

Law Commission Project on Intermediated Investment Securities

Third Seminar:

Issues affecting Transferees of Intermediated Securities

9.30am, 27 July 2006

Norton Rose
Kempson House
Camomile Street
London EX3A 7AN

EXECUTIVE SUMMARY	5
Formalities of transfer	5
The moment at which interests in securities are acquired	5
Settlement finality	5
Protection of an innocent purchaser	6
INTRODUCTION	7
Terminology	8
The benefits of Intermediation on transferability	8
FORMALITIES OF TRANSFER	10
Approach taken by English law	10
Methods of Transfer	10
Transfer of the legal title	11
Transfer of the equitable title	12
Acquisition of an interest in securities by the Investor	14
Transfer formalities in other Member States	14
The need for a transfer agreement	14
Authorised instructions	15
Perfection of transfer by credit	15
Approach taken by the FMLC	15
Approach taken by US Uniform Commercial Code	16
Approach taken by UNIDROIT Convention	17
Conclusions	18
THE POINT AT WHICH INTERMEDIATED SECURITIES ARE ACQUIRED	19
Approach taken by Member States	19
Approach taken by English law	19
Approach taken by the UNIDROIT Convention	20

Approach taken by the US Uniform Commercial Code	20
Approach taken by the FMLC	20
Conclusions	20
FINALITY OF TRANSFER	21
The Settlement Finality Directive	22
Application of harmonised legal framework to transfers outside of designated systems	24
Approach taken by the FMLC	24
Approach taken by the US Uniform Commercial Code	25
Approach taken by the UNIDROIT Convention	25
Debit must be authorised	25
Credit and debits may be ineffective or reversed by contract, domestic law or system rules	25
The effect of insolvency on the effectiveness of credits and debits	26
Conclusions	26
PROTECTION OF THE INNOCENT TRANSFEREE	26
The common law	27
Negotiability	28
Unavailability of negotiable status for intermediated securities	29
Good faith purchaser without notice	30
Actual notice	31
Constructive notice	31
Imputed notice	32
Good faith purchase and intermediated securities	32
Availability of good faith purchaser defence for intermediated securities	34
Approach taken by Member States	36
Approach taken by the FMLC	37
Approach taken by the US Uniform Commercial Code	38
Approach taken by UNIDROIT Convention	40
Onward dispositions	41

EXECUTIVE SUMMARY

- 1.1 We set out below a summary of the preliminary conclusions reached in this seminar paper.¹

Formalities of transfer

- 1.2 Rights arising under a harmonised legal framework should be constituted and perfected by a credit to the account holder's account. No other formalities should be necessary.
- 1.3 A harmonised rule on transfers should not prevent a transfer being effected by other means under domestic law. The rule is intended to provide a guaranteed means of transfer not the only means of transfer.
- 1.4 The harmonised legal framework should be neutral as to whether the transfer of intermediated securities is an assignment of existing property or the extinction and creation of new rights by way of novation.

The moment at which interests in securities are acquired

- 1.5 By establishing the credit to an account as the constitutive act that creates rights in intermediated securities, it follows that an account holder should acquire rights in securities upon credit of the securities to its account.
- 1.6 The matter of what constitutes a valid credit to an account may be left to national law and the rules of particular settlement systems. Domestic law may also give the transferee a proprietary interest at an earlier point in time (for example, upon acquisition of a proprietary interest by its intermediary).

Settlement finality

- 1.7 A harmonised legal framework cannot attempt to provide an exhaustive list of circumstances in which transfers may be reversed or treated as ineffective. A sufficient level of settlement finality can be achieved by (1) disapplying insolvency rules that void transfers and netting retroactively; (2) preventing a transferor from revoking a transfer order after a certain point in the settlement cycle; and (3) protecting the finality of transfers to innocent purchasers.
- 1.8 The Settlement Finality Directive fulfils the first two of these objectives in relation to certain designated settlement systems. The question remains as to whether harmonised rules should deal with the effect of insolvency and the revocation of transfer orders in the case of transfers outside of designated settlement systems. Our provisional conclusion is that they should not.

¹ These conclusions are preliminary only and are intended to provide a focus for discussion at the seminar.

Protection of an innocent purchaser

- 1.9 In most cases, the difficulty in tracing securities through omnibus accounts and in systems that net transactions will provide an effective shield against most claimants. As a result of the difficulties in tracing pre-existing interests as well as for reasons of efficiency, a person that holds securities through an intermediary should not expect the purchaser of the securities to investigate title to them. Accordingly, if an account holder's intermediary wrongfully transfers securities to a purchaser, the purchaser should take good title unless it has notice or strong suspicion of a violation of another's rights to those securities.
- 1.10 Broadly speaking, the US Uniform Commercial Code prevents an account holder from bringing a claim against a transferee other than in circumstances where the account holder's intermediary cannot remedy the loss itself. Rather than give the account holder a choice of defendant, the rule makes the transferee a defendant of last resort. The rule is consistent with an approach that focuses on the account holder's entitlement as a right against its intermediary. By reducing the possibility that a transferee's rights may be disputed, the principle enhances both liquidity and settlement finality. This approach differs from the laws of Member States (such as the UK) that provide no bar to a claim from an account holder against a transferee of misappropriated securities. In these systems the obstacle that the claimant faces lies solely in whether it can satisfy the constituent elements of the cause of action without the defendant providing a valid defence.
- 1.11 The Uniform Commercial Code goes further still in protecting the transferee by switching the burden of proof to the claimant. If a claimant is a wronged account holder, Article 8 requires the claimant to show the active collusion of the transferee in the violation of its rights. By way of comparison with English law, only personal actions (which do not require the asset to still remain in the recipient's hands) require the claimant to establish fault. Furthermore, collusion suggests a higher standard than the 'unconscionability' that must be shown for knowing receipt.
- 1.12 We believe that a harmonised rule should establish a robust protection for transferees of intermediated securities that reflects the particular commercial expectations and needs of participants in capital markets. While it would mark a departure from current legal practice in Member States, we would like to consider the option of limiting an account holder from making claims against a transferee other than where its intermediary is insolvent and cannot remedy the loss.

INTRODUCTION

- 1.13 This is the third of four seminar papers produced by the Law Commission as a focus for discussion of legal issues concerning the ownership, transfer and pledging of intermediated investment securities. The seminar papers and consultees' responses to them will provide the basis of the Law Commission's Consultation Paper on Intermediated Securities which we expect to publish in early 2007. Further information regarding the scope and context of the project as well as the approach we have adopted to tackling these issues is set out in the first seminar paper available on the project's web-page (at www.lawcom.gov.uk/investment_securities.htm).
- 1.14 The first of the seminars examined the general market needs of participants in intermediated holding systems as set against the twin policy objectives of increasing confidence and efficiency in the intermediated securities market. The primary aim was to establish a list of issues that we should address when considering an EU-wide legal framework.
- 1.15 The second analysed the legal issues most often associated with participants acting in their capacities as account holders and as intermediaries. These issues included (1) the protection of an account holder's securities from the claims of its intermediary's creditors; (2) the allocation of losses between account holders; the enforceability of account holder's rights; (3) the prevention of 'look-through' and upper tier attachment; (4) the scope and level of an intermediary's duties; and (5) intermediary's liability in respect to instructions given by third parties.
- 1.16 This seminar paper is devoted to considering legal issues that affect transferees of intermediated securities. These can be summarised as follows:
- (1) The formalities of transfer;
 - (2) The moment at which securities are deemed to have been transferred;
 - (3) The finality and irrevocability of transfers; and
 - (4) The defences available to a transferee against claims.
- 1.17 In keeping with the approach taken in the second seminar, we have attempted to set out the key practical concerns that the law should address in respect of each of these issues. We examine each issue from the point of view of English law as well as identify different approaches in the way the same legal issue is treated in other EU Member States. We look at the way the issue has been handled by each of:
- (1) the Financial Markets Law Committee's report on indirectly held securities (the 'FMLC Report'),²
 - (2) Revised Article 8 of the United States Uniform Commercial Code; and

² *Issue 3, Property Interests in Investment Securities*, July 2004. Available at http://www.fmlc.org/papers/fmlc1_3_july04.pdf.

- (3) The UNIDROIT Preliminary Convention on Substantive Rules regarding Intermediated Securities (the 'Convention').³

1.18 Finally, we make some brief conclusions at the end of each section. These conclusions are merely preliminary and are intended to provide a focus for discussion.

Terminology

1.19 Consistent with the terminology adopted in the first two seminar papers, we have ascribed the following meanings to the terms below:

- (1) 'Intermediated securities' refers to an account holder's entitlement to securities, as evidenced or constituted (depending on the legal system) by a credit in the account of its intermediary;
- (2) 'Intermediary' means a person that maintains a securities account for an account holder. A securities account for these purposes does not include any account that constitutes the primary record of entitlement against an issuer.
- (3) 'Account holder' means any party that holds intermediated securities through a credit in the account of its intermediary. This may include an account holder that is itself holding as intermediary on behalf of its own account holders.
- (4) 'Investor' refers to an account holder that is not acting as an intermediary in respect of the securities and is therefore ultimately entitled to the benefits derived from them.
- (5) Except where specifically stated, 'pledging' is used in this paper as a generic term to describe the use of securities (or intermediated securities) as collateral. It is not intended to distinguish between the taking of collateral by way of charge, mortgage, pledge or outright transfer. Obviously, each of these possessory and non-possessory methods gives rise to different property rights in the intermediated securities as will be discussed in later seminars.

The benefits of Intermediation on transferability

1.20 Transferability is one of the defining features of investment securities and essential to their economic value. The 'intermediation' of securities, that is to say, the holding of securities through one or more intermediaries, can enhance the transferability of securities in a number of ways.

³ March 2006, UNIDROIT 2006, Study LXXVIII – Doc 42.

- 1.21 For legal systems in which the dematerialisation of securities is not mandatory, intermediation provides a solution to the administrative and procedural burden of paper certificates by immobilising them at the level of the upper tier intermediary.⁴ The need for endorsed certificates or executed stock transfer forms to dispose of securities is also generally limited to transfers of directly held securities. Below this level, the record of ownership is represented by computerised book-entries. Computerisation can far better cope with the huge volume and complexity of trades that take place daily on the capital markets. It can also reduce the effect of human error and protect the investor from the risk that a physical certificate may be lost, destroyed or forged.
- 1.22 The role played by an account holder's intermediary in the transfer and settlement of intermediated securities can also generate significant efficiencies. A financial institution acting as intermediary will have the resources and expertise to access a computerised settlement system and settle trades effectively. The intermediary of an actively managed account is also likely to have authority conferred upon it by the account agreement to take action in relation to custody assets without the need to obtain a mandate on each occasion. Enabling an intermediary to manage its customers' accounts in this way creates time and cost savings.
- 1.23 Thirdly, intermediation allows intermediated securities to be transferred at any tier of the holding chain. The ability to transfer intermediated securities across the books of an intermediary rather than requiring each transfer to be recorded in the primary register of the issuer or settlement operator produces a highly effective division of labour. As one commentator has observed,
- ...it is more efficient to have many parties under a proper division of labour dealing and also competing with each other in serving thousands of customers rather than one large depository, petrified in rigid procedures and low incentives, performing a tremendous number of different and complex activities.⁵
- 1.24 Finally, legal systems that grant each intermediary in the chain with a legal position in the securities that it holds greatly expand the use of intermediated securities as collateral. With the consent of their account holder, intermediaries at each tier can more use securities as collateral, albeit that pledges taken over intermediated securities will be subordinated to interests taken at a higher tier.⁶
- 1.25 Intermediation can therefore be of great benefit to securities settlement. It can however also generate challenging legal issues. In some cases, this arises from a failure to adapt the legal concepts applicable to directly held physical assets to intermediated securities that are indirectly held and intangible in nature.

⁴ This upper tier intermediary will typically be a central securities depository (CSD).

⁵ N Paspasyrou, 'Immobilisation of Securities: part 1 – Proprietary Rights of Indirect Holders' JIBL (1996), 11(10), 430-435 p 431.

⁶ This principle of upper tier priority will be considered in detail in the Collateral Seminar.

FORMALITIES OF TRANSFER

- 1.26 Both market confidence and efficiency require that the steps necessary to transfer securities are legally certain and operationally convenient. Member States require a range of different formalities to be observed by the transferor and transferee in order for a transfer to be considered legally valid and binding on the parties and effective against third parties. A level of harmonisation is necessary, however, to remove legal uncertainty from cross-border settlement within the EU.

Approach taken by English law

Methods of Transfer

- 1.27 Before considering the formalities required to transfer securities under English law, it is first necessary to consider how the transfer should be characterised. There are three ways in which securities can be transferred in legal terms.

TRANSFER BY NEGOTIATION

- 1.28 The first method is by negotiation. Crucially this requires the securities being transferred to have negotiable status.⁷ Negotiation allows transfer to be effected by delivery of the negotiable instrument and confers considerable protection to the purchaser.⁸ Intermediated securities cannot have negotiable status as they are intangible assets akin to registered securities and therefore incapable of transfer by delivery. As a result, only an upper tier intermediary with the negotiable securities in its possession can transfer them by negotiation.

TRANSFER BY ASSIGNMENT

- 1.29 The second method of transfer is assignment. Both the legal and equitable title to securities can be transferred by assignment. Equitable assignment requires fewer formalities than assignment of the legal title but both types of assignment must be in writing.⁹ Legal assignment must be absolute (that is to say, the entirety of the assignor's interest in the securities must be assigned) and written notice must be given to the obligor (namely, the issuer).
- 1.30 As we discussed in the second seminar, an intermediary that operates an account governed by English law will, in the great majority of cases, hold securities on trust for the account holder. Accordingly, only the upper tier intermediary will hold the legal title to the underlying securities with the intermediaries and investor below them each having an equitable interest carved out of the equitable title of the intermediary directly above it.

⁷ Not all securities are negotiable. Registered securities are not negotiable whereas most forms of non-computerised bearer debt securities are negotiable securities. See para 1.116 below.

⁸ See paras 1.113-1.115 below.

⁹ Law of Property Act 1925, s 53(1) [in relation to equitable assignments] and s 136 [in relation to legal assignments].

- 1.31 Transfers by assignment across the books of an intermediary can therefore only take effect as assignments of an equitable interest. Unlike legal assignments of the underlying securities, intermediated securities that are equitably assigned are subject to pre-existing equities (such as a right of set-off). Equitable assignees are also generally unable to sue the intermediary on whose books the transfer occurred without joining the assignor to the action. These weaknesses make assignment an unattractive means of settling intermediated securities.¹⁰

TRANSFER BY NOVATION

- 1.32 There is both academic support¹¹ and case authority¹² for the proposition that transfers of intermediated securities take effect by way of novation. This third method does not involve the transfer of the same interest but the replacement of an obligation owed by an obligor to the transferor with a new, equivalent obligation owed from the obligor to the transferee. The obligor in the case of settlement of intermediated securities will be the issuer or the intermediary across whose accounts the transfer is effected.
- 1.33 Novation necessarily requires the agreement of the obligor. In the case of a novation on the books of an intermediary this agreement could be seen as implicit in the intermediary's debit and credit of the respective accounts.

Transfer of the legal title

- 1.34 As noted above, only the upper tier intermediary holding directly from the issuer will have the legal title to securities. The legal title to the securities can therefore only be transferred if the purchaser or an intermediary on its behalf acquires the legal title from the upper tier intermediary. This is effected by delivery (in the case of bearer securities) or by amendment of the register operated by or for the issuer (in the case of registered securities).
- 1.35 Upon transfer of the securities, the purchaser or its intermediary (if the purchaser holds indirectly) will hold them directly from the issuer. As the transfer is a transfer of directly held securities (and not intermediated securities) the formalities required to perfect it are outside the scope of this project.

¹⁰ A further weakness, is the inability of an assignment to transfer the burden of a contract along with the benefit. While securities will not typically impose a burden on the owner, it is not impossible that the assignor may be subject to restrictions of transfer or warranties and representations in relation to its ownership.

¹¹ See J Benjamin, *Interests in Securities* (2000), p 70.

¹² See *R v Preddy* [1996] AC 815 in which the House of Lords held that a mortgage advance credited to the account of the appellants from the account of its lender did not constitute theft under s 15(1) of the Theft Act 1968 as the advance did not *belong to another*. The debit and credit did not transfer the same chose in action but extinguished a chose in action in one account and created a new chose in action in the appellants' account.

Transfer of the equitable title

- 1.36 If a transfer takes place on the books of an intermediary,¹³ the transfer will constitute a disposition of an equitable interest. No change will be made to the records of the issuer or of the higher tier intermediaries above the intermediary on whose books the transfer was made. Legal title will remain with the upper tier intermediary.
- 1.37 The computerisation of account holders' records by financial intermediaries means that book-entry transfers are effected electronically. Parties to transactions may issue written confirmations but these are for record purposes and are not intended to constitute transfer documents, especially as they post date the transfer.
- 1.38 This method of electronic transfer may be at odds with the statutory requirements for disposing of equitable interests. Section 53(1)(c) of the Law of Property Act 1925 provides that,

A disposition of an equitable interest or trust subsisting at the time of the disposition, must be in writing signed by the person disposing of the same, or by his agent thereunto lawfully authorised in writing or by will.

- 1.39 In *Grey v Inland Revenue Commissioners* the House of Lords considered at length the meaning of 'disposition' in section 53(1)(c) of the Act.¹⁴ While they did not come to a conclusive definition, it was held that 'disposition' should be given its 'ordinary and natural meaning' and that assignments did fall within the scope of the section.¹⁵ Viscount Simonds noted that,

If the word 'disposition' is given its natural meaning, it cannot, I think, be denied that a direction given by Mr Hunter whereby the beneficial interest in the shares theretofore vested in him became vested in another or others is a disposition.¹⁶

¹³ It should be remembered that, unlike many settlement systems, CREST is not an intermediary. With the exception of CREST Depositary Receipts (CDIs) which represent interests in foreign listed securities, the legal title to securities does not reside with CRESTCo. CREST operates a register that establishes the legal title of the CREST participant, who consequently holds directly from the issuer of the securities. See Seminar Paper Two paras 1.192-1.193.

¹⁴ [1960] AC 1.

¹⁵ [1960] AC 1, Viscount Simonds at p 13.

¹⁶ [1960] AC 1, p 12.

- 1.40 While an assignment falls within the definition, it is less certain whether a transfer by novation constitutes a 'disposition' for the purposes of the Act. If the original obligation is extinguished and a new one created, there is arguably no disposition.¹⁷ However, there can be no certainty that novations would be excluded from an expansive application of the word. Furthermore, if the equitable interest is transferred by novation to an intermediary that holds the securities on trust for an account holder, the declaration of a sub-trust by the intermediary may itself constitute a 'disposition'.¹⁸ Consequently, the issue cannot easily be avoided.
- 1.41 Purported dispositions that do not comply with section 53(1)(c) are treated as void. This would have the effect of leaving the transferee with merely contractual rights against the seller, which would be vulnerable to the transferor's insolvency or to a subsequent transfer by the transferor to a third party.¹⁹
- 1.42 A number of solutions have been put forward by commentators to address the writing requirement presented by section 53(1)(c). It has been suggested that, the simple record-keeping of intermediaries should be sufficient to satisfy the requirement for writing.²⁰ This argument is based on the definition of 'writing' in the Interpretation Act 1978 which includes typing, printing, lithography, photography and other modes of representing or reproducing words in a visible form.²¹
- 1.43 An alternative answer is to argue that the interest of the purchaser in the securities is protected by a constructive trust.²² While it is generally not possible to specifically enforce a contract for the sale of listed securities in the secondary market, *Chinn v Collins* is authority for the proposition that contracts for the sale of shares do give rise to constructive trusts from the moment that the purchase price is paid.²³
- 1.44 A more complex analysis is based on the assumption that a transfer of securities into a pooled account confers on an account holder a co-ownership interest. If so, this co-ownership interest should be viewed as an alteration of the membership of the pool of co-owners by way of a succession rather than a disposition into the pool.²⁴

¹⁷ See J Benjamin, *Interests in Securities* (2000), p 72, note 48.

¹⁸ B Green, 'Grey, Oughtred and Vandervell – A contextual reappraisal' MLR (1984) Vol 47, No. 4 385, p 393.

¹⁹ See Trust Law Committee Working Party, *Equitable Problems in the Securities Markets* (1998).

²⁰ A O Austen-Peters, *Custody of Investments* (2000) p 69.

²¹ Interpretation Act 1978, s 5, Sch 1.

²² Trust Law Committee Working Party, *Equitable Problems in the Securities Markets* (1998) p 7.

²³ [1981] AC 533.

²⁴ Trust Law Committee Working Party, *Equitable Problems in the Securities Markets* (1998) p 9. See also J Benjamin *Interests in Securities* (2000) p 72.

- 1.45 Notwithstanding these possible solutions to the potential application of section 53(1)(c), the intermediated securities system in the UK could benefit from legislation to clarify that writing is not required to transfer intermediated securities.

Acquisition of an interest in securities by the Investor

- 1.46 The analysis above has touched briefly on the transfer of legal title across the books of the issuer (or CREST) and focussed secondly on transfers of the equitable interests across the books of an intermediary. This is the level at which the transfer takes place. If the transfer is not to the investor but to an intermediary through which the investor holds, the point at which the investor receives a proprietary interest in the securities is likely to be a matter of trust law. This is discussed in the next section dealing with the timing of transfers.

Transfer formalities in other Member States

- 1.47 While the formalities of transfer amongst Member States are subject to a range of variations, general requirements common to large groups of states can be identified.

The need for a transfer agreement

- 1.48 A large number of Member States require entry into a valid transfer agreement in order to transfer securities.²⁵ The agreement need not comply with specific formalities and it is not clear in every case whether a transfer agreement is a mandatory requirement or simply reflects the usual procedure for the transfer of securities in that particular legal system.
- 1.49 Both Belgium and Luxembourg require a valid transfer agreement between seller and purchaser. A valid contract is also necessary for transfers under Czech law although no formal arrangements are required.
- 1.50 Under German law, ownership in securities passes from seller to purchaser by a contract of transfer.²⁶ This transfer contract is distinct from the contractual obligation to purchase securities and is discharged simultaneously with the debit and credit of the accounts.
- 1.51 A contract between two investors initiates the transfer process in Italy by creating the right of the transferee to receive title to the securities.
- 1.52 In order for a transfer of securities to be legally effective in the Netherlands, there must be a valid agreement (written or unwritten) or other legal basis for transfer, by a person with power to dispose of the assets.

²⁵ These include Belgium, Luxembourg, Czech Republic, Germany, Estonia, Italy, Netherlands, Austria, Poland and Denmark (if not a transfer in a CSD account).

²⁶ Section 929 et seq. Civil Code. If transfer is not already completed earlier by contract, the of co-ownership interests in securities held in collective safe custody by the CSD will be effected by crediting the purchaser's account under Securities Deposit Act, section 24(2).

Authorised instructions

- 1.53 Settlement through central securities depositories (CSDs) is subject to compliance with the rules of the relevant settlement system. These rules are likely to specify the correct manner in which sale and purchase instructions are made to the CSD.
- 1.54 Examples of Member States that require authorised instructions for valid transfers include Denmark, Estonia, France,²⁷ Portugal²⁸ and Slovenia²⁹.

Perfection of transfer by credit

- 1.55 In a large majority of Member States³⁰ a transfer of securities is not effective against third parties until the purchaser's account is credited. The credit is the constitutive act necessary to give the purchaser property rights (or their equivalent).

Approach taken by the FMLC

- 1.56 The FMLC Report sets out a series of principles intended to form the basis of English legislation (the 'FLMC Principles'). The Principles do not make express reference to the steps necessary to transfer securities other than to state that dealings in interests in securities are made enforceable against third parties by the transfer of control without need for further formalities.³¹
- 1.57 A person is said to have control of interests in securities if:
- ...it is entitled, or entitled and able, to direct how they shall be dealt with. For example, X may take control by having the interests in securities credited to its own account. Alternatively, it may leave them in the client's account, but obtain the agreement of the intermediary that it will deliver the interests in securities in accordance with X's instructions without further consent of the customer. Whether the customer could itself continue to operate the client account would depend on the agreement with X. Where interests in securities are agreed to be given as security to the intermediary itself, no further step is required to perfect such security.³²

²⁷ Transfers of registered securities on the French CSD require an authorised financial intermediary maintaining the account to submit a registered share message setting out the necessary information.

²⁸ A debit entry must be accompanied by a written order of the account holder.

²⁹ In Slovenia, a transfer order submitted to a holder's registry member in the CSD constitutes both a legal transaction to dispose of securities and a mandate to the registry member to enter the order into the central registry.

³⁰ Examples of Member States requiring a credit to perfect the transfer include Germany, Greece, France, Italy, Cyprus, Latvia, Lithuania, Luxembourg, the Netherlands (for securities subject to the Securities Giro Administration and Transfer Act), Poland, Portugal, Slovakia and Finland.

³¹ FMLC Principle 6(a).

³² FMLC Principle 6(b).

- 1.58 Only the first example in this definition, the credit of securities to the transferee's account, constitutes a method of obtaining control by outright transfer. The other examples take the form of non-possessory security interests.³³ Control by way a credit to an account gives the transferee property rights without need for further formalities. The Principles do not however expressly make this the exclusive means of transferring an interest in securities. The commentary to the Principles notes that 'entry on the client account is essential to priority, not to property'.³⁴

Approach taken by US Uniform Commercial Code

- 1.59 Revised Article 8 of the UCC appears to take a slightly different conceptual approach to the transfer of securities. Unlike the prior version of Article 8, section 8-501 of revised Article 8 is not based on the idea that an entitlement holder acquires rights only by virtue of a 'transfer' from the securities intermediary to the entitlement holder. The significant fact is that the securities intermediary has undertaken to treat the customer as entitled to financial assets. The entitlement holder's rights against the securities intermediary do not depend on whether or when the securities intermediary acquired its interest – it is entirely possible that the entitlement holder may acquire rights against the intermediary despite a failure or operational gap in the delivery of the securities.³⁵ The section therefore focuses on the acts necessary to acquire the package of rights (called a 'securities entitlement') enforceable against an intermediary. This securities entitlement is not something that is traded. In most cases, settlement of securities will involve the termination of one person's securities entitlement and the acquisition of a securities entitlement by another person.³⁶
- 1.60 Section 8-501(b) sets out the general rule for acquiring a securities entitlement against an intermediary. It states:

(b) Except as otherwise provided in subsections (d) and (e), a person acquires a security entitlement if a securities intermediary:

- (1) indicates by book entry that a financial asset has been credited to the person's securities account;
- (2) receives a financial asset from the person or a financial asset for the person and, in either case, accepts it for credit to the person's securities account; or

³³ Note that it is sufficient, for the purposes of the FMLC definition of control, for a person to take 'positive' control (ie have the ability to dispose of securities). The Law Commission concluded in its recent report on Company Security Interests (Law Com No 296) that 'negative' control is necessary (ie the ability to prevent others from disposing of the asset) in order to comply with the meaning of control intended by the Financial Collateral Directive. We will consider this issue in more detail in the next seminar.

³⁴ FMLC, *Issue 3, Property Interests in Investment Securities* (July 2004), p 21.

³⁵ Note 3 of the Official Comment to UCC§8-501.

³⁶ Note 5 of the Official Comment to UCC§8-501. This analysis appears to replicate a transfer by novation in English law.

- (3) becomes obligated under other law, regulation, or rule to credit a financial asset to the person's securities account.
- 1.61 The Official Comment to the section notes that section 8-501(b)(1) is not intended to give any guidance as to what accounting, record-keeping, or information transmission steps suffice to indicate that the intermediary has credited the account. That is left to agreement, trade practice, or rule in order to provide the flexibility necessary to accommodate varying or changing accounting and information processing systems.³⁷ Paragraph (2) of sub-section (b) sets out a different operational test, turning not on the intermediary's accounting system but on the facts that accounting systems are supposed to represent. Paragraph (3) of sub-section (b) sets out a residual test to avoid any implication that the failure of an intermediary to make the appropriate entries to credit a position would prevent the customer from acquiring the rights of an entitlement holder.³⁸

Approach taken by UNIDROIT Convention

- 1.62 Article 4 of the Convention deals with the acquisition and disposition of intermediated securities. It states that:

Intermediated securities are acquired by an account holder by the credit of securities to that account holder's securities account;

- (1) No further step is necessary, or may be required by the domestic non-Convention law, to render the acquisition of intermediated securities effective against third parties.
- (2) Intermediated securities are disposed of by an account holder by the debit of securities to that account holder's securities account.
- (3) Without prejudice to any rule of the domestic non-Convention law requiring that no credit or debit may be made without a corresponding debit or credit, a debit or credit of securities to a securities account is not ineffective because it is not possible to identify a securities account to which a corresponding credit or debit has been made.
- (4) Debits and credits to securities accounts in respect of securities of the same description may be effected on a net basis.
- (5) This Article does not preclude any other method provided by the domestic non-Convention law for the acquisition or disposition of intermediated securities.

³⁷ Note 2 of the Official Comment to UCC§8-501.

³⁸ Note 2 of the Official Comment to UCC§8-501.

- 1.63 The Convention establishes a credit to an account holder's account as the one formal step necessary to make and perfect a transfer. This is subject only to the requirement in some legal systems that the credit be matched with a corresponding debit.³⁹ Basing an acquisition upon a credit to the account holder's account necessarily coincides with the point at which an account holder obtains rights against its intermediary under Article 9.
- 1.64 The absence of additional formalities does not however mean that every transfer effected by a credit will necessarily be final and irrevocable. Article 8 of the Convention requires that the intermediary making the debit or credit must be authorised to do so by the account holder or by domestic law. This is dealt with in more detail below in the section dealing with finality.⁴⁰
- 1.65 The Convention makes no reference to what record-keeping action must be taken to indicate that an intermediary has credited an account. This will consequently be subject to domestic law and the rules of the settlement system.
- 1.66 Finally, Article 4(5) of the Convention allows domestic law to provide for other methods of acquisition and disposition of intermediated securities. The purpose of the Article is not to establish an exclusive rule for transfer but to act as a safe harbour rule, giving transferees within the EU comfort that a credit will be sufficient to transfer the securities.

Conclusions

- 1.67 We agree with the approach taken by the Convention. Rights arising under a harmonised legal framework should be constituted and perfected by a credit to the account holder's account. No other formalities should be necessary. Whether or not these rights are subject to reversal is dealt with later in this paper.
- 1.68 The harmonised rules should not prevent transfer being effected by other means under domestic law. The rule is intended to provide a guaranteed means of transfer not the only means of transfer.
- 1.69 The harmonised legal framework should be neutral as to whether the transfer of intermediated securities is an assignment of existing property or the extinction and creation of new rights by way of novation.

³⁹ Examples of Member States with 'matching' systems include Germany, Spain, Cyprus, Austria and Portugal. In the case of Austria and Portugal the matching requirement applies only to transfers recorded on the register of the CSD. Finland and Sweden also have systems in which every transfer can be traced thereby minimising the likelihood of a shortfall arising. See Seminar Paper Two paras 1.98-1.100.

⁴⁰ See paras 1.98-1.99.

THE POINT AT WHICH INTERMEDIATED SECURITIES ARE ACQUIRED

- 1.70 The point in time at which securities are legally acquired follows on closely from a discussion of the formalities required to make and perfect a transfer. Simply put, a purchaser is likely to have a personal claim against the seller upon creation of a valid transfer agreement. The transfer is likely to occur and be effective against third parties simultaneously upon completion of the legal and operational steps required to make it.

Approach taken by Member States

- 1.71 While the formalities of transfer differ to a greater or lesser degree between Member States, a large number of them share the requirement that a transfer must be credited in the account holder's account before it can be effective against third parties. A credit will invariably take place simultaneously with the corresponding debit that disentitles the transferor. Making a transfer conditional upon a credit may simply satisfy an operational step set out by statute or settlement system rules,⁴¹ Alternatively, the credit may be necessary to identify the assets so as to satisfy general legal principles in relation to the transfer of fungible securities.⁴²
- 1.72 If a purchasing investor does not receive the securities directly but through an intermediary, the law in most Member States will not give the purchasing investor a proprietary interest effective against third parties until the intermediary credits its account.

Approach taken by English law

- 1.73 English law gives a transferee rights at an earlier point in time. On the assumption that the intermediary will hold securities on trust for its account holders, the account holders should generally receive equitable proprietary rights in the securities as soon as the trust is established and the trust assets become identifiable in the hands of the intermediary. This will most likely occur once the securities are credited to the intermediary's account. Failure to credit the securities to the account holder's account should not affect these rights provided that the account holder can demonstrate its entitlement to the trust assets.

⁴¹ Eg Spain, Portugal (article 80.1 CVM), Slovenia.

⁴² Under the Civil Code in Luxembourg, fungible securities constitute non-identifiable movables. Transfer does not occur until the movable is identified. In practice, identification will generally coincide with the credit of the securities in the transferee's account. In Italy, there is debate as to whether a transfer of securities between two intermediaries occurs upon a credit in the intermediary's account or upon a credit in its account holder's account. It has been suggested that the latter is the better view as it Italian law bases the transfer of title to fungible assets on the identification of those assets.

- 1.74 It is of course within the powers of the intermediary and account holder to agree that the account holder's entitlement should arise at some other point in time between credit of the intermediary's account and credit of the account holder's account. Furthermore, in *Momm v Barclays Bank*⁴³ the court held that payment of cash transfer into a payee's account was completed when the intermediary bank decided to accept the payor's instructions to credit the payee's account and the computer processes were set in motion.

Approach taken by the UNIDROIT Convention

- 1.75 The Convention has taken the same approach as that adopted by most EU Member States by establishing the moment of transfer as being the credit in the account holder's account. While the Convention does not prevent the account holder from enjoying additional (and potentially earlier) rights in securities, the account holder will not be protected under the Convention from the insolvency risk of its intermediary in respect of securities that it receives until such time as the credit is made. Nor will it receive Convention rights in the securities enforceable against its intermediary (and the issuer in direct enforcement systems)⁴⁴ until the securities are credited to its account.

Approach taken by the US Uniform Commercial Code

- 1.76 While the Convention does not specify exactly what actions constitute a credit in an account, the rights under the Convention do not extend to circumstances in which the intermediary is obligated to credit the account but has failed to do so. By contrast, Section 8-501(b)(3) of UCC Revised Article 8 ensures that an entitlement holder will receive a package of personal and property rights against its intermediary once its intermediary becomes obligated under other law, regulation, or rule to credit a financial asset to the person's securities account even if no credit has yet been made.

Approach taken by the FMLC

- 1.77 The FMLC Principles are silent on the issue of when securities should pass to a transferee. The FMLC Report does, however, suggest that the law should be clarified by legislation stating that, as against creditors of the intermediary, property passes to the account holder when (a) the parties so agree and (b) the assets are sufficiently identifiable in the hands of the intermediary.⁴⁵

Conclusions

- 1.78 By establishing the credit to an account as the constitutive act that creates rights in intermediated securities, it follows that an account holder should acquire rights in securities upon credit to the account holder's account.

⁴³ [1977] 1 QB 790

⁴⁴ By 'direct enforcement system' we mean domestic law or settlement system rules that permit an investor holding through an intermediary to have the right to enforce the terms of the securities directly against the issuer. This is a common legal position taken by Member States in the EU which treat the investor as having the sole legal ownership of the securities. See Seminar Paper Two, paras 1.188-1.190.

⁴⁵ *Issue 3, Property Interests in Investment Securities*, July 2004, p 21.

- 1.79 The matter of what constitutes a valid credit to an account may be left to national law and the rules of particular settlement systems. Domestic law may also give the transferee a proprietary interest at an earlier point in time (for example, upon acquisition of a proprietary interest by its intermediary).

FINALITY OF TRANSFER

- 1.80 The concept of settlement finality is not defined as a matter of general law in Member States. Even the Settlement Finality Directive, described below, makes no attempt to define the term. Nevertheless, finality of transfer is of pivotal importance to removing legal risk in the cross-border settlement of securities. The Committee on Payment and Securities Systems has defined it as:

...a concept that defines when payment, settlement and related obligations are discharged. A final transfer is an irrevocable and unconditional transfer which effects a discharge of the obligation to make the transfer.⁴⁶

- 1.81 Uncertainty as to the finality of transfers can affect both account holders and intermediaries. UNIDROIT has noted three ways in which finality is crucial in order for the transfer of securities to operate effectively:

- (1) first, where an intermediary is instructed to credit securities to an account of its own account holder on the basis of a corresponding credit made to its own account maintained with a higher tier intermediary, it needs to be confident that the credit to its own account cannot be reversed. This position arises in every case where an investor transfers securities to another investor who does not happen to maintain a securities account with the same intermediary – an extremely common situation;
- (2) second, an intermediary needs to be confident that, once instructions to effect an entry on a securities account have been given, or input into an electronic system, those instructions cannot be reversed, either as a result of a change of mind or (probably a more serious risk in practice) as a result of the insolvency of the person giving the instructions;
- (3) third, an account holder who receives a credit of securities to his account needs to be confident that the credit is not liable to be reversed as a result of the insolvency of another account holder from whose account a corresponding debit has been made.⁴⁷

⁴⁶ CPSS, *Central bank payment and settlement services with respect to cross-border and multi-currency transactions* (September 1993).

⁴⁷ UNIDROIT, *The UNIDROIT Study Group on Harmonised Substantive Rules Regarding Indirectly Held Securities – Position Paper* (August 2003), p 22.

- 1.82 Finality can be seen as comprising of two related but distinct legal issues. The first relates to the enforceability of a valid agreement in the event of the transferor's insolvency. The second is concerned with the revocability of the transfer for lack of validity or other grounds. The revocability of the transfer may depend not only the validity of the transfer but on the validity of the underlying contract.
- 1.83 As the time taken for trades to settle can still run into days, the possibility remains that a transferor may fall insolvent or wish to revoke the transfer prior to settlement taking place. Finality is largely achieved by relying upon system rules that prescribe the actions necessary to submit a valid transfer order and that identify exact point in time that a transfer order becomes irrevocable. Statutory rules can also exclude the application of national insolvency laws that could otherwise void a transfer. Because these system rules can conflict with general avoidance rules under national insolvency rules, their scope is often limited to participants holding directly from a CSD. Finality of transfer at lower levels of a chain of holding may therefore fall outside the rules specifically designed for securities settlement. Account holders below the level of the system rules must instead rely on general insolvency, property and contract laws.

The Settlement Finality Directive

- 1.84 In 1998, the Settlement Finality Directive⁴⁸ (the 'Directive') was passed to reduce systemic and legal risk in payment and securities settlement systems in the EU and has been described as a 'landmark in the harmonisation of substantive security and insolvency law'.⁴⁹ The Directive ensures the finality of transfer orders and netting, as well as the enforceability of collateral security within designated systems throughout the EU.
- 1.85 The Directive is narrow in scope. The 'systems' to which it applies are defined as formal arrangements between (usually) three or more participants with common rules and standardised arrangements for the execution of payment or securities transfer orders between the participants. Member States may designate systems as qualifying. Participants in a system are limited to supervised financial institutions, public authorities, central counterparties, settlement agents and clearing houses.

⁴⁸ Directive 98/26/EC of 19 May 1998 on settlement finality in payment and securities settlement systems.

⁴⁹ E Johansson, 'Transfer and Settlement of Securities: The New Order', (2005) EBLR 1093, p 1105.

- 1.86 Finality in respect of securities transfers is achieved by a combination of three provisions. Article 3 of the Directive ensures that transfer orders and netting made before the commencement of insolvency proceedings remain legally enforceable against a participant. Article 7 abolishes the 'zero hour rule'⁵⁰ applied by some Member States in respect of the moment at which insolvency proceedings are deemed to take effect. Finally, transfer orders are made irrevocable by Article 5 from the moment defined by the rules of the system.
- 1.87 As the Directive ensures the finality of transfers, the revocation of transfer orders is not permitted within a designated system. Recital 13 of the Directive indicates however that nothing should prevent a participant or a third party from exercising any right or claim resulting from the underlying transaction which they may have in law to recovery or restitution in respect of a transfer order. An account holder's remedies for fraud, negligence or other wrongdoing in relation to misappropriated securities are therefore unchanged by the Directive and will depend upon the domestic law of the relevant Member State. As has been mentioned before in the course of these seminars, an account holder's legal remedies (beyond those against its own intermediary) lie outside of the scope of the EU Commission's objective to harmonise legislation in this area of securities law.
- 1.88 While an account holder may recover securities or damages in the event of fraud, the manner in which it does so must not lead to an unwinding of a netting transaction or the revocation of the particular transfer order in question.⁵¹ If securities are returned to the account holder this could be done either outside of the settlement system or, if allowed, by a new transfer order within the system. The original order is not revoked.
- 1.89 Reversal of erroneous credits is generally a matter for the rules of the system.⁵² It should be possible to reverse credits that have been made erroneously without contravention of the Directive as no valid transfer order is likely to have been made.⁵³

⁵⁰ Under the 'zero hour rule' the commencement of insolvency proceedings was treated as taking effect retroactively from the first minute of the day on which the proceedings were initiated. Under Article 6(1) of the Directive, the moment of opening of insolvency proceedings shall be the moment when the relevant judicial or administrative authority handed down its decision.

⁵¹ Recital 13, Settlement Finality Directive.

⁵² The systems of most Member States do permit erroneous credits to be reversed although some do not have specific rules on this (e.g. Estonia, Ireland, Latvia, Lithuania, Malta, Slovenia). While French law provides that a person who receives something in error must return it, Article L.330-1 of the Monetary and Financial Code which applies in the case of delivery versus payment systems, indicates that transfers are irreversible notwithstanding any legislation to the contrary.

⁵³ Slovakian law requires a separate transfer order to rectify an erroneous credit.

Application of harmonised legal framework to transfers outside of designated systems

- 1.90 The Directive is currently under review to consider ways in which it can be improved or clarified to adapt to changes in the financial markets.⁵⁴ A harmonised legal framework for intermediated securities would necessarily need to be compatible with the Directive and avoid encroaching on issues of finality that fall within its scope.
- 1.91 The question remains as to whether the treatment of finality should be harmonised within the EU where the transfer is not covered by legislation implementing the Directive. Transfers outside of designated systems are most likely to be subject to general principles of contract, property and insolvency law. In particular, mandatory national insolvency rules may protect general creditors at the expense of transferee by voiding transfers, in some cases retroactively. They may also treat close-out netting transactions as unenforceable.
- 1.92 Extending harmonised rules to cover all settlements of intermediated securities would be consistent with the general scope of application that we envisage for a harmonised legal framework. If other harmonised rules are not limited to CSDs and their direct participants, it would seem incongruous to limit their application when dealing with settlement finality. On the other hand, as we have seen, settlement finality has significant implications for national insolvency law and policy, an area that a harmonised legal framework should generally avoid. By permitting transfers, netting and set-off to take effect despite insolvency, the Directive is detrimental to the interests of general creditors. To simply extend the effect of the Directive to all securities settlements could unduly upset the balance between protecting creditors on the one hand and promoting efficiency and stability in securities markets on the other.⁵⁵

Approach taken by the FMLC

- 1.93 The commentary on the FMLC Principles states that English legislation should be silent on the question of irrevocability for insolvency purposes as the policy justification for disapplying insolvency displacement rules is systemic and should not be universally applied in all intermediated systems.⁵⁶

⁵⁴ See K Lober, *The Developing EU Legal Framework for Clearing and Settlement of Financial Instruments*, European Central Bank Legal Working Paper Series No. 1 (February 2006) pp15-19 which sets out the scope and application of the Directive in greater detail.

⁵⁵ See E Johansson, 'Transfer and Settlement of Securities: The New Order', (2005) EBLR 1093, p 1106.

⁵⁶ *Issue 3, Property Interests in Investment Securities*, July 2004, p 24.

Approach taken by the US Uniform Commercial Code

- 1.94 Where the buyer and seller of securities do not use the same broker but hold through separate financial intermediaries, the settlement function will generally be performed through a clearing agent or clearing corporation. These clearing corporations will net the transactions of the respective intermediaries and will have their own rules regarding the finality and reversibility of settlements. Article 8-111 preserves the clearing corporation's ability to set its own rules even if they conflict with the Uniform Commercial Code.
- 1.95 The commentary to the section notes that permitting clearing corporations to have their own rules is desirable to ensure that commercial law does not operate as an obstacle to developments in securities practice. It notes that,
- Even if practices were unchanging, it would not be possible in a general statute to specify in detail the rules needed to provide certainty in the operations of the clearance and settlement system.

Approach taken by the UNIDROIT Convention

- 1.96 Article 8 of the Convention sets out the circumstances in which a credit to an account may be deemed ineffective or capable of reversal.

Debit must be authorised

- 1.97 A debit will not be valid unless the relevant intermediary has authority to make the debit.⁵⁷ Authority can be given by the account holder or can otherwise be conferred by domestic law. While not explicit in the drafting, authority could be given as a general mandate to the intermediary to deal in the intermediated securities and may not require a specific transfer instruction. Authority should not, however, arise automatically upon the opening of an account unless the account agreement confers that authority. No authority is required to *credit* an account.

Credit and debits may be ineffective or reversed by contract, domestic law or system rules

- 1.98 Article 8(2) states that:
- The domestic non-Convention law and, to the extent permitted by domestic non-Convention law, an account agreement or the rules and agreements governing the operation of a settlement [or clearing] system, may provide that a debit or credit of securities or a designating entry is not effective or is liable to be reversed.
- 1.99 Article 8(3) goes on to state that, subject to the Convention rule protecting innocent purchasers, domestic non-Convention law will determine the consequences of an ineffective or reversed debit and credit, including its effect on third parties.

⁵⁷ Article 8(1).

- 1.100 The reliance on domestic law presents a large hole in the harmonisation of finality rules. That said, to attempt to harmonise how domestic law should treat the variety of circumstances in which transfers can be reversed appears both unrealistic and overly invasive. A harmonised rule protecting innocent purchasers may be sufficient to protect the integrity of the system and provide certainty to transferees and to intermediaries that hold on their behalf.

The effect of insolvency on the effectiveness of credits and debits

- 1.101 Article 22 of the Convention ensures that if the rules of a securities settlement system preclude the reversal of a credit/debit or the revocation of a transfer order, the rules shall continue to have effect notwithstanding the commencement of insolvency proceedings.
- 1.102 A contracting state must designate a system as a 'securities settlement system' in order for it to qualify as such under the Convention. It is likely that systems designated in the EU will also be systems that have been designated to fall within the scope of the Settlement Finality Directive's protections against insolvency.

Conclusions

- 1.103 A harmonised legal framework cannot attempt to provide an exhaustive list of circumstances in which transfers may be reversed or treated as ineffective. A sufficient level of settlement finality can be achieved by (1) disapplying insolvency rules that void transfers retroactively; (2) preventing a transferor from revoking a transfer order after a certain point in the settlement cycle; and (3) protecting the finality of transfers to innocent purchasers.
- 1.104 The Settlement Finality Directive fulfils the first two of these objectives in relation to certain designated settlement systems. We shall examine in the next section how a rule protecting innocent purchasers should be formulated to achieve the third. The question remains as to whether harmonised rules should deal with the effect of insolvency and the revocation of transfer orders in the case of transfers outside of designated settlement systems. Our provisional conclusion is that they should not.

PROTECTION OF THE INNOCENT TRANSFEREE

- 1.105 The extent to which the law should protect a transferee from pre-existing interests in the securities that it acquires is a complex and far reaching question. What is clear is that the vast majority of securities trades will not require the transferee to invoke a defence against adverse claims at all. Generally, this will be due to the simple fact that the intermediary has transferred the securities with the express or implied authority of the account holder (together with any other party with an interest). Only in exceptional circumstances of fraud or error will securities be transferred without this authority.

- 1.106 Where securities have been transferred without the consent of an interested party, the transferee is still unlikely to need to rely on a defence. In systems that employ clearing and netting functions the claimant will face considerable practical difficulty in tracing the securities to their recipient. If it is not possible to identify the recipient, the claimant will be left with a claim against the party at fault for the transfer.
- 1.107 Some commentators have queried the assumption that the securities market could not function if innocent purchasers were not given complete protection from adverse claims.⁵⁸ Certainly it is true that for every innocent purchaser that is able to invoke its legal protection against a claimant, there is an innocent claimant that may be harmed (if, for example, the claimant is left with a personal claim against an insolvent intermediary). Where the transferee has purchased misappropriated securities in good faith, the law must determine which of the two innocent parties - the defrauded beneficial owner or the good faith purchaser - is entitled to the property and which must satisfy itself with a personal claim. Which of the two competing principles of commercial law should prevail: security of title to protect the owner or security of transfer to protect the transferee?
- 1.108 We will first consider the approach taken by English law.

The common law

- 1.109 The common law has always favoured the principle of security of title.⁵⁹ This principle provides that a person should be deprived of his proprietary rights only in exceptional circumstances.⁶⁰ *Nemo dat quod non habet*: no-one can transfer a better title than that which he himself possesses. Applying this rule, the account holder can recover his securities from the transferee because the intermediary did not have authority to transfer them. It is irrelevant that the transferee purchased the securities in good faith. It is the purchaser that must check that the transferor can sell the securities free of any pre-existing interests in them.

⁵⁸ J S Rogers, *Negotiability, Property and Identity* 12 Cardozo L Rev (1990) 471, pp 478-484.

⁵⁹ See R Goode, *Commercial Law* (3rd ed 2004) p 416.

⁶⁰ For the exceptions to the *nemo dat* rule see above pp 417 to 443.

- 1.110 By placing this risk on the purchaser, the common law rule can constitute a significant barrier to trade. This is especially true in the securities markets. A purchaser in a non-matching settlement system⁶¹ may have no knowledge of the identity of the original owner of the securities. Furthermore, to expect the purchaser in any settlement system to conduct a thorough investigation of title would significantly reduce the efficiency of the market and damage the appeal of intermediated securities as investments or as collateral.⁶² Swift and reliable transfers maintain liquidity in the market which benefits sellers and purchasers alike. It is thus in the interests of the efficient operation of clearing and settlement systems to give a robust level of protection to an innocent transferee that has given value.
- 1.111 Protecting the innocent transferee may also represent a more realistic allocation of the risks that arise from improper transfers. If an investor opens an account with an intermediary of its choosing, it accepts the risk that the intermediary might deal with the securities fraudulently. The investor should not be able to shift this risk onto a transferee that has no easy means of investigating the intermediary's title to the securities prior to purchase.
- 1.112 A number of statutory and common law exemptions to the *nemo dat* rule have developed largely as a reflection of evolving commercial expectations. Significantly, in addition to these exemptions, the common law rule may be displaced by the doctrine of negotiability and by the equitable defence of a good faith purchaser.

Negotiability

- 1.113 A holder in due course of a negotiable instrument takes free from defects in the transferor's title. A holder in due course is similar in many respects to a good faith purchaser for value without notice.⁶³
- 1.114 A holder in due course must provide value, be in good faith and have no notice of any defects in the title of the transferor. There is a presumption that a holder has given value for the instrument.⁶⁴

⁶¹ A system that operates in a jurisdiction that does not require credits to match corresponding debits in order for a transfer to be legally effective.

⁶² See the FMLC report, *Issue 3, Property Interests in Investment Securities* (July 2004) p 13.

⁶³ R Goode, *Commercial Law* (3rd ed 2004) p 495. "A holder in due course is a holder who has taken a bill, complete and regular on the face of it, under the following conditions: namely, (a) that he became the holder of it before it was overdue, and without notice that it had previously been dishonoured, if such was the fact; (b) that he took the bill in good faith and for value, and that at the time the bill was negotiated to him he had no notice of any defect in the title of the person who negotiated it": Bills of Exchange Act 1882, s 29(1).

⁶⁴ Bills of Exchange Act 1882, s 27(2).

1.115 A holder is in good faith if it has acted honestly.⁶⁵ However, the good faith requirement appears to have largely been subsumed within the doctrine of notice. A holder in due course must have no actual or imputed notice of a defect in the transferor's title.⁶⁶ However, constructive notice of a defect in the transferor's title does *not* preclude a holder from taking an instrument as a holder in due course. So it does not matter if the holder was negligent and would have discovered the defect in the transferor's title if he had taken more care. However, if the holder has deliberately turned a blind eye to the possibility of a defective title, the court may interpret this as bad faith.⁶⁷

Unavailability of negotiable status for intermediated securities

1.116 Whether an instrument has negotiable status is determined by statute or commercial usage. Examples of negotiable instruments include cheques, bills of exchange and promissory notes. Traditional paper bearer securities are negotiable instruments.⁶⁸ Most commentators take the view that registered securities and bearer securities in electronic form have not yet acquired (or cannot acquire) negotiable status.⁶⁹ One of the main arguments against their negotiability is the inability of book-entry securities to be transferred by physical delivery; delivery requires the transfer of possession and intermediated securities, as intangibles, are incapable of possession. It is arguably fundamental to negotiability that a transferee should be able to present a physical certificate as representing an original promise to the bearer without further need to demonstrate its title. Therefore, an innocent transferee of intermediated securities cannot presently rely on the benefits of negotiability to protect itself from the claims of a defrauded account holder.

⁶⁵ See, for example, Bills of Exchange Act 1882, s 90(1).

⁶⁶ Knowledge of the equitable interest amounts to actual notice. The definition is the same in the context of good faith purchase: see para 1.120 below. Imputed notice is actual notice which a holder's counsel, solicitor or agent, acquires, provided that the notice was obtained in the same transaction in which the question of notice arises. An agent's constructive notice will not be imputed to the holder: see R Goode, *Commercial Law* (3rd ed, 2004) p 524.

⁶⁷ *Jones v Gordon* (1887) 2 App Cas 616, 628 – 629 by Lord Blackburn.

⁶⁸ See J Benjamin, *The Law of Global Custody* (2002 2nd ed) p 16 and n 6.

⁶⁹ See above pp 17 to 19 and the FMLC report, *Issue 3, Property Interests in Investment Securities* (July 2004) p 13. But see E Micheler, "Farewell Quasi-Negotiability? Legal Title and Transfer of Shares in a Paperless World" (2002) *Journal of Business Law* 358. J S Rogers described his objection to negotiability for dematerialised securities as follows: 'What negotiability does is enable us to use physical objects as tokens of abstract rights without applying the legal concepts that ordinarily govern rights in physical objects. Saying that one takes the token free from prior adverse claims to "it", really means that one takes the abstract right, and that what may once have happened to the physical token is irrelevant. It would, then, be ironic to attempt to preserve the concept of negotiability once we dispense with the physical tokens'. J S Rogers, *Negotiability, Property and Identity* 12 *Cardozo L Rev* (1990) 471, p 508.

Good faith purchaser without notice

- 1.117 In the absence of protection through negotiability, the doctrine of good faith purchaser acts to mitigate the effects of the strict application of the common law rule protecting security of title. The doctrine provides that a good faith purchaser of a legal estate for value and without notice of prior equitable interests takes free of those equitable interests. The requirements are similar to the conditions for negotiability. The purchaser must have acted honestly and provided value, and must have had no notice of any equitable interest at the time when the purchaser gave value for the property and when it was transferred to him. There is conflicting authority as to whether the burden is on the defendant to demonstrate that it gave value and had no notice⁷⁰ or on the plaintiff to show that the test is not satisfied.⁷¹ A number of academics have written in favour of the authorities that impose the burden on the defendant.⁷²
- 1.118 Section 199 of the Law of Property Act 1925 provides that a purchaser is not prejudicially affected by notice of any instrument, matter, fact or thing, unless:
- (1) it is within his own knowledge, or would have come to his knowledge if such inquiries and inspections had been made as ought reasonably to have been made by him;⁷³ or
 - (2) in the same transaction with respect to which a question of notice to the purchaser arises, it has come to the knowledge of his counsel, as such, or of his solicitor or other agent, as such, or would have come to the knowledge of his solicitor or other agent, as such, if such inquiries and inspections had been made as ought reasonably to have been made by the solicitor or other agent.⁷⁴
- 1.119 Thus, a purchaser has notice of an equitable interest under section 199 if it has actual, constructive or imputed notice of that interest.

⁷⁰ *Thomson v Clydesdale Bank Limited* [1893] AC 282, 289 by Lord Herschell LC; *Polly Peck International plc v Nadir (No 2)* [1992] 4 All ER 769 by Scott LJ.

⁷¹ *Attorney- General v Biphosphated Guano Company* (1898) 11 ChD 327, 337 by Thessiger LJ; *Lipkin Gorman v Karpnale* [1991] 2 AC 548, pp 574-577.

⁷² See AO Austen-Peters, *Custody of Investments* (2000), p 154 note 211 which refers to K Barker, 'After Change of Position: Good Faith Exchange in the Modern Law of Restitution' in PBH Birks (ed), *Laundering and Tracing* (1995) 206; RP Meagher, WMC Gummow and JRF Lehane, *Equity, Doctrines and Remedies* (3rd ed 1992) 257-259, PBH Birks, 'Overview: Tracing, Claiming and Defences' in PBH Birks (ed), *Laundering and Tracing* (1995) 334.

⁷³ Law of Property Act 1925, s 199(1)(ii)(a).

⁷⁴ Law of Property Act 1925, s 199(1)(ii)(b). This does not "exempt a purchaser from any liability under, or any obligation to perform or observe, any covenant, condition, provision, or restriction contained in any instrument under which his title is derived, mediately or immediately": Law of Property Act 1925, s 199(2).

Actual notice

- 1.120 Knowledge of an equitable interest amounts to actual notice. A purchaser has actual notice if it has knowledge of information from any source which is of such a nature that a reasonable man or a man of business would act upon the information.⁷⁵ It is immaterial whether it acquired the notice before or at the time of the purchase and whether or not it acquired the information from an interested party.⁷⁶

Constructive notice

- 1.121 A purchaser has constructive notice of matters that would have come to his knowledge if such inquiries had been made as ought reasonably to have been made by him.
- 1.122 The English courts have made a clear distinction in the application of constructive notice between transactions involving land and other commercial transactions. Hayton points out that in the purchase of land “there are elaborate inquiries and inspections that have to be made.”⁷⁷ However, for property other than land, the purchaser is under no duty to make inquiries as to title in the absence of suspicious circumstances since “the courts are most reluctant to import a duty of inquiry as to title which would restrict the flow of commerce.”⁷⁸ Thus, the Court of Appeal in *Polly Peck International plc v Nadir (No 2)* held that, in the context of commercial transactions not involving land, a purchaser will not have constructive notice unless suspicious circumstances existed but he deliberately or recklessly failed to make the inquiries that an honest and reasonable man would have made.⁷⁹
- 1.123 For transactions which are not of a commercial nature, knowledge of circumstances which would indicate the facts to an honest and reasonable man or which would put an honest and reasonable man on inquiry may be sufficient to establish constructive notice.⁸⁰ Thus, the degree of knowledge that is required to establish that a purchaser has constructive notice of an equitable interest in the commercial context is higher than the degree of knowledge that is required for land transactions.

⁷⁵ See J McGhee, *Snell's Equity* (13th ed 2000) para 4-19 and *Lloyd v Banks* (1868) 3 Ch App 488.

⁷⁶ *Lloyd v Banks* (1868) 3 Ch App 488.

⁷⁷ D J Hayton, *Underhill and Hayton's Law of Trusts and Trustees* (16th ed 2003) p 989. See J McGhee, *Snell's Equity* (13th ed 2000) paras 4-20 – 4-26.

⁷⁸ D J Hayton, *Underhill and Hayton's Law of Trusts and Trustees* (16th ed 2003) p 989. See, for example: *Baden v Société Générale pour Favoriser le Développement du Commerce et de l'Industrie en France SA* [1992] 4 All ER 161; *Manchester Trust v Furness* [1895] 2 QB 539; *Eagle Trust plc v SBC Securities Ltd* [1992] 4 All ER 488, 507-508.

⁷⁹ [1992] 4 All ER 769.

⁸⁰ Above at 777 by Scott LJ. See also *Re Montagu's Settlement Trusts* [1992] 4 All ER 308, 323.

Imputed notice

- 1.124 Any actual or constructive notice which a purchaser's counsel, solicitor or agent acquires will be imputed to the purchaser provided that the notice was obtained in the same transaction in which the question of notice arises.⁸¹ Notice acquired in a previous transaction will not be imputed to the purchaser and even notice acquired in the same transaction will only be imputed if it is so material to the transaction that the agent is under a duty to inform the purchaser.⁸² The agent's knowledge will not be imputed to the purchaser if the agent was concealing information from the purchaser in order to defraud him.⁸³
- 1.125 Within the context of multi-tiered holding of securities the question arises as to whether it is possible to impute the notice of lower tier account holders to the upper tier purchaser of securities. Where a lower tier account holder has directed the purchase of securities despite its knowledge that this would violate a claimant's property rights, it seems highly unlikely that it could plead the extinction of the claimant's property rights on the grounds that it holds through a higher tier purchaser that had no knowledge of any adverse claim.

Good faith purchase and intermediated securities

- 1.126 Before we examine the role of the good faith purchaser defence in the intermediated holding system, we should briefly consider the types of adverse claim to which it provides a defence.
- 1.127 If the account holder can identify a third party recipient of misappropriated securities, it may have a personal claim, a proprietary claim, or both against the recipient.⁸⁴ As only the upper tier intermediary has legal title to the securities, a claim by an account holder will be an equitable claim rather than a claim at law.⁸⁵

⁸¹ Law of Property Act 1925, s 199 1(ii)(b). See also *Merry v Abney* (1663) 1 Cas in Ch 38; *Le Neve v Le Neve* (1747) 2 Amb 436; *Kemmis v Kemmis* [1988] 1 WLR 1308, 1333 by Nourse LJ.

⁸² J McGhee, *Snell's Equity* (13th ed 2000) para 4-27.

⁸³ *Kennedy v Green* (1834) 3 My & K 699; *Cave v Cave* (1880) 15 Ch D 639; *Houghton & Co v Nothard, Lowe & Willis Ltd* [1928] AC 1.

⁸⁴ Where the claimant has both options, the election need not be made until judgment.

⁸⁵ There are a number of obstacles to bringing a strict liability claim at law through an upper tier intermediary. First, where intermediated securities have been transferred and the upper tier legal owner remains unchanged, we presume it is not possible for the upper tier legal owner to bring a claim at law to recover a misappropriated equitable interest. Secondly, only an equitable claim can trace securities into a mixed fund. Thirdly, if the upper tier intermediary was responsible for disposing of the property, it may be estopped from bringing an action at law by the principle of non-derogation from grant: see *Re Diplock* [1948] Ch 465.

- 1.128 There are a variety of equitable personal claims that the account holder may be able to bring against the transferee to recover the value of his securities. The most important is the action for knowing receipt. In order to establish liability for knowing receipt there must be a disposal of the account holder's assets in breach of trust, beneficial receipt by the transferee of the claimant's traceable assets and knowledge on the part of the transferee that the assets were transferred in breach of trust.⁸⁶ Crucially, it is irrelevant whether the transferee retains the assets or not.⁸⁷ The fault requirement is satisfied where the transferee's state of knowledge makes it 'unconscionable' for him to retain the benefit of the receipt.⁸⁸ Importantly, as the liability is fault-based the burden of proof falls on the claimant to establish unconscionability.
- 1.129 In contrast to personal rights which are only good against the person against whom they originally arose, equitable proprietary rights attach to the property itself and are good against anyone who has the property or who has interfered with it. Where the account holder can trace its equitable interest in securities (or assets substituted for them) into the transferee's hands, the account holder may bring an equitable proprietary claim to recover the securities from the transferee. Unlike a personal claim, a proprietary claim enjoys priority over an insolvent defendant's unsecured creditors. It also entitles the claimant to recover any increase in the value of the property as well as any income derived from it.
- 1.130 Good faith purchase of a legal interest is an effective defence against such equitable proprietary claims.⁸⁹ The transferee must prove that it purchased the securities in good faith, for value and without notice of the account holder's prior equitable interest to be able to rely on the defence. The difference in the burden of proof for personal claims and for proprietary claims may be relevant when we consider how a harmonised rule should apply to protect innocent transferees in intermediated holding systems.⁹⁰

⁸⁶ *El Ajou v Dollar Land Holdings plc* [1994] 2 All ER 685.

⁸⁷ A Burrows, *The Law of Restitution* (2nd ed 2002) p 196.

⁸⁸ *BCCI v Akindele* [2001] Ch 437, 455 by Nourse LJ. Whereas before conflicting case law favoured a dishonesty standard or a wider definition embracing constructive notice, the test of unconscionability was intended to provide a context-sensitive test that makes it unnecessary to distinguish between dishonesty and negligence.

⁸⁹ At present, 'change of position' is not available as a defence to an equitable proprietary claim. The defence is available to a defendant in a restitutionary claim whose position has so changed that it would be inequitable to require him to make restitution. Change of position was first recognised as a defence to a restitutionary claim in *Lipkin Gorman v Karpnale* [1991] 2 AC 548. However, since the House of Lords held in *Foskett v McKeown* [2001] 1 AC 102 that equitable proprietary claims are concerned with the vindication of the claimant's proprietary rights in the original asset or its traceable substitute and not unjust enrichment, it must follow that the defences particular to the law of restitution, including change of position, are at present not available to an equitable proprietary claim. See *Foskett v McKeown* [2001] 1 AC 102, 129 by Lord Millett.

⁹⁰ See footnote 29 below.

Availability of good faith purchaser defence for intermediated securities

- 1.131 Let us now examine the operation of the good faith purchaser defence to claims in an intermediated holding system. The good faith purchase rule protects a person who in good faith acquires *legal* title without notice of any prior equitable interests in the property. As we have noted previously, the legal title to securities may only be acquired by delivery or re-registration of the underlying securities held directly from the issuer. In many cases, intermediated securities will be transferred by book-entry in the books of an intermediary. The purchaser will acquire only an *equitable* interest and may therefore be unable to rely on this defence against equitable proprietary claims.⁹¹
- 1.132 On the other hand, if the claimant brings a *personal* claim for knowing receipt against the transferee, the transferee is not liable to return the value of the securities unless the claimant can show that it is unconscionable for the recipient to retain them. The effect of requiring the claimant to prove fault is practically the same as allowing the recipient to rely on a defence of good faith purchase, save that in the former case the recipient is further advantaged by the reversal of the burden of proof.⁹²

⁹¹ See the FMLC report, *Issue 3, Property Interests in Investment Securities* (July 2004) p 13.

⁹² The burden of proof is an important issue in practice and the discrepancy between the account holder's personal and proprietary claims against the transferee should be considered in more detail. See: P Birks, Birks, *An Introduction to the Law of Restitution* (Revised edition 1989) pp 140 to 146; Lord Nicholls, "Knowing Receipt: The Need for a New Landmark" in Cornish et al (eds), *An Introduction to the Law of Restitution* (1998) p 231; Birks, "Knowing Receipt: Re Montagu's Settlement Trusts Revisited" (2001) vol 1, issue 2 *Global Jurist Advances*, Article 2, 8 to 11; Smith, "Unjust Enrichment, Property and the Structure of Trusts" (2000) 116 *LQR* 412, 434.

- 1.133 The unavailability of a good faith purchaser defence for purchasers of an equitable interest can be viewed as another example of the incremental development of different causes of action resulting from the division of English law into concurrent jurisdictions of common law and equity. These differences can lead to a disparity between the level of protection that legal and beneficial ownership can provide. Traditionally, the debate has centred on the appropriateness of the lower protection offered to equitable owners and not on the absence of a good faith defence for equitable transferees.⁹³ In the context of ownership, many commentators have argued that the scheme of legal and equitable claims and remedies should be rationalised so as to eliminate arbitrary discrepancies.⁹⁴ Others have argued that ownership rights of beneficial owners are necessarily more fragile and that to attempt to mirror the position of legal and equitable owners unduly ignores the fact that there is a trust and a trustee.⁹⁵
- 1.134 At a more specific level, we believe that the particular circumstances and commercial expectations of multi-tiered settlement systems require that the good faith purchaser defence be available to transferees of legal and equitable interests alike. A purchasing investor may have little or no knowledge or control over whether its purchase order results in a transfer of legal title in the issuer's (or CREST) register or of equitable title across the books of an intermediary. The price an investor pays for intermediated securities is the same as it would pay for the legal title to the underlying securities; there is no reduction to reflect the absence of a defence against third party claims.
- 1.135 To require the purchaser to obtain the legal title in order for it to have a defence from third party proprietary claims could seriously undermine the benefits of intermediation. The systemic efficiencies created by effecting transfers across the books of lower tier intermediaries would be lost if all transfers had to be made at the highest tier. Securities immobilised with the upper tier intermediary in the form of global certificates would have to be split into definitive certificates to allow for transfers of the legal title to portions of the issue.

⁹³ The classification of knowing receipt as a fault-based rather than strict liability claim has been the subject of much academic and judicial debate. Writing extra-judicially, Lord Nicholls has argued that both fault-based and strict liability personal actions should co-exist in equity. Birks also later favoured a strict liability claim in unjust enrichment to exist alongside fault-based knowing receipt. This would ensure that equitable owners were granted the same protection as legal owners (under the common law action for money had and received) and beneficiaries under a will and intestacy (under the principle in *Re Diplock*). However, the courts have not adopted a strict liability equitable action.

⁹⁴ See Lord Nicholls, *Knowing Receipt: The Need for a New Landmark* in Cornish *et al* (eds), *Restitution: Past, Present and Future* (1998); Virgo, *The Principles of the Law of Restitution* (1999).

⁹⁵ See Smith, *Unjust Enrichment, Property and the Structure of Trusts* (2000) 116 LQR 412, p 431 in which he states: 'Equitable proprietary rights are not protected in the same way as legal ones. In general, they are protected less well. They are always subject to destruction by bona fide purchase of a legal interest or overreaching, and wrongful interference with them is dependent on fault. Beneficiaries cannot generally sue in conversion when a defendant interferes with the trust property; nor are they owed the duties of care which are owed to the legal owner...It is in the nature of the trust institution that beneficiaries are vulnerable to breaches of trust, in ways which they would not be if they were the legal owners of the trust property'.

- 1.136 Viewed from the perspective of the original equitable owner of the securities, the absence of a defence for purchasers seems similarly perverse. An investor that holds through a single intermediary is vulnerable to a transfer of the legal title by its intermediary to a good faith purchaser without notice. However, if the investor happens to hold through multiple tiers of intermediaries, the odds increase that the transferee will receive only an equitable interest and thus be without a defence against the original investor's claim.
- 1.137 We must keep in mind that in sophisticated settlement markets, the transferee remains shielded by the practical difficulties involved in tracing misappropriated securities settled on a net basis. Nevertheless, where tracing is successful, we can see no reason why a good faith purchaser of an equitable interest in securities should not have the same protection as the good faith purchaser of the legal estate.

Approach taken by Member States

- 1.138 The majority of Member States protect the innocent transferee of securities from adverse claims. Many of them expressly provide for this protection in their securities legislation. In Italy, for example, the transferee of securities obtains good title to those securities provided that there was a valid transfer contract and the transferee had no knowledge of the adverse claim. Article 9 of the Spanish Securities Markets Law provides that a person purchasing securities shall not be liable for any claim for their recovery, unless he acted in bad faith or with gross negligence at the time of purchase.⁹⁶ Securities laws in Portugal, Cyprus, Slovakia, Slovenia, Sweden, Luxembourg and the Czech Republic contain similar rules protecting good faith purchasers.
- 1.139 A number of Member States, including some that have enacted specific securities legislation, rely on general legal principles to protect innocent transferees. As civil law jurisdictions do not distinguish between legal and equitable ownership, good faith purchase protection in these countries is often more comprehensive than the protection afforded to good faith purchasers under general principles of English law. For example, Greek securities legislation does not protect good faith purchasers of dematerialized securities. Instead, innocent transferees of securities held in the Dematerialised Securities System can rely on Article 1036 of the Greek Civil Code which protects good faith acquirers of movables. General legal principles on the protection of good faith purchasers also protect innocent transferees of securities in Hungary and Austria.
- 1.140 In some Member States general civil law principles only provide limited protection to good faith purchasers. Polish law prevents the innocent transferee of movables which have been lost by, stolen or otherwise forfeited from the owner from acquiring good title until three years after the loss, theft or forfeiture.⁹⁷ There is a similar provision in Lithuania.⁹⁸

⁹⁶ As securities are easily traceable in matching systems such as the Spanish system, adverse claims against transferees are more likely.

⁹⁷ Polish Civil Code, Article 169. This provision does not apply to money or bearer securities.

- 1.141 In a number of Member States it is uncertain whether general principles on good faith purchase can be applied to the transfer of intangibles. For example, there are no specific rules under French law which protect the good faith purchaser of securities. However, French jurists suggest that a book-entry may be classified as a 'thing' for the purposes of Article 2279 of the Civil Code such that persons who have a book-entry in their favour in respect of securities purchased from an intermediary can benefit from the protection that Article affords to good faith purchasers of tangibles. However, the position is unclear and a proposal is under consideration to create a specific rule in the French Monetary and Financial Code providing that the credit of securities in a securities account protects the good faith acquirer of securities against adverse claims. There is similar uncertainty surrounding the law in Belgium, Poland and Lithuania.
- 1.142 German law has conceptual difficulties with according good faith acquisition to securities that are held in the form of a permanent global certificate. Constructive possession is a prerequisite of good faith acquisition of movables and this presupposes that the investor has the right to obtain the respective physical object. This is not possible where the securities are immobilised as a global certificate. While the prevailing legal opinion is that the book-entry rather than the global certificate provides the legal basis of the acquisition, doubts remain regarding this analysis.⁹⁹
- 1.143 Several Member States do not protect innocent transferees. In Denmark the original owner of securities can always recover them from a transferee acting in good faith, provided he can identify his securities in the transferee's account.¹⁰⁰ However, the transferee can claim compensation from the CSD, regardless of whether the CSD has been negligent.¹⁰¹ The position is similar in Latvia.

Approach taken by the FMLC

- 1.144 The FMLC report recommends that "there should be a clear rule in favour of the good faith purchaser for value without notice".¹⁰² The distinction between legal and equitable rights should be irrelevant. Principle 7(e) provides that:

In a case of fraudulent or other wrongful disposition by the intermediary, a good faith purchaser without notice of the fraud or other wrong takes free of customer claims.¹⁰³

⁹⁸ Lithuanian Civil Code, Article 4.96(1). The German Civil Code also does not protect the innocent transferee if the account holder lost the securities due to theft [S 935(1). This restriction does not apply to bearer securities: s 935(2).]

⁹⁹ See D Einsele, 'Modernising German Law: Can the UNIDROIT Project on Intermediated Securities Provide Guidance' in UNIDROIT *Uniform Law Review* Vol X 2005 1 / 2 at p251.

¹⁰⁰ Securities Trading Act, Article 69.

¹⁰¹ Above, Article 80(2).

¹⁰² Above, p 13.

¹⁰³ Above, p 17.

1.145 The Commentary to the FMLC Report notes that:

While in general customers are entitled to the protection of their property rights, where they entrust their assets to unreliable intermediaries, it would not be fair for the risk of intermediary fraud to be transferred to good faith purchasers.

Approach taken by the US Uniform Commercial Code

1.146 Revised Article 8 of the UCC takes a different approach to the protection of innocent transferees of intermediated securities¹⁰⁴ by splitting the protection into three rules. Each rule deals with subtly different (though sometimes overlapping) scenarios. The first is a general rule set out in Article 8-502 which protects a person who acquires intermediated securities (referred to as an 'entitlement holder')¹⁰⁵ from claims made against the underlying securities or against its own entitlement. The second rule in Article 8-510 almost duplicates the first but covers a narrow range of persons who take securities interests in the entitlement holder's account without becoming entitlement holders themselves.¹⁰⁶ The third rule in Article 8-503 protects purchasers from claims made by entitlement holders. This rule applies to most adverse claims that could arise (as claimants will usually be wronged entitlement holders) and takes precedence in application over the other two rules.

1.147 Before an entitlement holder can even bring a claim against a purchaser, it must satisfy four requirements established in Article 8-503(d). First, there must be insolvency proceedings against the entitlement holder's intermediary. Secondly, the intermediary must not have sufficient interests in the financial asset to satisfy the security entitlements of all its entitlement holders. Thirdly, by transferring the financial asset to the purchaser the intermediary must have violated its obligations under Section 8-504 to maintain sufficient interests in the financial asset to satisfy its entitlement holders. Finally, the trustee or other liquidator must have elected not to pursue the financial asset. These requirements have the effect of protecting a transferee that acquires securities from an intermediary against assertions from the intermediary's account holders that the intermediary acted wrongfully. They provide an additional layer of protection to purchasers by limiting the circumstances in which a claim can be made and thereby reinforce the principle that an entitlement holder must look first to its intermediary for redress.¹⁰⁷ Adverse claims asserted by persons other than entitlement holders are not subject to these extra conditions.¹⁰⁸

¹⁰⁴ If the financial asset is a directly held security, purchasers are protected by UCC§8-303. If the financial asset is a negotiable instrument that is not a security under Article 8, purchasers are protected as holders in due course under Article 3.

¹⁰⁵ An entitlement holder is "a person identified in the records of a securities intermediary as the person having a security entitlement against the securities intermediary": UCC§8-102(a)(7). A person acquires a security entitlement in accordance with UCC§8-501.

¹⁰⁶ Official Comment 2 to §8-510.

¹⁰⁷ See above.

¹⁰⁸ See UCC§8-502 and UCC§8-510.

- 1.148 Even if the four conditions in Article 8-503(d) are satisfied, the entitlement holder must also satisfy Article 8-503(e). This provides that an entitlement holder cannot assert a claim against the purchaser if the purchaser has given value, obtained control¹⁰⁹ and has not acted in collusion with the intermediary in violating the intermediary's obligations to maintain sufficient interests in the financial asset.¹¹⁰
- 1.149 The collusion test provides the purchaser with yet more protection. Rather than focusing on the purchaser's notice of adverse claims, the entitlement holder must show that the transferee was actively involved in wrongful conduct in order to bring a claim. The formulation of this rule is based on the policy objective that it is undesirable to impose on purchasers of intermediated securities *any* duty to investigate whether the transferor has authority to make the transfer.¹¹¹ Any such duty would also impair the ability of intermediaries to perform their function to deal with securities on behalf of their account holders and would not be in the interests of account holders.
- 1.150 The rule in Article 8-503 (d) and (e) differs from a typical good faith purchaser defence. Rather than specifying that a certain class of transferee takes free from all claims, the subsections specify the circumstances in which a claim can be brought against a transferee. The effect is not only to shift the burden of proof from the purchaser to the entitlement holder bringing the adverse claim but to prevent the claimant from even bringing an action against the transferee unless a number of factual criteria have first been satisfied.
- 1.151 When combined with the difficulties of tracing securities in a clearing and settlement system, the rule in Article 8-503 makes it very difficult for an entitlement holder to bring a claim against a purchaser of intermediated securities. The Official Comment to Article 8-503 justifies the limitations on claimants to bring claims against transferees as follows:

¹⁰⁹ A purchaser has control of a security entitlement if he becomes the entitlement holder, the intermediary has agreed that it will comply with the purchaser's instructions with regard to the financial asset or his interest therein without further consent of the original entitlement holder, or another person has control of the security entitlement on behalf of the purchaser: UCC§8-106(d). The requirement that a protected purchaser should obtain control is designed to ensure that to qualify for protection the purchaser must take through a transaction that is implemented by the appropriate mechanism.

¹¹⁰ There is uncertainty as to the time when the collusion must occur: at the time of the purchase or when the purchaser obtains control? Hakes suggests that collusion at either point in time is sufficient. See R Hakes, "UCC Article 8: Will the Indirect Holding of Securities Survive the Light of Day" (2002) *Loyola of Los Angeles Law Review*, vol 35, 661, 720 to 721.

¹¹¹ See UCC§8-503 Comment 3.

The limitations...on the ability of a customer of a failed intermediary to recover securities or other financial assets from the transferee are consistent with the fundamental policies of investor protection that underlie this Article and other bodies of law governing the securities business. The commercial law rules for the securities holding and transfer system must be assessed from the forward-looking perspective of their impact on the vast number of transactions in which no wrongful conduct occurred or will occur, rather than on the post hoc perspective of what rule might be most advantageous to a particular class of persons in litigation that might arise out of the occasional case in which someone has acted wrongfully. Although one can devise hypothetical scenarios where particular customers might find it advantageous to be able to assert rights against someone other than the customer's own intermediary, commercial law rules that permitted customers to do so would impair rather than promote the interest of investors and the safe and efficient operation of the clearance and settlement system.¹¹²

- 1.152 The UCC's formulation of the purchaser protection highlights a number of important questions for this project. Should there be one general rule against adverse claims or a number of distinct rules depending on the type of claimant and the nature of the purchaser's interest? Should a harmonised rule restrict account holders to suing their intermediary and prevent them from bringing an action against the transferee other than in exceptional circumstances? Should the test require notice or active collusion? And should the burden be on the claimant to show notice or on the purchaser to demonstrate its innocence?

Approach taken by UNIDROIT Convention

- 1.153 Article 7 protects an account holder from adverse claims where the account holder does not at the time its account is credited have knowledge of an adverse claim with respect to the securities. An adverse claim with respect to any securities is defined in Article 1(i) as:

a claim that a person has an interest in those securities that is effective against third parties and that it is a violation of the right of that person for another person to hold or dispose of those securities.

- 1.154 Like a good faith purchaser under English law, the account holder must have provided value for the securities, unless the acquisition in question is the grant of a security interest.¹¹³ It must also have no knowledge of the adverse claim at the time of the credit to his account. A person has knowledge of an adverse claim where he has actual knowledge or knowledge of facts that indicates that:

there is a significant probability that there is an adverse claim and deliberately avoids information that would establish the existence of the adverse claim.¹¹⁴

¹¹² Official Comment 3 to §8-503.

¹¹³ Article 7(2).

¹¹⁴ Article 7(4)(b).

- 1.155 This level of knowledge is broadly similar to constructive notice in English law. In the context of commercial transactions (not involving land) under English law, a purchaser does not have constructive notice unless suspicious circumstances exist and he deliberately or recklessly fails to make the inquiries that an honest and reasonable man would make.¹¹⁵ Comparing the two tests, one can see that the Convention does extend the defence to account holders who recklessly avoid information that would establish the existence of the adverse claim. Furthermore, the Convention does not address whether the knowledge of an account holder's agent can be imputed to an account holder.¹¹⁶
- 1.156 The Convention does not require the transferee to have acted in good faith. UNIDROIT's report on the most recent draft of the Convention explained that several delegations urged the Committee to avoid language based on good or bad faith in light of previous attempts in international texts to define these concepts.¹¹⁷ Any question of honesty or good faith is adequately dealt with by the knowledge requirement in Article 7(4).
- 1.157 The Convention is not clear as to whether it is for the purchaser to demonstrate its absence of knowledge or for the claimant to show that the purchaser was, or should have been, aware of its claim.

Onward dispositions

- 1.158 The Convention also deals with onward dispositions by a transferee to a subsequent innocent third party (the 'subsequent acquirer').
- 1.159 The effect of Article 7(5) is to protect the subsequent acquirer who purchases securities from a person who could not validly transfer securities from his account because the initial credit of the securities to his account was ineffective or liable to be reversed. The subsequent acquirer cannot rely on this protection if the credit to his account is conditional, the onward disposition was not for value, or he had knowledge at the time his account was credited that the original credit of securities to the transferor's account was ineffective or liable to be reversed. Knowledge has broadly the same meaning as under Article 7(4). Article 7(6) provides that:

For the purposes of paragraph 5 the acquirer has knowledge that the further credit or designating entry is made as a result of a purported disposition made in the circumstances referred to in that paragraph if the acquirer has actual knowledge that it is so made, or has knowledge of facts sufficient to indicate that there is a significant probability that it is so made and deliberately avoids information that would establish that that is the case.

¹¹⁵ [1992] 4 All ER 769.

¹¹⁶ See above para.

¹¹⁷ UNIDROIT Committee of Governmental Experts for the Preparation of a Draft Convention on Substantive Rules regarding Intermediated Securities, *Report* (May 2006) p 15. Available at <http://www.unidroit.org/english/publications/proceedings/2006/study/78/s-78-43-e.pdf>.

- 1.160 In order to maintain market confidence, any proposals on the protection of innocent transferees should also protect subsequent acquirers of onward dispositions.

Conclusions

- 1.161 'Securities may be less liquid than money, but their value lies in liquidity'.¹¹⁸ The protection of innocent purchasers from adverse claims promotes liquidity and reflects the commercial expectations of owners of investment securities.
- 1.162 In most cases, the difficulty in tracing securities through omnibus accounts and in systems that net transactions will provide an effective shield against most claimants. As a result of the difficulties in tracing pre-existing interests as well as for reasons of efficiency, a person that holds securities through an intermediary should not expect the purchaser of the securities to investigate title to them. Accordingly, if an account holder's intermediary wrongfully transfers securities to a purchaser, the purchaser should take good title unless it has notice or strong suspicion of a violation of another's rights to those securities.
- 1.163 Broadly speaking, the US Uniform Commercial Code prevents an account holder from bringing a claim against a transferee other than in circumstances where the account holder's intermediary cannot remedy the loss itself. Rather than give the account holder a choice of defendant, the rule makes the transferee a defendant of last resort. The rule is consistent with an approach that focuses on the account holder's entitlement as a right against its intermediary. By reducing the possibility that a transferee's rights may be disputed, the principle enhances both liquidity and settlement finality. This approach differs from the laws of Member States (such as the UK) that provide no bar to a claim from an account holder against a transferee. In these systems the obstacle that the claimant faces lies solely in whether it can satisfy the constituent elements of the cause of action without the defendant providing a valid defence.
- 1.164 The Uniform Commercial Code goes further still in protecting the transferee by switching the burden of proof to the claimant. If a claimant is a wronged account holder, Article 8 requires the claimant to show the active collusion of the transferee in the violation of its rights. By way of comparison with English law, only personal actions (which do not require the asset to still remain in the recipient's hands) require the claimant to establish fault. Furthermore, collusion suggests a higher standard than the 'unconscionability' that must be shown for knowing receipt.

¹¹⁸ J H Sommer, 'A Law of Financial Accounts: Modern Payment and Securities Transfer Law', 53 Business Law (1997-1998) 1181, p 1194.

1.165 We believe that a harmonised rule should establish a robust protection for transferees of intermediated securities that reflects the particular commercial expectations and needs of participants in capital markets. While it would mark a departure from current legal practice in Member States, we would like to consider the option of limiting an account holder from making claims against a transferee other than where its intermediary is insolvent and cannot remedy the loss.