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Thévenoz, Luc

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Transfer of intermediated securities

LUC THÉVENOZ

6.1 Introduction

The ability to sell or charge financial assets is inherent to financial markets and essential to most investors. Assets that cannot be realised may lose all or most of their value. Most financial assets are issued as securities. In times when securities were transferred as certificates or negotiable instruments (*valeurs mobilières, papiers-valeurs, Wertpapiere*), the rules providing the methods and the effects of such transfers were critical to the safety of the securities markets. They were taught at law schools, and were not deemed to be an easy subject. In most cases, financial market securities are no longer sold or pledged by way of certificates. In many legal systems and markets, certificates have been displaced altogether. Nowadays, securities traded in the financial markets are held through intermediaries such as banks, securities dealers and other financial intermediaries. The rules governing the full or partial transfer of such intermediated securities, the methods available and their effects, are as important as the corresponding rules were to certificated securities. They form a core component of any statutory or case law governing intermediated securities. Their efficiency and predictability is essential to the proper functioning and stability of the financial markets.

The provisions regarding the transfer of intermediated securities thus constitute a very important chapter of the international harmonisation of the law of intermediated securities, from the 2006 Hague Securities Convention to the 2009 Geneva Securities Convention and the future EU Securities Law Directive.

From a legal viewpoint, ‘transfer’ is a non-technical term. In its two authentic languages, the Hague Securities Convention uses ‘*transfert*’ in French, but ‘disposition’ in English, to mean ‘any transfer of title whether outright or by way of security and any grant of a security interest, whether

possessory or non-possessory'.¹ The Geneva Securities Convention also uses the French '*transfert*', and the English 'transfer' in its heading for Chapter III 'Transfer of intermediated securities', but refrains from further use of that concept in respect of acquisition and disposition of intermediated securities.² The EU Consultation Document of January 2011 uses acquisition and disposition consistently.

This chapter examines the main provisions of the Geneva Securities Convention concerning the acquisition and disposition of intermediated securities, and of any limited interest (such as security interests) in the same. Wherever it is useful, we compare the provisions of the Convention with the principles discussed in the EU Consultation Document. As we shall see, the latter is in line with the Convention on most issues:

- both deal only with voluntary acquisitions and dispositions; the existence, requirements for, and priority of, interests arising automatically from the operation of the law (non-consensual interests) are exclusively determined by the applicable national law, or the 'non-Convention law' for the purposes of the Convention;³
- both make one method (credit and debit) available generally for transferring full title to intermediated securities or any limited interest therein;
- both offer a choice of three other methods (designating entry or earmarking, control agreement, agreement with and in favour of the relevant intermediary), of which Contracting or Member States⁴ may elect to make one or more available to account holders, or none at all;
- both include key provisions on the effectiveness of acquisitions and dispositions against third parties and in insolvency;

1 Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary, concluded in The Hague on 5 July 2006 (Hague Securities Convention), Art. 1(e).

2 The word 'transfer' is further used in set phrases such as 'fraudulent transfer' or 'title transfer.'

3 Many provisions of the Convention defer to additional or different provisions of the applicable law governing a particular issue falling within the scope of the Convention. As defined in Art. 1(m) in connection with Art. 2, those provisions are referred to as 'the non-Convention law'. The EU Consultation Document merely refers to 'the applicable law'. In this chapter, both have the same meaning.

4 Treaties and legal instruments of the European Union speak of Member States while the Convention refers to Contracting States.

- none interferes with the contents and characterisation of the interests that are created, transferred, or extinguished; these questions are entirely left to the applicable law;
- both protect an innocent acquirer (*acquisition de bonne foi*) when certain circumstances affect the transaction;
- both determine the priority of competing interests in (i.e. successive dispositions over) the same intermediated securities;
- both explicitly state that the rules on acquisitions and dispositions do not determine who the issuer of the securities must recognise as shareholder or bondholder.

While covering the same ground, the EU Consultation Document differs from the Convention by closely connecting debits and credits with concerns about the integrity of the intermediated holding system and the avoidance of so-called excess securities. Where the Convention deals with these concerns in a separate Chapter IV, Principle 4(2) of the EU Consultation Document requires an intermediary to make a credit 'only if it holds a corresponding number of securities of the same description', and Principle 4(4) mandates the intermediary to 'reverse erroneous credits' or to buy in additional securities if the requirement is not satisfied.

This difference of emphasis highlights the concern of significant European jurisdictions with the integrity of securities issues. Principles 4(2) and 4(4) remain nonetheless well within the framework set out by the Convention. Subject to the protection of an innocent acquirer, Article 16 of the Convention defers entirely to the non-Convention law to determine when a credit may or must be reversed. Article 24, which requires the intermediary to hold or have available enough securities to cover the credits made to the securities accounts it maintains, also defers to the non-Convention law to determine the methods of complying with that requirement. This chapter does not deal further with these issues, which are extensively discussed in Chapters 7 (Mooney) and 8 (de Vauplane) of this book.

This chapter examines the methods available for acquiring and disposing of intermediated securities (section 6.2), the rights and interests that may be created or transferred according to these methods (section 6.3), and the effectiveness of such acquisitions and dispositions (section 6.4). It will then examine and compare the provisions on innocent acquisition (section 6.5) and priority (section 6.6).

6.2 Methods for acquisition and disposition

6.2.1 *Debits and credits*

Intermediated securities exist as book-entries in securities accounts maintained by financial institutions. The form of their recording is reflected in synonyms such as account-held securities,⁵ or book-entry securities.⁶ As a result, credits to the transferee's account and debits to the transferor's securities account are quintessential to the dematerialised world of intermediated securities. As far as we know, they are available in all jurisdictions where securities are held through intermediaries. Credits and debits are therefore the one method that must be available to all account holders under the Convention and the EU Principles alike.

When the intermediated holding system developed (in the 1960s), and before it was supported by statutory provisions, entries made in accounts recording the securities holdings of clients generally received evidential value. They were deemed to evidence the acquisition of certain rights by the account holder, not to effectuate that acquisition. The acquisition relied on traditional legal rules dealing, for example, with certificated securities. The key legal requirements were, for example, the delivery of the securities to the acquirer or the acquirer's bank, the endorsement of the certificate, or the registration of the new securities holder in the company registry. The book entries in the accounts of the transferor and the transferees were not legally decisive. Book entries in securities accounts operated essentially like entries in a company account: they recorded assets or claims, but did not create or transfer them.

The development of the intermediary holding system has placed tremendous importance on credits and debits. Book entries have become the 'gold standard' of the holding pattern worldwide. This is why in many jurisdictions statutes were enacted that changed the legal doctrines applicable to dematerialised or immobilised (intermediated) securities, retaining credits and debits as a transfer's decisive elements.

Debits and credits do not occur in a void. They rely on transactions concluded on an exchange or directly between the parties and generally result from instructions issued by the parties to their respective intermediaries. National legal doctrines have therefore connected credits

5 As in the EU Consultation Document.

6 As in the German version (*Bucheffekten*) of the Swiss Intermediated Securities Act of 2008, which uses '*titres intermédies*' in its French version. On this Act, see further Chapter 13 (Kuhn).

and debits with other relevant circumstances, such as (valid) instructions from the transferor. Many jurisdictions also require – with varying degrees of stringency – that there be no credit to the transferee’s account without a matching debit in the transferor’s account. The circumstances under which a credit or a debit may be deemed invalid or liable to be reversed differ significantly among legal systems.

It seems however that all or most legal systems consider that the time of the acquisition is the time when the credit is made to the acquirer’s securities account. This is the time when the acquisition becomes effective against third parties and effective in the insolvency of the acquirer and in the insolvency of the relevant intermediary. Even though a credit might be subsequently reversed for a number of reasons, it is also the trigger for the protection of an innocent acquirer.

What constitutes a credit (or a debit) to a securities account has various definitions, depending on the operational arrangements and on the legal rules applicable to a given system or jurisdiction.

Given the universality of credits and debits, on one hand, and the diversity of legal rules and operational systems on the other, the Geneva Securities Convention sets out a limited set of harmonised rules:

- Intermediated securities are acquired when a credit is entered in the account of the acquirer, and they are disposed of when a debit is made to that account.
- What constitutes a credit or a debit is not determined by the Convention.
- Except that a debit must be authorised by the account holder,⁷ the Convention does not determine which other requirements must be satisfied for a credit or a debit to be valid; non-Convention law determines those requirements and the effects of an invalid or reversed book entry.
- The Convention neither precludes nor includes a ‘no credit without debit’ rule, which is left entirely to the non-Convention law.
- The non-Convention law determines when a credit or a debit is or can be made conditional.
- On all these questions, the non-Convention law may defer to the account agreement or to the uniform rules of a securities settlement system.

The connection between debits and credits is an area of significant differences between national legal and regulatory regimes. Many jurisdictions of the civil law tradition (including France, Germany, Switzerland and Japan) consider the intermediated securities debited from the transferor’s

7 Art. 15(1)(a) of the Convention.

account to be the very same as the ones that are credited to the account of the transferee.⁸ It is the same property that is relinquished by the transferor and acquired by the transferee. The book-entries should occur at the same moment, as far as operationally possible, though it is rarely the case in fact, but legal doctrines ensure that there is a single conceptual and legal moment for the acquisition/disposition and that any mismatch between the relevant accounts are corrected as soon as possible.

Because the Convention deals in separate paragraphs of Article 11 with credits (paragraphs 1 and 2) and with debits (paragraphs 3 and 4), some observers have suggested that the Convention favours the Anglo-American approach to intermediated securities. Under the English law of trusts, which is the conceptual framework for securities held in 'street name' by banks and broker-dealers for their clients, account holders acquire an equitable interest in the assets held by the intermediary; they are the beneficiaries of a trust.⁹ When an account holder sells shares, she is not legally transferring her equitable interest to the acquirer. Rather, her beneficial interest, derived from her bank's holding, is extinguished, while a comparable interest is created by the buyer's bank for the buyer. Although a securities entitlement under Article 8 of the Uniform Commercial Code is not identical with a beneficial interest under English trust law, the same analysis applies to the creation of the acquirer's entitlement and to the extinguishment of the seller's entitlement in the United States. In these and similar legal systems, a seller is not technically transferring her interest to the buyer of intermediated securities, but is causing the acquisition of the buyer's interest, usually at the cost of relinquishing her own.

While the structure of Article 11 of the Convention would appear to favour the English and American approach by treating credits and debits separately, and does not require that they are necessarily connected or inter-dependent, Article 16 allows Contracting States to thoroughly interconnect debits and credits so that they become two sides of the same coin. The Official Commentary to the Convention has put to rest any concern about full deference to the non-Convention law on these issues.¹⁰

8 I have discussed this conceptual differences in Thévenoz, 'Intermediated Securities', at 401 et seq.; see also Paech, *Cross-Border Issues*, at 13.

9 See Benjamin, *Interests in Securities*, 10; [UK] Financial Markets Committee, *Issue 3*, at 36–59; Micheler, 'The Legal Nature', at 131.

10 Kanda et al., *Official Commentary*, s. 11–4 and s. 11–12 and example 11–1 at s. 11–13.

The EU Consultation Document, which is drafted in the form of a set of principles rather than legal rules, takes those things in its stride and deals with credits and debits in Principle 4(1). However, other principles deal separately with credits or debits, wherever appropriate.¹¹ In substance, however, the Consultation Document does not propose to push any further the limits of harmonisation in the area of credits and debits. While it requires that the account provider (intermediary) crediting securities to the transferee's account may only do so if it holds 'a corresponding number of securities of the same description', the breach of this requirement does not result in the invalidity of the credit, but imposes on the account provider to remedy the situation by either reversing the erroneous credit or by obtaining additional securities of the same description.¹²

6.2.2 *Choice among other methods*

Other methods for the acquisition and disposition of intermediated securities, or interests therein, are available in most jurisdictions but have not reached the same level of universal acceptance as credits and debits. While it is unnecessary for international harmonisation to impose them, it is important to recognise them wherever they exist as methods capable of transferring intermediated securities or limited interests therein. Uniform rules then apply to the protection of an innocent acquirer and to the priority of interests created in the same intermediated securities.

Article 12 of the Convention, followed on that matter by Principle 4(5) of the EU Consultation Document, lists the three most common methods and sets out their basic features. Each state may choose one, several, or none of them. For the sake of international transparency, the Convention requires that this choice should be specified in a declaration, and may be varied any time with the declaration modified accordingly.

All these methods have in common that the intermediated securities over which rights are transferred remain credited to the transferor's securities account. As stated in Article 12(1) of the Convention, each method requires two steps:

1. the account holder and the acquirer enter into an agreement in respect of the rights to be created or transferred; and
2. the specific condition of the relevant method is satisfied.

11 See the EU Consultation Document, Principles 4(2), 4(4), 5(3), 5(7), 7(1), and 8(1).

12 Principles 4(2) and 4(4).

6.2.3 Designating entry (or earmarking)

A designating entry (*identification*), called earmarking in the EU Consultation Document, is a book entry in favour of the acquirer, authorised by the account holder and made by the intermediary into that account holder's securities account.¹³ As a book entry, it evidences the fact that someone other than the account holder has an interest in the whole account, or in certain intermediated securities. This form of publicity is somewhat limited by the nature of securities accounts. Securities accounts are not public registries and they may not be consulted by anyone who is not authorised by law or by the account holder. Moreover, limited reliance can be placed in an account statement or in a printout of an electronic access to a securities account, which may be modified within a minute after printing the statement or accessing the account. Unencumbered intermediated securities may be earmarked (or debited) within a minute after the statement has been printed or the account electronically inspected. But designating entries, like debits and credits, are book entries and, in that respect, they conform to the 'gold standard' of intermediated securities. The symmetry between those methods appeals to many jurisdictions.

When the account holder grants an interest in intermediated securities which remain credited to her securities account, it is not enough that an entry be made to record the existence of that interest; it is also necessary that the entry has certain effects protecting the acquirer against further unauthorised dispositions of the same intermediated securities by the account holder. These questions are not dealt with extensively.

It is for the non-Convention law to determine whether a designating entry provides the acquirer with 'positive' or 'negative control', or possibly both, over the designated securities. By positive control, we mean that the intermediary maintaining the account is required to comply with any instructions given by the acquirer in relation to those intermediated securities 'in such circumstances and as to such matters as may be provided by the account agreement, a control agreement or the uniform rules of a securities settlement system, without any further consent of the account holder'.¹⁴ By negative control, we mean that the intermediary 'is not permitted to comply with any instructions given by the account holder in relation to the intermediated securities as to which the entry is made without the consent of that person'.¹⁵ While the non-Convention

13 Art. 15(1)(b) of the Convention. 14 *Ibid.*, Art. 1(l)(ii). 15 *Ibid.*, Art. 1(l)(i).

law determines the issue, the Convention requires the Contracting State to make a declaration stating that its non-Convention law provides for designating entries as a method available to grant an interest in intermediated securities and specifies the type of control resulting from the designating entry.¹⁶

Book entries rely on the authority of the person whose rights are affected. Like debits, designating entries must be authorised by the account holder.¹⁷ Conversely, the removal of a designating entry must be authorised by the person in whose favour it was made.¹⁸

6.2.4 Control agreement

While certain jurisdictions prefer the formalism of designating entries, others favour the flexibility of control agreements. Essentially, both methods may have the same effects over the relevant intermediated securities and provide the acquirer with positive or negative control, or both, as determined by the non-Convention law.¹⁹ The one significant difference is that control agreements do not require a book entry in the account of the transferor; they open a wide space for contractual provisions regulating the various circumstances under which the account holder and the acquirer may respectively issue instructions to the intermediary and thus effect dispositions over the assets.

Like a designating entry, a control agreement imposes additional obligations on the intermediary for the benefit of the acquirer. The difference is that the exact extent of those obligations is typically determined between all three parties involved. Technically, control agreements may be tripartite or bipartite.²⁰ Two-party control agreements are typically negotiated between the account holder and the intermediary, obviously on the basis of what has been agreed upon between the account holder and the acquirer. Such a two-party agreement is a contract for the benefit of a third party, and creates contractual rights for the acquirer. In certain jurisdictions, control agreements may be executed by the account holder and the acquirer and merely notified to the intermediary. The binding effect of a control agreement imposing obligations on a person, the intermediary, who is not a party to it seems to contradict the doctrine of privity of contracts and must probably rely on some specific statutory provision.

¹⁶ *Ibid.*, Art. 11(5) and (6). ¹⁷ *Ibid.*, Art. 15(1)(b).

¹⁸ *Ibid.*, Art. 15(1)(c). ¹⁹ *Ibid.*, Art. 1(k). ²⁰ *Ibid.*, Art. 1(k).

Since interests granted by any method are meant to be effective against third parties, it is often questioned whether it is safe to create such interests without the limited form of publicity effected by a designating entry, i.e., a book entry. As a matter of fact, the whole intermediary holding system relies on the reliability and integrity of intermediaries. An interest granted by any of the Article 12 methods is only as good as the capacity and willingness of the relevant intermediary to apply the limitations resulting from designating entries or control agreements. For the potential acquirer of, say, a security interest, the only safe way to ensure that it will enjoy a priority over any other subsequent interest is to have this fact confirmed by the relevant intermediary. It is all the more important that intermediaries often enjoy a first interest in the intermediated securities credited to their client securities accounts, either as a statutory lien (an area not harmonised by the Convention or by the contemplated Securities Law Directive), or as a contractual interest created in accordance with the last of the Article 12 methods (see below section 6.2.5). In that respect, an interest granted by a designating entry made into a securities account is more transparent than the same interest granted by way of a control agreement, but it is not safer against fraud or error on the intermediary's side.

6.2.5 Agreement with and for the benefit of the relevant intermediary

The last optional method – actually the first listed in Article 12(3) of the Convention – may only be used to grant an interest to the intermediary maintaining the account where the intermediated securities are credited. Where provided for by the non-Convention law, the agreement between the account holder and her intermediary suffices to create that interest and make it effective against third parties. It is sometimes referred to as a 'self-perfecting' agreement, because the first step required (an agreement between the transferor-account holder and the transferee about the grant of an interest in intermediated securities) is enough to 'perfect' that interest, i.e., to make it effective against third parties.

The justification for this method is obvious for jurisdictions where control agreements are used: the collateral agreement (or other transaction concluded between the account holder and the intermediary) binds the very same parties as the ones required for a valid control agreement. There is no need for an additional contract. The position of the intermediary as the beneficiary of the interest is secured by the control it exercises over the securities account it itself maintains.

In jurisdictions where self-perfecting collateral agreements and statutory liens coexist for the benefit of the intermediary, the difference between both interests may be blurred. Typically, the terms of a custody account will confer on the intermediary a broader security interest over the intermediated securities it holds for its clients in respect of the securities which are pledged, the obligations that are guaranteed, and the realisation of the securities by private sale.

6.3 Rights and interests transferred

While the Convention and the EU Consultation Document deal with *how* intermediated securities can be acquired and disposed of, they say precious little on *what* – i.e., on the rights and interest that may thus be transferred or granted. This issue deserves a closer examination in the light of the provisions of the Convention.

Article 11(1) and (3) speak of ‘intermediated securities’ being ‘acquired’ or ‘disposed of’, implicitly referring to the full title to these intermediated securities, or in other words to the complete set of the rights arising from the credit of these securities to a securities account.²¹ However, Article 11(4) broadens the subject matter of dispositions made by credits and debits by providing that ‘[a] security interest, or a limited interest other than a security interest, in intermediated securities may be acquired’ by the same method. Further, Article 9(3) confirms that a credit can be made to grant a security or other limited interest, in which case ‘the non-Convention determines any limits on the rights’ resulting from that credit.²²

In many jurisdictions, Article 12 methods are typically used to transfer limited interests in intermediated securities, most often security interests, but Article 12 itself contains no such limitation. Its paragraph 1 refers to the grant of ‘an interest in intermediated securities, including a security interest or a limited interest other than a security interest.’ Indeed, if ‘an interest . . . *includ[es]* . . . a limited interest’, then it is not *restricted* to it; otherwise, the first part of the phrase and the term ‘including’ would have no meaning. In other words, Article 12 may also be employed to transfer the full, unlimited interest in the intermediated securities which

21 Under the heading ‘Intermediated Securities’, Art. 9 describes the rights conferred upon an account holder by the credit of securities to her securities account.

22 The same rule is expressed in different terms in Principle 3(4) of the EU Consultation Document.

remain credited to the securities account of the transferor.²³ The possibility of transferring the full title to intermediated securities by one of the Article 12 methods may seem counter-intuitive, but it was a deliberate choice made during the preparation and negotiation of the Convention and is necessary to its correct implementation.

The first reason is legal and it is related to the limited purpose and scope of the harmonisation envisioned by the Convention. It has been said earlier (see Chapter 1 at page 8) that the Convention refrains from interfering with the legal characterisation, under national property laws, of the rights of an account holder. Notions of property, limited interests (*droits réels limités, beschränkte dingliche Rechte*) and security interests (*sûretés ou garanties, Sicherheiten*) differ very significantly among jurisdictions. The purpose and scope of the Convention is not to harmonise the substantive notions of property law among jurisdictions, but to create legal certainty regarding, inter alia, how and when proprietary rights (or non-proprietary rights, as the case may be) in respect of intermediated securities are acquired, charged, transferred or otherwise disposed of. This is why Chapter II of the Convention deals with these methods; the effectiveness of the rights so created or transferred; their respective priority, and the protection, of innocent acquirers. The Convention does not prescribe or describe what these rights are. This is also true of the (optional) Chapter V on 'Special provisions in relation to collateral transactions',²⁴ which does not interfere with existing legal doctrines regarding the legal characterisation of interests created either by a 'security collateral agreement' or by a 'title transfer collateral agreement'.²⁵

In this self-limitation of the Convention lies the fundamental reason why the methods in Articles 11 and 12 apply to whatever full or partial interest the parties want to create or transfer in accordance with the non-Convention law. If Article 12 was confined to limited interests, or security interests, or collateral interests, legal certainty in cross-border legal situations would require that these concepts are defined by the Convention, implying that the Convention characterises (or re-characterises) notions of the non-Convention law. This would defeat the functional approach underlying the Convention and interfere with the property notions of national law deterring states from adopting harmonised rules, thereby thwarting the whole process.

23 Kanda et al., *Official Commentary*, s. 12-14.

24 See Zaccaroli, 'Taking Security', at 169.

25 These terms are defined in Art. 13(3)(b) and (c) of the Convention.

This fundamental reason is buttressed by a practical consideration. It is a matter of fact that in some markets, both title transfer and non-title transfer collateral transactions are effected by some Article 12 method. For example, some central banks take intermediated securities from qualifying intermediaries in repos transactions (repurchase operations) without debiting the relevant securities from the participants' securities account. This flexibility is important and the negotiations revealed no reason why Article 12 methods should be restricted to non-title transfer transactions.

6.4 Effectiveness

It is good to know that A has acquired certain intermediated securities from B, or that B has granted a security interest in some other intermediated securities to A. But the property acquired by A is only good to the extent that it is effective against third parties, including:

- against the creditors of B if B becomes bankrupt;
- against subsequent acquirers of an interest in the same intermediated securities, over which A's interest may have priority (see below section 6.6);
- against holders of prior interest in the same intermediated securities, if and to the extent that A must be protected as an innocent acquirer (see below section 6.5);
- as well indeed as in the insolvency of the intermediary maintaining the relevant securities account.

The Geneva Securities Convention does that in two identical paragraphs in Articles 11 and 12 respectively, paragraph 2 of both of which read:

No further step is necessary, or may be required by the non-Convention law or any other rule of law applicable in an insolvency proceeding, to render the acquisition of intermediated securities effective against third parties.²⁶

What are these further steps that are unnecessary to the effectiveness of an interest? The rule mostly addresses formalities, filings, registrations, and other publicity requirements that certain jurisdictions impose to make third parties aware of security interests. For example, the general rule in a

²⁶ Para. 2 of Arts. 11 and 12 of the Convention. The same rule is contained in the EU Consultation Document, Principle 5(2). However, we will see below that the EU Consultation Document has a broader notion of effectiveness.

jurisdiction may require that a security interest be registered or filed with some public agency or registry. Another jurisdiction may require notice of the security interest to be given to holders of earlier security interests in the same assets. Such formalities may be required for the interest to be effective and enforceable against third parties, or they may be optional but would afford the (new) interest priority over earlier, unpublicised interests.

The ‘no further step’ rule applies to the non-Convention law as much as to the law applicable in an insolvency proceeding. It does not displace validity requirements set out by the non-Convention law, such as the no-debit-without-credit rules discussed earlier. Validity requirements are reserved by Article 16. Articles 11(2) and 12(2) provide for the *erga omnes* effectiveness of valid dispositions and only disable additional formalities and publicity requirements.

In the Convention, validity of the acquisition and effectiveness against third parties coincide in time. Effectiveness is an additional characteristic of an interest that has been validly acquired. An interest becomes effective against third parties only if, and as soon as, it has been acquired. If the interest is or becomes invalid, it does not become or cease to be effective. When the non-Convention law provides for the invalidity of an interest or the reversal of a book-entry, it must also provide for the *inter partes* and *erga omnes* effects of such invalidity or reversal.²⁷

Effectiveness is the premise or precondition of several other provisions of the Convention:²⁸

- Article 14: Within limits set out in subsequent paragraphs, paragraph 1 states that: ‘Rights and interests that have become effective against third parties under Article 11 or Article 12 are effective against the insolvency administrator and creditors in any insolvency proceeding.’
- Article 21: Within (narrower) limits set out in subsequent paragraphs, paragraph 1 states: ‘Rights and interests of account holders of a relevant intermediary that have become effective against third parties under Article 11 and interests granted by such account holders that have become effective under Article 12 are effective against the insolvency administrator and creditors in any insolvency proceeding in relation to the relevant intermediary . . . ’

27 Art. 16 of the Convention; see also Art. 15(2) leaving for the non-Convention law to determine the consequences of an unauthorised book entry.

28 See also Arts. 18, 20, 22, 23(2)(b), 39.

- Article 19 ‘determines priority between interests in the same intermediated securities which become effective against third parties under Article 12 or Article 13’.
- Articles 17 and 18 do not explicitly connect the protection of an innocent acquirer with the effectiveness of her acquisition, but the relevant time for the ‘know or ought to know’ test refers to the identical facts that trigger the effectiveness of the interest against third parties.²⁹

The EU Consultation Document uses effectiveness in a broader sense. Principle 4 (‘Methods for acquisition and disposition’) deals with ‘the operational side of acquiring and disposing through accounts’.³⁰ Principle 5 (‘Legal effectiveness of acquisitions and dispositions’) regulates effectiveness ‘between the account holder *and* the account provider and against third parties’.³¹ The same Principle 5 deals with questions of validity and reversal as well as with conditional entries.³² In other words, where the Convention neatly distinguishes validity from effectiveness against third parties, the EU Consultation Document includes the latter in the former.

Principle 5(5) clarifies that ‘Effectiveness . . . does not determine whom an issuer has to recognize as legal holder of its securities.’ The point is well taken, and echoes Article 8(2) of the Convention stating that the Convention ‘does not determine whom the issuer is required to recognise as the shareholder, bondholder or other person entitled to receive and exercise the rights attached to the securities or to recognise for any other purpose’.

Notwithstanding the different uses of ‘effectiveness’ in the two instruments, their respective rules are essentially compatible, except on one significant issue. Unlike Articles 14 and 21 of the Convention, Principle 6 (‘Effectiveness in insolvency’) does not differentiate between insolvency of the relevant intermediary and insolvency of any other party. Extensive and sometimes difficult negotiations in the UNIDROIT process have demonstrated the need to better protect account holders in the insolvency of the relevant intermediary, which Article 21(2) does by allowing narrower exceptions to that protection than Article 14.³³ For example, it is hard

29 Namely, when the credit is made, Art. 17(e), or when the interest becomes effective against third parties under Art. 12, see Art. 19(3).

30 Consultation Document, at 10 (first paragraph under sub-section 4.2).

31 Principle 5(2), emphasis added.

32 Reversal of book-entries is further addressed in Principle 7.

33 In Art. 14(1), the Convention reserves the application ‘of any substantive or procedural rule of law applicable by virtue of an insolvency proceeding’ and only provides an

to see why the protection of intermediated securities in the insolvency of the relevant intermediary should be subject to the superior ranking of some claims, such as claims of the tax or revenue authorities or from employees of the relevant intermediary. The whole notion is that intermediated (or account-held) securities are the property of account holders in the custody of the relevant intermediary and the intermediary system at large. They are not transformed into mere contractual claims against the insolvent intermediary. In most systems, property not belonging to the insolvent party is not subject to the claims of that party's creditors; it must be set aside from the insolvency and delivered to the persons having proprietary rights. It would have been useful if that distinction had been made in Principle 6.

6.5 Innocent acquisition

The protection of 'bona fide' or 'innocent' acquirers from the seller's defective title and adverse claims of other persons retaining an interest in the asset is an important aspect of any property transaction. Such '*protection de l'acquéreur de bonne foi*' originates with tangible property, specifically with movables (chattels). The possessor of a particular movable thing is presumed to be its owner, or at least to have the power to fully dispose of title to that thing (*'en matière de meubles, possession vaut titre'*), unless particular circumstances require that a diligent buyer should enquire about the possessor's title. In jurisdictions where land and other assets are registered in public registries, the same doctrine often protects acquirers who have relied on the information publicised in the registry. Protection of innocent acquirers against hidden title defects is essential to the value and marketability of assets. Rules setting out the protection of purchasers of certificated securities, and the limits thereof, are an important chapter of the law governing negotiable instruments and certificated securities. The same need arises for intermediated securities. But several jurisdictions struggled with these issues because, whether the securities held through intermediaries are fully dematerialised or merely immobilised, the acquirer cannot rely on the seller's physical possession

illustrative listing of such rules. In connection with an insolvent intermediary, Art. 21(2) only reserves two narrow exceptions. For an explanation of these two provisions and the underlying policies, see the Official Commentary, under Arts. 14 and 21 respectively, with reference to the preparatory documents.

of the securities nor on a public registry.³⁴ Securities accounts are not open for public inspection.

Traditional rules on movable or immovable property may be helpless to protect innocent acquirers of intermediated securities or of any security or other limited interest therein. But there is an undisputed need to protect market participants and the securities markets against such problems which have the potential to disrupt transactions.

Unlike the EU Consultation Document, to which we revert later, Articles 17 and 18 of the Convention set out an extensive protection. An innocent acquirer (or '*acquéreur de bonne foi*') of intermediated securities, or of any interest in intermediated securities, is protected against two types of defective situation:

- a person other than the transferor ('another person') has an interest in securities or intermediated securities *and* the rights of that other person are violated by the acquisition; or
- there is a defective entry prior to the acquisition, such as an invalid, conditional or reversible credit or designating entry, which may invalidate the acquisition.

The Convention thus protects acquirers from two types of defect: the infringement of the rights of another person and earlier defective entries which, for any reason that may have nothing to do with the rights of another person, might invalidate the acquisition.

Such protection requires the acquirer to be '*de bonne foi*', innocent of these problems. The innocence test raised many dogmatic debates during the negotiations of the Convention,³⁵ but the final outcome seems essentially uncontroversial. A person is innocent unless she 'actually knows or ought to know, at the relevant time, of' the interest of the other person or of the earlier defective entry. The protection does not apply to donations and other gratuitous acquisitions. The relevant time is when the acquisition becomes effective against third parties.

What happens when an innocent acquirer is protected under Article 18(1) or (2)? Essentially, his acquisition and the book entry on which it relies, if any, are valid; he takes his interest free from the claims

34 See particularly Nizard, *Les titres négociables*, at 253 et seq.; Einsele, *Wertpapier als Schuldrecht*, at 97 et seq.

35 See inter alia the Summary report of the Informal Working Group on Art. 14 of the draft Convention, UNIDROIT 2008 CONF. 11–Doc. 8, of March 2008.

of the person whose rights are infringed upon or who would benefit from the invalidation of the acquisition; furthermore, he is not liable to that person.³⁶

Conversely, the applicable law determines the consequence when an acquirer is not protected under Article 18(1) or (2). These consequences may result from various types of provisions, including the rules of the non-Convention law regarding who retains which rights and interests, which book entries are invalid or must be reversed, and the possible liability of the transferor, acquirer and intermediaries involved. Article 18(4) refers to 'the applicable law' in respect of the rights and liabilities of the acquirer because other doctrines and remedies may apply, such as unjust enrichment, breach of contract, tort, for which the relevant rules of conflicts designate applicable laws which may be different from the non-Convention law.

The protection of innocent acquirers under Article 18(1) and (2) is a minimum rule. The non-Convention law may expand it, as was discussed and accepted during the negotiations.³⁷

For unexplained reasons, the protection of an innocent acquirer is the chapter where the EU Consultation Document differs most strikingly from the Geneva Securities Convention. Principle 8 is markedly different on several major issues:

- Its scope is significantly narrower than the Convention, as Principle 8 only protects 'against the reversal of a crediting' or 'an earmarking'. It does not address other remedies against the innocent acquirer, such as claims for restitution or damages. And it does not afford any protection to the other two acquisition methods offered in Principle 4.
- Despite textual differences,³⁸ the innocence test does not seem to depart significantly from the Convention. However, it applies to a less defined set of facts, i.e., 'that the crediting or earmarking should not have been made'.

The comments to the Principles in the EU Consultation Document do not provide an explanation for these differences. The broader description of the facts subject to the innocent test may be explained by the nature of

36 Arts. 15(2) and 16 of the Convention, dealing with the consequences of invalid dispositions or book entries, are 'subject to Art. 18'.

37 Art. 18(4) refers to 'the rights and liability, *if any*, of the acquirer' (emphasis added). See Kanda et al., *Official Commentary*, s. 18–16 and s. 18–17.

38 Compare 'unless it actually knows or ought to know, at the relevant time' and 'unless it knew or ought to have known.'

the document, which on most issues is expressed in broad principles for the purpose of the consultation, obviously to be later turned into precise and minute legal drafting.

However, it is difficult to understand why an innocent acquirer under a control agreement should not enjoy the same protection as an innocent acquirer taking his interest through a designating entry. All methods are deemed equivalent by the Principles, which leave the choice to EU Member States. The manner in which the acquirer takes his interest does not change anything regarding its knowledge (or lack thereof), nor regarding the need for protection when other conditions are satisfied.

Additionally, the protection afforded by Principle 8 in the EU Consultation Document is insufficient. Not only should an innocent acquirer be protected against the reversal of the book entry through which he takes his interest, but he should be protected also against other types of claim resulting from his acquisition. Damages and restitution are the most obvious ones. What good is it to have a credit maintained if one has to retransfer intermediated securities to an aggrieved party or pay damages to compensate their loss?

The protection of innocent acquirers, i.e. acquirers acting in good faith, must be broader. It cannot be limited to the validity and irreversibility of the book entries, and must extend to the validity of the rights that have been acquired innocently. The impact of that protection on the party who holds a previous interest in the same intermediated securities is a different issue. It will be illustrated below when comparing the respective scopes of the innocent acquisition rule and the priority rule.

6.6 Priority

The ability of an account holder to grant successive interests in intermediated securities, for example through multiple collateral transactions, is an important feature of the intermediary holding system. It must be supported by clear priority rules. Traditionally, an interest typically takes precedence over subsequent interests in the same property. *Prior tempore potior iure* encapsulates the basic, first-in-time principle governing the ranking of successive partial dispositions of the same intermediated securities. But policy reasons may dictate otherwise, and the parties may agree to multiple transactions.

Article 19 of the Convention determines the priority between interests that become effective under one of the Article 12 methods or under

another method which is provided by the non-Convention law, but not by the Convention itself (non-harmonised method, see Article 13). While the provision may look complex, its three main rules are easily explained.

The first rule is absolute: any interest which became effective against third parties according to an Article 12 method has priority over any interest which became effective by any other method provided by the non-Convention law.³⁹ The priority of internationally harmonised methods over non-Convention methods does not apply to statutory liens and other non-consensual interests, which arise automatically under the non-Convention law and enjoy the priority determined by it.

The second rule determines the priority between Article 12 dispositions. Article 19(3) sets out a strict first-in-time priority among all dispositions made under Article 12, whichever method was employed. This rule, however, can be modified. Under Article 19(7), a Contracting State may declare that an interest granted by a designating entry has priority over any interest granted by another Article 12 method.⁴⁰ This option was introduced at the request of members of the European Union; it reflects a policy choice that designating entries should enjoy a preferential treatment over other Article 12 methods which are not based on book entries. This preferential treatment of designating entries over other methods is presently reflected in Principle 9(1)(c) of the EU Consultation Document.

The third rule allows holders of Article 12 interests to contractually modify their respective ranking as between themselves, obviously without affecting the interests of third parties.⁴¹

The reader will have noted that Article 19 does not apply to interests granted by way of a credit.⁴² It is important to note as well that Article 18, the provision on innocent acquisition, does not modify the priorities determined by Article 19.⁴³ This suggests a complex interaction between the two provisions, on one hand, and debits, credits, and Article 12 methods, on the other. The issue was identified early in the processing leading to the Convention, and was very carefully examined. It arises

39 Art. 19(2) of the Convention. Under Art. 13, the Convention does not preclude any method, other than those in Arts. 11 and 12, that may be provided by the non-Convention law. Contracting States may therefore continue to allow non-harmonised methods for the transfer of intermediated securities or the creation of an interest therein, but such methods enjoy a lower priority than the harmonised methods in Art. 11 and 12 of the Convention.

40 Art. 19(7). 41 EU Consultation Document, Principle 19(6).

42 Art. 19(1) of the Convention only refers to interests made effective under Arts. 12 or 13.

43 Art. 18(6).

from the fact that the innocent acquisition rule and the priority rule are typically antagonistic. Priorities are essentially based on a first-in-time principle (*prior tempore, potio iure*): earlier dispositions have priority over subsequent ones. The protection of an innocent acquirer is definitely a last-in-time rule: innocence protects the last acquirer against holders of previous interests. It is impossible to apply both rules at the same time. In every situation, it must be clear whether the confrontation between two interests (or two dispositions) is governed by one or the other rule.

The Convention achieves this by giving a broad scope to the innocent acquisition provision, only carving out all priority contests between competing interests in the same intermediated securities credited to the same securities account, which are exclusively governed by Article 19, the priority provision.

This is best explained by two examples. In both examples, we assume that A has €1 million worth of bonds credited to his securities account with Bank 1. The applicable law is that of Ruritania, which is a party to the Geneva Securities Convention and has made a declaration that its non-Convention law allows an interest in intermediated securities to become effective against third parties by a designating entry. A has granted to B a pledge over all the bonds credited to A's securities account to secure a loan of €500,000. Upon A's instruction, Bank 1 has made the relevant designating entry. A then takes from C a second loan of €800,000 to be secured by a further pledge over €800,000 worth of bonds.⁴⁴

Example 1. A has instructed Bank 1 to make a designating entry in his securities account in favour of C. Article 19(3) applies to that situation: B's interest has priority over C's interest. If both loans are not paid back, the bonds will be realised, with the first €500,000 paid to B and whatever remains paid to C. The priority of B's interest over C's interest does not hinge upon whether C knew or ought to know at any time that the bonds were subject to a senior interest.

Example 2. A has instructed Bank 1 to transfer certain bonds worth €800,000 to the securities account of C with Bank 2. Depending on the effects of a designating entry under Ruritanian law,⁴⁵ Bank 1 must, may

44 Art. 12(4) provides that an interest made effective under Art. 12 may apply to 'all intermediated securities from time to time standing to the credit of a particular securities account', or to 'a specified category, quantity, proportion or value of such intermediated securities.'

45 Arts. 1(1) and 12(6).

or may not reject the instruction, as unauthorised by B.⁴⁶ Whether or not it was authorised to do so, or whether by mistake, Bank 1 has executed the instruction and the bonds have been debited from A's securities accounts with Bank 1 and credited to C's securities with Bank 2. Please note that, because A and C have so agreed, the credit of bonds made to C's securities account provides C with a pledge (and no more) over these bonds.⁴⁷ Article 19 does not apply to Example 2 because C's interest has not become effective under Article 12. Whether C's interest is junior to B's interest depends here on whether C is protected as an innocent person. C is protected under Article 18(1)⁴⁸ unless she knows or ought to know, at the time of the credit to her account, that B has a prior interest. If C is not protected under Article 18(1), then her situation will depend on the non-Convention law. Supposing that C is protected, what happens to B, to whom all intermediated securities standing to the credit of A's account Bank 1 are pledged, now that bonds worth only €200,000 remain credited to that account? Unless A was allowed by B or by the non-Convention law to dispose of the intermediated securities transferred to C,⁴⁹ B is protected because the debit was not authorised in the meaning of Article 15(1)(a). The non-Convention law – and to the extent it permits, the account agreement or the uniform rules of a securities settlement system – determines the consequences of that unauthorised debit. It may result in the obligation of Bank 1 to buy in the missing securities.

These examples illustrate three important features of the Convention. First, Articles 18 and 19 never apply to the same situation; their respective scopes are set out in Articles 18(6) and 19(1), and they are mutually exclusive. Second, unless the acquirer of a security interest (or any interest for that purpose) knows or ought to know of a prior (senior) interest, she is protected against that prior interest when she takes her own interest by way of a credit to her securities account, a protection that is not afforded when she takes her interest by way of any other method. This is the (intended) result of the unique role of credits and debits in the intermediary holding system. In that respect at least, a credit is stronger than a designating entry or a collateral agreement. Third, the protection of an innocent acquirer does not necessarily create a loss for the person whose rights have been violated. The non-Convention law determines

46 Art. 15(1)(a) and (e). 47 Art. 11(4).

48 Art. 18(2) does not apply because the unauthorised debit to A's account is not a 'defective entry' as defined in Art. 17(d).

49 Art. 15.

the consequences for that person.⁵⁰ If the debit must be annulled or reversed, then the interest is safeguarded as long as the intermediary is not insolvent and can buy in the missing securities. If the debit stands, then the intermediary is most probably liable to that person for having wrongfully executed the transfer instruction; that liability is governed by the non-Convention law and the intermediary may not exclude liability for its gross negligence or wilful misconduct.⁵¹

6.7 Harmonisation and the non-Convention law

Chapter III of the Convention, 'Transfer of intermediated securities', definitely belongs to the core of the harmonisation of the law pursued by the Convention. Nonetheless the present chapter, like most others in this book, evidences the very significant role that non-harmonised provisions, typically referred to as 'the non-Convention law', will and must retain. This is a unique feature of the Geneva Securities Convention as compared with other conventions concluded under the aegis of UNIDROIT or the United Commission on International Trade Law (UNCITRAL). It makes one wonder what the value is of a harmonisation convention that leaves so much space to national laws. Interestingly, the extent of the harmonisation contemplated by the EU Consultation Document is not significantly greater. Few of the policy choices that the Convention leaves for the non-Convention law would actually be made at the European Union level,⁵² and most of them would remain (as is now the case) with EU Member States.

The reasons for such self-limitation have been made clear all along the harmonisation process, from early preparatory documents to formal negotiations in the formal setting of a diplomatic conference. Legal and operational systems for the intermediary holding of securities are very similar in some core features, but remain hugely different as to how those core features are obtained. The legal nature of a credit to a securities

50 When a credit cannot be reversed because the acquirer is protected, legal systems which put a great emphasis on the no-credit-without-debit rule tend to maintain the debit and protect the innocent loser through liability claims.

51 Art. 28(3) and (4).

52 Besides the issues discussed in the text of this chapter, see also EU Consultation Document, Principle 4(3) (if allowed at all, conditional credits 'must be identifiable as such in the account'; Principle 7(1) (book entries can only be reversed in listed circumstances); Principle 9(1)(c) (interests granted by way of earmarking have priority over interests granted by other methods).

account maintained by a French bank is very different from the same credit made to a securities account maintained by a German bank. But they serve the same function and are broadly used in the same contexts and for the same purposes. This similarity of functions resulting from such dissimilar legal systems is not special to the intermediary holding system; it is a very general feature of the law of financial markets, where national legal doctrines and national regulation retain a pre-eminent role. In this context, harmonisation must be limited to the core, functional issues, if it is to be successful at all.

Looking at the results in Chapter III of the Convention only, is there still enough value in the limited uniform provisions resulting from the negotiations between fifty states, which began in Rome and were completed in Geneva? We submit there is indeed, and more than meets the eye. This includes the effectiveness in insolvency proceedings of rights in intermediated securities when they have been made effective against third parties in accordance with the provisions of the Convention. It includes the recognition of a universal method (credits and debits), with the clear recognition that matching debits and credits may be required by law, or may not be required, subject always to the protection of an innocent acquirer. It also includes the three-pronged menu of additional methods that are internationally recognised as strict functional equivalents, even though they are not available in every state, with the corresponding priority rule. Additionally, it prominently recognises that legal provisions, account agreements, and the rules of securities settlement systems, vary hugely as to when book entries are valid or invalid, conditional, or must be reversed, but that such rules cannot defeat the protection of an innocent acquirer.

Diversity and harmonisation are in a dynamic equilibrium. Legal harmonisation contributes to financial stability by improving the internal soundness of and the international compatibility between legal systems. The legal certainty it promotes is valuable to the proper functioning of the financial markets, and ultimately to the financial stability. The two major recent financial crises, the first triggered by the US real estate market, the second by the sovereign debt crises in Europe, suggest that every contribution to the resilience of the financial infrastructure counts.

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