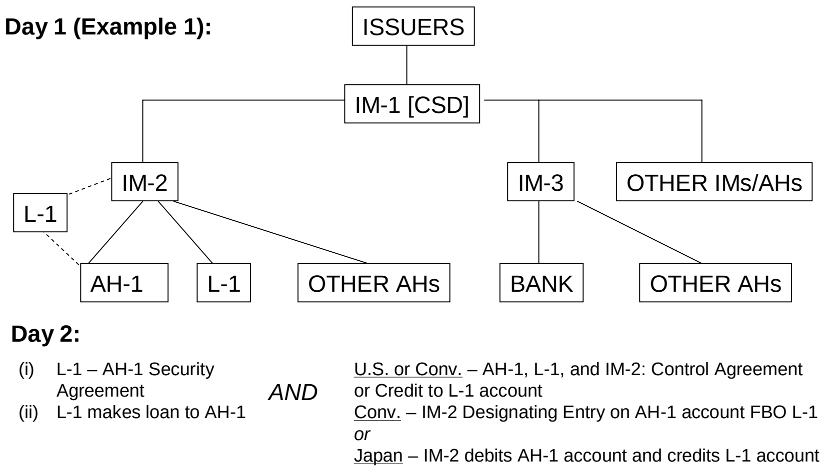


Example 5B reflects the flip side of Example 5A. In the former, Japanese law (the law relating to the issuer as well as the Book-Entry Transfer Act) applies from the issuer down the tiers to the ultimate account holder, AH-1, who has a securities account with P-1. But, in Example 5B, AH-1 happens to be a foreign intermediary that is maintaining its account with P-1, under the Book-Entry Transfer Act, on behalf of its account holders with whom its relationships are governed by foreign, non-Japanese law. There seems to be no fault or problem to find in this setting. But Example 5B, when compared with Example 5A, provides a useful contrast. In Example 5B the foreign intermediary, AH-1, has taken full advantage of Japanese law, including the system created by the Book-Entry Transfer Act. But in Example 5A, none of JASDEC, its direct on indirect participants, or their respective account holders may make use of the Japanese system under the Book-Entry Transfer Act.

5. Conflicting Interests in the Same Securities Account (*Herein* of "Same-Tier" Perfection and Priority)

EXAMPLE 6

Conflicting interests in the same securities account (*herein* of "same tier" priority)



Example 6 returns again to the basic fact pattern of Example 1 and the diagram presented in Part I. AH-1, an account holder of IM-2, wishes to obtain a loan from Lender 1 (L-1) to be secured by securities credited to AH-1's securities account with IM-2.

Under United States law, L-1 could take steps to "perfect" its security interest by obtaining "control" of AH-1's security entitlement.[388] In Example 6 L-1, IM-2, and AH-1 have entered into a "control agreement" under which IM-2 agreed to obey the entitlement orders (*i.e.*, instructions) of L-1, without further consent of AH-1, with respect to the security entitlement. Alternatively, L-1 could achieve control by having the relevant financial assets credited to L-1's securities account, such as an account with IM-2.[389] Perfection, including perfection by control, ensures that L-1's security interest will be effective against AH-1's creditors and in AH-1's bankruptcy. Perfection by control, moreover, ensures L-1's security interest of priority over certain later-in-time security interests as well (as we shall see shortly when examining transactions on Day 3

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[388] *See* II.A.5.b., *supra.*

[389] L-1 also could perfect its security interest by filing a financing statement. UCC § 9-312(a). But that would provide considerably weaker priority protection as the security interest would be subordinate to a security interest perfected by control at a later time. UCC § 9-328(1).

of Example 6).[390] And perfection by a credit to the account of a secured party offers additional protection against those who might assert earlier-in-time adverse claims, as does perfection by control generally but to a more limited extent.[391]

Japanese law would afford similar protections to L-1's security interest if a credit were made to L-1's securities account on the books of IM-2 or another intermediary.[392] The credit could be made to L-1's proprietary account or its pledge account; in either case it would be effective against AH-1, its creditors, and in AH-1's bankruptcy. And, as the recipient of a credit under the Book-Entry Transfer Act, L-1 also would be eligible for protection as a good faith purchaser under Japanese law.[393]

The Convention would recognize the effectiveness of L-1's security interest against third parties if a credit were made to L-1's securities account regardless of whether United States or Japanese law were the non-Convention law.[394] And, as under United States and Japanese law, the credit would make L-1 eligible for protection as an innocent acquirer under Convention Article 14.[395] Alternatively, if the United States were to make the appropriate declaration under Convention Article 10(4)(a) in respect of Article 10(2)(c), the Convention likewise would recognize the effectiveness of L-1's perfection by means of a control agreement.[396] The Convention also recognizes perfection by means of a designating entry on a securities account if applicable under the relevant non-Convention law and a Contracting State has made an appropriate declaration under Article 10(4)(a) in respect of Article 10(2)(b).[397] Neither United States nor Japanese law provides that a designating entry is an appropriate perfection method, however.

The Convention also defers to the non-Convention law for any necessary "evidential requirements" for creating an effective interest in intermediated securities.[398] Under United States law, normally a security agreement consisting of an authenticated record or control of a security entitlement is a condition of the effectiveness of a security

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[390] *See id.*

[391] *See* II.A.5.a., *supra.*

[392] *See* II.B.5., *supra.*

[393] *See id.*

[394] *See* II.C.5.a.(i), *supra.*

[395] *See id*; II.A.5.a., II.B.5.a., *supra.*

[396] *See* II.A.5.b, *supra*; II.C.5.b., *supra.*

[397] *See* II.C.5.b., *supra.*

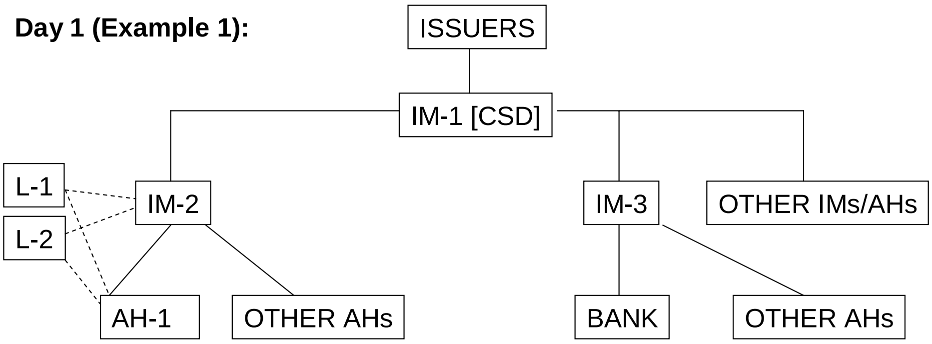
[398] Conv. Art. 12.

interest, and there are no evidential requirements for the acquisition of another type of interest.[399] Under Japanese law, the only requirement for acquisition is a credit to the account of the acquirer and there are no further evidential requirements.[400]

EXAMPLE 6 (continued)

Conflicting interests in the same securities account (*herein* of "same tier" priority)

Day 1 (Example 1):



Day 3 (Alternative A):

(i) L-2 – AH-1 Security Agreement
(ii) L-2 makes loan to AH-1

AND

U.S. or Conv. – AH-1, L-2, and IM-2: Control Agreement
or
Conv. – IM-2 Designating Entry on AH-1 account FBO L-2
Japan – Status quo

Day 3 (Alternative B):

(i) IM-2 – AH-1 Security Agreement
(ii) IM-2 makes loan to AH-1

U.S. or Conv. – No additional steps taken

Day 3, Alternative A, of Example 6 posits that a new lender, L-2, enters into a security agreement with AH-1, makes a loan to AH-1, and perfects its interest either under United States law or the Convention regime by a control agreement or, if permitted under another non-Convention law and an appropriate declaration, a designating entry. This presents squarely a priority contest between L-1 and L-2 with respect to securities of the same description credited to the same securities account of AH-1.

Before resolving the priority contest under United States law and the Convention regime, note that this priority contest does not—indeed, cannot—occur under Japanese law. The only method of perfecting a pledge (or, as we shall see, another limited interest) is a credit of securities to a securities account under the Book-Entry Transfer Act.[401] Assuming that the relevant securities were credited to the account of L-1 on Day 2, the

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[399] *See* II.A.5.b., *supra.*

[400] *See* II.B.5.b.

[401] *See* II.B.2., 5.b., *supra.*

securities are no longer credited to AH-1's account and no longer available for the creation by AH-1 of a competing interest under Japanese law.

As between competing security interests perfected by control under United States law, a temporal rule of first-in-time applies.[402] L-1's security interest having been perfected first, on Day 2, it is senior to the security interest held by L-2, perfected on Day 3. Article 15 of the Convention provides a similar rule. Priority among interests made effective against third parties by virtue of control agreements ranks according to the time "when a control agreement is entered into, or, if applicable, a notice is given to the relevant intermediary."[403] Note, in particular, that the United States priority rule applies to competing interests in the same securities account and, likewise, the Convention priority rule applies to conflicts in respect of the same intermediated securities (*i.e.*, securities credited to the same account).[404]

Note further that Article 14(1) of the Convention does not provide protection for innocent acquirers, such as L-1 and L-2, who acquire interests other than by a credit.[405] Similarly, United States law, by embracing a temporal priority rule for security interests, does not provide an innocent acquisition (or last-in-time) rule that would permit L-2 to take senior to or free of L-1's interest in this factual setting.[406] Outside of the context of the priority of competing security (and other) interests with respect to the securities entitlements, however, United States law does provide innocent acquisition protection for purchasers (including secured parties) who take other than by credit. In situations not governed by the UCC Article 9 priority rules or the similar rules under section 8-510(c), UCC section 8-510(a) protects an innocent acquirer of an interest in a security entitlement (such as L-1 or L-2) from liability based on an adverse claim if the purchaser does not have notice of the adverse claim.[407] For example, suppose that AH-1's security entitlement could be traced to the deposit of stolen securities and the real owner were to assert an adverse claim. In the absence of notice of the adverse claim at the relevant time of acquisition, neither L-1 nor L-2 would be liable. Moreover, if AH-1 did not have

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[402] *See* II.A.5.b., *supra.*

[403] Conv. Art. 15(3)(c). The Convention accommodates not only three-party (account holder, interest acquirer, and intermediary) control agreement systems under the non-Convention law but also those that contemplate a two-party (account holder and interest acquirer) control agreement with notice to the intermediary.

[404] *See* II.A.5.b., *supra*; II.C.5.b., *supra.*

[405] *See* II.C.5., *supra.*

[406] *See* II.A.5.

[407] UCC § 8-510(a). The Unites States delegation has proposed s similar rule for the Convention. *See* II.C.5.b., *supra.*

notice and is protected under section 8-502, L-1 and L-2, even if they took with notice, would be protected under the "shelter" principle.[408]

Alternative B of Day 3 posits that the new lender to AH-1 is IM-2, the same intermediary on whose books AH-1's securities account is maintained. Under United States law an intermediary has control of a securities account that it maintains for its entitlement holders without taking any further steps, resulting in "automatic" control and perfection for IM-2's security interest.[409] Moreover, under an exception to the first-in-time priority rule for security interests perfected by control, IM-2's security interest has priority over the earlier perfected security interest of L-1.[410]

Under the Convention regime, if United States law were the non-Convention law and the United States had made an appropriate declaration under Convention Article 10(4)(a) in respect of Article 10(2)(a), IM-2's automatic control and perfection would be given effect under the Convention.[411] As to priority, however, the Convention parts company with United States law. The Convention would invoke the first-in-time priority rule under Article 15(3), which would afford priority to L-1's security interest over that of IM-2 and displace the contrary priority rule of United States law.[412] Moreover, the Convention priority regime would subordinate IM-2's security interest to that of L-1 even if IM-2's security interest were perfected by control *before L-1 achieved control*.[413] As a practical matter, however, the Convention priority rule merely shifts the burden to IM-2 to notify L-1 of IM-2's interest and, if IM-2 so wishes, to seek a subordination from L-1 as a condition to IM-2's entering into a control agreement. Under the United States priority rule, the burden is on L-1 to inquire of IM-2 and to negotiate for IM-2's subordination.

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[408] UCC § 8-510(b).

[409] *See* II.A.5.b, *supra.*

[410] *Id.*

[411] *See id.*; II.C.5.b., *supra.*

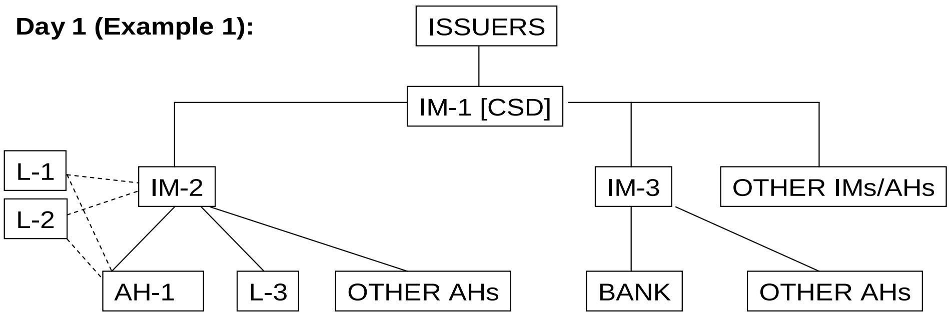
[412] *See* II.C.5.b., *supra.*

[413] *Id.*

EXAMPLE 6 (continued)

Conflicting interests in the same securities account (*herein* of "same tier" priority)

Day 1 (Example 1):



Day 3 (Alternative C):

(i) L-3 – AH-1 Security Agreement
(ii) L-3 makes loan to AH-1

AND

U.S. or Conv. – IM-2 debits AH-1 account (notwithstanding Control Agreements FBO L-1 and L-2) and credits account of L-3 with IM-2

As under Alternative A to Day 3 of Example 6, under United States law the security interests of L-1 and L-2, who are beneficiaries of control agreements with AH-1 and IM-2, are perfected by control. Control of a security entitlement also may be achieved if the purchaser (here, L-3) "becomes the entitlement holder."[414] Under Alternative C, L-3 obtained control by receiving a credit of the financial assets to L-3's own account as an entitlement holder. While the general first-in-time priority rule would appear to award priority in the order of L-1, L-2, and L-3, if L-3 acquired its security entitlement without notice of an adverse claim, it is sheltered from liability under UCC section 8-502, even if L-1 and L-2 could "trace" their perfected security interests to the credit made in favor of L-3.[415]

What are the rights of L-1 and L-2 as against IM-2? It is reasonable to assume that IM-2's action in debiting AH-1's account and crediting the account of L-3 was in breach of its contractual obligations to L-1 and L-2 under their respective control agreements. If AH-1 were to default and L-1 and L-2 were to suffer losses by virtue of the elimination of their collateral (assuming there was no residual value after satisfaction of L-3's security interest), the existence of a damage claim would be clear. But, would IM-2 be obliged to restore the missing collateral? The UCC does not address that issue and the answer is not clear under other United States law. But if IM-2 were to become insolvent, it is highly unlikely that L-1 and L-2 would be entitled to share in the pool of

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[414] *See* II.A.5.b., *supra.*

[415] *See* II.A.5.a., *supra.*

securities with IM-2's account holders (regardless of whether IM-2 was a broker-dealer or a bank).

The Convention, like section 8-502, would allow L-3 to assert the rights of an innocent acquirer under Article 14.[416] But the Convention does not address the rights of L-1 and L-2 arising out of the (apparently wrongful) debit to AH-1's account or whether those rights of L-1 and L-2 are based on property rights, contractual rights, or tort liability under the non-Convention law.

What is the situation if L-3 does not qualify for protection as an innocent acquirer? Under United States law, if L-3 acquired its security entitlement with notice of an adverse claim it would not qualify for protection under UCC section 8-502. Presumably L-1 or L-2 (or both) could "trace" the debit to AH-1's account to the credit to L-3's account. If so, L-3's security entitlement is derivative of AH-1's original entitlement and would be subject to the temporal priority rule of UCC section 9-328(2)(B), which addresses conflicts between security interests perfected by control. Although L-3 received a credit, as between it and AH-1 the interest of L-3 is a security interest and AH-1 is the beneficial owner.[417]

The Convention does not provide a positive legal rule in the case of a credit to an account holder who does not qualify for protection as an innocent acquirer. It implicitly leaves the results to the non-Convention law. Under the non-Convention law, L-1 and L-2 might seek to "trace" the debit to AH-1's account to the credit to L-3's account, asserting a claim against L-3 for damages in conversion or another theory. Or, perhaps, L-1 and L-2 would seek an order requiring L-3 to transfer the relevant securities credited to its account to another account for the benefit of L-1 and L-2 or requiring a reversal of the offending debit and credit. If United States law were the non-Convention law, the priority rules of UCC section 9-328 would be applied, as discussed above.

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[416] II.C.5.a.(i), *supra*.

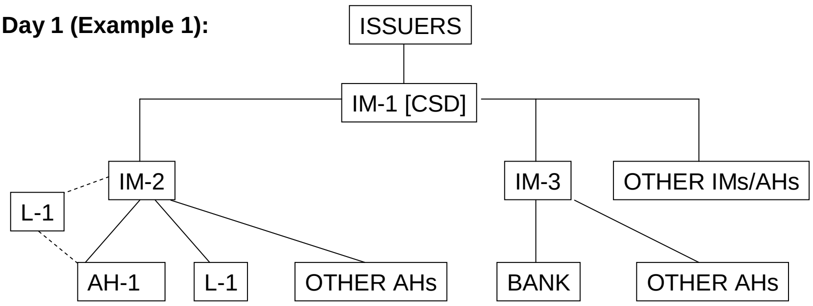
[417] L-3 might assert that the security entitlement that it acquired is *not the same security entitlement* of AH-1 as to which L-1 and L-2 achieved control. This argument would be based on the idea that L-3 has acquired a different set of property (and other) rights and would conclude that there is no priority contest at all between L-3 and L-1 and L-2. Contrary to this argument, UCC section 8-106, Comment 4, makes it clear that the acquisition of a security entitlement by a purchaser (here, L-3) with the same (or even another) intermediary amounts to becoming the entitlement holder with respect to the original entitlement. Moreover, UCC section 9-328(2)(B) clearly provides a temporal ranking among control parties even when control is achieved in different ways by different persons. But 9-328(2)(B) might be viewed as a somewhat odd formulation because control by credit could follow in time control by control agreement (as in Example 6) but arguably the reverse could not occur. A better view is that if following the transactions contemplated by Example 6 a control agreement were entered into by AH-1, IM-2, L-3, and L-4, fourth priority would be awarded to L-4 under 9-328(2)(B).

6. Interests other than Security Interests Accompanied by Control Agreement, Designating Entry, or Credit

EXAMPLE 7

Variation on Example 6: Full interest or limited interest other than security interest accompanied by control agreement, designating entry, or credit

Day 1 (Example 1):



Day 2:

(i) L-1 – AH-1 Agreement for AH-1 to sell full or limited interest (e.g., fractional interest, specified payments, right of use [usufrucht], etc.) to L-1
(ii) L-1 advances funds to AH-1 as purchase price

AND

U.S. or Conv. – AH-1, L-1, and IM-2: Control Agreement
or
Conv. – IM-2 Designating Entry on AH-1 account FBO L-1
or
Japan – IM-2 debits AH-1 account and credits L-1 account

Example 7 is a variation on Example 6. In Example 6 a security interest was perfected by control agreement (United States or Convention), designating entry (Convention), or Credit (Japan, United States, or Convention). In Example 7, however, the interest transferred by AH-1 to L-1 is either a full ownership interest or a limited interest other than a security interest in the relevant securities. To be clear, each method of transfer covers the entirety of the relevant securities (*e.g.*, transfer of a limited interest in 100 shares by credit of 100 shares to the transferee's account), but the interest transferred as between the parties, AH-1 and L-1, may be more limited.

Under all three regimes a credit to the account of L-1 is effective against creditors of AH-1 and in AH-1's insolvency proceedings. The credit as well makes L-1 eligible for protection under the applicable innocent acquirer rule. The observations concerning the effect of a credit in Examples 6 are applicable here (except that as between AH-1 and L-1 the interest transferred may be full or limited in Example 7 and the interest in Example 6 was a security interest).[418]

More interesting is the transfer of an interest other than a security interest by way of control agreement under United States law or the Convention or by designating entry under the Convention. The concept of control under United States law and under the

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[418] *See* II.D.5., *supra.*

Convention regime is agnostic as to whether the subject interest in securities is a security interest, another form of limited interest, or the full ownership interest.[419]

Under United States law, the principal difference between Example 7 (transfer of full interest or limited interest other than a security interest) and Example 6 (transfer of security interest) is that the concept of "perfection"—an important concept in the operation of UCC Article 9—plays no role outside of the realm of security interests. In Example 7, the control agreement between AH-1, IM-2, and L-1 confers control on L-1, but because L-1 did not obtain a security interest, its interest is not "perfected" in the technical sense of Article 9. The principal attribute of perfection of a security interest, as we have seen, is that it affords the perfected security interest protection against judicial lien creditors of the debtor and in the debtor's insolvency proceedings. But the purchase of an interest other than a security interest in a security entitlement need not be perfected in order to achieve such status. To the extent that the interest has been effectively transferred to the purchaser, the interest is no longer property of the transferor and there is nothing for a creditor to reach or an insolvency administrator to administer. That said, there are nonetheless compelling reasons under United States law or the Convention for L-1 to enter into a control agreement with IM-2 and AH-1 or to receive a credit on the books of IM-2 (or another intermediary).

Under United States law, control of a security entitlement affords two important benefits to a purchaser of an interest other than a security interest. First, it confers eligibility on the purchaser for the innocent acquisition protection from claims of holders of adverse claims, even if the control is achieved under a control agreement and not pursuant to a credit.[420] Second, a purchaser with control has priority over purchasers who do not have control and purchasers with control rank in priority according to the time control is obtained (*i.e.*, a priority rule analogous to the UCC section 9-328(2)(B) rule (for security interests) that applies to the interests of purchasers who do not hold security interests).[421] But this brief statement of United States legal doctrine suggests at least two puzzles.

Assume first that before L-1 achieved control under its control agreement, AH-1 had sold its entire interest in its security entitlement with IM-2 to another person, X, who did not obtain control. This raises the first puzzle. How could AH-1 possess any remaining interest that could be transferred to L-1? The solution to this puzzle lies in the priority rule summarized above—a purchaser with control has priority over a purchaser without control. *Implicit* in this priority rule is the *power* of the transferor to transfer the previously transferred interest (absent control) to a purchaser that obtains control.

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[419] *See* UCC § 8-106 (any purchaser may obtain control).

[420] UCC § 8-510(a); *see* II.A.5.a., *supra.*

[421] UCC § 8-510(c).

Now assume that L-1 purchased AH-1's entire interest in its security entitlement with IM-2 and, as in Example 7, L-1 acquired control under its control agreement. Assume further that subsequently AH-1 sold the entire interest in the security entitlement a second time to L-2 and that L-2 also obtained control pursuant to a control agreement. This raises the second puzzle. Should the priority rule confer "priority" of L-1's interest over L-2's interest when L-2 obtained nothing because AH-1 had nothing to transfer to L-2? Or, is it implicit in the "priority" regime that AH-1 retained the power to transfer more than it had, as in the case described above in which L-1 obtained priority over the interest of X (when X did not have control)? The answer is that once L-1 purchased *and* obtained control over AH-1's entire interest, AH-1 had nothing left to transfer to L-2. Admittedly, in this case, it is somewhat infelicitous to refer to L-1's "priority" over L-2, inasmuch as L-2 has no property interest whatsoever.

Next consider the facts of Example 7 under the Convention regime. Under Convention Article 10, a control agreement (when applicable under the non-Convention law and an appropriate declaration) is a method of "grant[ing] an interest in intermediated securities . . . so as to be effective against third parties." This structure might be read to imply that unless one of the Article 10 methods were employed the granting or creation of an interest would be *in*effective against third parties. But Article 11(b) makes it clear that other methods under the non-Convention law also may have the same effect. Perhaps a more precise way to express the effect of Article 10 would be to provide that the specified methods of making an interest effective against third parties invoke the Convention's priority rules in Article 15 and effectiveness in insolvency proceedings under Article 17. Even then, without more Article 17(1) also raises the implication that other methods of effective transfer under non-Convention law might not be effective in insolvency proceedings.

In order to avoid such an implication, at the fourth session the United States proposed what is now Article 17(2), based on Article 30(2) of the Cape Town Convention.[422] Article 17(2) provides:

> Nothing in this Convention impairs the effectiveness of an interest in intermediated securities against the insolvency administrator and creditors in any insolvency proceeding where that interest is effective under the non-Convention law.[423]

Thus, Article 10 provides for Convention methods for the acquisition of an interest in intermediated securities to become effective against third parties, but it does not provide

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[422] "Nothing in this Article impairs the effectiveness of an international interest in the insolvency proceedings where that interest is effective under the applicable law." Cape Town Conv. Art. 30(2).

[423] Conv. Art. 17(2). Recall as well that the United States proposed that Article 17(1) be expanded to provide that rights and interests in intermediated securities are effective in any insolvency proceeding and that Article 17(1) not be limited to insolvency proceedings of the relevant intermediary, as in its current formulation. *See* II.C.2., *supra*.

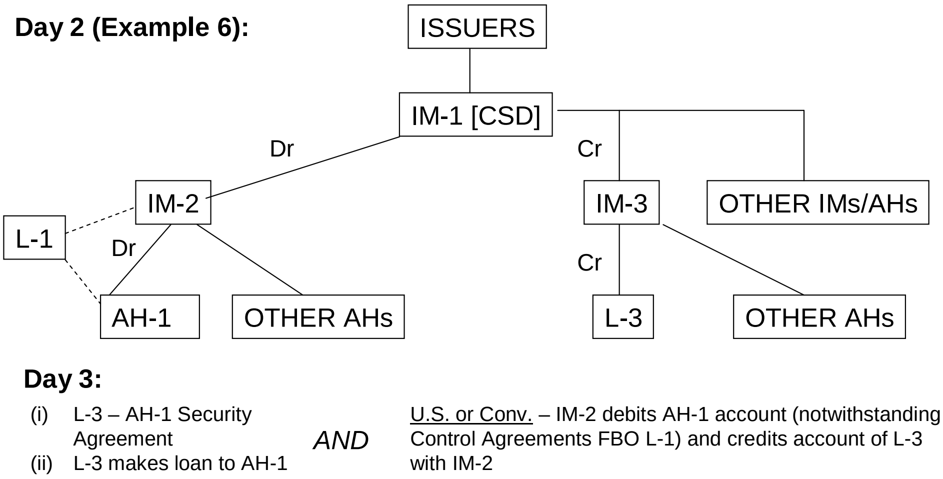
that these methods are the exclusive methods. Stated otherwise, it does not provide that an acquisition of an interest through another method under the non-Convention law is not effective against third parties.

The Convention omits protections under Article 14(1) for innocent acquisition of interests that become effective under Article 10, *e.g.*, by control agreement or designating entry. Of course, any such protections should defer to the first-in-time priority scheme under Convention Article 13, which deals with competing Article 10 interests in the same intermediated securities. But there is little reason to withhold such protection as against other earlier-in-time adverse claims. The United States has proposed a limited expansion of the Article 14 protections to cover this omission.[424] The United States also has proposed that Article 14 be clarified to the effect that if the interest of an account holder is protected under the Convention's innocent acquisition rule a subsequent derivative Article 10 interest in the relevant intermediated securities should be protected as well under the shelter principle.[425]

7. Priorities: Transfers on Different Tiers and with Different Intermediaries

EXAMPLE 8

Intermediary (IM-2) debits account notwithstanding control agreement and as a result secured party (L-3) receives credit on books of another intermediary (IM-3)



Example 8 begins with Example 6, Day 2, when L-1 has perfected its security interest by control agreement between L-1, IM-2, and AH-1. On Day 3, IM-2 debited

[424] U.S. Observations on Innocent Acquisition, *supra* note 265, at 3.

[425] *Id.*

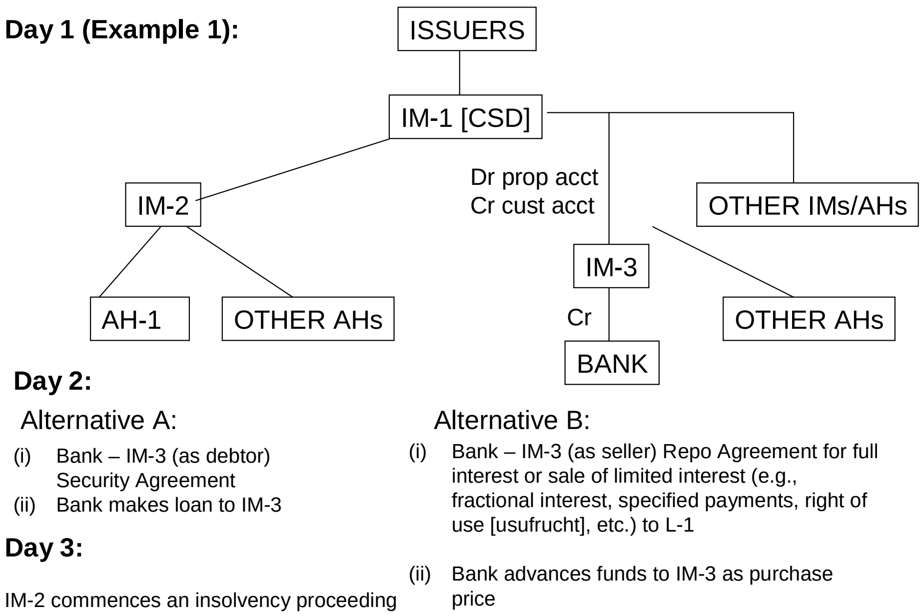
AH-1's account notwithstanding the control agreement (or designating entry) in favor of L-1. As in Example 2, IM-2 instructed IM-1 to debit IM-2's customer account and to credit IM-3's account with IM-1 for the benefit of L-3, IM-3's account holder. IM-3 then credited the account of L-3.

As in Example 6, Day 3, Alternative C, under United States law L-3 has perfected its security interest by control because it has become the entitlement holder. The only difference is that, in Example 8, L-3 has received a credit in its account not with IM-2, as in Example 6, but with another intermediary, IM-3. The same reasoning and results explained in connection with Example 6, Day 3, Alternative C apply equally to Example 8. L-3 is eligible for protection as an innocent acquirer under both United States law and the Convention regime.

8. Intermediary as Debtor or Seller

EXAMPLE 9

Intermediary (IM-3) as debtor or seller credits account of account holder (Bank) followed by IM-3's insolvency proceeding



Example 9 illustrates the role of an intermediary first as a borrower and debtor in a secured transaction and second as the initial seller (and funds recipient) in a repurchase transaction. In Alternative A of Day 2, Bank and IM-3 entered into a security agreement covering 100 shares of ABC stock and Bank loaned funds to IM-3. In the meantime, IM-3 credited 100 ABC shares to the securities account of Bank on the books of IM-3, having also instructed IM-1 to debit IM-3's proprietary account and credit its customer account for 100 ABC shares.

Under Japanese law the credit by IM-3, made either to Bank's proprietary account (*jouto tanpo*, or title transfer) or pledge account (pledge), renders the transfer of property effective against IM-3's creditors and in IM-3's insolvency proceeding, and makes Bank eligible for protection as a good faith purchaser.[426] The fact that IM-3 acts both as intermediary and debtor has no adverse effect on the integrity of the credit and the interest in the securities that Bank acquires. In case of an insolvency proceeding for IM-3, Bank would share with other ABC shares account holders (up to the amount of the obligations of IM-3 secured by the shares).[427] Inasmuch as a credit was made to Bank's account, as noted above the only relevant Japanese law relating to "priority" would be the protections for a good faith purchaser.[428]

Under United States law, Bank also would have a perfected security interest in the ABC shares, effective against IM-3's creditors and likewise Bank would be eligible for innocent acquisition protection.[429] But United States law features three attributes that may be surprising to some and which differ substantially from Japanese law.

First, the perfection of Bank's security interest does not arise from, and indeed is unrelated to, the credit that Bank received to its securities account with IM-3. Instead, a security interest in investment property created by a securities intermediary is perfected upon its creation (*i.e.*, upon "attachment").[430] Stated otherwise, such a security interest is *automatically perfected*. While the credit may be of some evidential value and provide a basis for innocent acquisition protection, it has no effect on the perfection of Bank's security interest.

Second, conflicting automatically perfected security interests created by an intermediary rank equally as to priority and are not ranked based on a first-in-time principle.[431] Secured loans to intermediaries generally are specialized transactions made by professional lending institutions. By electing to rely on automatic perfection, and not to obtain control, these secured creditors assume the risk that the intermediary-debtor may not have sufficient unencumbered financial assets of the relevant description. In the event of priority conflicts, then, secured creditors would share pro-rata in the relevant

[426] *See* II.B.4., 5.a., *supra.*

[427] *See* II.B.4., *supra.*

[428] *See* II.B.5., *supra.*

[429] *See* II.A.5.a., *supra.*

[430] UCC § 9-309(10).

[431] UCC § 9-328(6).

financial assets. Security interests perfected by control, however, have priority over automatically perfected security interests created by an intermediary.[432]

Third, and perhaps most surprising, in case of a shortfall in ABC securities necessary to cover the claims of ABC entitlement holders (other than claims of entitlement holders who are creditors holding security interests), the ABC entitlement holder claims have priority over the claims of the holders of automatically perfected security interests (even if such holders also are entitlement holders).[433] In other words, the automatic perfection of a security interest held by a creditor (such as Bank) of an intermediary (such as IM-3) is subordinated to the claims of the intermediary's entitlement holders. However, a security interest that is perfected by control has priority over the claims of the intermediary-debtor's account holders.[434] For example, to perfect its security interest by control in Example 7, Bank might have entered into a control agreement with IM-3 and IM-1.[435]

The Convention's approach to Example 9 is similar to the Japanese law approach. The credit to Bank would be adequate to protect Bank's security interest against IM-3's creditors and (subject to one caveat, mentioned below) to make Bank eligible for innocent acquisition protection. Also like Japanese law, but unlike United States law, the Convention contains no special rules applicable in the situation in which an intermediary creates a security interest in favor of an account holder (*i.e.*, by a credit). And, like Japanese law, it is the credit to Bank on the books of IM-3 that invokes the Convention's recognition of Bank's interest. In the case of an insolvency proceeding of IM-3, the Convention's pro rata sharing rule is consistent with the approach of Japanese law were there to be a shortfall in the ABC shares.[436] In sum, were Japanese law the non-

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[432] UCC § 9-328(1).

[433] UCC § 8-511(a).

[434] UCC § 8-511(b).

[435] *See* II.A.5.b., *supra.* The priority rule in section 8-511(b) (like the priority rules under section 9-328, which apply as among secured parties) applies notwithstanding any knowledge (wrongful or otherwise) that Bank (the secured party) may have had concerning the interests of IM-3's entitlement holders. However, were Bank to meet the wrongful collusion standard under section 8-503(e), the entitlement holders (or an insolvency representative of IM-3 acting on their behalf) would not be barred from asserting against Bank the rights arising out of the entitlement holders' property interests. As to whether the priority rules of sections 8-511(b) and 9-328 would yield to such claims based on law other than the UCC, arising out of the egregious behavior of Bank, see section 9-328, Comment 8 (courts may look to non-UCC principles in appropriate circumstances in the case of wrongful behavior).

[436] *See* II.B.4., *supra*; II.C.4., *supra.*

Convention law the application of the Convention would not lead to any material changes in result.

In applying the Convention regime when the non-Convention law is United States law, Article 11 of the Convention would recognize the automatic perfection of a security interest created by an intermediary as a non-Convention method of making an interest effective against third parties.[437] As to the priority applicable to Bank's automatically perfected security interest versus another security interest, if the other security interest were perfected by a control agreement, the Convention would award priority to the security interest so perfected over one perfected by a non-Convention method (such as automatic perfection under United States law).[438] That result is consistent with the domestic priority rule under United States law, described above.

Finally, with one exception the Convention (unlike United States law[439]) does not address the priority contest (as such) between an automatically perfected security interest created by an intermediary under United States law (effective under Article 11 of the Convention) and the account holders of the intermediary-debtor in the case of a shortfall in the relevant securities.[440] The exception is found in Article 16(2), which was added at the fourth session of the committee of governmental experts. Under this provision a person acquiring an interest from an intermediary under Article 10 has priority over the intermediary's account holders if the acquiring person meets the standard of innocence specified in Article 14 (*i.e.,* is without wrongful knowledge as that concept may be finally resolved for purposes of the Convention).[441] However, the Convention is silent as to the priority that would apply if the acquiring person failed to qualify for the "safe harbor" under Article 16(2).

As a practical matter, this issue normally would arise only in the context of the insolvency of the intermediary-debtor. The United States priority rule—subordination of the automatically perfected security interest—would be a "conflicting rule applicable in" the insolvency proceeding within the meaning of Convention Article 22(1). Under the Convention regime when United States law is the non-Convention law, it would follow that Bank's status as an account holder, entitled to pro rata treatment under Convention Article 22(2), would be overridden by the United States priority rule that would subordinate Bank's automatically perfected security interest to IM-3's other account holders. This would be so even if Bank otherwise qualified for protection under Article 14(2).

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[437] Conv. Art. 11(b).

[438] Conv. Art. 15(2); *see* II.C.5.b., *supra.*

[439] UCC § 8-511(a), (b).

[440] Conv. Art. 16(1).

[441] Conv. Art. 16(2).

Could Bank resist this subordination of its automatic perfection by arguing that it is entitled to protection as an innocent acquirer under Article 14 by virtue of the credit[442] to Bank's account with IM-3? It is true as a general matter that Bank is entitled to that protection (if it qualifies) as a result of that credit. However, as among Bank, conflicting secured creditors perfected by an Article 10 method, and the other account holders of IM-3, the carefully crafted priority scheme of Articles 15(2), 16, and 22(1) should thwart Bank's argument. Admittedly, however, additional clarity in the text on this point would be welcome.

Alternative B of Example 9 posits that instead of a secured transaction the underlying transaction between Bank and IM-3 is a sale by IM-3 to Bank (as the initial step in a repurchase transaction). Bank has advanced funds to IM-3 and IM-3 has transferred ownership to Bank by crediting the 100 ABC shares to Bank's account with IM-3. This changes little from the results in Alternative A under Japanese law and the Convention regime. The principal difference is that, as between Bank and IM-3, Bank's interest in the securities would not be limited to the amount secured by the security interest, as in Alternative A. Under United States law, there is another, more significant, difference as well. Because Bank would not hold an automatically perfected security interest (or any security interest at all), Bank's interest would not be subordinated to IM-3's other entitlement holders in the event of a shortfall in ABC securities in IM-3's insolvency proceedings.

III. CLEARANCE AND SETTLEMENT IN THE SHADOW OF PRIVATE LAW

A. Background: Function and Significance of Clearance and Settlement

Part I offered a very brief introduction to systems for clearance and settlement in the securities markets.[443] Although this Part provides considerably more detail, a comprehensive treatment of clearance and settlement (even as to systems operating in the United States and Japan) is beyond the scope of this paper. Instead, the principal goal of this part is to relate the structures of clearing and settlement systems to the private law of property and contract in the intermediated system of securities holdings and to identify

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[442] Recall that the credit entry is not even a perfection step under United States law when the debtor is the securities intermediary entering the credit.

[443] *See* I.A., *supra*. For an overview of clearance and settlement systems and structures, see Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Bank for International Settlements, *Delivery Versus Payment in Securities Settlement Systems* (1992) (hereinafter, "1992 CPSS *DVP*"). While the descriptions of actual systems in the 1992 CPSS *DVP* report are dated, it provides an excellent presentation of the various systemic structures and the nature of the settlement risks in modern securities markets.

the role of that body of private law in the structure and operation of clearing and settlement systems.

"Clearance" refers generally to a system and process in which market transactions (usually referred to as "trades") between securities market professionals are confirmed and compared in order to establish that trades were made between parties and the terms of the trade (*e.g.*, ABC, a buyer, and XYZ, a seller of a specified number of shares of a particular issue of an equity security issued by a particular issuer).[444] It may include the netting of instructions and the establishment of final positions for settlement.[445] "Settlement" refers generally to a system and process in which securities that were the subject of a trade are transferred (*e.g.*, by a seller) to the appropriate recipient (*e.g.*, to a buyer; these transfers usually are referred to as "deliveries") and in which funds corresponding to the trade (*e.g.*, a buyer's payment of the purchase price for securities) are transferred to the appropriate recipient (*e.g.*, to a seller).[446] As a general matter, clearance and settlement systems aspire to a "delivery versus payment" (or "DVP") structure in which a person required to deliver securities does not do so until it is paid and a person required to pay for securities does not do so until a delivery is made.

The fundamental role of clearance and settlement systems in the securities markets is obvious. Sellers want to be paid and buyers want securities to be delivered to them. But sellers do not want to deliver until they are paid and buyers do not want to pay until the delivery is made. As important as DVP systems may be, they necessarily remain aspirational in some respects; every system ever devised or conceived to effect DVP for clearance and settlement imposes (or retains) at least some risk. Over the past two decades various international organizations have recognized the crucial role of these systems, studied the risks imposed by various systems, and made recommendations for improving and assessing the systems.[447]

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[444] Committee on Payment and Settlement Systems, Bank for International Settlements, *A Glossary of Terms Used in Payments and Settlements* (2003).

[445] *Id.*

[446] *Id.* (defining "[s]ettlement" as "[t]he completion of a transaction, wherein the seller transfers securities or financial instruments to the buyer and the buyer transfers money to the seller").

[447] *See, e.g.*, Group of Thirty, *Global Clearing and Settlement: A Plan of Action* (2003); 2001 CPSS-IOSCO *Recommendations*, *supra* note 133; International Securities Services Association, *Recommendations* 2000 (2000); International Federation of Stock Exchanges, *Clearing and Settlement Best Practices* (1996) (hereinafter "IFSE, *Best Practices*"); 1992 CPSS, *DVP*, *supra* 443; Group of Thirty, *Clearance and Settlement Systems in the World's Securities Markets* (1989).

B. Systems for Clearance and Settlement: Structure and Risk

Structures of DVP clearance and settlement systems may be found in several varieties. In many systems the traditional "clearance" (comparison and matching) functions have become integrated into the trading and settlement system itself. In such systems, when trades are made the trade transaction information (security issue, number or amount, parties, etc.) is automatically and electronically transmitted to the settlement system and the separate steps of comparison and matching have been eliminated.[448] The principal focus for present purposes, however, is on the settlement process—that is the process where the most substantial risks arise and are addressed.

A "real-time gross settlement" model for a settlement system provides for "[t]he continuous settlement of funds or securities transfers individually on an order by order basis as they are received."[449] Such a system is "real-time" inasmuch as the "processing of instructions [is made] on an individual basis at the time that they are received rather than at some later time.[450] Settlement is "gross" (as opposed to "net" settlement) because settlement of funds or securities transfer instructions occur individually (on an instruction by instruction basis)."[451]

The Fedwire system operated by the Federal Reserve System in the United States for United States Treasury, agency, and certain other securities is a real-time gross settlement system.[452] The Japanese book-entry system for JGBs and the BOJ-NET payments system also operate on a real-time gross settlement basis.[453] Systems that are

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[448] *See, e.g.*, DTCC, New York Stock Exchange Trade Processing, *available at* http://www.dtcc.com/products/cs/equities_clearance/tcr_nyse.php (description of the Online Comparison System operated by the New York Stock Exchange); JASDEC, STP for Securities Settlement Environment Typical in Japan, *available at* http://www.jasdec.com/en/finance/s02.html (description of JASDEC's Pre-Settlement Matching System for straight through processing).

[449] 2001 CPSS-IOSCO *Recommendations, supra* note 133, at 48.

[450] 1992 CPSS, *DVP*, *supra* note 133, at A2-6.

[451] 2001 CPSS-IOSCO *Recommendations*, *supra* note 133, at 47.

[452] "The Fedwire Securities Service processes securities transfers on an individual or gross basis in real time, and the transfer of the securities and the related funds (if any) is final and irrevocable when made." Federal Reserve Banks, Federal Reserve Financial Services, Fedwire Securities Service, *available at* http://www.frbservices.org/serviceofferings/fedwire/fedwire_security_service.html.

[453] BOJ, Response to the Disclosure Framework for Securities Settlement Systems, The JGB Book-entry System and the BOJ-NET JGB Services at 24 (2003). While the actual operations of these systems in the United States and Japan are real-time, they are not

not real-time may settle at various times during a settlement day, at the end of the day, or on the following day.

A "netting" system must be distinguished from a gross system. In a netting system the trades made by participants[454] in the system are subjected to multilateral netting so that on the settlement date each participant will be entitled to receive or obliged to deliver a single, netted number (or amount, in the case of debt securities) of each issue of securities.[455] NSCC's CNS system and the JSCC netting system for exchange traded corporate equity securities are examples of netting systems.[456] Netting also may be employed in the settlement of payment obligations (as opposed to obligations to deliver securities) in DVP settlement systems. In the NSCC CNS system and the JSCC netting system, on each settlement date each participant is entitled to receive or is obliged to pay a single amount of funds after netting payment entitlements and obligations for all transactions in all issues of securities to be settled on that date.[457]

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wholly gross systems inasmuch as some deliveries against payment in the system reflect the result of the earlier netting of market transactions. *See* note 456, *infra*.

[454] The system participants normally may enter into transactions in the relevant market for their own accounts as well as on behalf of their clients.

[455] The statement in the text assumes, of course, that the participant has engaged in one or more transactions with respect to the relevant issue of securities for that settlement date.

[456] NSCC, Clearance and Settlement, Overview *available* at http://nscc.com/clearandset.html (hereinafter, "NSCC, Overview"); Japan Securities Clearing Corporation (hereinafter, "JSCC"), Basic Structure of Clearance & Settlement System (hereinafter, "JSCC, Basic Structure"), *available at* http://www.jscc.co.jp/english/system/index.html#clearance. For securities transactions settled over Fedwire, moreover, Fixed Income Clearing Corporation (hereinafter, "FICC") operates a netting system in which transactions among the twenty-one primary government securities dealers are subjected to multilateral netting in advance of settlement over Fedwire. FICC, Government Securities Division, Products & Services/Netting and Settlement, *available at* http://www.ficc.com/gov/gov.prod.net.settle.jsp?NS-query=. These dealers use so-called "clearing banks" to transfer and receive netted amounts of securities against payment in the Fedwire system. *Id.* Similarly, a significant portion of JGB transactions are netted in the JGBCC system in advance of settlement of netted transactions using the BOJ's book-entry system and BOJ-NET. *See* note 155, *supra*.

[457] NSCC, Overview, *supra* note 456; JSCC, Basic Structure, *supra* note 456. Actually, in the NSCC system, net debit (negative) or credit (positive) funds balances are netted a second time against debit and credit funds balances in the DTC settlement system in order to reach a single net debit or credit position at the end of the settlement date. *See* NSCC, Rules and Procedures, Procedure VIII, ¶ D.4., *available at* http://www.nscc.com/legal/nsccrules.pdf. As noted above, netted obligations and entitlements resulting from FICC's comparison and netting operations are settled against

Financial risk is inherent in all systems for clearance and settlement in the securities markets. DVP systems are designed to eliminate (or, more accurately, substantially reduce) the risk of a loss of "principal"—*i.e.*, the full value of the transaction. This is the risk that a market participant would pay for securities but not receive delivery or deliver securities and not receive payment.[458] Principal risk is reduced in DVP systems through structures that impose a strong linkage between payment and delivery.

Another risk, and one that is not solved by a DVP system, is "liquidity" risk. As explained in the 1992 CPSS, *DVP* report:

> Liquidity risk includes the risk that the seller of a security that does not receive payment when due may have to borrow or liquidate assets to complete other payments. It also includes the risk that the buyer of the security does not receive delivery when due and may have to borrow the security in order to complete its own delivery obligations.[459]

In some situations liquidity risk also may contribute to "systemic" risk—"the risk that the inability of one institution to meet its obligations when due will cause other institutions to fail to meet their obligations when due."[460]

Until a transaction has been settled a market participant also is exposed to "replacement cost risk." This is the risk that a default by one party will deny the other party the expected gain on the transaction.[461] For example, a buyer might be required to buy the securities at a higher price or a seller might be forced to sell to another person at a lower price.[462]

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payment in the Fedwire system through the two clearing banks and those resulting from JGBCC's operations are settled against payment in the JGB book-entry system and BOJ-NET. *See* note 456, *supra*.

[458] *See, e.g.*, IFSE, *Best Practices*, *supra* note 447, at 11; 1992 CPSS, *DVP*, *supra* note 443, at 13.

[459] *See, e.g.*, IFSE, *Best Practices*, *supra* note 447, at 12; 1992 CPSS, *DVP*, *supra* note 443, at 3-4, 13-14, A2-4.

[460] *See, e.g.*, IFSE, *Best Practices*, *supra* note 447, at 12; 1992 CPSS, *DVP*, *supra* note 443, at 14, A2-7.

[461] *See, e.g.*, IFSE, *Best Practices*, *supra* note 447, at 12; 1992 CPSS, *DVP*, *supra* note 443, at 2-3, 13, A2-6.

[462] The longer the settlement cycle, the greater is the possibility for prices of the securities to vary from the contract price, thereby increasing the risk that the non-defaulting parties

A real-time gross DVP settlement system essentially eliminates principal risk by employing simultaneous electronic book-entry transfers of securities by debit and credit and transfers of funds by debit and credit. On the other hand, such systems must address some fundamental realities of the securities markets. For example, market participants often must receive securities in order to generate funds to pay for the securities (such as by resale or as collateral for credit extensions). It follows that such systems require market participants to maintain large funds and securities balances to cover the real time settlement or to obtain credit in order to avoid defaults in delivery and payment obligations.[463]

A netting system that settles netted securities deliveries and receipts and settles netted payment obligations and receipts at the end of a processing period also can eliminate principal risk, assuming that it incorporates a DVP arrangement. And by virtue

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will incur replacement cost losses. *See, e.g.*, 2001 CPSS-IOSCO Recommendations, supra note 133, at 10:

> The longer the period from trade execution to settlement, the greater the risk that one of the parties may become insolvent or default on the trade, the larger the number of unsettled trades, and the greater the opportunity for the prices of the securities to move away from the contract prices, thereby increasing the risk that non-defaulting parties will incur a loss when replacing the unsettled contracts.

For example, in the Continuous Net Settlement (hereinafter, "CNS") system operated by NSCC in conjunction with DTC, settlement occurs on the third business day following a trade date (*i.e.*, T+3), which is the settlement "cycle." *See* NSCC, Overview, *supra* note 456; 2001 CPSS-IOSCO *Recommendations*, *supra* note133, at 10. Until the mid-1990s, settlement occurred on the fifth business day following the trade date (*i.e.*, T+5). FRANK J. FABOZZI, THE HANDBOOK OF FIXED INCOME SECURITIES 45 (2005). Settlement also occurs at T+3 for the clearance system operated by JSCC for equity securities. JSCC, Basic Structure, *supra* note 456. In the United States treasury and agency securities markets, trades normally are settled on the first business day following the trade date (T+1). Working Group on Government Securities Clearance and Settlement, Report to the Federal Reserve Board 10 (December 2003), *available* at http://www.federalreserve.gov/boarddocs/press/other/2004/20040107/attachment.pdf. In the Japanese market for JGBs settlement normally occurs on T + 3. Asian Development Bank, Bond Market Settlement and Emerging Linkages in Selected ASEAN+3 Countries 118 (2005). However, plans are being discussed to move to a T + 1 settlement. JGBCC, Business Plan, *available at* http://www.jgbcc.co.jp/e_irbusiness.html.

[463] *See, e.g.*, 1992 CPSS, *DVP*, *supra* note 443, at 17-19. Credit extensions may take the form of secured or unsecured loans, secured or unsecured overdrafts in funds accounts or securities accounts, or securities borrowing and lending. *Id.*

of the netting procedures there are far fewer actual transfers (debits and credits) of securities.[464]

Most netting systems involve a clearing entity that assumes the role of a "central counter-party" (hereinafter, "CCP").[465] A CCP normally assumes the obligations of its participants to deliver and pay for securities. In effect, the CCP comes between those entitled to receive securities and those entitled to receive payments. NSCC[466] and JSCC[467] each functions as a CCP in its respective netting operations for exchange traded securities. Their participants are, of course, obliged to make deliveries and payments to the CCP (NSCC or JSCC, as the case may be). A CCP, then, assumes its participants' delivery and payment obligations to pay and deliver to other participants and, correspondingly, becomes the beneficiary of participants' entitlements to receive deliveries and payments.[468]

Consider next what follows when a participant in a settlement system fails to deliver securities to the CCP at the end of the settlement cycle in accordance with its obligation —*i.e.*, in case there are insufficient securities of a relevant issue available in the participant's account with the CSD (generally known as a "fail to deliver," an "FTD," or (simply) a "fail"). Such a participant is said to have an "open short position." In NSCC's CNS system, the defaulting participant's obligation is deferred, or "rolled over," to the next following settlement date and the obligation is incorporated into the netting

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[464] *See, e.g.,* DTCC 2006 Annual Report 16 ("On a yearly basis in 2006, NSCC's CNS system reduced financial settlement from $174.9 trillion to $3.8 trillion, a netting factor of 98%."). Such a system must address other risks, however, such as the risk of default in delivery or payment which can result in replacement cost risk and liquidity risk.

[465] In some systems the CCP stands for "central contra-party," but the function is the same.

[466] *See* NSCC, Overview, *supra* note 456 ("Through CNS, NSCC becomes the contra-party to each compared trade and guarantees settlement for eligible transactions as of midnight of the day the trade is reported to the member as compared.").

[467] JSCC, Basic Structure, *supra* note 456 ("The JSCC guarantees settlements of each transaction for all exchange-traded cash products and TSE-traded derivatives by functioning as a central counter-party, by which the JSCC novates the debts of the clearing participants, i.e., the obligations of payment or delivery, whilst acquiring credits to the other parties.").

[468] The manner of effecting deliveries depends on the market and the type of securities involved. For example, NSCC effects deliveries by instructing DTC to make debits and credits to its participants' securities accounts with DTC. JSCC gives similar instructions to JASDEC. For securities settled on Fedwire or the BOJ's JGB Book-entry System and BOJ-NET, after netting within the FICC or JSCC system, real-time deliveries against payment are made.

process for settlement on that date.[469] This is the "*continuous* net settlement" feature for which CNS is named.

It is worth considering, at this point, the reasons why a participant might fail to deliver in NSCC's CNS system. The SEC staff has explained:

> A "fail to deliver" in NSCC's CNS occurs when an NSCC member (e.g., a broker-dealer or a bank) fails to deliver securities on settlement date. There are many reasons why NSCC members do not or cannot deliver securities to NSCC on the settlement date. Many times the member will experience a problem that is either unanticipated or is out of its control, such as (1) delays in customer delivery of shares to the broker-dealer; (2) an inability to borrow shares in time for settlement; (3) delays in obtaining transfer of title; (4) an inability to obtain transfer of title; and (5) deliberate failure to produce stock at settlement which may result in a broker-dealer not receiving shares it had purchased to fulfill its deliver obligations. In addition, market makers may maintain temporary short positions in CNS until such time as there is sufficient trading to flatten out their position.[470]

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[469] NSCC, Rules and Procedures, Procedure VII, ¶ B., *available at* http://www.nscc.com/legal/nsccrules.pdf. However, the participant's open short position is "marked to market" on the following settlement date and on settlement dates thereafter until it settles (*i.e.*, until it is "closed out"), to the end that if the market value of the securities has increased the participant is obliged to pay to the CSD (NSCC) funds to cover this increase. *See* NSCC, Overview, *supra* note 456 ("Closing fail positions are marked-to-market daily, which reduces risk and ensures the integrity of the system"). When the value of the relevant issue is in a rising-price environment this obligation provides some incentive for the defaulting participant to settle by delivering the securities.

[470] SEC, Division of Market Regulation, *Responses to Frequently Asked Questions Concerning Regulation SHO*, Answer to Question 7.3, *available at* http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm (hereinafter, "SEC, *FAQ-SHO*"). Note that another cause of a fail may be a participant's insolvency and inability to perform. The mechanisms and structures that provide assurance to the participants (and the market in general) that a CCP will have the ability to satisfy its obligations (such as funds of participants on deposit, credit facilities, and, ultimately, assessments to the participants themselves) are beyond the scope of this paper. Similarly, this paper does not address generally the vulnerability (or not) of persons who have received deliveries or payments to avoidance or other claims by the insolvency representative of an insolvent participant.

NSCC, in its role as a CCP, ensures that its participants ultimately will not suffer losses arising out of a participant's failure to deliver or pay. But NSCC does not ensure the actual timely performance of these obligations.[471]

The SEC has addressed problems occasioned by persistent open short positions in its Regulation SHO.[472] As the SEC has observed, "[r]egulation SHO is intended to

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[471] For example, in the CNS system fails are rolled over to the next settlement date, as discussed above, and NSCC does not actually cause the fail to be cured by the actual delivery of securities. Ultimately, in the face of a participant's default or insolvency NSCC must ensure that other affected participants do not suffer a loss.

[472] 17 C.F.R. §§ 200-203 (2007). For an overview of Regulation SHO as it was originally issued effective January 3, 2005, see SEC, Division of Market Regulation, *Key Points About Regulation SHO* (April 11, 2005) *available at* http://www.sec.gov/spotlight/keyregshoissues.htm (hereinafter, "SEC, *Key Points*"). Under certain limited conditions, Regulation SHO requires a participant to close out an open short position (*i.e.*, to deliver securities to NSCC). The close out obligation arises only with respect to an issue of "threshold securities" that qualify for that status for thirteen consecutive settlement dates and only if a participant has an open delivery fail (short) position on each of those dates. *See* 17 C.F.R. § 242.203(c)(6) (2007) (defining "threshold security"); SEC, *Key Points*, *supra*, ¶ IV.A.6. In general, threshold securities are certain publicly traded securities that have aggregate fail to deliver positions at registered clearing agencies (such as NSCC) exceeding in duration and volume the limits specified in the definition. *Id.*, ¶ IV.A.1. Regulation SHO is intended primarily to reduce risks associated with so-called "naked short sales"—the sale of securities in the market by a seller that neither owns the securities on the trade date nor has reasonable grounds to believe that it can borrow the securities for delivery on the settlement date. *Id.* ¶ III. According to an announcement at an open meeting of the SEC on March 4, 2008, the SEC now is taking a somewhat different position. It is proposing a new Rule 10b-21, that:

> would prohibit short sellers from misrepresenting their ability or intent to deliver securities to cover short sales by the settlement date where that deception results in a failure to deliver. Examples of the types of prohibited activities would include: (i) misrepresenting ownership of securities; (ii) misrepresenting having obtained a "locate" before effecting the short sale; and (iii) marking a sale ticket "long" when the seller does not actually own the security.

Davis, Polk & Wardwell Newsflash, SEC Proposes New Antifraud Rule to Combat "Abusive" Naked Short Selling, *available at* http://www.dpw.com/images/newsflash.gif (March 5, 2008).

address the limited situations where fails are a potential problem."[473] Moreover, the SEC staff believe that the complete elimination of fails to deliver (or forcing close-outs of the fails) actually could have adverse effects on the market.[474] DTCC concurs.[475]

Next consider the situation of the participant who has an open long position—*i.e.*, a participant who failed to receive sufficient securities from NSCC on the settlement date. Under CNS this long position, like a short position, will be rolled over to the next following settlement date. A participant's (otherwise) long position may be reduced or eliminated under NSCC's Stock Borrow Program (SBP). Under SBP participants may voluntarily offer unencumbered securities for lending to NSCC for the purpose of satisfying delivery obligations.[476] A participant that wishes to cover its open long position may invoke NSCC's buy-in procedures. By giving a buy-in notification the

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[473] SEC, *FAQ-SHO*, *supra* note 470, Answer to Question 7.1.

[474] *Id.*, Answer to Question 7.3 ("Moreover, forcing close-outs of all fails can increase risk in clearing and settling transactions as well as potentially interfering with the trading and pricing of securities."). In 2007, the SEC modified Regulation SHO to expand its impact so as to further reduce fails to deliver. *See* Press Release 2007-114, SEC, SEC Votes on Regulation SHO Amendments and Proposals; Also Votes to Eliminate "Tick" Test (June 13, 2007) *available at* http://www.sec.gov/news/press/2007/2007-114.htm.

[475] Press Release, DTCC, DTCC Responds to The Wall Street Journal Article, "Blame the 'Stock Vault?'" (July 6, 2007) (hereinafter, "DTCC Press Release"):

> [I]t would be impossible with the high volume of trading (over 5 billion shares daily) across equity markets to force all trades to complete in three days. Those seeking a solution would force a return to an earlier period in history, akin to a time when paper stock certificates and payments were exchanged on a trade-for-trade basis. Were this line of argument to be successful, it would bring the robust equity markets in the U.S. to a screeching halt, and destroy our competitiveness with other capital markets around the world.

Somewhat ironically, the remedy actually provided by Regulation SHO is the close-out of open short positions, and mandating close-outs for the threshold securities addressed by Regulation SHO would seem to have the greatest impact on price. Moreover, maintaining indefinite short positions that are not required to be closed out by Regulation SHO also would appear to impose risks and the potential to affect pricing.

[476] DTCC, Equities Clearance and Settlement, Stock Borrow Program *available at* http://www.dtcc.com/products/cs/equities_clearance/sbp.php. The system automatically borrows securities for delivery to participants with open long positions at the end of the settlement cycle. *Id.* Such borrowings and deliveries have no effect on the obligations of participants with open short positions, however. Those participants' open delivery obligations are unaffected.

participant can obligate participants with open short positions in the relevant securities issue to deliver securities on the second settlement date following the date of notification.[477]

A participant with an open long position normally will enter credits on the accounts of its entitlement holders even if the long position and the credits produce a shortfall in the relevant issue of securities. That is to say, the participant's customers who bought securities for settlement on that settlement date will receive the credits to which they are entitled even if the aggregate credits in favor of the participant's customers exceed the aggregate securities of the relevant issue held by the participant.[478]

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[477] NSCC, Rules and Procedures, Procedures VII, ¶ J., X, ¶¶ A., B., *available at* http://www.nscc.com/legal/nsccrules.pdf. If sufficient securities are not delivered in timely fashion the participant may buy the securities at the market price and hold the open short participants responsible for any losses. *Id.*, Procedure X, ¶ B.

[478] DTCC has explained:

> [T]he broker for the buyer does not pay the contractual value for the trade to the clearing system until the stock is delivered, although the broker's customer may be given a security entitlement on the broker's records immediately. That security entitlement is what makes it possible for the markets and investors to buy and sell securities freely throughout the day or over several days. If an investor had to wait until stock was delivered and paid for, they'd have to wait several days to trade that stock again. Imagine an investor buying a stock in the morning, then finding market information being announced mid-day that might adversely impact that stock and then being told you can't sell out your position to minimize the potential loss. Freedom to trade is a cornerstone of our equity markets and a fundamental principle in the regulatory schemes that govern the markets. The SEC has flatly rejected the argument that there are such things as phantom shares or credits being created in the market. DTCC Press Release, *supra* note 475.

Stated otherwise, the investor must be in a position to sell, even if, by virtue of a shortfall arising out of a fail to deliver, the investor has not acquired full ownership.

The last quoted sentence of the DTCC press release seems difficult to square with the following statement of the SEC staff (depending on the meaning one might give to "phantom shares or credits"):

> Naked short selling has no effect on an issuer's total shares outstanding. There is significant confusion relating to the fact that *the aggregate number of positions reflected in customer accounts at broker-dealers may in fact be greater than the number of securities issued and outstanding*.

Absent other protections, the routine shortfalls in customer securities in the CNS system would impose additional risks on entitlement holders in the event of a participant's insolvency and failure. However, other protections in fact exist. First, there are capitalization requirements for broker-dealers under the Exchange Act and SEC Rules, which serve to make a firm's failure less likely.[479] Second, in lieu of requiring a strictly "matched book" in which securities of each relevant issue are required to be maintained that match precisely (or exceed) securities entitlements in respect of that issue, a broker-dealer must comply with reserves and custody requirements that are designed to protect customers' exposure to the broker-dealer.[480] In addition, and relevant to the first two elements of customer protection, broker-dealers are subject to reporting requirements.[481] Finally, retail investors are afforded protection from SIPC up to $500,000.[482]

In case a direct participant fails to deliver in JSCC's netting system for exchange traded equities, as in NSCC's CNS system, the participant's delivery obligation is rolled over to the next following settlement date. But the similarity of the systems largely ends at that point. The JSCC participant that has a net payment obligation is required to pay, in addition to its net payment obligation, an amount sufficient to cover the price of the securities; conversely, that amount is deducted from the amount otherwise payable to a

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> This is due in part to the fact that securities intermediaries, such as broker-dealers and banks, credit customer accounts prior to delivery of the securities. For most securities trading in the U.S. market, delivery subsequently occurs as expected. However, fails to deliver can occur for a variety of legitimate reasons, and flexibility is necessary in order to ensure an orderly market and to facilitate liquidity.

SEC, *FAQ-SHO*, *supra* note 470, Answer to Question 7.1 (emphasis added). The size of NSCC's aggregate CNS open delivery obligations (net of securities borrowings under the NSCC SBP) on December 31, 2006, was about $2.64 billion (which is slightly less than 13% of DTCC's consolidated liabilities). DTCC 2006 Annual Report 63, n.10.

[479] *See* GUTTMAN, SECURITIES, *supra* note 41, § 4.17, 4-38 to 4-45 (3d ed. 2004) (discussing net capital requirements under SEC Rule 15c3-1); WEISS, TRADE, *supra* note 96, 445-49 (same).

[480] *See* GUTTMAN, SECURITIES, *supra* note 41, §§ 4.14-416, 4-29 to 4-38 (discussing reserves and custody requirements under SEC Rule 15c3-3); WEISS, TRADE, *supra* note 96, 450-51 (same).

[481] *See* GUTTMAN, SECURITIES, *supra* note 41, § 4-13, 4-27 TO 4-29 (discussing reporting requirements); WEISS, TRADE, *supra* note 96, 445-49 (same).

[482] *See* II.A.4., *supra*.

net recipient of funds.[483] If the delivery has not occurred after the fifth settlement date following the failure to deliver, a participant with a long position in the relevant issue of securities may "buy in" securities pursuant a system provided by JSCC.[484] Unlike in the NSCC system, a participant with a long position, *i.e.*, who did not receive securities on the settlement date, does not credit its account holders' accounts for securities that it did not receive if that would create a shortfall.[485] Instead, the participant must allocate among its account holders the securities of the relevant issue.[486] This necessarily means that one or more would-be account holders do not receive the securities to which they are entitled.[487] For present purposes, this is the most significant distinction between the two systems.[488]

As noted above, in their roles as CCPs, NSCC and JSCC are not required to deliver securities or make settlement payments, although they assume the delivery and payment obligations. Instead, as CCPs they must protect their participants from the ultimate loss of a failure to deliver or pay. This obligation to pay damages would be triggered, for example, by the insolvency of a participant and the recognition that an insolvent defaulting participant will not deliver or pay.

C. Systems for Clearance and Settlement and the Private Law of Property and Contract

The basic goals of systems for clearance and settlement are the final payment and delivery of securities in consummation of market transactions. Ideally, the systems are designed to achieve these goals while minimizing, if not eliminating, the various associated risks. The overarching goal of "delivery," of course, is the acquisition by the beneficial owner of a property interest in securities in order to capture the economic (and other) benefits of ownership within an intermediated system (whatever the system's type or structure). Designing a clearance and settlement system for the realization of these goals necessarily requires an understanding and application of the applicable private law

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[483] Tokyo Interviews, *supra* note 142. In similar fashion, the amount payable by or to a direct participant that fails to receive securities is adjusted accordingly.

[484] *Id.*

[485] *Id.*

[486] *Id.*

[487] There is no common method for such allocation in the Japanese securities industry. Each firm adopts its own internal rules. *Id.*

[488] The prohibition of creating such a shortfall (or inflation) under the Book-Entry Transfer Act is not yet applicable to the exchange traded equity securities presently subject to the JSCC netting system. But the same result is achieved *de facto* under current law and procedures. *Id.*

that determines the method and finality of payments and deliveries of securities in the relevant intermediated system. It also requires an understanding of the extent to which otherwise applicable rules may be modified by contract or system rules. For example, the provisional nature of credits that are not yet final in some netting systems illustrates the important relationship between contract principles and system rules, on one hand, and the property rules on the other. The application of these principles results in provisional and reversible credits that otherwise would create security entitlements under United States law or property interests in securities under Japanese law.

The development of modern securities clearance and settlement systems in both the United States and Japan generally took place in the absence of fundamental changes in the private law dealing with property interests in securities.[489] Although the 1977 amendments to the UCC (primarily to Article 8) provided a framework for uncertificated securities, the revisions did not address securities held through intermediaries in any fundamental or systematic manner.[490] Developers of the systems accepted, and worked with, the private law as they found it.

The impetus for the 1994 revisions to the UCC (primarily Articles 8 and 9) was the desire to bring the private law into line with the market practices of dealing with and holding securities through intermediaries. In particular, the revisions embraced market practices in the United States, including systems for clearing and settlement.[491] In Japan, however, the Book-Entry Transfer Act was a considerably more ambitious reform with the goals of dematerializing all securities and bringing all non-JGB securities (and to some extent, JGBs) into the JSCC-JASDEC system. While that Act certainly accommodated market practices, it also sought to redirect clearing and settlement practices into a unified and efficient system.

The handling of failed deliveries illustrates the stark contrast between Japanese private law and clearing and settlement practice and the corresponding law and practice that prevails in the United States. In both the NSCC's CNS system and in JSCC's netting system, fails to deliver are rolled to the next following settlement date. But in the United States a system participant with a long position resulting from a fail nonetheless normally credits its entitlement holders even in the face of a shortfall in the relevant security issue. And even if credit book entries were not made, the entitlement holders normally would acquire security entitlements in any event by virtue of the participant's obligation to

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[489] *See, e.g.,* Mooney & Kinami, *Transfer*, *supra* note 386, *passim* (discussion of difficulties and potential for inappropriate results in applying traditional principles of property law to the indirect holding of securities).

[490] The 1977 revisions to Article 8 did, however, include a few provisions dealing with such holding through intermediaries. *See* UCC (1978 official text) §§ 8-313(1)(d), (g), (h)(1), (j); 8-317(4); 8-320.

[491] *See* UCC Article 8, Prefatory Note, ¶ I.D. ("Need for Different Legal Rules for the Direct and Indirect Holding Systems").

credit their accounts.[492] This illustrates the adaptation of Article 8's private law of property in the United States to practices in the securities markets. Neither DTCC nor the SEC appears to view this situation as problematic. Almost all fails are settled within a few days and Regulation SHO addresses the situations that the SEC apparently believes are longer-term problems.

The situation of account holders in case of fails to deliver is quite different under Japanese law. Under the Book-Entry Transfer Act an intermediary is not permitted to credit its customer accounts so as to create a shortfall of customer securities (whether the shortfall would be occasioned by fails to deliver, as posited here, or otherwise). As explained above, in the case of a persistent fail the intermediary must allocate the would-be shortfall to customers with the result that some account holders who have paid for securities will not receive a credit (or at least not for the full number or amount involved). But such adjustments to avoid shortfalls generally are unusual if not rare in Japan.[493] Intermediaries normally borrow the securities necessary to avoid or cure (*i.e.*, by closing out short positions by delivery) fails to deliver.[494]

Ideally the United States markets and regulators could address fails to deliver not by crediting entitlement holders even in the face of a shortfall (as is current practice) but by eliminating fails altogether as has been achieved to a great (but not complete) extent in Japan. Arguably, however, what is feasible in Japan may not be feasible in the United States. For example, it is possible that the volume of transactions and units traded in the United States public markets and the number of issuers in these markets are considerably larger than in Japan. Moreover, the Japanese system operating under the Book-Entry Transfer Act has not yet been fully tested under the high volume of the corporate equities market, for which it will be implemented in January 2009.[495] But given modern information technology and systems, it is difficult to make a credible argument that the differences in approach are primarily volume-related.[496]

Borrowing securities for delivery at settlement presumably would be an incomplete and inadequate solution because of the unavailability of securities of some issues or for administrative reasons. Recall DTCC's dire prediction that requiring the close-out of all fails would "bring the robust equity markets in the U.S. to a screeching

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[492] *See* II.A.2., *supra*.

[493] Tokyo Interviews, *supra* note 142.

[494] *Id.*

[495] *See* II.B.1., *supra*.

[496] For example, the average daily number of transactions for which NSCC became the counter-party in its CNS system was 17 million in calendar year 2006. U.S. Comments on Article 14, *supra* note 291, at 5. By way of comparison, in May 2006 JSCC expanded its daily capacity to 11 million transactions. JSCC 2006 Annual Report at 7.

halt, and destroy our competitiveness with other capital markets around the world."[497] Moreover, given the relative merits of avoiding fails and shortfalls, on one hand, and avoiding disruption of entitlement holder expectations, on the other, it is not surprising that entitlement holder expectations are protected. This is especially so because approaches other than a strictly matched book provide important protections for entitlement holders in the United States.[498]

From the pragmatic perspectives of regulatory oversight and account holder protection, arguably it might make sense for Japanese law to permit credits to an account that would create a shortfall in order to honor account holder expectations. But regardless of the merits of such an approach from these perspectives, it would raise difficult conceptual problems under the core rationale of the Book-Entry Transfer Act. The Book-Entry Transfer Act views the credited account holder as "the owner" of the underlying security. This property interest is grounded on the integrity of a strictly matched book in which an intermediary has available to it (somewhere) the securities credited to its customers' accounts. Of course, the Book-Entry Transfer Act could be changed in this respect, but I suspect that it is quite unlikely that such a fundamental departure from the conceptual bases of the Book-Entry Transfer Act would be made, at least not until serious and persistent problems are identified in the Japanese markets.

Notwithstanding the foregoing, the conceptual and doctrinal bases of the private law of property and contract should not drive the structure of securities holding in an intermediated system. Nor should they dictate the process or structure of clearing and settlement systems. To the contrary, lawmakers and regulators must design systems of holding, clearance, and settlement so as to reduce the various risks identified above and to provide efficient financial markets. Then, to the extent necessary, legal regimes such as UCC Article 8 and the Book-Entry Transfer Act should be adjusted so as to complement and provide certainty for these systems.

Definitive answers to regulatory policy questions such as whether to strictly prohibit naked short selling (as under Japanese law) and whether to permit intermediaries to credit account holder accounts even in the face of a shortfall (as under United States law) are beyond the scope of this paper. But the search for safer and more efficient systems should drive the private law. To allow private law concepts (whether traditional or innovative) to drive the development of systems of intermediated securities holding, clearance, and settlement would be to have the tail wag the dog. Yet this realization presents a high hurdle for the Convention's goal of adopting a one-size-fits-all approach that could be applied to enormously varied systems around the world, even though there is a core of basic issues that all intermediated systems must confront.

A final word on the relationship between clearance and settlement systems and private law: Recognizing a more modest structural role for private law does not suggest

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[497] DTCC Press Release, *supra* note 475.

[498] *See* text at notes 479-82.

that its role is less important. Once structural arguments are resolved, the private law must intervene (or be adjusted) to ensure that the desired results will follow. Moreover, the proper resolution of some private law issues is important for *any* system of intermediated securities holding. Appropriate innocent acquisition and immunity rules provide, perhaps, the best examples.

IV. CONCLUSIONS AND RECOMMENDATIONS

As the Convention process moves toward a diplomatic conference, several challenges remain. The principal challenge, mentioned above, is the resolution of a fundamental issue inherent in the project: Is it possible to craft the Convention so as to be capable of coherent application in the widely varying regimes around the world while nonetheless including meaningful legal principles in the Convention text?

In addition to this overarching challenge, this paper has noted a number of beneficial changes that should be made to the current Convention text. These include (i) adoption of a satisfactory test for innocent acquisition and, in particular, the test for "knowledge" (as well as some other technical adjustments to the innocent acquisition rules),[499] (ii) reinstatement of (or an optional provision for) a limited immunity for intermediaries that make proper book entries,[500] (iii) clarification and expansion of the effects of insolvency proceedings on interests in intermediated securities,[501] and (iv) provision for a limited extension of innocent acquisition protection for acquisitions under Article 10 when the first-in-time priority rule of Article 15 does not apply.[502]

Perhaps the most significant challenge at the diplomatic conference will be the conservation, preservation, and maintenance of the substantial progress made to date. Two final challenges are (i) to provide Convention text that will be clear and understandable to lawyers and judges who are not highly specialized and (ii) to ensure clarity as to when the Convention text resolves an issue and as to when the issue is left to the non-Convention law.

The United States and Japanese legal regimes also face challenges. In the United States there appears to be general satisfaction with both the regulatory regime and the private law relating to intermediated securities. In particular, United States experts generally agree on the adequacy of the existing mechanisms for protecting the financial interests of entitlement holders as well as the operation and structure of the mature-but-evolving clearance and settlement systems.

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[499] *See* II.C.5.a.(i), *supra*.

[500] *See* II.C.5.a.(ii), *supra*.

[501] *See* II.C.2., *supra*.

[502] *See* II.C.5.b., *supra*.

As explained above, the existing United States regime, as buttressed by recent changes to Regulation SHO, may have rendered the ubiquitous fails to deliver and shortfalls largely innocuous for most purposes. But there is, nonetheless, a growing concern about the impact of these phenomena on the exercise of investor rights—shareholder voting, in particular.[503] There now is reason to believe that the SEC may at some point come to grips with the impact on voting in situations in which the aggregate amount of the directly held securities and the amount credited to securities accounts exceeds the aggregate issued and outstanding amount of a given issue.[504] Whether some basic structural changes must be made to the United States regime in order to resolve the voting problems, such as moving toward a more transparent systemic approach, remains to be seen.

The stiffest challenges for the Japanese regime may be found in the application of the Book-Entry Transfer Act system to equity securities beginning in 2009. But these challenges are largely of an applied and systemic nature as opposed to problems associated with the legal doctrine imposed by the Book-Entry Transfer Act. Given the thorough and recent overhaul of Japanese legal doctrine for intermediated securities, it seems doubtful that material changes in the structure of the Book-Entry Transfer Act will be made. Nevertheless, this paper has identified some possible points of Japanese legal doctrine that might be adjusted so as to provide more flexibility, while leaving the heart of the Book-Entry Transfer Act system intact. These include (i) recognition of the property interest of one who holds through an account holder acting in the capacity of agent or nominee,[505] (ii) adoption of a SIPA-like insolvency distributional scheme that also might recognize the rights of a person who is entitled to receive a credit to a securities account even if the credit has not been entered,[506] (iii) adaptation of the relevant portion of the Japanese book-entry system to foreign custodial holdings,[507] (iv) adoption of the concept of immunity from liability for innocent acquirers and intermediaries who make proper book entries,[508] and (v) introduction of the concept of perfection of an interest by way of a control agreement.[509] I make no definitive claim that any of these adjustments should be adopted, but only that they warrant consideration and discussion.

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[503] *See* text at note 106 and following.

[504] *See* text at notes 107-08.

[505] *See* II.B.2., *supra.*

[506] *See* II.A.4., *supra*; II.D.2. (discussing Example 3A), 3. (discussing Example 4), *supra*.

[507] *See* II.D.4., *supra* (discussing Examples 5A and 5B).

[508] *See* II.A.5.a., *supra*; II.C.5.a.(ii), *supra*; II.D.1. (discussing Example 2).

[509] *See* II.B.5.b., *supra*; II.D.5., *supra* (discussing Example 6).

Finally, the discussion and analysis in this paper reflect at least one overarching lesson learned from the evolving reforms in laws and systems in the securities markets during the past twenty-five years. Reforms of private law relating to intermediated securities and reforms of the systems for securities holding, including clearance and settlement systems, must go hand in hand. The important recent reforms in Japan demonstrate that Japanese lawmakers, regulators, practitioners, and scholars have learned that lesson well. For this, they deserve congratulations and thanks.