

Modernizing Securities Ownership, Transfer and Pledging Laws

A DISCUSSION PAPER
ON THE NEED FOR
INTERNATIONAL HARMONIZATION

Randall D Guynn

Partner, Davis Polk & Wardwell

With responding comments by

Professor James Steven Rogers *(USA)*

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Capital Markets Forum

Section on Business Law
International Bar Association

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This publication is a Discussion Paper Comments and the views expressed in the Discussion Paper and Comments are the views of the respective author and commenters and not those of the International Bar Association or the Officers of the Capital Markets Forum.

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Foreword

The Capital Markets Forum is pleased to present its sixth discussion paper. It is written by Randall Guynn and is an essay on the need for international harmonization of modernised national securities ownership, transfer and pledging laws. It has rarely happened before that even prior to its publication a discussion paper of the Forum has found such significant attention in the financial press and has been so eagerly awaited as this paper. The Financial Times of November 21, 1995 carried an extensive interview of Mr. Guynn on the Position Statement regarding the subject of this paper issued by the Ad Hoc Committee acting under the auspices of the Capital Markets Forum and described below, and the Forum has received many indications of interest in the paper from central bankers, regulators, financial institutions and others.

We are delighted to present, together with this study, the useful comments written by three eminent experts in the field, namely Professor Rogers of Boston College Law School, the principal draftsman for the recent project to revise the commercial law rules that govern the ownership transfer and pledging of securities in the United States, Professor Sono of the Hokkaido University in Sapporo and former Secretary of UNCITRAL, and Dr. Than, Deputy General Counsel of Dresdner Bank.

This paper is a direct response to a call for assistance raised in the market. The market demanded ways to improve the operational and legal infrastructure for cross-border securities clearance, settlement, and custody. It was particularly concerned over the possible need to modernise national laws regarding the ownership, transfer and pledging of securities held through multi-level systems of intermediaries. One study that addressed these concerns in a thoughtful way was the 1993 study by the Euroclear Operations Centre entitled "Cross-Border Clearance, Settlement, and Custody: Beyond the G30 Recommendations". That study suggested that "the International Bar Association or perhaps an agency like Unidroit would be appropriate for developing and implementing" recommendations to address any significant legal risks in cross-border securities transactions,

The International Bar Association did not ignore this call. The Banking Law Committee of the IBA's Section on Business Law formed a Subcommittee which,

under the leadership of Mr. Guynn, became a forum for discussion of the subject. The Subcommittee met at the IBA/SBL Annual Conferences in New Orleans (1993) and Melbourne (1994) and was reconstituted at the Annual Conference in Paris (1995) as the Ad Hoc Committee on Modernizing Securities Ownership, Transfer and Pledging Laws under the auspices of the Capital Markets Forum. The Ad Hoc Committee is chaired by Mr. Guynn. All its members have a high degree of expertise in the subject, most of them acting as legal advisers to banks, brokers or central securities depositaries established on a national or international level.*

After the Ad Hoc Committee was well into its work, the Committee on Payment and Settlement Systems of the central banks of the Group of Ten issued its report on Cross-Border Securities Settlements (CBSS Report), which was published by the Bank for International Settlements in March 1995. That report identified legal risk, especially choice of law uncertainties, as one of the principal risks that differentiates cross-border securities transactions from domestic transactions. The CBSS Report can be seen as a challenge to lawyers, financial regulators and national legislatures to modernise national laws and regulations in order to eliminate or reduce the additional legal risks associated with cross-border transactions.

In November 1995, the Ad Hoc Committee issued a Position Statement. The Statement calls for a review of existing laws governing the ownership, transfer and pledging of securities to assess their consistency with, and where necessary amendment or interpretation to reflect, four fundamental principles. These four principles are:

- Interests in securities held through a financial intermediary should be defined by legislation or otherwise interpreted as a type of interest in a pro-rata portion of the pool of securities or interests in securities held by the intermediary with whom the interest holder has a direct contractual relationship evidenced solely by the interest holder's

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account with the intermediary, and not as a traceable property right in individual securities or a mere contractual claim.

- The pool of securities or interests in securities held by an intermediary to satisfy the interest of its interest holders should be protected against the claims of the intermediary's creditors either by defining the interest as a type of property or co-property right or by amending or interpreting existing insolvency laws for financial intermediaries to give explicit effect to this policy.

- Conflicts of laws rules should be interpreted or modernised to reflect the development of the system for holding, transferring and pledging interests in securities by book-entry to accounts with financial intermediaries so that the selection of the law governing the characterisation, the validity of any transfer or pledge, or the effectiveness or opposability of any pledge of interests in securities represented or effected by book-entry to accounts with a financial intermediary is determined by agreement among the relevant parties or, in the absence of such agreement, by reference to where the office of the financial intermediary maintaining such accounts is located or otherwise by reference to the intermediary's jurisdiction.

- Procedures for creating and enforcing a pledge of interests in securities credited to accounts with financial intermediaries should be simplified.

The rationale and scope of these principles are explained in this paper.

The Capital Markets Forum wishes to submit these principles to discussion. As with all its previous discussion papers, the Forum will host discussion groups in leading financial centres around the world to obtain the reactions not only from the legal experts, which are limited in number due to the highly technical nature of the subject matter, but from a broad range of persons and organizations which take an interest, including business lawyers, law professors, central bankers, regulators, legislators, banks and investment banks. We are grateful to Hendrik Haag that he has agreed to co-ordinate these discussion groups.

We expect that discussion will facilitate consideration of the issues, elicit thoughtful comment and eventually achieve broad acceptance of the fundamental principles that should be implemented in any modern system of law governing the ownership, transfer and pledging of securities held in multi-tiered securities holding systems. We hope that such collective endeavour of analysis will be the beginning of the effective introduction into the national laws of those legal principles which have sustained the test of such endeavour, in consequence of

their prior endorsement by international regulators in particular at the level of the Bank for International Settlements or the International Organisation of Securities Commissions (IOSCO), an international convention or some other international effort.

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I. Introduction

The central thesis of this paper is that most national laws governing the ownership, transfer and pledging of securities have become obsolete and should be modernized to reflect certain fundamental principles.

Most current laws do not allow investors or secured creditors to determine in advance - with sufficient *certainty and predictability* - the substantive law that will govern their rights and obligations or those of possible adverse claimants. Nor do most of them allow investors or secured creditors, once the governing substantive law has been ascertained, to be certain that they have a distinct package of rights that cannot successfully be attacked by adverse claimants.

These legal uncertainties and other friction costs operate as a deadweight cost on local, national and global economies. They increase the cost of capital for private and public issuers. They reduce the value of securities to investors and secured creditors. They increase the legal and other operating costs of issuers, investors and secured creditors. They operate as a significant constraint on the reduction of credit and liquidity exposures. They contribute to systemic risk in times of financial distress.¹ If they are not corrected through multi-national law reform, they not only will continue to impose unnecessary friction costs on day-to-day transactions, but also could be a significant factor in a financial crisis.

If investors and secured creditors cannot determine with certainty whether they have unassailable interests in securities transferred or pledged through financial intermediaries, or if existing laws make it too costly to obtain such certainty, market participants may be deterred from entering into many financially beneficial and risk-reducing transactions. This can depress the value of securities issued by private and governmental issuers, increasing their cost of capital. It can also inhibit decreases in the cost of credit in an economy by making securities less valuable as collateral. In short, legal uncertainty as to the enforceability, priority or finality of transfers or pledges, or the imposition of costly or impractical procedural requirements to increase

that certainty, can impose significant friction costs on ordinary transactions and operate as an important constraint on desirable reductions in credit and liquidity exposures.

Indeed, legal uncertainties and friction costs in obtaining valid transfers and pledges of interests in securities currently may be preventing a large portion of the world's stock of securities from being put to one of its highest and best uses when opportunities for such use arise. Put simply, they may be inhibiting the development of efficient, centralized collateral pools that can be used to secure credit exposure on loans and other extensions of credit, as well as counterparty credit exposure on transactions in foreign exchange, securities, futures, options, forwards, swaps or other derivative contracts.

The value of a security is a function of more than the issuer's creditworthiness or profit potential. It is also a function of the security's liquidity both for sales and collateral transactions - that is, the security's ready availability for purchase, sale, lending or pledging at the right time and in the right place. For example, if existing pledging procedures make it prohibitively expensive or impossible for borrowers or transaction counterparties to grant effective pledges of their interests in securities at the right place and at the right time, potential borrowers or transaction counterparties may be prevented from minimizing their overall cost of credit or cost of entering into transactions involving credit exposure to them. Conversely, if such procedures make it prohibitively expensive or impossible for potential lenders or transaction counterparties to obtain enforceable, first priority pledges of a borrower's interest in securities, potential lenders or transaction counterparties may not be willing to enter into a number of otherwise risk-reducing and profit-maximizing lending or other transactions involving credit exposure to a borrower or transaction counterparty. As a result, a portion of the world's stock of securities may not be put to its highest and best use. The cost of credit may be higher and the value of securities may be lower than they otherwise would be.²

Legal uncertainties and friction costs could also cause liquidity to dry up very rapidly in the event of the failure of a major financial institution. Other financial institutions are increasingly likely to hold billions of dollars of gross claims against the failed institution. Legal uncertainties tend to be exaggerated during times of distress. Persons exposed to unsecured credit risk tend to behave most desperately at such times. If there is uncertainty about whether the other institutions' gross claims can be reduced through the

liquidation of collateral to a small fraction of the gross amount, the other institutions may face the prospect of crushing losses or even insolvency. Similarly, if it is prohibitively expensive or impossible to obtain valid pledges of interests in securities, other institutions may not be willing to make new credit available or enter into new transactions with the failed institution. An unwillingness to make credit available or enter into new transactions with the failed institution could rapidly spread to other institutions, sending shock waves throughout the financial world.

These risks and costs have been magnified in recent years because of the dramatic growth in the value and velocity of local and international financial transactions. For example, the annual volume of cross-border securities transactions settled through Euroclear and Cede1 has grown from about \$5 trillion in 1987 to nearly \$30 trillion in 1994.³ The annual volume of domestic and cross-border transactions settled through the German Kassenverein, the U.S. Depository Trust Company (DTC) and the French Saturne and RELIT systems was over \$50 trillion in 1994.⁴ The volume of transactions in U.S. government securities settled through Fedwire,⁵ together with transactions settled solely on the books of the major U.S. clearing banks may be close to \$1 trillion or more per day. And the volume of transactions in foreign exchange and other spot market, option, futures, forward and swap contracts is several trillions of dollars per day.

Back-to-back purchase and sale transactions by professional dealers account for a large portion of this growth. But the fastest growing element of turnover consists of various types of *collateral transactions* in the form of repurchase agreements (repos), reverse repos, buy/sell transactions, collateral transferred to secure extensions of credit and counterparty credit exposures, and securities loans.⁶

At the same time, the customary settlement time frames have been shrinking to reduce certain forms of risk. Trades in some countries used to settle up to a month after the trade. But since 1989 when the Group of Thirty recommended that customary settlement cycles be reduced to five business days after the trade (T+5) and eventually to T+3,⁷ the settlement cycles in most countries have approached at least the T+5 ideal. The settlement cycles in the U.S. corporate and Euro securities markets have been compressed to T+3. The settlement cycle in spot-market foreign exchange transactions is T+2. And many transactions in U.S. and other government securities are settled on a same-day basis. While compressions of the settlement time frames reduce

replacement cost risk for some investors and secured creditors,⁸ they may increase legal and other forms of operating costs and risks for the same or other investors and financial intermediaries. As a result of all these trends, legal costs and risks that may have seemed tolerable only a few years ago have become matters of greater concern.

It is also no longer possible to insulate domestic issuers, investors and markets from these global market forces or related friction costs and risks. The collapse of communism, the bust of the boom in Mexico, the growing impotence of central bankers to control foreign exchange rates through market intervention, and the sudden failure of the Barings group are all signs that national borders have been obliterated as far as telecommunications, financial transactions and market forces are concerned. Local issuers, investors and markets are now part of a larger interdependent network that forms an increasingly globalized marketplace. The exploding growth in the value and velocity of global financial transactions will no longer safely permit a purely local focus.

The deficiencies of most national laws are well known among practicing lawyers who are called upon to give legal opinions as to the enforceability, priority or finality of various securities transfer or pledging arrangements. They have also attracted the attention of a growing number of financial policymakers and other observers.⁹

The current situation is a classic example of what Montesquieu called the separation of laws from the circumstances in which they were made or, perhaps even more accurately, the reverse.¹⁰ The new wine of holding, transferring and pledging securities by book-entry through multiple tiers of intermediaries has evolved in response to commercial needs and technological developments. The old wineskins of existing laws need to be replaced by modern bottles that will not burst.

This paper assumes that reductions in the cost of capital for issuers, increases in the value of securities to investors and secured creditors, reductions in the legal or other operating costs to issuers, investors and secured creditors, and the elimination of constraints on reductions in credit, liquidity and systemic risks are generally desirable. These assumptions should not be controversial. The current gap between most national laws and modern financial practices is probably the result of neglect rather than design. Existing laws may frequently have been drafted in the nineteenth century or before, or they may continue to be based on outdated assumptions about how securities

are held, transferred and pledged.

A country may also have legitimate local interests that need to be balanced against some of these international considerations under certain circumstances. These other specific interests should not become excuses, however, for preserving national laws that are overbroad for the specific purposes involved. It may frequently be possible to replace such laws with laws more narrowly tailored to promote the local objectives, while eliminating the aspects of those laws that compromise the finality of transfers and pledges of securities. For example, it is possible to draft laws that ensure adequate communications between issuers and ultimate owners and control hidden accumulations of ownership for fiscal and other purposes, assist enforcement of restrictions on foreign ownership of companies in certain specialized industries such as national defense, and give effect to restrictions on transfer and other special terms, without purporting to require all owners to have actual possession of physical certificates or to be the recorded owners on the books of the issuer.¹¹ A complete analysis of conflicting local interests or the possible overbreadth of existing laws is beyond the scope of this paper.

This paper first describes the changes in the way investors hold, transfer and pledge securities that have caused most national laws on the subject to become obsolete. It explains how deficiencies in most existing laws create the deadweight costs described above. It then discusses the fundamental principles that should be reflected in each country's laws so that they can be more accurately tailored to the new commercial environment. It unabashedly advocates a result-oriented approach. The desired legal result should be determined in advance, and then national laws should be enacted or revised to produce the result intended.

This paper takes the position that the desired result is a set of national laws that allows issuers, investors and secured creditors to determine in advance - with certainty and predictability - the substantive law that will govern their rights and obligations and, perhaps most importantly, those of possible adverse claimants. It should also allow them to become certain that they have a distinct package of rights that cannot successfully be attacked by an adverse claimant once they have taken certain clearly defined and reasonable actions. It suggests that the defined result can be achieved, and may not be achievable unless, the laws of a critical number of countries are revised to reflect four basic principles.

First, interests in securities held through one or more tiers of financial

intermediaries should no longer be forced into the procrustean beds of either traceable property rights in individual securities or mere contractual claims against the intermediaries. Instead, they should be recognized as a new type of interest in a pro-rata portion of a pool of securities or interests in securities held by the intermediary with whom the interest holder has a direct contractual relationship, evidenced solely by the interest holder's account with the intermediary. Such interests would not include traceable property rights in individual securities. They would not entitle the holder to the return of any specific securities. Instead, they would only entitle the holder to the return of an equivalent amount and type of securities. Such interests *and any claims adverse* to those of the *interest holder* would be realizable only against the intermediary with whom the interest holder has a direct contractual relationship, and not by attaching individual securities or interests in securities held by an upper-tier intermediary. The threat of upper-tier attachments is the principal impediment to achieving finality of securities transfers and pledges in the modern world.

Such interests would also be different from mere contractual claims because deposited securities would not become the property of the intermediary. Unlike money deposits, the intermediary would generally be required to maintain a sufficient pool of deposited securities or interests in securities (rather than loans or other assets) to satisfy the interests of all the interest holders.

Second, the pool of securities or interests in securities held by an intermediary to satisfy the interests of its interest holders should be protected against the claims of the intermediary's general creditors. It may be possible to achieve this result by defining the interest holder's interest as a new type of property right in a pro-rata portion of the pool of deposited securities or interests in securities. If this is not likely to be effective in the intermediary's insolvency, however, existing insolvency laws for financial intermediaries should be amended to give explicit effect to this policy.

Third, conflict of laws rules should be interpreted or modernized to reflect the development of the system for holding, transferring and pledging interests in securities by book-entry to accounts with financial intermediaries so that the selection of the law governing the characterization, the validity of any transfer or pledge, or the effectiveness or opposability of any pledge of interests in securities represented or effected by book-entry to accounts with a financial intermediary is determined by agreement among the relevant parties

or, in the absence of such agreement, by reference to where the office of the financial intermediary maintaining such accounts is located or otherwise by reference to the intermediary's jurisdiction. Better-informed applications of the *lex situs* or *lex loci actus* rules, or the creation of new direct statement rules, would all be examples of an appropriate method of reaching the same result. It would also be consistent with this approach to have back-up categorical rules to promote certainty and predictability, such as applying the internal law where an intermediary's chief executive office is located, when it may be impossible to determine where the relevant office maintaining the accounts is located.

Fourth, the procedures for creating and enforcing a pledge of interests in securities evidenced by book entries on the records of intermediaries should be simplified. Procedures that were intended or have the effect of making it prohibitively expensive or impossible for such interests in securities to be validly pledged to secure credit exposure should be eliminated or supplemented to facilitate such collateralization. Similarly, procedures that delay or otherwise restrict the liquidation or realization of the value of pledged securities or interests in securities should be eliminated where there is a sufficiently liquid market for the securities in question, the pledgee has the right to liquidate or otherwise realize on the value of such securities on the face of its agreements with the pledgor or under applicable law and it is reasonably possible for the pledgor (or its receiver) to recover damages from the pledgee to the extent the liquidation or realization is later shown to have been wrongful.

There are at least two national laws, and one model law being considered for enactment in the United States, that appear already to satisfy these four basic requirements, and can be used as models for reform. They are the Belgian Royal Decree No. 62 dated November 10, 1967 Facilitating the Circulation of Securities (as amended, April 7, 1995); the Luxembourg Grand-Ducal Decrees of February 17, 1971, December 18, 1991 and June 8, 1994; and Revised Article 8 of the Uniform Commercial Code." Perhaps the most important innovation of each of these laws is that they define a person's interest in securities held through any or certain types of financial intermediaries in terms other than traceable property rights in individual securities or mere contractual claims. Each defines such interests (with more or less clarity) as a property interest that is evidenced solely by an accounting entry on the books of the interest holder's intermediary and that does not include traceable property rights in individual securities. This innovation should promote the

finality of transfers and pledges made by book entry to accounts with an intermediary and substantially increase the certainty and predictability of existing conflict of laws rules. It invites courts to apply the law where the accounts with the intermediary are located to govern disputes over the finality and priority of transfers and pledges on the records of the intermediary.¹³ Each of these laws also has relatively simple and efficient pledging and realization procedures consistent with modern technology.

II. A Word About Terminology

This paper uses a variety of terms that may not have the same meaning from jurisdiction to jurisdiction, or when translated from English into another language. It also uses certain terms more broadly than their traditional meanings intend.

For example, the term “pledge” is used to mean both possessory and nonpossessory interests in property to secure the performance of an obligation, which are the potential equivalents of ownership if certain conditions (e.g., default) are satisfied. Although such a broad usage of the term is not uncommon, the term originally was limited to possessory interests in physical property. The terms “charge” and “security interest” are probably the more general alternatives commonly used in England and the United States, respectively.¹⁴ Neither of these terms, however, is particularly well understood by lawyers in the other of these two jurisdictions or in civil law countries. Civil law lawyers generally seem more comfortable with the term pledge, even when speaking of nonpossessory pledges. It therefore seemed that the goal of clarity would be served best by using the word pledge rather than either of these alternatives.

The phrase “collateral transaction” is also used very broadly to mean not only any pledge of securities to secure credit exposure on a loan for borrowed money or counterparty credit exposure on a securities or other transaction, but also any repurchase agreement (repo), reverse repo, buy/sell agreement and securities loan. The term “secured creditor” is used to mean any person having secured credit exposure on a collateral transaction.

This paper assumes that the principal difference between physical and dematerialized securities is simply the way in which they are evidenced. Any securities that are evidenced by individual physical certificates or by a single jumbo or global certificate for the entire issue are treated as physical securities. Any issue of securities that are represented solely by book entries on the records of the issuer or its agent (or other person) are treated as dematerialized securities. Whether registered physical securities are properly classified as

physical or dematerialized securities, or as some other category, is beyond the scope of this paper.¹⁵ Both physical and dematerialized securities can be held directly or through accounts with one or more tiers of intermediaries (indirectly). When interests in physical securities are transferred by book-entry on the records of financial intermediaries, without any change in the actual possession of the physical certificates, the physical securities are not transformed into dematerialized securities, but are viewed as immobilized physical securities in which interests are transferred by book entry.

Legal rules and market practices related to which person's records are the official records for purposes of recording interests in dematerialized or immobilized securities may differ from jurisdiction to jurisdiction. For instance, the records of a central securities depository (CSD) or specified member of a CSD may be the official records for dematerialized securities rather than the records of the issuer or its agent. For the sake of simplicity, however, this paper assumes that the official records of dematerialized securities are always the records of the issuer or its agent.

III. The Need for Multi-National Law Reform

To appreciate the commercial developments that have caused most national securities ownership, transfer and pledging laws to become obsolete, it is useful to consider them against the backdrop of a very simple market economy. For economists, the baseline market economy is the one that was faced by Robinson Crusoe. Crusoe was the unfortunate voyager who was shipwrecked on a deserted island. He lived in a simple world in which he could gather physical commodities and fashion some of them into capital assets. But there was no one with whom to trade when he first arrived. Much later, when he was able to exchange physical commodities with his native companion, Friday, any trades would have been settled by face-to-face delivery of one physical commodity against payment with another physical commodity, much as one delivers an orange against payment with paper money today. Crusoe and Friday operated in a barter economy, without any apparent form of money, and without financial intermediaries to safekeep their money or other assets, or to settle their trades.

With a few notable exceptions, such as the German and Austrian Kassenvereins at the end of the last century, the type of physical possession and face-to-face settlement that would have taken place on Crusoe's island accurately typifies the way in which investors held securities and settled trades in most countries until this century. The major costs and risks associated with holding physical money and securities directly, and settling exchanges of them in face-to-face transactions, are the risks of loss or theft of the physical securities or money, and the costs of protecting them against such risks, and the risks, out-of-pocket expenses and opportunity costs of delivering them across long distances.

For example, imagine the costs and risks associated with a modern international securities transaction if an antiquated physical settlement procedure were used. Suppose that a trader for Deutsche Bank agreed to sell Erie Railway bonds to a trader for Dai Ichi Bank against payment in gold (which was a more universally accepted form of money than paper currency in many

countries until the last century or so).¹⁶ In order to achieve simultaneous delivery-versus-payment in the Deutsche / Dai Ichi trade, Deutsche might ship the physical securities, and Dai Ichi the gold, to their respective agents in New York. On the appointed settlement date, the agents would meet face-to-face to exchange the securities and gold. The Deutsche agent might then ship the payment in gold back to its principal in Germany and the Dai Ichi agent the physical securities back to Japan.

Such a securities holding and settlement system would involve substantial amounts of loss, theft and illiquidity risks and costs. The gold or physical securities might be lost or stolen during the long ocean voyages (loss/theft risk), and from the time one side of the trade left the hands of its owner until the countervalue was received (the settlement pipeline) both the asset being delivered and the asset being received would effectively be unavailable to the owner for use or investment in the local markets. The temporary loss of the use of both assets amounts to a deadweight opportunity cost on both counterparties that has been called the “pipeline liquidity (or illiquidity) risk or cost” and has been carefully analyzed elsewhere.¹⁷

A. COMMERCIAL AND LEGAL DEVELOPMENTS ON THE MONEY SIDE OF TRANSACTIONS

As the volume, velocity and geographical extent of commercial transactions grew during the fourteenth and fifteenth centuries in Europe and elsewhere, market participants gradually discovered that they could substantially reduce the loss, theft and pipeline illiquidity costs and risks of money on the payment side of commercial transactions through certain innovations in the money holding and payment systems. These included immobilizing gold and other forms of physical money into the vaults of financial intermediaries, substituting paper certificates for bulkier forms of money, holding and transferring claims for physical money by book-entry through one or more tiers of banking institutions, treating such claims against banking institutions as a form of money, and having certain intermediaries assume certain pipeline liquidity costs and risks. Indeed, not only has such physical money been immobilized and supplemented by claims against banking institutions, it has been largely dematerialized altogether in the form of book entries on the records of central banks.

The first bank-like institutions in Europe were probably the money

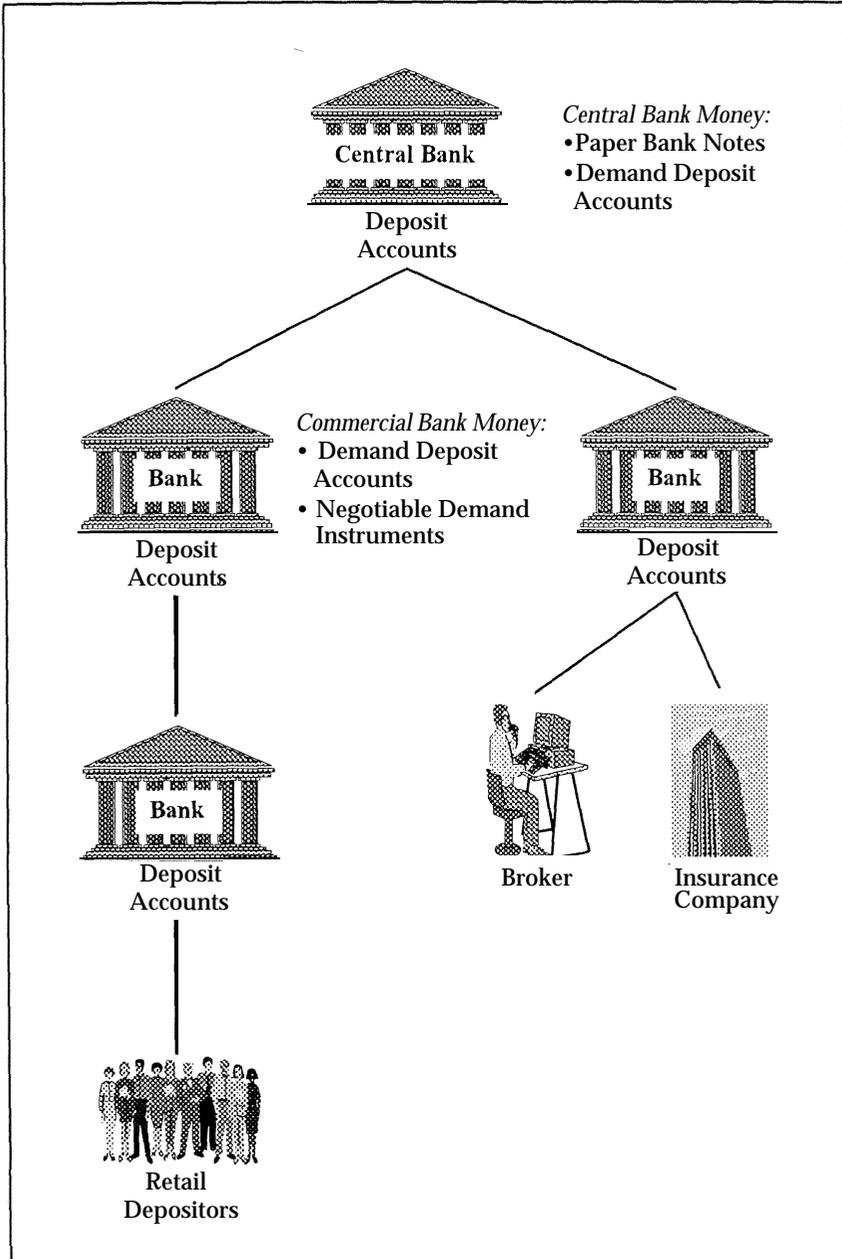
changers that immobilized a portion of the gold or other money supply of a given locality, and provided book-entry payment services that were more convenient and safe than physical delivery.¹⁸ As documented by Adam Smith in *The Wealth of Nations*,¹⁹ the supply of circulating gold money was gradually replaced by circulating bank notes (i.e., paper money) and demand deposit accounts that were issued or credited against the deposit of gold money in the banks. Smith called such paper money and deposit accounts “bank money”. Bank money can be payable or redeemable in gold, but can also be bare claims against the issuing banks (i.e., fiat money) if the public confidence in such bank money gives it the same “currency” as gold, silver or other money.

In most countries, central bank notes eventually drove out private bank notes as paper currency in part because of the greater level of public confidence in central bank notes and in part because of the enactment of legal tender laws. Legal tender laws designate some, but not all forms, of paper money as “legal tender” for all public and private debts. Demand deposit claims against private commercial banks (e.g., checks and other negotiable instruments and electronic accounting entries on the books of banks or interbank clearing houses) have nevertheless continued to form an important part of the money supply in most developed economies. In recent years, the vast quantity of money held and used for payment in developed countries has been completely dematerialized in the form of credits to electronic demand deposit accounts at central banks (i.e., central bank money) or commercial banks (i.e., commercial bank money).

Most depositors generally are *not* permitted and do not demand or desire to have accounts *directly* with the central bank issuers of central bank money.²⁰ Instead, they generally are only permitted and demand or desire to hold interests in such money *indirectly* through accounts at private commercial banks. Thus, at least in developed countries today, the vast quantity of interests in central bank money is not held or transferred physically or by direct book-entry on the books of central bank issuers. Instead, they are held and transferred indirectly through accounts at one or more tiers of commercial bank intermediaries,²¹ as illustrated by Figure 1.

The earliest European depository institutions acted as mere custodians for deposits of gold and other precious metals, charging fees for their custody and book-entry payment and foreign exchange services.²² The deposits often were only temporary to facilitate a specific payment or money changing transaction. The depositories typically maintained a balance between the

Figure 1. Multi-Tiered Money Holding and Payment System



amount of their deposit liabilities and the amount of gold or other precious metal actually on deposit. As confidence in the depositories grew, however, more and more depositors left their money on deposit permanently.

Depositories transformed themselves from mere custodians to banking institutions when they realized that it was unnecessary to carry gold or other precious metal reserves equal to 100% of their demand notes and other deposit liabilities to satisfy the normal flow of depositor withdrawals. As a result, they began to lend out all but a fraction (e.g., 20%) of the gold or other money deposited with them, causing the amount of their outstanding deposit liabilities and demand notes to exceed the amount of gold and other precious metal they held on reserve to satisfy withdrawal demands.²³ (Of course, the total assets of such institutions-in the form of gold, loans and other assets - continued to balance with total liabilities.) Because the public confidence in such demand notes was frequently as strong as the confidence in gold and other precious metal money, the depositories (now banks) effectively participated in determining the quantity of money and credit in their respective economies. At least since Adam Smith, the issuance of "bank money" and the making of loans against fractional reserves of gold or central bank money has been considered the most beneficial power of banks and, indeed, the essence of banking.²⁴

The general public benefitted from these developments in a number of ways. Depositories enjoyed certain economies of scale in reducing the loss and theft risks associated with holding and transferring money. Competition forced the depositories to pass on the benefits of these economies of scale to depositors in the form of lower custody and payment charges. When the depositories transformed themselves into banking institutions and began to compete for deposits to fund their lending operations, they developed ways to reduce or more efficiently manage the risks and costs associated with making loans and other extensions of credit. Fractional reserve lending also increased the supply of money and credit in affected economies. Competition forced banks to pass on the benefits of these developments to the market in the form of lower custody, credit and pipeline liquidity costs and risks.

For example, custody and payment charges were reduced or eliminated, and many depositors began receiving payment for their deposits in the form of interest or free services. The increased supply of credit reduced the cost of loans and other extensions of credit, including those made to investors during a settlement pipeline. For example, central banks and other banking

intermediaries today frequently make uncompensated intraday extensions of credit through the assumption of daylight overdraft exposure in connection with money and securities settlement systems. All of these developments increased the liquidity of money, allowing potential borrowers and lenders to have or obtain more money at the right place in the right time at a lower overall cost (including transaction or operating costs).

These commercial developments were accompanied or followed by legal developments that further reduced the friction costs and risks associated with holding and transferring money. Roman and early European law treated gold and other money deposits as “regular deposits”, to use a modern civil law term.²⁵ The holder of a regular deposit was treated as having traceable property rights in individual gold coins or other precious metals deposited.²⁶ Over time, however, such deposits became redefined as “irregular deposits”.²⁷ That is, in the absence of express agreement and physical segregation, the depositor was treated as a general creditor of the bank.²⁸ By the time these legal concepts developed in the United States, the treatment of money deposits as a debtor/creditor relationship was so well established in England, at least, that the civil law concept of an “irregular deposit” of money was called a “general deposit” and the concept of a “regular deposit” of money was called a “special deposit”.²⁹

These legal developments had two important effects on the rights and duties of depositors, and those of adverse claimants. First, because the nature of a depositor’s rights was defined as a general claim against the bank instead of a traceable property right in individual gold or other money deposited, depositors and banks could determine in advance with relative certainty and predictability the substantive law that would govern their rights and obligations and those of possible adverse claimants. The substantive law governing the rights and duties of persons that had actual possession of physical money, and the rights of adverse claimants, generally became the law where the physical money was located.³⁰ But the substantive law governing the rights and duties of persons holding interests in physical money through a bank, and the rights of adverse claimants, generally became the law where the deposit accounts were located.³¹ Second, because depositors did not have traceable property rights in individual gold or other metal coins, it became possible for money to be transferred by book-entry through one or more banks, without concern over whether the rights of any depositor could be successfully challenged by an adverse claimant seeking to obtain an attachment of indi-

vidual gold or other money subdeposited with another bank. This feature has been a key to the finality of money payment transactions.

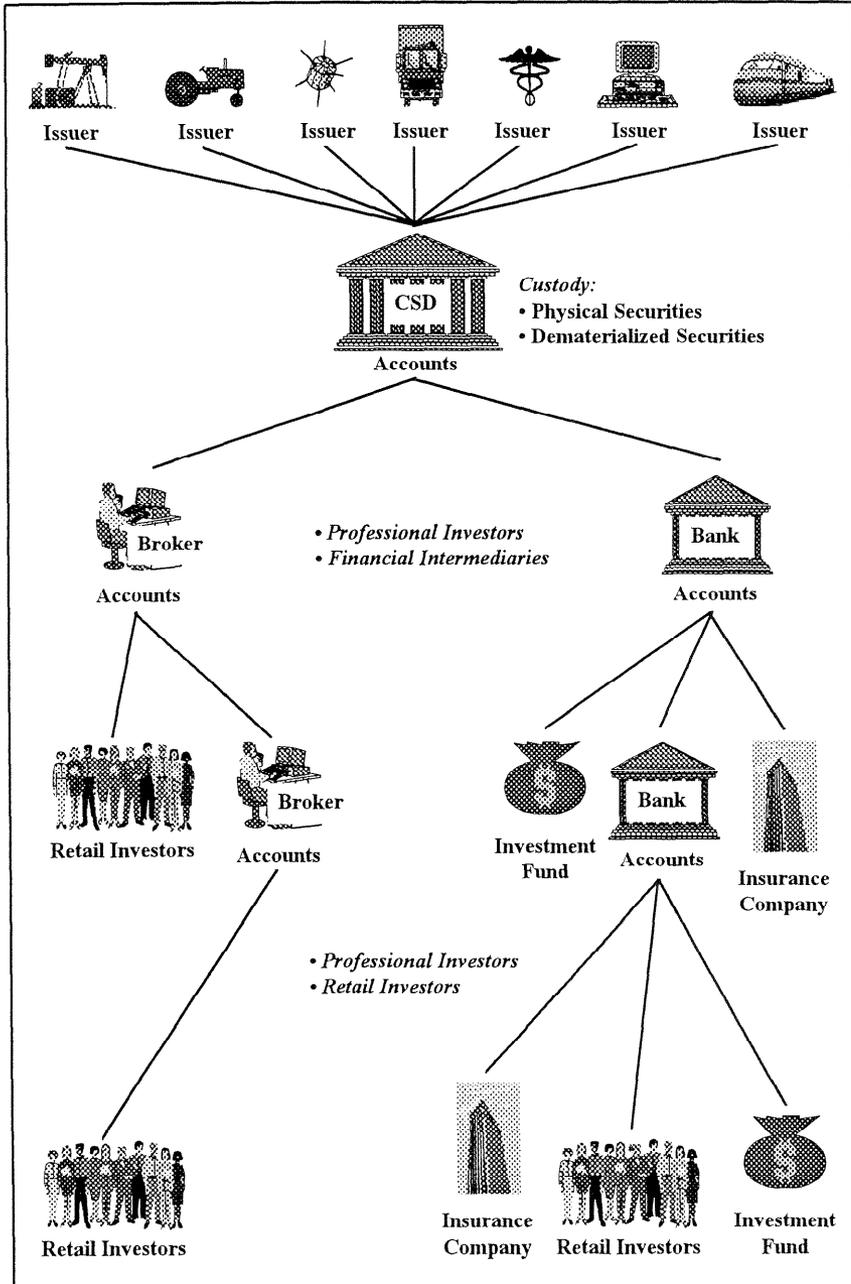
B. COMMERCIAL DEVELOPMENTS ON THE SECURITIES SIDE OF TRANSACTIONS

The commercial evolution in the structure for holding and transferring securities has followed a similar pattern, although its development has been centuries behind the development of the structure for holding and transferring money. As with money, investors have discovered that they can substantially reduce the loss, theft and illiquidity costs and risks of holding, transferring and pledging securities by doing so through one or more tiers of financial intermediaries such as banks, brokers and central securities depositories like the German Kassenverein, the U.S. Depository Trust Company, the French SICOVAM, Cede1 Bank and Euroclear. This has resulted in the emergence of a multi-tiered securities holding, transfer and pledging structure similar to the structure for holding and transferring metal, paper or dematerialized money. The differences between physical and dematerialized securities, however important they may be, should not obscure the more fundamental distinction between the direct and indirect aspects of the modern securities holding, transfer and pledging systems.

The efficiencies associated with a multi-tiered structure have led national and international policymakers to encourage the immobilization of physical securities and the centralization of settlement. For example, the Group of Thirty recommended in 1989 that each domestic market should establish a central securities depository (“CSD”) to hold securities in the relevant market.³² The recommended scheme contemplated that the settlement of transactions in both physical and dematerialized securities would be centralized through a CSD. Most markets that did not already have established CSDs in 1989 have organized one or more CSDs and centralized local settlement through them.³³

A simplified version of the multi-tiered securities holding system is represented by Figure 2. It illustrates how a large number of professional and retail investors actually hold, transfer and pledge interests in securities. Just as a central bank sits at the top of the multi-tiered system for holding and transferring money in a particular currency, so a CSD and issuers generally sit at the top of a multi-tiered structure for holding, transferring and pledging

Figure 2. Multi-Tiered Securities Holding, Transfer and Pledging System



interests in the securities of a particular market. A CSD generally has actual possession or control of a large portion of the physical or dematerialized securities in a given market. As shown by Figure 2, some professional investors and financial intermediaries have direct contractual relationships with CSDs. They hold interests in securities through accounts on the records of the CSDs. Other investors (especially retail investors) generally hold their interests through brokers or other financial intermediaries at a lower tier in the multi-tiered structure. Three or more intermediaries can often stand between an investor or intermediary and the individual physical or dematerialized securities in a given market.

To maximize the efficiencies of the multi-tiered structure, most CSDs and other financial intermediaries have adopted the practice of holding physical securities in fungible pools and of holding interests in dematerialized or registered physical securities through accounts in the name of the CSD or other financial intermediary (i.e., in “nominee name”) with the issuer or its agent. The ultimate investor’s ownership interest frequently may not be shown on the books of the issuer, the CSD or other financial intermediary, except the particular intermediary with which it has a direct contractual relationship. The investor’s direct intermediary will typically hold interests in the security in an omnibus account with the CSD or other intermediary at the next level up the multi-tiered structure.

When a transfer or pledge is made between two customers of a single intermediary in a multi-tiered structure, the only thing that generally happens is that accounting entries are made on the books of that intermediary. There frequently are no physical movements of securities and no accounting entries made on the books of the issuer or its agent. As far as the issuer is concerned, nothing has changed with respect to actual possession or record ownership of the securities issued by it.

The multi-tiered holding system reduces the traditional loss, theft and illiquidity costs and risks associated with holding, transferring and pledging securities. All the physical securities in a particular market can be immobilized in a modern vault, thus making it more difficult for thieves to break in and steal. The transfer and pledge of interests in physical and dematerialized securities can take place by accounting entries on the books of one or more intermediaries, without any movement of physical securities or accounting entries on the books of the issuer or its agent. This allows investors to mobilize their interests in securities more efficiently for trading and collateral purposes

than if they had to transport the securities physically or deal with individual issuers. By holding securities in fungible pools, intermediaries can provide these efficiencies at a very acceptable processing cost.

The real world, of course, is not as simple as Figure 2. Domestic and foreign investors actually hold, transfer and pledge interests in securities issued by domestic and foreign issuers through a much more complicated network of domestic and foreign banks, brokers, CSDs and other financial intermediaries. This complex global network has been carefully analyzed elsewhere.³⁴ The important point for purposes of this discussion paper is that there is no “domestic” portion of this complicated global network that is or can be entirely insulated from the rest.

Some countries have resisted the Group of Thirty’s recommendation to establish a CSD, at least as generally conceptualized. Australia, New Zealand and the United Kingdom are the most notable examples, although only Australia has expressly rejected the recommendation.³⁵ These countries have tried to preserve their historical issuer-direct systems for holding, transferring and pledging interests in securities, at least for securities of domestic issuers, even if certain functions have been centralized through a type of CSD.³⁶ Although there has been no rigorous comparison of such systems to those centered around traditional CSDs, the existing issuer-direct systems probably increase the cost of capital to public and private issuers who are deprived of the option of having their securities transferred and pledged through a multi-tiered system, decrease the value of their securities to investors and secured creditors, increase the operating costs of issuers, investors and secured creditors, operate as a significant constraint on the efficient reduction of credit and liquidity exposures through the efficient mobilization of domestic securities as collateral, and contribute to systemic risks in times of financial distress.

The reason that these assertions are probably true is that it can be prohibitively costly for intermediaries to process large volumes of securities transactions within the (rapidly decreasing) customary time frames if they are required to trace each customer’s interest to an identifiable physical certificate or accounting entry on the books of the issuer or its transfer agent. In addition, it is far more complicated for issuer-direct systems to implement an efficient scheme for netting offsetting delivery and payment obligations, either on a bilateral or multilateral basis, unless the books of all the issuers in a particular market are managed by a central intermediary. Some observers have sug-

gested that the principal reason for the failure of the proposed Taurus settlement system in the United Kingdom was the overly ambitious desire to provide the sort of efficiencies increasingly demanded by the market while preserving the issuer-direct features of the system it was supposed to replace.

C. THE STATE OF MOST NATIONAL LAWS ON THE SECURITIES SIDE OF TRANSACTIONS

Although the vast quantity of securities issued by domestic or foreign issuers in most markets is now held, transferred and pledged by domestic and foreign investors through the book-entry facilities of a complex network of domestic and foreign intermediaries, few countries have updated their securities ownership, transfer or pledging laws to reflect these commercial developments. Instead, many national laws continue to reflect assumptions of a bygone era when securities of domestic issuers were held, transferred and pledged by actual physical possession or changes in physical possession mainly by domestic investors or secured creditors, or by accounting entries made directly on the books of the issuer or its agent. Very few of these laws have been revised specifically for the multi-tiered holding system.

Substantive Laws. For example, take the U.S. substantive laws governing the ownership, transfer and pledging of securities. Except for a special body of federal regulations governing U.S. treasury securities, these laws have been enacted at the individual state rather than the national level. Prior to 1958, most U.S. state laws assumed that all securities were represented by physical certificates and held, transferred and pledged directly by investors. The ownership, transfer and pledging of securities were often defined in terms of who had actual possession of physical certificates. In a multi-tiered holding structure, however, physical certificates are immobilized at the top tier. Investors do not have actual possession of physical certificates. Moreover, transfers and pledges are effected by accounting entries on the books of lower-tier intermediaries, without any change in the actual possession of the physical certificates.

An organized attempt to modernize and harmonize the different U.S. state laws in this area was made in 1958 with the publication of the original version of Article 8 of the Uniform Commercial Code (“UCC”), a model U.S. law that was later enacted by a number of states. The original version of Article 8 contained references to the ownership and delivery of securities through

certain financial intermediaries, but it did not deal effectively with the commercial developments described above. It generally seemed to define the interest of an investor or secured creditor in securities held through an account with a broker or clearing corporation as a traceable property right in individual securities. Although it contained provisions for the delivery of securities through a broker, these provisions assumed that the delivery would take place by the broker obtaining actual possession of specific physical securities. It also contained provisions for the delivery of securities by book-entry directly on the books of a clearing corporation. It did not contain specific provisions, however, for the delivery of securities by book-entry on the books of financial intermediaries that did not have actual possession of physical securities or were not clearing corporations.

The pledging of securities in 1958 was governed by Article 9 of the UCC, which governed the pledging of personal property, including physical securities and accounts. Article 9 did not contain specific provisions, however, for the pledging of securities by book-entry on the records of financial intermediaries.

Article 8 was amended in 1978, mainly to provide specific rules for the ownership, transfer and pledging of uncertificated (dematerialized) securities. The 1978 version also included provisions specifically designed for the transfer and pledging of interests in certificated or uncertificated securities by book-entry on the records of any financial intermediary, including any financial intermediary that held such securities through another financial intermediary. The 1978 version, however, continued to appear to define a person's interest in securities held through an account with a financial intermediary as a traceable property right in individual securities.

The federal regulations governing the ownership, transfer and pledging of U.S. book-entry treasury securities ("Book-Entry Treasury Rules") have relied on Article 8 and other similar laws, as well as certain legal fictions, for many of their substantive provisions. They provide that book-entry treasury securities held through one or more tiers of depository institutions (and not directly with the U.S. Treasury or a Federal Reserve bank) "shall. . . be deemed to be maintained in bearer definitive form [i.e., as bearer physical securities],"³⁷ even though they are not. The substantive rules governing the transfer and pledging of interests in such securities are then supplied by "applicable law" which typically will be the version of Article 8 in effect in a relevant state. By relying on Article 8 or other laws for their substantive provisions, the Book-Entry Treasury Rules effectively incorporate the conceptual flaws of these

other laws.

The major deficiencies of the 1978 version of Article 8 and the Book-Entry Treasury Rules were described in a 1990 essay by Professor Charles Mooney, who argued that these deficiencies could not be avoided so long as the laws were based on a “property law construct”.³⁸ Although this probably overstates the case somewhat, their fundamental flaw does lie in defining the interest of an investor or secured creditor in securities held through intermediaries in terms of *traceable* property rights in individual securities.

The substantive laws in most countries suffer from the same fundamental flaw. For example, in most civil-law countries an interest in securities or other assets that are segregated from the assets of the depository and the depository’s other clients is treated as a “regular deposit”. A person with an interest in a regular deposit is generally treated as having a traceable property right in individual securities or other assets on deposit.³⁹ The laws of these countries generally do not contain provisions specifically designed for securities held, transferred or pledged on the books of financial intermediaries that do not have actual possession of physical securities or record ownership on the books of the issuer or its agent. The legal results, assumptions and omissions are generally the same in common-law countries, even though different legal terms are used.

When a person’s interest in securities held through financial intermediaries is defined as a traceable property right in individual securities, it may be difficult to ascertain with sufficient certainty and predictability the substantive law that will govern the person’s rights and obligations or those of possible adverse claimants. For example, under the *lex situs* conflict of laws rule, the substantive law governing a traceable property right in specific securities is generally the law of the jurisdiction where the specific physical securities or accounts evidencing dematerialized securities are located. If an issue of physical securities is located in more than one jurisdiction and it is not possible to trace an interest in them to specific securities located in only one of the jurisdictions (because, for instance, they are all held as one fungible pool partly located in one country and partly in another), the rule may not allow market participants to determine the applicable substantive law in advance.

Even when the substantive law can be determined in advance, a different law may apply to different issues of securities held through the same financial intermediary. For example, if an investor or secured creditor holds traceable property rights through a single financial intermediary in 50 differ-

ent issues of securities evidenced by physical certificates or issuer records located in 25 different jurisdictions, the *lex situs* rule might subject transfers and pledges of such securities to 25 different substantive laws. The applicable substantive law may also change in the case of physical securities if they are moved from one location (i.e., subcustodian) to another. This can make it prohibitively expensive or otherwise impractical or impossible for investors or secured creditors to follow the procedures for obtaining an enforceable, first priority transfer or pledge of each issue of such securities, which are frequently held through a single securities account, especially in an environment characterized by accelerating turnover and increasingly compressed settlement time frames. It also would substantially increase the operating risks and costs of intermediaries that must facilitate such transfers and pledges, which are typically passed on to issuers, investors and secured creditors in the form of higher costs.

This practical problem can be even more serious in real life than the example suggests. CSDs and other financial intermediaries frequently hold *thousands* or even *tens of thousands* of issues of securities. Increasingly, the physical certificates and issuer records representing these securities, as well as the relevant buyers and sellers, are located in different countries. It may be impossible, and would certainly be impractical, for an investor or secured creditor to comply with burdensome and potentially conflicting or overlapping procedural and other requirements that may apply if multiple laws govern the transfer or pledge of securities made on the books of a single intermediary.

The threat of such practical problems can lead to wasteful efforts by issuers to control the *lex situs* rule in order to make their securities more attractive to the market. For example, a significant number of market participants may hold interests in a large number of securities through a single CSD or other financial intermediary. These securities may be more valuable to these market participants if they can be transferred and pledged under a single set of laws, regardless of where the issuers are located. An issuer of dematerialized securities whose books are located in a different jurisdiction would not ordinarily be able to satisfy this market demand. However, by causing a portion of its otherwise dematerialized securities to be evidenced by one or more physical certificates deposited with the intermediary, the issuer can change the relevant governing law from the law where its books are located to the law where the physical securities (and intermediary's books) are located.

Unless investors and secured creditors follow the relevant procedures for obtaining enforceable interests under all laws that might conceivably be applicable, they may face uncertainty about whether interests can be successfully attacked by adverse claimants. This could hinder the effectiveness of modern pledging procedures that exist in some jurisdictions (e.g., a pledge of securities in the form of a credit to a pledged account on the records of a financial intermediary), unless the pledgee has obtained actual possession (or would be deemed to have constructive possession) of physical securities or has (or would be deemed to have) a recorded interest in its name on the books of the issuer of registered or dematerialized securities.

When securities held through a financial intermediary are not segregated from the intermediary's own assets, the interest holder may be treated as having a general contractual claim against the intermediary, instead of traceable property rights in individual securities. For example, under general principles of law in most civil-law countries a person with an interest in unsegregated securities is generally treated as having an "irregular deposit".⁴⁰ Irregular securities deposits are treated like general money deposits

the deposited securities become the property of the intermediary and the interest holder becomes a general creditor of the intermediary. The legal result is generally the same in common-law countries, although different legal terms are used.

Treating an interest in securities held through a financial intermediary as a general contractual claim against the intermediary might resolve the legal uncertainties about which law applies and reduce the costs of obtaining an enforceable, first priority transfer or pledge of the interest. But it would achieve these benefits at the expense of creating other problems, such as exposing investors and secured creditors to the insolvency risk of their intermediaries. While such a risk may be tolerable in the case of securities intermediaries with strong credit ratings, many investors currently believe that they should be able to enjoy the efficiencies of the modern holding, transfer and pledging structure without assuming any significant insolvency risk of their intermediaries.

There also may be important differences between money and securities that dictate the need for a different legal treatment. Securities are typically more complex than bank notes and other demand claims that qualify as money, having ancillary entitlements such as voting rights that are not associated with money. Equity securities, for example, often include voting

rights, corporate governance entitlements, distribution entitlements and other aspects not shared by money. Even most bearer debt securities include certain distribution and other rights not shared by money. It may be difficult, absent an express agreement, to allocate these ancillary rights effectively if intermediaries acquired outright ownership of deposited securities, although standardized gap-filling rules probably could be developed.

Conflict of Laws Rules. The conflict of laws rules governing the transfer and pledging of interests in securities, and available commentary on how they should be applied, also have not been updated in most jurisdictions to reflect the new commercial environment. Existing rules or illustrations of their application often assume that an investor's interest in securities held through intermediaries is either a traceable property right in individual securities or a general contractual claim.

For example, take the *lex situs* rule, which is probably the dominant conflicts rule in most developed countries for commercial law matters,⁴¹ and the existing illustrations of its application to securities transactions. Its proper application may depend more on the characterization of the legal rights at issue than the content of the rule itself.⁴² Thus, if an investor's interest in securities is characterized as a traceable property right in individual securities, the rule will generally dictate that the validity of any transfer or pledge of, or any adverse claim for, such securities will be governed by the law where the individual physical or dematerialized securities were located at the time the transfer or pledge took place or the adverse claim arose.⁴³ In contrast, if the interest is characterized as a contractual claim against the intermediary, the rule will generally dictate that the validity of any transfer or pledge of, or any adverse claim to such claim will be governed by the law where the accounts are located.⁴⁴ The leading commentators do not explain how the rule would be applied if the interest being transferred or pledged does not fall into the traceable property rights or mere contractual claim categories.

There are similar gaps in the applicable conflict rules under U.S. law. The 1978 version of Article 8, for example, contains a specific rule (8-106) for determining the substantive law governing the validity of a security, the rights and duties of the issuer with respect to the registered transfer of such a security on the issuer's books and the effectiveness of a registered transfer of the security on the issuer's books. It does not contain a specific rule for determining the substantive law governing the rights and duties of a purchaser or adverse claimant with respect to interests in securities held or

transferred by book-entry on the records of a financial intermediary. As noted above, such transfers generally do not result in a change in record ownership on the books of the issuer, and they raise questions independent of the validity of the underlying securities. Under the 1978 version of Article 8, these other questions would be determined by the general provisions of Section 1-105 of the UCC and judge-made law. Section 1-105 allows the parties to a transaction to select the substantive law of any jurisdiction having a reasonable relationship to the transaction. In the absence of such a contractual choice of law or if a dispute involves an adverse claim by a person not bound by the contract, Section 1-105 effectively specifies that the law of the forum will govern any transaction bearing an “appropriate” relationship to it. Not only does this encourage forum shopping after a dispute arises, but the UCC also does not provide any guidance on what may be an appropriate relationship or what law would apply if an appropriate relationship to the forum is not found.

The corresponding rules for determining the substantive law governing the procedures for obtaining an effective pledge of securities and the effect of such a pledge are contained in the 1978 version of Article 9 of the UCC. Section 9-103(l)(b) of that version provides that the law governing these issues with respect to individual physical securities is the law where the securities are located when the last event occurs on which the pledge is based. Section 9-103(6) of that version provides that the law governing these issues with respect to individual dematerialized securities is the law of the issuer’s jurisdiction. Section 9-103(3)(b) of that version provides that the substantive law governing these issues with respect to mere contractual claims for deposited securities (i.e., “general intangibles”) is the law of the debtor’s jurisdiction. There is no specific rule for determining the substantive law governing these issues with respect to interests in securities held through intermediaries that are neither traceable property rights in individual securities nor mere contractual claims.

Pledging Procedures. The procedures for obtaining a valid pledge of securities in most countries are generally quite simple when the pledgor has actual possession of physical securities or is identified as the interest holder of dematerialized securities directly on the books of the issuer or its agent. Most countries will treat a pledge of physical securities as valid if there is an agreement between the parties and the pledgee takes actual possession of the physical securities (appropriately endorsed). Most also treat a pledge of dematerialized securities as valid if there is an agreement between the parties

and the pledgor has the securities transferred into an account in the pledgee's name on the books of the issuer or its agent.

The procedures frequently are not clearly defined or simple, however, when the subject of the pledge is an interest in securities held through accounts with a financial intermediary. If the interest being pledged is treated as a traceable property right in physical securities, most countries will treat a pledge of such interest as valid if (i) there is an agreement between the parties and (ii) each intermediary between the pledgee and the physical securities credits the pledgee's interest in such securities to a segregated account in the pledgee's name on its books or the intermediary with actual possession of the pledged securities physically segregates them (appropriately endorsed) for an agent of the pledgee or for the pledgee itself. If the interest being pledged is treated as a traceable property right in dematerialized securities, most countries will treat a pledge of such interest as valid if (i) there is an agreement between the parties and (ii) each intermediary between the pledgee and the dematerialized securities credits the pledgee's interest in such securities to a segregated account in the pledgee's name on its books or the issuer or its agent credits the pledgee's interest to an account in the name of an agent of the pledgee or in the name of the pledgee itself. A few countries will treat a pledge of such interests as valid if there is an agreement between the parties and the interest is merely credited to an account in the name of the pledgee on the books of the financial intermediary.⁴⁵

If the interest being pledged is treated as a mere contractual claim against the intermediary, most common-law countries will treat a pledge of such claim as valid if there is an agreement between the parties and public notice of the pledge is filed where the debtor on the claim that is being secured (not the debtor on the claim that is acting as collateral - i.e., the financial intermediary) is located. The procedures for obtaining a valid pledge of such a claim are more complicated in civil law countries. In most civil law countries, the procedures consist of (i) reading the collateral agreement out loud before a public notary in the jurisdiction where the debtor on the claim that is acting as collateral (i.e., the financial intermediary) is located, (ii) having such financial intermediary acknowledge and agree to respect the pledge by notarial deed and (iii) having such financial intermediary provide a list to the notary of each item credited to the accounts representing the pledged claims. Step (iii) must generally be repeated each day on which there is any activity in the accounts.

IV. Fundamental Principles of Law Reform

National laws should allow investors and secured creditors to determine in advance with certainty and predictability the substantive law that will govern their rights and obligations with respect to interests in securities held or obtained through accounts with financial intermediaries, as well as the rights of potential adverse claimants. Such laws should also allow them to be certain that they can obtain and hold such interests free of adverse claims once certain clearly defined and reasonable actions have been taken. In particular, national laws should facilitate and not hinder the development of efficient, centralized collateral pools to secure credit exposure on loans and other extensions of credit, as well as counterparty credit exposure on foreign exchange, securities, futures, options, forwards, swaps and other derivative contracts. These results can be achieved if national laws are enacted, revised or interpreted to reflect four fundamental principles:

- **Interests in securities held through a financial intermediary should be defined by legislation or otherwise interpreted as a type of interest in a pro-rata portion of the pool of securities or interests in securities held by the intermediary with whom the interest holder has a direct contractual relationship evidenced solely by the interest holder's account with the intermediary, and not as a traceable property right in individual securities or a mere contractual claim.**

- **The pool of securities or interests in securities held by a financial intermediary to satisfy the interest of its interest holders should be protected against the claims of the intermediary's general creditors, either by defining the interest as a type of property or co-property right or by amending existing insolvency laws for financial intermediaries to give explicit effect to this policy.**

- **Conflicts of laws rules should be interpreted or modernized to reflect the development of the system for holding, transferring and pledging interests in securities by book-entry to accounts with financial intermediaries so that the selection of the law governing the**

characterization, transfer and pledge of interests in securities represented or effected by book-entry to accounts with a financial intermediary is determined by agreement among the relevant parties or, in the absence of such agreement, by reference to where the office of the financial intermediary maintaining such accounts is located or otherwise by reference to the intermediary's jurisdiction.

• Procedures for creating and enforcing a pledge of interests in securities credited to accounts with intermediaries should be simplified.

Such revisions would substantially reduce the legal uncertainties and other friction costs caused by the gap between existing laws and the way in which most securities are held, transferred and pledged by investors and secured creditors today.

A. NEW TYPE OF INTEREST IN SECURITIES

The first suggested principle of multi-national law reform is designed to break out of the procrustean bed of defining interests in securities held through financial intermediaries as either traceable property rights in individual securities or mere contractual claims against the intermediaries. Like contractual claims, such interests and any adverse claims to such interests would be realizable only against the intermediary with which the interest holder has a direct contractual relationship, and not by attaching individual securities or interests in securities held by the intermediary with any upper-tier intermediary. They would thus be different in this fundamental respect from traceable property rights in individual securities or pools of individual securities.

They would also be different from mere contractual claims, however, because the pool of securities or interests in securities to which the interest relates would not become the property of the intermediary. The intermediary would generally be required to maintain a sufficient pool of deposited securities or interests in securities to satisfy the claims of all the interest holders.

Regulators could provide investors and secured creditors with further protection against the insolvency risk of their intermediaries by imposing minimum capital and periodic auditing requirements, conducting periodic examinations and establishing investor insurance schemes. Investors and

secured creditors should also have the option of holding, transferring and pledging securities directly with issuers or in physical form, even if such an option involves a trade-off with efficiency.

B. PROTECT INTEREST AGAINST INTERMEDIARY'S GENERAL CREDITORS

The pool of securities or interests in securities held by an intermediary to satisfy the interests of its interest holders should be protected against the claims of the intermediary's general creditors. It may be possible to achieve this result by defining or otherwise interpreting an interest holder's interest as a type of property right or co-property right in a pro-rata portion of the pool of deposited securities or interests in securities. If this is not likely to be effective in the intermediary's insolvency, however, existing insolvency laws should be amended to give explicit effect to this policy.

C. CONFLICT OF LAWS RULES

The third suggested principle is that conflict of laws rules should be interpreted or modernized to reflect the development of the system for holding, transferring and pledging interests in securities by book-entry to accounts with financial intermediaries so that the selection of the law governing the characterization, the validity of any transfer or pledge, or the effectiveness or opposability of any pledge of interests in securities represented or effected by book-entry to accounts with a financial intermediary is determined by agreement among the relevant parties or, in the absence of such agreement, by reference to where the office of the financial intermediary maintaining such accounts is located or otherwise by reference to the intermediary's jurisdiction. Better-informed applications of the *lex situs* or *lex loci actus* rules, or the creation of new direct statement rules, would all be examples of an appropriate method of reaching the same result. It would also be consistent with this approach to have back-up categorical rules to promote certainty and predictability, such as applying the internal law where an intermediary's chief executive office is located, when it may be impossible to determine where the relevant office maintaining the accounts is located.

In interpreting or modernizing the rules for interests in securities credited to accounts with intermediaries, sharp distinctions should be made

between the rights and duties of (i) issuers, (ii) persons who are identified as the holders of interests in registered or dematerialized securities directly on the books of an issuer or its agent, (iii) persons who have actual possession of physical securities and (iv) persons who are identified as the holders of interests in physical or dematerialized securities on the books of financial intermediaries.

The substantive law governing the validity of securities and the rights and duties of issuers should be the law of the issuer's jurisdiction. The law governing any contest between the rights of any person identified as the holder of an interest in dematerialized securities directly on the books of an issuer or its agent and the rights of any adverse claimant in such interest should be the law where the books are located (typically the issuer's jurisdiction). The law governing any contest between the rights of persons that have actual possession of physical securities and those of any adverse claimant in such physical securities should be the law where the physical securities are located. The law governing the rights and duties of an intermediary with respect to interests in securities credited to accounts with it, as well as any contest between the rights of any person identified as the holder of such an interest on the books of the intermediary and those of any adverse claimant in such interest, should be the law where the intermediary's office maintaining such accounts is located or otherwise by the law of the intermediary's jurisdiction.

The third principle is consistent with an informed application of the *lex situs* rule, assuming that an interest in securities held through a financial intermediary is defined as recommended above. Such an interest would be evidenced solely by the interest holder's account with the intermediary and would therefore be located where the intermediary's office at which the accounts are booked is located. Because investors and secured creditors would not have traceable property rights in individual securities, the location of individual securities would be irrelevant. The principle would also be consistent with the *lex loci actus* rule.⁴⁶

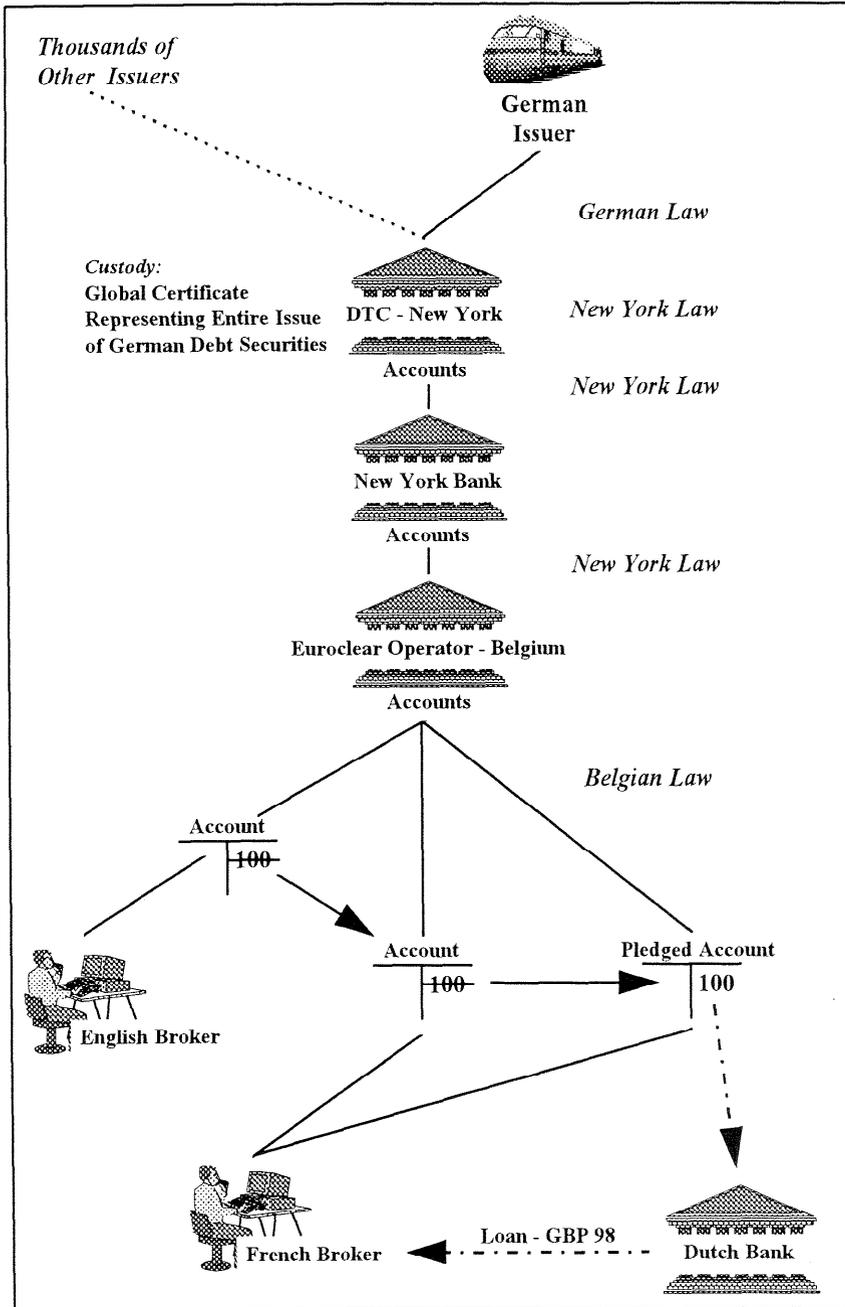
The following example illustrates how the third principle would be applied to a typical international transaction involving interests in physical securities. Suppose that a German corporation issues debt securities represented by a global certificate immobilized at DTC (located in New York) and registered in the name of Cede & Co., DTC's nominee, with part of the initial distribution being made to U.S. investors and part of it being made to non-U.S.

investors. An English broker purchases an interest in the securities and takes delivery of the interest by book-entry to its account with the Euroclear operator (located in Belgium). The Euroclear operator holds a position in the securities for the benefit of Euroclear participants through a New York participant of DTC. Suppose that the English broker transfers its interest in the securities to a French broker by book-entries on the records of the Euroclear operator. The French broker then pledges its interest in the securities to a Dutch bank to secure a loan from that bank by having its interest in the securities credited to a “pledged account” on the books of the Euroclear operator in favor of the Dutch bank. See Figure 3.

Under the *lex situs* rule, if the English broker’s interest in securities credited to the Euroclear account is defined as recommended above, the law governing the validity of the book-entry transfer of the interest in the German securities from the English broker to the French broker would be Belgian law because the “thing” (*res*) being transferred is not a traceable property right in a portion of the global certificate or a mere contractual claim against the Euroclear operator, but a type of interest in a pro-rata portion of the pool of securities or interests in securities held by the Euroclear operator evidenced solely by the English and French brokers’ accounts with the Euroclear operator. For the same reason, the law governing the effectiveness of the book-entry pledge of the interest in German securities from the French broker to the Dutch bank would be Belgian law. The result would be the same under the *lex loci actus* rule, regardless of how the “thing” is defined, because the sole actions taken to effect the transfer and pledge are the book entries to the accounts with the Euroclear operator. Of course, the result would also be the same under a rule that directly restates the third suggested principle, or a more detailed variation of it, rather than simply interpreting existing rules to be consistent with the third principle.

It would also be consistent with all three approaches for (i) German law to govern the validity of the individual securities and the rights and duties of the issuer, (ii) New York law to govern any contest between the rights of DTC and those of any adverse claimant in the individual physical certificate, (iii) New York law to govern any contest between the rights of the New York participant and any adverse claimant with respect to interests in the securities credited to accounts on DTC’s records, and (iv) New York law to govern any contest between the rights of the Euroclear operator and those of any adverse claimant with respect to interests in the securities credited to accounts on the

Figure 3. Conflict of Laws - Physical Securities



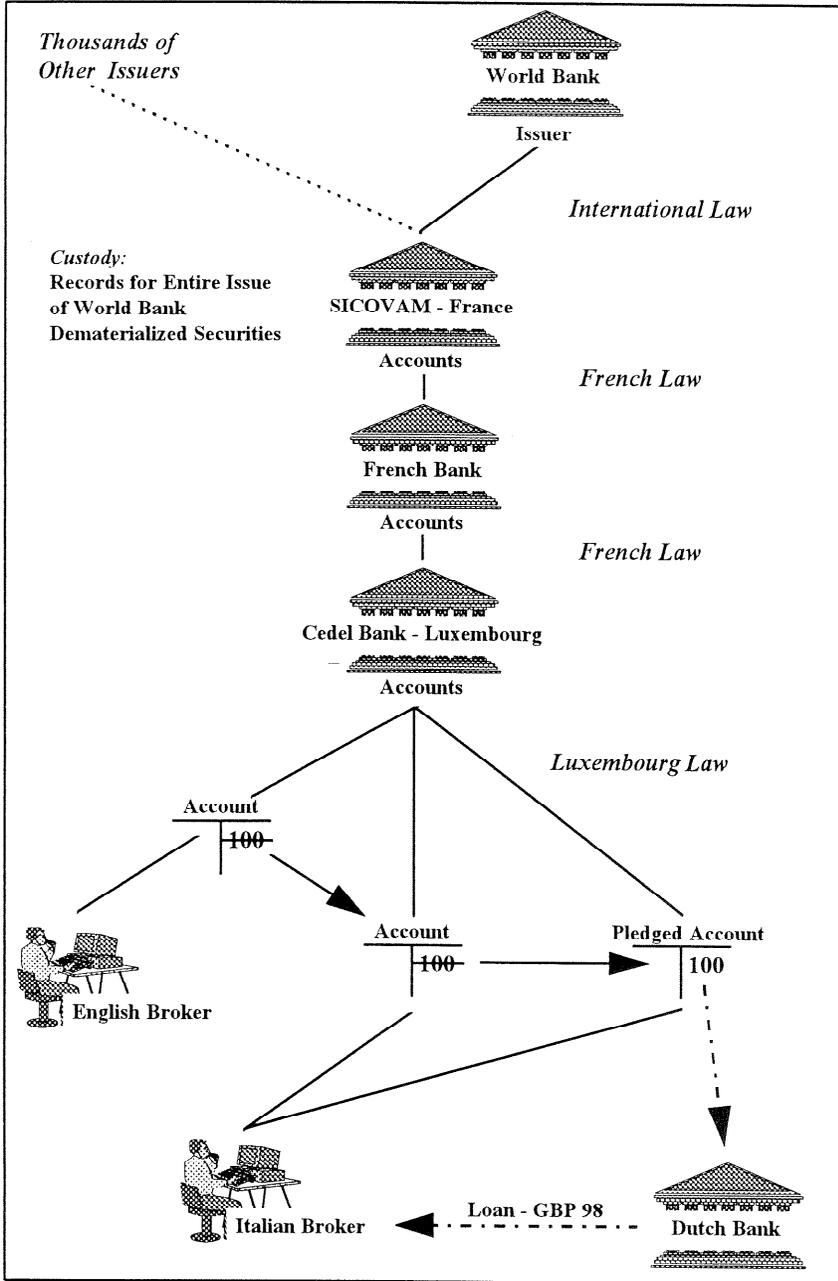
New York participant's records.

The following example illustrates how the third principle would be applied to a typical international transaction involving interests in dematerialized securities. Suppose that the World Bank issues French-franc denominated dematerialized debt securities represented by credits to accounts on the books of SICOVAM (located in France), with part of the initial distribution being made to French investors and part of it being made to non-French investors. An English broker purchases an interest in the securities and takes delivery of the interest by book-entry to its account with Cedel Bank (located in Luxembourg). Cedel Bank holds a position in the securities for the benefit of Cedel participants through a French participant of SICOVAM. Suppose that the English broker transfers its interest in the securities to an Italian broker by book-entries on the records of Cedel Bank. The Italian broker then pledges its interest in the securities to a Dutch bank to secure a loan from that bank by having its interest in the securities credited to a "pledged account" on the books of Cedel Bank in favor of the Dutch bank. See Figure 4.

Under the *lex situs* rule, if the English broker's interest in securities credited to the Cedel account is defined as recommended above, the law governing the validity of the book-entry transfer of the interest in the World Bank securities from the English broker to the Italian broker would be Luxembourg law because the "thing" (*res*) being transferred is not a traceable property right in some of the individual dematerialized securities on the records of SICOVAM or a mere contractual claim against Cedel Bank, but a type of interest in a pro-rata portion of the pool of securities or interests in securities held by Cedel Bank evidenced solely by the English and Italian brokers' accounts with Cedel Bank. For the same reason, the law governing the effectiveness of the book-entry pledge of the interest in World Bank securities from the Italian broker to the Dutch bank would be Luxembourg law. The result would be the same under the *lex loci actus* rule, regardless of how the "thing" is defined, because the sole actions taken to effect the transfer and pledge are the book entries to the accounts with Cedel Bank. Of course, the result would also be the same under a rule that directly restates the third suggested principle, or a more detailed variation of it, rather than simply interpreting existing rules to be consistent with the third principle.

It would also be consistent with all three approaches for (i) some form of international commercial law existing or adopted by the World Bank's member states or any commercial law selected by the World Bank or applicable

Figure 4. Conflict of Laws - Dematerialized Securities



to the official record holder of its securities to govern the validity of the individual securities and the rights and duties of the World Bank, (ii) French law to govern any contest between the rights of the French participant and any adverse claimant with respect to interests in the securities credited to accounts on SICOVAM's records, and (iii) French law to govern any contest between the rights of Cedel Bank and those of any adverse claimant with respect to interests in the securities credited to accounts on the French participant's records.

D. SIMPLIFIED PLEDGING AND REALIZATION PROCEDURES

The final suggested principle is that procedures for creating and enforcing a pledge of interests in securities credited to accounts with intermediaries should be simplified. The collateralization of credit exposure should be encouraged and not inhibited by excessively expensive or impossible pledging or realization procedures. There does not appear to be any compelling public policy reason why secured creditors should be required to obtain actual or constructive possession of physical securities or have their interests in dematerialized securities recorded directly on the books of the issuer or its agent in order to obtain an effective pledge of an interest in such securities credited to accounts with a financial intermediary. Nor does there appear to be any compelling reason for public filing requirements or notarial formalities. These types of procedures tend to discourage the collateralization of credit exposures, increasing the cost of credit and decreasing the value of securities.

It should be sufficient for secured creditors to obtain "control" over the pledged interest on the books of the intermediary. Such a procedure is analogous to obtaining possession of physical securities or having an interest in dematerialized securities recorded in the name of a pledgee directly on the books of an issuer or its agent. The required control can be obtained by having interests in the underlying securities credited to a special account in the name of the pledgee or having the intermediary agree to follow the instructions of the pledgee to liquidate the securities or interests in securities (subject to applicable collateral realization procedures) without any further action by the pledgor. An agreement between the pledgor and pledgee would contain provisions describing when the pledgee would have the right to give such instructions. The pledgee should be able to allow the pledgor to keep trading interests in securities credited to the special account prior to any default. This

should foster the development of efficient domestic and global collateral pools that can be used to secure various types of credit exposure.

Similarly, procedures that delay or otherwise restrict the liquidation or realization of the value of pledged securities or interests in securities should be eliminated where there is a sufficiently liquid market for the securities in question, the pledgee has the right to liquidate or otherwise realize on the value of such securities on the face of its agreements with the pledgor or under applicable law and it is reasonably possible for the pledgor (or its receiver) to recover damages from the pledgee to the extent the liquidation or realization is later shown to have been wrongful.

V. Sample Modernized Laws

There are at least two national laws, and one model law being considered for enactment in the United States, that appear already to satisfy these four basic principles, and can be used as models of reform. They are the Belgian Royal Decree No. 62 dated November 10, 1967 Facilitating the Circulation of Securities (as amended, April 7, 1995); the Luxembourg Grand-Ducal Decrees of February 17, 1971, December 18, 1991 and June 8, 1994; and Revised Article 8 of the Uniform Commercial Code.

A. BELGIUM: ROYAL DECREE NO. 62

Belgian Royal Decree No. 62 was specifically designed for the transfer and pledging of interests in securities held through C.I.K. (the Belgian national clearing agency) and its affiliates (which include a broad range of financial institutions with offices in Belgium).⁴⁷ It has recently been amended to clarify the nature of a person's interest in securities held through one of these intermediaries and to address other issues. It appears to satisfy all four principles.

First, Articles 10 to 13 of the Royal Decree, as interpreted by leading Belgian scholars and practicing lawyers,⁴⁸ define the interest of an investor or secured creditor in securities held through accounts with C.I.K. or its affiliates as a package of personal rights and co-property rights in favor of each person credited with interests in securities of the same type. This package of rights does not include traceable property rights in individual securities, but only a right to a notional portion - represented by a credit to an account - of a pool of assets of the same type held by the intermediary on behalf of the collectivity of its interest holders. The title of the interest holder is the book entry and not the actual physical or dematerialized securities or interests in such securities held by the intermediary. An interest holder can obtain additional contractual rights against its intermediary by agreement.

Second, the package of rights includes a right of *revendication*, exercis-

able in the event of the insolvency of the intermediary. That right entitles the holder to the return of a specific quantity of securities or interests in securities, which right is superior to the claims of the intermediary's general creditors. This right has been characterized by leading Belgian scholars and lawyers as reflecting a co-proprietary right to a notional portion of the pool of securities of the same type held by the intermediary on behalf of the collectivity of its interest holders.

Third, the applicable conflict of laws rule in Belgium is the *lex rei sitae* (*lex situs*) rule. Because the interest of a person who holds securities through accounts with C.I.K. or any of its affiliates is represented solely by book entries to the accounts, and does not include traceable property rights in individual securities, leading Belgian lawyers have indicated that any such interest being pledged should be held to be located where the accounts are located for purposes of applying the *lex rei sitae* conflict of laws rule.⁴⁹ The explanatory memorandum accompanying the recent amendments to the Royal Decree similarly indicated that transfers and pledges of the interest would be governed by Belgian law as long as the intermediary against whom the interest can be exercised is established in Belgium.⁵⁰

Fourth, Article 5 of the Royal Decree provides that a valid pledge of an interest in securities held through an account with C.I.K. or one of its affiliates can be obtained by having the interest credited to a pledged account. In addition, a secured creditor may liquidate pledged securities that are subject to the Belgian Royal Decree through a private or public sale in a Belgian or foreign regulated market, as long as prior notice is given to the pledgor, with no need to obtain the prior authorization of a Belgian court.

B. LUXEMBOURG: GRAND-DUCAL DECREES

The Luxembourg Grand-Ducal Decrees were designed for the transfer and pledging of interests in securities held through financial intermediaries located in Luxembourg. They appear to satisfy all four principles.

First, the Grand-Ducal Decrees, as interpreted by leading Luxembourg lawyers, define the interest of an investor or secured creditor in securities held through accounts with a financial intermediary in Luxembourg as a right of ownership. This right does not include traceable property rights to individual securities identified by individual serial numbers, but it consists of a right of ownership in a given number of non-individually identified securities of the

same type held by the intermediary in a pool on behalf of the collectivity of all owners of the same type of securities. The title of the interest holder is the book-entry, and transfer of the title is made by book entry in the name of the transferee.

Second, the interest includes a right of revendication, exercisable in the event of the insolvency of the intermediary. That right entitles the holder to the return of a specific quantity of securities or interests in securities, which right is superior to the claims of the intermediary's general creditors.

Third, the applicable conflict of laws rule in Luxembourg is the *lex rei sitae* (*lex situs*) rule. Because the interest of a person who holds securities through accounts of a Luxembourg intermediary is represented solely by book entries to the accounts, and does not include traceable property rights in individual securities, leading Luxembourg lawyers have indicated that any such interest being pledged should be held to be located where the accounts are located for purposes of applying the *lex rei sitae* conflict of laws rule.

Fourth, the Grand-Ducal Decrees provide that a valid pledge of an interest in securities held through an account with a Luxembourg-based intermediary can be obtained by having the interest credited to a pledged account. In addition, a secured creditor may liquidate pledged securities that are subject to the Luxembourg Grand Ducal Decrees through a private or public sale in a Luxembourg or foreign regulated market, as long as prior notice is given to the pledgor, with no need to obtain the prior authorization of a Luxembourg court.

C. UNITED STATES: REVISED ARTICLE 8 OF THE UNIFORM COMMERCIAL CODE

Revised Article 8 is a model law approved in 1994 by the American Law Institute and the U.S. National Conference of Commissioners on Uniform State Laws. It also contains certain revisions to Article 9 of the UCC related to the perfection of security interests in security entitlements. It has been enacted into law in several states, and is pending for consideration in several others. It appears to satisfy all four principles.

First, Section 8-102(a)(17) defines the interest of an investor or secured creditor in securities held through accounts with a financial intermediary as a "security entitlement" - a *sui generis* package of personal rights and property interests more fully defined in Part 5 of Article 8. Section 8-501 indicates

that a security entitlement is evidenced solely by a book entry to an account on the books of a financial intermediary. Section 8-503 provides that financial assets underlying a security entitlement are held by the securities intermediary for the entitlement holders and are not property of the securities intermediary. The totality of Revised Article 8 and the official comments make it clear that a security entitlement does not include traceable property rights in individual securities or interests in securities held by an upper-tier intermediary that could be attached by an adverse claimant to a security entitlement.

Second, Section 8-503 also provides that the financial assets underlying a security entitlement are not subject to the claims of creditors of the securities intermediary, except for creditors who obtain control over the security entitlement.

Third, Revised Section 8-110 provides that the law governing the rights and duties of the securities intermediary and entitlement holder with respect to a security entitlement and whether an adverse claim can be asserted against an entitlement holder is the law of the intermediary's jurisdiction. Revised Section 9-103(6)(d) similarly provides that the law of the intermediary's jurisdiction governs the perfection, the effect of perfection or non-perfection and the priority of a security interest in a security entitlement. The intermediary's jurisdiction is defined as any jurisdiction selected in an agreement between the intermediary and the entitlement holder or, in the absence of such agreement, the jurisdiction where the office specified in such agreement as the place where the accounts are maintained is located or, in the absence of such a specification, the jurisdiction where the office specified in the entitlement holder's account statement as the place serving the entitlement holder's account is located or, in the absence of such specification, the jurisdiction where the intermediary's chief executive office is located,

Fourth, Revised Section 9-115 provides that a secured creditor may obtain an effective pledge of a security entitlement by obtaining "control" over the entitlement. Revised Section 8-106(d) provides that a secured creditor (purchaser) has control of a security entitlement if it becomes the entitlement holder or if the securities intermediary agrees that it will comply with entitlement orders originated by the secured creditor (purchaser) without further consent by the entitlement holder. A person becomes an entitlement holder by having the security entitlement credited to an account in its name on the books of the intermediary.

In addition, both existing and revised Section 9-504 of the UCC permit

a secured creditor to liquidate pledged securities that are subject to Article 9 in any commercially reasonable manner, without judicial process and in many circumstances even without prior notice to the pledgor.

VI. Conclusion

This paper has tried to show that certain national laws governing the ownership, transfer and pledging of interests in securities held through intermediaries need to be modernized to allow investors and secured creditors to be able to determine in advance-with certainty and predictability-the substantive law that will govern their rights and obligations or those of possible adverse claimants. They also need to be modernized to allow investors and secured creditors who hold interests in securities through intermediaries to be certain, once the governing law has been ascertained, that they have a distinct package of rights that cannot successfully be attacked by adverse claimants. This objective can be achieved if the laws of a critical number of major countries are revised to reflect the four basic principles discussed above. The relevant laws of Belgium and Luxembourg, and Revised Article 8 of the U.S. Uniform Commercial Code, appear to satisfy these four basic principles. They can therefore serve as models for reform in other countries.

Notes

1. There is no settled definition of the term “systemic risk”. The following definition was proposed at a conference last year on systemic risk: “the likelihood of a sudden, usually unexpected, collapse of confidence in a significant portion of the banking or financial system with potentially large real economic effects.” P. Bartholomew & G. Whalen, *Fundamentals of Systemic Risk*, Conference on Banking, Financial Markets, and Systemic Risk, U.S. Office of the Comptroller of the Currency (Washington, D.C., December 2, 1994). Some commentators have suggested that concern for systemic risk has been overblown because although the potential magnitude of the problem is very large, its probability is very small and market participants will not necessarily behave as if they cannot distinguish an unsound condition in one part of the economy from a sound condition everywhere else. See, e.g., A. Schwartz, *Systemic Risk and the Macroeconomy*, Conference on Banking, Financial Markets, and Systemic Risk, U.S. Comptroller of the Currency (Washington, D.C., December 2, 1994).
2. In most situations, the increased cost of credit is probably a matter of single or double digit basis points, but it could be much greater. For example, World Bank economists have estimated that the legal uncertainties and impediments to obtaining an enforceable pledge of securities or other personal property in Bolivia may increase the cost of credit in that country by 1,400 to 5,000 basis points (about one-third or more of the prevailing interest rates). See H. Fleisig, J. Aguilar & N. de la Peña, *How Legal Restrictions on Collateral Limit Access to Credit in Bolivia* (June 1994).
3. *Cross-Border Securities Settlements*, page 10 (Report prepared by the Committee on Payment and Settlement Systems of the central banks of the Group of Ten countries) (Bank for International Settlements: Basle, March 1995).
4. *Cross-Border Securities Settlements*, page 10.
5. *Cross-Border Securities Settlements*, page 10.

6. See, e.g., *Cross-Border Securities Settlements*, pages 41-42. A repo is a contract to sell and subsequently repurchase securities at a specified date and price. A reverse repo is a repo viewed from the perspective of the buyer. A buy/sell transaction is the simultaneous sale of a security and execution of a forward contract to buy the same security at an agreed upon price and date.
7. *Clearance and Settlement Systems in the World's Securities Markets*, page 14 (Group of Thirty: New York & London, March 1989) (Recommendation 7).
8. See, e.g., *Cross-Border Securities Settlements*, page 17-18 (prepared by the Committee on Payment and Settlement Systems of the central banks of the Group of Ten countries) (Bank for International Settlements: Basle, March 1995). Replacement cost risk is the risk that a party's counterparty in a securities transaction will not perform its obligation to deliver securities or make payment in accordance with the terms of their agreement, and is measured by the difference between the market price of the security and the contract price.
9. See, e.g., *Cross-Border Securities Settlements*, page 34, Annex 3; Remarks by A. Greenspan, Chairman, Board of Governors of the Federal Reserve System, Financial Markets Conference of the Federal Reserve Bank of Atlanta (March 3, 1995); R. Breuer, Member, Board of Directors, Deutsche Bank, Risk Management in Cross-Border and Multi-Currency Securities Clearance and Settlement, in *Symposium Proceedings, International Symposium on Banking and Payment Services*, pages 133-41 (Federal Reserve System: Washington, D.C., 1994); R. Guynn, *Modernizing Legal Rules to Reduce Settlement Risk*, *Capital Markets Forum Yearbook*, vol. 1, pages 172-79 (Graham & Trotman and International Bar Association: London, 1993); *Cross-Border Clearance, Settlement, and Custody: Beyond the G30 Recommendations*, pages xx-xxi, 14-16 (Euroclear Operations Centre: Brussels, June 1993).
10. Montesquieu, *The Spirit of the Laws*, Book 29, Chapter 14 (1748) (as translated by A. Cohler, B. Miller & H. Stone, Cambridge University Press, 1989).
11. See, e.g., Securities Exchange Act of 1934 (Exchange Act), Sections 14(a) and 14(b), and Rules 14a-13, 14b-1, and 14b-2 promulgated thereunder (imposing inquiry, disclosure and other obligations on issuers and intermediaries to facilitate the distribution of proxy materials, annual reports and other

shareholder information to, and the exercise of voting and other rights by, persons holding interests in an issuer's securities through such intermediaries); Exchange Act Section 17A(d) and Rule 17Ad-8 promulgated thereunder (requiring clearing agencies to disclose to issuers the identity of participants holding interests in the issuer's securities through the clearing agency); Exchange Act Sections 13(d) and 16(a), and Rules 13d-1, 13d-2 and 16a-1 promulgated thereunder (requiring persons who own directly or through a nominee interests in the shares of an issuer in excess of certain threshold amounts to disclose such ownership and changes therein to the issuer and the public); Uniform Commercial Code, Revised Article 8. Investment Securities (With Conforming and Miscellaneous Amendments to Articles 1, 4, 5, 9, and 10) (American Law Institute and National Conference of Commissioners on Uniform State Laws, 1994) (as approved by American Bar Association, February 14, 1995), Revised Sections 8-202 and Official Comment 2 (terms of security generally), 8-204 and Official Comment 4 (transfer restrictions).

12. Uniform Commercial Code, Revised Article 8. Investment Securities (With Conforming and Miscellaneous Amendments to Articles 1, 4, 5, 9, and 10) (American Law Institute and National Conference of Commissioners on Uniform State Laws, 1994) (as approved by American Bar Association, February 14, 1995).
13. J. Rogers, Beyond G30: Update: A New Approach to the Commercial Law of Securities Holding Through Intermediaries: the Proposed Revision of Article 8 of the United States Uniform Commercial Code, *Euroclear Review, Supplement* (September 1994). See also J. Rogers, Policy Perspectives on Revised UCC Article 8, *UCLA Law Review*, vol. 43, no. 5 (forthcoming June 1996); J. Benjamin, Computerization and Negotiability, Part 2, *Butterworth's Journal of International Banking and Financial Law*, pages 357-364 (September 1995); R. Goode, The Nature and Transfer of Rights in Globally Traded Securities, H8 (Oxford Law Colloquium, 1995).
14. See, e.g., Model Law on Secured Transactions, pages v-vii, x, 1 (European Bank for Reconstruction and Development: London, 1994).
15. In some countries, it is possible to have registered securities in both physical and dematerialized form. In others, registered securities apparently may be treated as a form of dematerialized securities. Finally, in some countries dematerialized securities may be treated as either bearer or registered securities, while in others they are treated only as registered securities.

16. See, e.g., Senator J. Sherman, Congressional Globe, 40th Cong., 3rd Sess., I, pages 626-30 (1869) (legal tender paper money is not real money like gold, but only a forced substitute that is nevertheless more convenient for many purposes); Legal Tender Cases, U.S. Reports, vol. 79, pages 457-681 (U.S. Supreme Court, 1870) (holding that legal tender paper money is legally equivalent to gold money); M. Friedman & A. Schwartz, A Monetary History of the United States, 1867-1960, chapter 2 (National Bureau of Economic Research: 1963) (discussing importance of gold as a form of money during the nineteenth century, especially for international transactions).
17. See, e.g., Cross-Border Clearance, Settlement, and Custody: Beyond the G30 Recommendations, pages x-xiii, 9-11, 14 (Euroclear Operations Centre: Brussels, June 1993).
18. See, e.g., Sir F. Pollock, The Early History of Banking, The Law Quarterly Review, vol. 34, page 11 (1918).
19. Book II, Chapter II (1776).
20. See, e.g., Cross-Border Securities Settlement, page 18 (Report prepared by the Committee on Payment and Settlement Systems of the central banks of the Group of Ten countries) (Bank for International Settlements: Basle, March 1995).
21. See, e.g., Diagrams 1, 4 and A1 and related discussion in C. E. V. Borio and P. Van den Bergh, The Nature and Management of Payment System Risks: An International Perspective, pages 9, 27, 67, 68-69 (Bank for International Settlements, BIS Economic Papers No. 36: Basle: February 1993).
22. See, e.g., T. Rogers, First Nine Years of the Bank of England, page 7-8 (Clarendon Press: Oxford, 1887); E. Nevin & E. Davis, The London Clearing Banks, pages 11, 17 (1970); Sir F. Pollock, The Early History of Banking, The Law Quarterly Review, vol. 34, page 22 (1918); J. Knox, A History of Banking in the United States, page 2 (1908); J. Van Ryn & J. Heenen, Principes de Droit Commercial, vol. 4, pages 246-47 (2d ed. 1988). This view is also supported by the legal meaning of the Latin word for deposit (*depositum*) under Roman law, which was a type of bailment. The depository was required to return the identical property deposited. Institutes of Justinian, Book III, Title xiv, No. 3 (T. Sandars, trans., 1869). See also *Coggs v. Bernard*, Lord Raymond's Reports, vol. 2, pages 912-13 (Kings Bench 1703) (Holt, C.J.); J. Story, Commentaries on the Law of Bailments, Chapter 1, Section 4 (1832). It was distinguished from a *mutuum*, which was a

transfer of property for consumption where only an equivalent amount rather than the identical property was required to be returned. Institutes of Gaius, Book III, Section 90 (E. Poste, trans., 1875); Institutes of Justinian, Book III, Title xiv (T. Sandars, trans., 1869). Even in civil law countries today, a “regular” deposit is a type of bailment, see, e.g., French Civil Code, Article 1932 (requiring depository to return the identical property received), whereas an “irregular” deposit is a type of debtor/creditor relationship. See, e.g., M. Planiol, *Treatise on the Civil Law*, vol. 2, nos. 2213-15 (Louisiana State Law Institute trans., 12th ed. 1959). But see H. de Page & R. Dekkers, *Traite Elementaire de Droit Civil Belge*, vol. 5, pages 253-56 (2nd ed. 1975) (irregular deposit only connotes that depository may return equivalent rather than identical property deposited, not that title to the deposited property transfers to the depository or that the depository may use the property for its own benefit without the depositor’s consent as in a debtor/creditor relationship). The adjectives may have been added after the more limited meaning of the word *depositum* eroded because of the development of modern banking practices.

23. See A. Smith, *Wealth of Nations*, Book II, Chapter II (1776); T. Rogers, *The First Nine Years of the Bank of England*, pages 6-9 (Clarendon Press: Oxford 1887); A. Usher, *The Early History of Deposit Banking in Mediterranean Europe*, pages 3, 183-84 (1943); R. de Roover, *Money, Banking and Credit in Mediaeval Bruges*, pages 203-04, 247-48 (1948).
24. See, e.g., A. Hamilton, *Treasury Report on a National Bank* (December 13, 1790); P. Webster, *An Essay on Credit: In Which the Doctrine of Bank, Is Considered, and Some Remarks are Made on the Present State of the Bank of North America* (Philadelphia 1786). The concentration of this power in a central bank also fueled one of the great national debates in U.S. history. See, e.g., A. Jackson, *State of the Union Message* (December 5, 1836).
25. See, e.g., Institutes of Justinian, Book III, Title xiv, No. 3 (T. Sandars, trans., 1869); *Coggs v. Bernard*, Lord Raymond’s Reports, vol. 2, pages 912-13 (Kings Bench 1703) (Holt, C.J.); J. Story, *Commentaries on the Law of Bailments*, Chapter 1, Section 4 (1932); M. Planiol, *Treatise on the Civil Law*, vol. 2, nos. 2204-12, pages 274-71 (Louisiana State Law Institute trans., 11th ed. 1939); French Civil Code, Article 1932.
26. See, e.g., Institutes of Justinian, Book III, Title xiv, No. 3 (T. Sandars, trans., 1869); French Civil Code, Article 1932.
27. See, e.g., M. Planiol, *Treatise on the Civil Law*, vol. 2, nos. 2213-15, pages

- 277-78 (Louisiana State Law Institute trans., 11th ed. 1939).
28. See, e.g., M. Planiol, nos. 2214-15, page 278; J. Van Ryn & J. Heenen, *Principes de Droit Commercial*, vol. III, page 148 (2nd ed. 1981). But see H. de Page & R. Dekkers, *Traite Elementaire de Droit Civil Belge*, vol. 5, pages 253-56 (2nd ed. 1975) (distinguishing irregular deposits of assets from loans and money deposits, arguing that the former allows the depository to return equivalent rather than the identical assets deposited, but does not result in the transfer of ownership of or the right to use the deposited assets).
 29. See, e.g., *Bank of the United States v. Bank of Georgia*, U.S. Reports, vol. 23, pages 341-42 (U.S. Supreme Court, 1825); *Marine Bank v. Fulton Bank*, U.S. Reports, vol. 69, pages 255-56 (U.S. Supreme Court, 1864).
 30. See, e.g., A. Dicey & J. Morris, *The Conflict of Laws*, page 965 (12th ed. 1993); F. Mann, *The Legal Aspect of Money*, pages 13-14 (5th ed. 1992).
 31. See, e.g., Dicey & Morris, page 925; Y. Loussouarn & J. Bredin, *Droit du Commerce International*, pages 733-34, 737-39 (1969); M. Vasseur & X. Marin, *Les Comptes en Banque*, pages 620-22 (1966); Rome Convention on the Law Applicable to Contractual Obligations, Article 4 (June 19, 1980); Uniform Commercial Code (United States), § 4A-507(l)(b) (1989); Restatement (Second) of Conflict of Laws, § 195 and Comment d (1971) (United States); UNCITRAL Model Law on International Credit Transfers, ch. I, footnote * (1992).
 32. *Clearance and Settlement in the World's Securities Markets*, page 7 (Group of Thirty: New York & London, March 1989) (Recommendation 3).
 33. See *Clearance and Settlement Systems Status Reports: Autumn 1992* (Group of Thirty: Washington, D.C. & London, 1992).
 34. See, e.g., *Cross-Border Securities Settlements*, pages 11-17 (prepared by the Committee on Payment and Settlement Systems of the central banks of the Group of Ten countries) (Bank for International Settlements: Basle, March 1995); *Shaping the Global Back-Office: A Front-Office Concern*, pages 131-57 (Price Waterhouse Financial Institutions Study, December 1994); *Cross-Border Clearance, Settlement, and Custody: Beyond the G30 Recommendations*, pages 31-33 (Euroclear Operations Centre: Brussels, June 1993).
 35. See *Clearance and Settlement Systems Status Reports: Autumn 1992*, Australia, page 3, New Zealand, pages 2-3, United Kingdom, page 5 (Group of Thirty: Washington, D.C & London, 1992). The reason given for this resistance in the Australian report was that "Australian issuers are

fundamentally opposed to any innovations in the processes of clearing, settlement and transfer of ownership that would detract from their current ability to determine beneficial ownership and to communicate with shareholders.” The United Kingdom report characterized the proposed Taurus system as a type of CSD.

36. See, e.g., M. Chamberlain, *Crest and UK Settlement* (Presentation at Seminar on Improving UK and US Book Entry Regimes, jointly sponsored by Travers Smith Braithwaite and Davis Polk & Wardwell, New York, April 27, 1995).
37. U.S. Code of Federal Regulations, title 31, section 306.118(b) (1995). The Book-Entry Treasury Rules contain separate provisions for the transfer and pledge of interests in book-entry treasury securities between depository institutions that have accounts directly with a Federal Reserve Bank. See U.S. Code of Federal Regulations, title 31, section 306.118(a) (1995).
38. C. Mooney, *Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries*, *Cardozo Law Review*, vol. 12, pages 305-427 (1990). See also J. Benjamin, *Custody - An English Law Analysis*, Part 1, *Butterworth's Journal of International Banking and Financial Law*, pages 121-123 (March 1994) (English law has failed to keep pace with modern practices).
39. See, e.g., M. Planiol, *Treatise on the Civil Law*, vol. 2, nos. 2204-12, pages 274-277 (Louisiana State Institute trans., 11th ed. 1939); H. de Page & R. Dekkers, *Traite Elementaire de Droit Civil Belge*, vol. 5, page 216-17 (1941); *Institutes of Justinian*, Book III. Title xiv, No. 3 (T. Sandars, trans., 1869).
40. See, e.g., M. Planiol, nos. 2213-15, pages 277-78. I understand that this legal result would no longer be implied in France with respect to dematerialized securities credited to accounts with a financial intermediary. The irregular deposit concept predates the dematerialization of securities in France, which was introduced in 1983. The official records of an issue of dematerialized securities in France are those of a specific financial intermediary, rather than those of the issuer, and the financial intermediary typically holds the entire issue on a fungible basis. Nevertheless, I understand that ownership or property rights in the entire issue of dematerialized securities would no longer be implied in favor of the financial intermediary by operation of the irregular deposit doctrine under French law. I also understand that in the event of the intermediary's insolvency, the dematerialized securities would be transferred to another financial

intermediary, and not be available to satisfy the claims of the first intermediary's general creditors, except to the extent of the first intermediary's own-account position.

41. See, e.g., A. Dicey & J. Morris, *The Conflict of Laws*, pages 915-37 (12th ed. 1993); Y. Loussouarn & J. Bredin, *Droit du Commerce international*, page 699 (1969) (calling rule the *lex rei sitae* rule). Although the dominant approach for resolving conflicts of laws in the United States is probably governmental interest analysis, see B. Curry, *Selected Essays on the Conflict of Laws* (1963) - a flexible approach that involves the balancing of governmental interests after a dispute arises - that approach has recently been roundly criticized for being biased in favor of the law of the forum, encouraging forum shopping after a dispute arises, and generally failing to promote certainty and predictability in commercial transactions. L. Kramer, *Rethinking Choice of Law*, *Columbia Law Review*, vol. 90, pages 277-345 (1990); L. Brilmayer, *Conflict of Laws: Foundations and Future Directions* (Little Brown: Boston, Toronto & London, 1991). Moreover, even the United States has generally had categorical conflict of laws rules for the ownership, transfer and pledging of securities. See, e.g., Sections 8-106 and 9-103 of the 1978 version of the Uniform Commercial Code.
42. See, e.g., Dicey & Morris, pages 34-47.
43. See, e.g., Dicey & Morris, pages 930-32.
44. See, e.g., Dicey & Morris, pages 925.
45. See, e.g., New York Uniform Commercial Code (1995), sections 8-313(d) (if accompanied by a "confirmation" of the "purchase") and 8-320(a) (if the financial intermediary is a "clearing corporation"); Belgian Royal Decree No. 62, Article 5 (if the financial intermediary is C.I.K., the Belgian national clearing agency, or one of its affiliates, including many financial institutions with operations in Belgium); Luxembourg Grand-Ducal Decree of June 8, 1994, Article 8.
46. See *Macmillan Inc. v. Bishopsgate Investment Trust plc* (No. 3), 9 All England Law Reports 747 (1995); R. Goode, *The Nature and Transfer of Rights in Globally-Traded Securities*, H8 (Oxford Law Colloquium, 1995).
47. For example, the Euroclear Operations Centre of Morgan Guaranty Trust Company of New York is considered a C.I.K. affiliate for purposes of the Belgian Royal Decree No. 62.
48. See, e.g., J. Van Ryn and J. Heenen, *Principes de Droit Commercial*, vol. III, pages 148-49 (2nd ed. 1981); M. van der Haegen, *Transfer and*

Collateralization of Book-Entry Securities in Belgium (25th Biennial Conference, International Bar Association, Section on Business Law, Subcommittee E5, Melbourne, Australia, October 13, 1994) (IBA Speech); M. van der Haegen, *Le Système Euroclear*, *Revue de la Banque*, vol. 3, page 139 (1994); P. Wood, *Comparative Law of Security and Guarantees*, page 86 (1995) (Comparative Law).

49. See, e.g., M. van der Haegen, IBA Speech; P. Wood, *Comparative Law*, pages 86-87.

50. Parliamentary Document, Senate of the Kingdom of Belgium, Session 1994-1995, Explanatory Memorandum, No. 1321-1, page 11.

Comments

**Toward International Harmonization of the Commercial Law of the
Modern Securities Holding and Transfer System:
Some Reflections from the United States Article 8 Revision Project**

By James Steven Rogers

Lawyers around the globe are increasingly becoming aware of the need for modernization of the domestic commercial law foundation of the securities holding system. In the United States, work has recently been completed on the drafting of a major revision of the commercial law to provide an adequate modern structure for the system of book entry securities holding through a multi-level system of intermediaries that has developed in recent decades. Because securities transactions are increasingly international, lawyers are also increasingly becoming aware of the desirability of harmonization of different nations' laws on this subject.

In contemplating the work that needs to be done to achieve a reasonably adequate level of international harmonization of the commercial law of the modern securities holding and transfer system it may be useful to differentiate three levels of challenge. First, there is the level of achieving consensus on the fundamental principles that should be implemented by any modern system of law governing securities transfers through intermediaries. Second, there is the level of implementing these principles within the domestic legal regimes of particular states. Third, there is the level of achieving a sufficient degree of consensus on choice of law principles that the inevitable elements of international non-uniformity in legal analysis or results will not impair the planning of securities transactions.

Randall Guynn's paper, "Modernizing Securities Ownership, Transfer and Pledging Laws," provides an important contribution at the first level, that is, identifying fundamental points on which it may be realistic to hope that different nations might reach consensus. Having served as the principal draftsman for the recent project in the United States to revise the branch of our commercial law that governs these matters, it goes without saying that I agree entirely with Guynn's suggestions concerning fundamental principles that should be implemented in any nation's commercial law of securities transfers. Indeed, to put the point another way, the four fundamental principles identified by Guynn aptly summarize the basic objectives that guided the American revision project. Guynn's paper makes an important contribution by endeavoring to state these guiding principles in a fashion that facilitates the

effort to generalize the work that has occurred in the United States and other nations in recent years to provide an adequate private law foundation for the modern securities holding system.

The second level - implementing these fundamental principles within the domestic legal systems of particular states - is perhaps the most challenging aspect of the task of modernizing the commercial law of the securities holding and transfer system. Here, as in any other branch of the law, general principles can be implemented in various ways in different legal systems. There has probably never been a legal system that did not proscribe murder and theft, yet one would hardly suppose that the existence of consensus on these fundamental points means that the law of major crimes is uniform among all nations or that a lawyer experienced in the law of crimes and criminal procedure in one nation could deal readily with another nation's laws on these matters. For essentially the same reasons, reaching consensus on the fundamental principles that should guide the modernization of the law of securities holding through intermediaries will necessarily be the beginning, not the end of the effort to achieve a workable level of international harmonization. Differing local conditions and history are likely to make it necessary to implement the basic principles in different ways, because these basic principles cannot stand alone but must instead be integrated into the general corpus of each nation's own domestic law.

Inasmuch as the United States has recently undertaken this task, it may be useful to provide a brief synopsis of the drafting process, both to enable lawyers in other nations to understand the present status of the law of securities holding in the United States, and, perhaps, to provide some perspective on the challenges of law revision on this subject that may be of interest to those involved in similar projects in other nations.

In the United States, regulation of issuance of and trading in securities and regulation of participants in the securities markets is primarily dealt with by federal legislation and regulations promulgated thereunder by the federal Securities and Exchange Commission. However, commercial law, including the commercial law foundation of the securities markets, has traditionally been governed primarily by the law of the individual states rather than by federal law. In the present century, the various states have been relatively successful in achieving uniformity on matters of commercial law via the uniform state laws process. The basic commercial statute in the United States, the "Uniform Commercial Code" (UCC) is the joint product of two non-governmental

bodies, the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI). The commercial law of securities transfer and securities holding is found in Article 8 of the UCC. When the need for revision of one of the Articles of the UCC becomes apparent, a Drafting Committee is established by the NCCUSL and the ALI. The membership of the Drafting Committee is drawn from the members the two sponsoring bodies. A "Reporter," usually a law professor, is appointed to prepare drafts for consideration and review by the members of the Drafting Committee. A large group of advisers having specialized experience and knowledge in the particular subject work with the Drafting Committee and the Reporter. Drafts are also commonly circulated to and reviewed by various other organizations, such as the appropriate committees of the American Bar Association. After a several year process of drafting and review, a proposed final draft is presented to the full membership of the sponsoring bodies at their respective annual meetings.

Upon approval by both NCCUSL and the ALI, the revision becomes part of the "Official Text" of the Uniform Commercial Code. That, however, does not of itself give force of law. Rather, it means only that NCCUSL, and the recommend that the individual states adopt the revision as part of their own statutory law. The revision becomes effective if and only if it is adopted as law by a particular state in the same fashion as any other item of state legislation.

The impetus for the Article 8 revision project came from several of the studies issued after the October 1987 stock market break, in which it was suggested that uncertainties about the application of the Article 8 rules to securities held through financial intermediaries, particularly the rules governing perfection of security interests in securities so held, might have adversely affected the willingness of financial institutions to provide essential financing to securities firms in periods of market disturbance. The chairman of the Securities and Exchange Commission requested that the American Bar Association undertake a study of possible revisions of Article 8 and related provisions of bankruptcy law. In response, the Business Law Section of the ABA formed an Advisory Committee on Settlement of Market Transactions. In February of 1991 the ABA Committee issued an Interim Report, making tentative recommendations for revision of Article 8 and various provisions of the federal Bankruptcy Code.

At the same time that the ABA Committee was at work, the United States Congress was considering various legislative packages for amendments to the federal securities laws in response to the October 1987 market break and the

failure of Drexel Burnham in February of 1990. Included in the legislation adopted as the Market Reform Act of 1990, was a provision giving the Securities and Exchange Commission the authority to promulgate federal regulations that would preempt state law on the transfer and pledge of securities if the SEC finds, after recommendations of an Advisory Committee and consultation with the Secretary of the Treasury and Board of Governors of the Federal Reserve System, that the absence of a uniform federal rule substantially impedes the safe and efficient operation of the national system for clearance and settlement of securities transactions.

In response to these developments, NCCUSL and the ALI formed a Drafting Committee in the Spring of 1991 and directed the Committee to proceed as quickly as possible with the work of revising Article 8 to meet the needs identified in these various studies. The SEC's advisory committee followed the work of the Article 8 Drafting Committee closely, having concluded early in its own deliberations that if it were possible to address the problems within the existing UCC state law framework, that would be preferable to the exercise of the new federal preemptive authority. The revision of Article 8 was approved by NCCUSL and the ALI at their annual meetings in the summer of 1994. The process of consideration and enactment by the individual states is now proceeding quite rapidly. As of this writing, Revised Article 8 has been adopted as law in about a dozen states, including several states with large commercial and financial centers, e.g. Illinois and Texas. Legislation to adopt Revised Article 8 is pending in ten or more other states, and it is anticipated that legislation to do so will be introduced in most of the other jurisdictions within the next year or so.

The Article 8 revision project has also prompted significant action at the federal level in connection with the market for United States Treasury securities. A book entry system for Treasury securities was established in the 1970s by the U.S. Department of the Treasury and the Federal Reserve Banks. The law governing the Treasury book entry system is a somewhat complex hybrid of state commercial law and federal Treasury regulations based on the old version of Article 8. In recognition of the inadequacies of this framework, the Department of the Treasury began work nearly a decade ago on a proposed new system of federal regulations governing the book entry system for federal government securities. When the Article 8 revision project got underway, Treasury suspended its project to devise a separate system of commercial law rules. The Department is now considering the possibility of a more limited set of federal

regulations, relying on the approach taken in Revised Article 8.

Several points about this process warrant comment. Even from this somewhat simplified account of the process in the United States, one can readily see that the process of formulating the revised legal rules and causing them to become law in any nation with a moderately complex governmental structure is itself no small task. In the United States, the Article 8 project has required the cooperative efforts of a large number of governmental and non-governmental bodies that have interests and responsibilities for different aspects of both securities markets and the general process of private law revision. Achieving the political will to undertake that process is not easy. The task is all the more challenging given the highly technical nature of the subject matter. Revising the commercial law of the securities transfer system is a bit like infrastructure repair. The commercial law rules of the securities holding and transfer system function somewhat like the utility systems of a building or the transportation system of a nation. When they are working right, no one notices them. As they age, it takes more and more effort to keep them working, and the people who know how they work come to realize that they may break down altogether if conditions put them under heavy load. At some point prudence demands that they be replaced with systems that are designed for modern conditions and have the capacity to handle heavy loads, even though at the time they are replaced they are still “working.” Until a catastrophe has occurred, it is hard to persuade a building owner, a nation, or a legislator to devote the time and expense necessary to modernize such systems, yet the whole point is to prevent the catastrophe from occurring.

The rather technical nature of the subject presents another challenge to the law revision process. Even within the community of lawyers familiar with financial markets and securities transactions, the number of people who profess any degree of expertise in the subject of the commercial law of the securities holding and transfer process is quite small. As securities holding systems through intermediaries become increasingly complex and sophisticated, and as they depart more and more from the old pattern of physical delivery of certificates, the subject becomes less and less accessible to the average lawyer. Accordingly, a successful law revision project in this area is likely to require a considerable degree of effort to enable the specialists and the generalists to converse intelligibly. One of the strengths of the rather complex uniform state law process in the United States is that it made it necessary to undertake that communication effort.

Both NCCUSL and the ALI sponsor projects dealing with a wide range of legal topics, and their members represent a wide spectrum of the legal profession. Although NCCUSL and the ALI take great pains to assure that law revision projects dealing with specialized subjects have the benefit of the assistance of a body of expert advisers, it would probably be fair to characterize the members of both organizations as generalist lawyers with a serious interest in and commitment to improvements in all aspects of the legal system rather than specialists in particular branches of the law. For example, at the outset of the Article 8 revision project one could probably have counted on one hand - with a few fingers unused - the number of people among those appointed to the Article 8 Drafting Committee, or among the full membership of the sponsoring organization that would ultimately have to approve the work of the Drafting Committee, who had any familiarity with either old Article 8 or the modern securities holding system. To the specialist lawyers from the securities markets who did have a high level expertise in these matters, the task of revising the law through such a process must have seemed considerably less appealing than a process that would have left the matter entirely in the hands of the experts. Yet a process such as that of NCCUSL and the ALI for the formulation of uniform state laws does have a key strength. A process that requires the participation of intelligent and dedicated lawyers without special expertise demands that the legal rules and related explanatory material be stated in a fashion accessible and understandable to generalist lawyers who, after all, are perfect representatives of the ultimate "consumers" of any body of law - the judges called upon to decide disputes arising under that law. Unless a nation's law of securities holding and transfer can readily be understood by judges in that nation, one cannot achieve the degree of certainty necessary to the safe and efficient operation of the modern securities holding and transfer system.

For the reasons mentioned in this comment, as well as for many beyond its scope, it seems likely that even if the domestic law of all or most major financial centers is revised to take account of the development of modern systems or securities holding via book entry and multiple levels of intermediaries, and even if each such nation's domestic law implements basic principles along the line of those identified in Guynn's paper, significant differences will remain among the laws of different nations, if only in the details of the manner in which the fundamental principles are implemented. To lawyers, of course, details are everything. Thus, there is perhaps no aspect of the challenge of seeking international harmonization of the commercial law of the modern

securities holding and transfer system that is more important than the third level noted at the outset of this comment - achieving a sufficient degree of consensus on choice of law principles that the inevitable elements of international non-uniformity in legal analysis or results will not operate as an impediment to the operation of international securities transactions. It is to be hoped that one consequence of law revision projects in individual nations on these matters will be the development of a sufficient level of familiarity among business lawyers, academics, and others with the special problems of the modern securities holding system to enable lawyers in different nations to work cooperatively toward an understanding of general principles of international choice of law that takes account of the special features of modern securities holding systems.

**The Extent of Possible Adaptation of Domestic Laws to the Modern
Securities Holding and Transfer System**

By Kazuaki Sono

Introduction: The Present State of Affairs and Its Nature. Mr. Guynn warns the legal profession to be aware of the changes which have been brought by the technical innovation at a global scale in the practice of securities dealings. His paper clarifies four essential legal issues where modifications of the traditional rules are urgently needed and presents a model for modernization generally in line with the recent legislation in Belgium and Luxembourg as well as the revised Article 8 of the Uniform Commercial Code (UCC) of the United States. Since securities dealings are now conducted on a global dimension, it is highly desirable to avoid disparity in domestic laws on essential points which affect the rights and obligations of those dealing with securities. Mr. Guynn's well-thought proposed principles would probably meet the approval of those who are involved in day-to-day securities dealings and are concerned with the present legal uncertainties.

However, the enlightenment from Mr. Guynn's paper provides me with an opportunity to reflect upon whether the present practice in securities dealings should still be regarded as a mere change in the pattern. If the present phenomenon is only an extension or modification of the past practice, the law should be adjusted to meet the change, and the starting point from which modification should be considered would be the traditional law which used to deal with materialized securities. On the other hand, if the phenomenon of the evolution before us has already reached such a point that it could no longer be called the same animal, a legal order should be established anew without regard to and without being bound by the basic rules in the traditional law. An attempt to adjust in light of the old law would not only exclude our innovative thinking but may even restrict the scope of maneuverability in devising new rules. Most of the following observations are based on my inclination to think that the present pattern of dealings in "dematerialized" or "immobilized" securities through a chain of intermediaries by account is already beyond the limit of such adaptation.

According to Mr. Guynn, some professional investors and some financial intermediaries may hold interests in securities through accounts on the records of a central securities depository, which has actual possession or control of a large portion of the physical (but immobilized) or dematerialized

securities in a given market on a fungible basis, but retail investors at a lower tier in the multi-tiered structure will ordinarily not be shown on the books. The ultimate investor will be provided with an account by his direct intermediary, which would purportedly indicate that the account holder has an interest in certain securities, and a transfer or pledge of such an interest will be reflected in that account. The investor's direct intermediary will typically hold similar interests through an omnibus account with another intermediary at the next level up in the multi-tiered structure, and a higher intermediary may eventually reach central securities depositories. Thus, as far as the issuer is concerned, nothing will change with respect to the record ownership of the securities issued by it.

This practice is supported on the ground of economy because processing large volumes of securities transactions by tracing each customer's interest to an entry on the book of the issuer or its transfer agent will be prohibitively costly. Dispensing with this technical process also enhances mobility of investors' interests for trading purposes and assists intermediaries in efficiently implementing netting among them of offsetting deliveries. This aspect is said to be important because the securities market is a complicated global network and no domestic portion can be insulated from the rest of the world.

Treating such an interest in an account held through a financial intermediary as a mere contractual claim will expose investors and their creditors who are secured by the pledge of the interest in the investor's account to the insolvency risk of the intermediary. Thus, the investor should be accorded a kind of property right over a pool of securities held by the intermediaries, and so should his secured creditor. According to the article, there is no compelling public policy reason why secured creditors should be required to have their interests in dematerialized or immobilized securities recorded directly on the book of the issuer or its agent to obtain a valid pledge of an interest in such securities held through a financial intermediary.

However, in this connection, it is important to keep in mind that Mr. Guynn does not intend to disturb the following well-established rules: (a) The substantive law governing the validity of securities and the rights and duties of issuers is the law of the issuer's jurisdiction; (b) The law governing any contest between the rights of any person identified as the holder of an interest in dematerialized or immobilized securities directly on the book of an issuer or its agent and the rights of any adverse claimant in such interest is also the law of the issuer's jurisdiction. Hence, the scope of applicability of the concrete

rules which are being proposed are confined mostly around the relationship between an investor, an intermediary with whom the investor has a direct dealing, and general creditors of the intermediary. Mr. Guynn has carefully avoided being overly ambitious. However, how long can we continue to modify the existing legal principles in the name of adaptation to the present practice even within these confines?

The *Lex Situs* Principle: Where is the Location of an Account? The article assumes that the principal difference between physical and dematerialized securities is simply the way in which they are evidenced. Thus, both physical and dematerialized securities can be held directly or through accounts with one or more tiers of intermediaries indirectly. Securities as property, therefore, exist at the place where the account is held and they will be transferred by book entry. The logic of the article concludes that the law governing any contest between the rights of any person identified as the holder of such an interest on the book of the intermediary and any adverse claimant in such interest should be the law where the office of the intermediary maintaining the account representing such interest is located, i.e., *lex situs*.

The basis of the *lex situs* principle, a 19th century rule, is the sovereign's jurisdictional power over physical existence within its territory. Therefore, when dealings in securities were handled by the disposition of physical certificates within the territory, the *lex situs* approach was appropriate. However, when securities transactions are conducted through accounts without regard to the existence or whereabouts of physical certificates, the situation changes totally even if they are called securities transactions as before, nearing to dealings in abstracted intangible assets. Certainly securities may still exist in the non-atom hyperspace, but the *lex situs* is a principle of the atom world.

When we are determined to "adapt" the traditional law to the new realities, the tradition will continue to influence our way of thinking. Thus, we have to identify the *situs* in order to determine which law should control. The new Belgian law provides that, for the conflict of law purposes, such a place is where the account is held and the Belgian law applies when (a) the account is held in Belgium (b) by an intermediary which is established in Belgium. The difficulty in identifying the location of an account seems to be well demonstrated by the second requirement.

Indeed, in the computerized global accounting, it is often impossible to name one place as the location of an account. The account of an investor may be accessible at any of the intermediary's several branches which may not be

in the same country. The computer centre of an intermediary may be located at a place distant from the head office. Nevertheless, if we were to stick to the traditional *lex situs* approach, some place must be identified as the location of an account. This is what the Belgian law does for the purpose of its own conflict rule. At the same time, it would also be conceivable for other countries to provide differently, particularly when a branch of an intermediary with account accessibility is located therein.

The revised Article 8 of the UCC, however, no longer speaks of the location of an account. It directly specifies the law of the intermediary's jurisdiction as the law applicable without going through the channel of the traditional *lex situs*. Moreover, different from the Belgian law, the term "jurisdiction" is so broadly defined that it includes a jurisdiction selected by the parties (§ 8-110). This is a grant of the parties' autonomy in determining the applicable law. This reminds us of our familiar approach on intangible obligations. In the absence of a straight-forward choice by the parties, the UCC also provides other tests in determining the applicable law such as the location of the office specified in the transactions as the place where the accounts are maintained, and the location of the office which is specified in the account statement as the place serving the account. These tests also reflect a reasonable effort in search of the parties' intentions. And, only when these tests could not be applied, the law of the jurisdiction where the intermediary's chief executive office is located is used as the test of the last resort. The result is similar to the Belgian or Luxembourg laws only in this last respect.

The UCC demonstrates that, once we are freed from the string of the *lex situs* dogma, how realistic one can be to deal with the new animal. If an approach similar to the UCC is followed by other legislatures, parties involved in the global network of security transactions will be assured more predictability about the applicable law and the legal results at least within those confines.

The Meaning of a Package of Personal and Property Rights. Under the Belgian law, an account holder in securities has a package of contractual rights and co-property rights over a pool of securities of the same type held by the intermediary on behalf of the collectivity of its account holders on a fungible basis. This co-property right is a collective right which is being held with other account holders of the same type. The right will entitle the account holder to revendicate a notional portion of the pool of securities and is therefore a right *in rem*. The Luxembourg law and the revised UCC are also substantially to the same effect. It is important to note, however, that the account holder's right

does not extend to a traceable property right to securities held by an upper-tier intermediary under any of these laws.

In general, if something is in custody for a client, the ownership remains with the client. When some goods are placed under custody with an agreement that the same may be kept mixing with others of the same kind which are also under custody from other clients, co-ownership exists over the pool of the goods held by the depository in proportion to the deposited goods, provided that the pool is kept distinct from the assets of the depository. On the contractual obligation side, the depository may satisfy the request by the depositor for return by delivering the same quantity of goods from the pool of the goods. Moreover, since the original deposit was on a fungible basis, the depository need not return the same quantity of goods from the pool but may deliver the same quantity of goods from any other source to satisfy this contractual obligation. This is a situation where the depositor has “a package of personal and property rights”. Thus, basically the approach of the Belgian and Luxembourg laws as well as of the UCC is not unfamiliar to lawyers to this extent.

The preceding paragraph, however, assumed that the intermediary which maintains customers’ accounts did not have the right to dispose of the customers’ property. This is because, once the intermediary is given the right of disposition such as the power to redeposit in its own name or to use for its own collateral purpose, the property right may shift to the depository whether or not such a disposition subsequently takes place in fact.

Mr. Guynn states that other institutions may not be willing to make new credit available to a failed institution if it is difficult to obtain valid pledges of interests in securities. This seems to imply that the institution will ordinarily have an authority to dispose. The article further indicates that the intermediary would “generally” be required to maintain a sufficient pool of deposited securities to satisfy the claims of all the interest holders. This statement implies that the power to dispose may not necessarily be excluded and hence an obligation of the intermediary might only be contractual. Suppose the pool becomes empty at one point but later filled again by the intermediary with securities of the same type. Can we say that the depositor has a co-ownership over the pool together with other depositors who deposited securities of the same type?

Thus, even if a pro-rata proprietary right could exist over a pool of securities even where a deposit was made on a fungible basis, such assurance might not be of any utility where the intermediary has been authorized to

dispose of them. In such a case, the only right which remains for the depositor might only be a right *in personam* as an ordinary contractual obligation, although it can still be transferred or assigned and pledged through a book entry as such.

However, it is vitally important to bear in mind that the question of whether a property right shifts to the depository or not when the authority to dispose of the securities has been given is after all a question of law which only the applicable law can answer, and how it will be answered is not a matter of legal logic but of policy. And, in this respect, the new Belgian and Luxembourg laws and the UCC are quite unique.

Under these laws, such an authorization to the depository seems not to lead to a transfer of ownership to the depository, and, perhaps even in the hypothetical situation mentioned above, the ownership would vest on the investors over the pool of securities. This approach certainly creates an attractive environment so far as intermediaries in those countries and their customers are concerned, and this is the approach Mr. Guynn proposes for other legislatures to follow. His emphasis on the need for a uniform approach is also understandable for the following reasons.

Since dealings in securities are mostly on a fungible basis, no traceable property right can be asserted climbing the ladder of the chain even under these three laws. In case of insolvency of an intermediary, even if the investor can assert his "property right" in securities to be separated from the assets of the intermediary, that right would often consist of rights in an account which the intermediary holds with an upper-intermediary in its own name. The investor might assert this right against the upper-intermediary by way of subrogation, but, as already observed, this intermediary's right to the upper-tier intermediary might turn out to be merely contractual at that level in the interwoven complexity of applicable laws. Thus, the extent of the protection of the investor through the "property right" idea would in fact be limited unless the relevant applicable laws are also revised in line with the proposal.

A Postscript. As the freedom of international capital movement is enjoyed on a global scale, securities transactions have also become global and are now conducted in such a completely different manner that domestic legislatures could never have visualized before. To me, it seems that the phenomenon is already beyond the limit to which the traditional approaches could be stretched, even if the article's proposal would succeed within its narrow confines. The ultimate legal solution would eventually have to be

undertaken on the same global dimension on a comprehensive basis, while in the meantime implementing such a practical step as Mr. Guynn's proposal or as the UCC with regard to the disposition of the *lex situs* issue in order to avoid total confusion.

Meanwhile, as the article notes, regulators could provide investors and secured creditors with further protection against the insolvency risk of their intermediaries by imposing minimum capital and periodic auditing requirements, conducting periodic examinations and establishing investor insurance schemes. After all, creditors of securities firms are mostly investors and the firms' assets are collateral for investors as a whole in any event.

**Cross-Border Safe Custody and Settlement of Securities Transactions:
Some Aspects under German Law**

By Dr. Jürgen Than

Cross-border safe custody of securities and settlement of securities transactions have been discussed in Germany for many years and have been the subject of detailed analysis by securities as well as legal experts. In 1896, a special law on the safe custody and procurement of ownership of securities was enacted, which was revised in 1937 as the “Law on the Safe Custody and Procurement of Securities,” which is commonly known under its short title as “*Depotgesetz*” (Law on Securities Deposits). Important revisions were passed in 1972, 1985, and 1994 by the Second Law on Improvements of the Financial Market. The most important amendment in respect of the discussion paper of Randall Guynn was section 5 paragraph 4, which was enacted on 26 July 1985 (BGBl. I 1985, 1507) and amended in 1994 (BGBl. I 1994, 1749). It reads as follows:

“(4) Central depository banks may entrust a foreign custodian with the collective safe-custody of securities, provided that the bank and the foreign custodian have established a mutual account relationship which allows a cross-border clearing of transactions in securities by book-entry (*grenzüberschreitender Effekten giroverkehr*), and further provided that:

1. The foreign custodian in its country of domicile operates as a central depository bank and is subject to state supervision or an equal supervision with respect to the protection of investors,
2. The depositor is granted a legal status in respect of the collective holding of this custodian which is equal to the legal status provided for by this Law,
3. The right of the central depository bank to request the physical delivery of the securities is not subject to any prohibition of the country of domicile of the custodian and
4. The securities:
 - (a) Are admitted to official trading at a stock exchange or on the regulated market or are incorporated in the free market within the Federal Republic of Germany, or
 - (b) Are admitted to official trading or to trading in another market in the domestic state of the foreign custodian which (i) is regulated and supervised by recognized state authorities, (ii) takes place on

a regular basis and (iii) is either directly or indirectly accessible to the public, or

- (c) Are investment certificates which are issued either in accordance with the regulations as provided for by the Law concerning Investment Trust Companies (Gesetz über Kapitalanlagegesellschaften) or by a foreign-based investment company in accordance with the provisions of the European Union Council directive 85/611/EEG dated 20 December 1985 in respect of the coordination of the statutory and administrative provisions relating to certain organisms as regards joint investments in securities.

The liability of central depository banks pursuant to section 3 paragraph 2 sentence 1 in respect of fault of the foreign custodian may not be limited by agreement.”

This provision enables the *Deutscher Kassenverein* (DKV) as a central securities depository in Germany to establish links with foreign central securities depositories by opening a mutual account relationship that allows a cross-border clearing of transactions in securities by book entry. The catalogue of prerequisites to be fulfilled for such cross-border account relationship demonstrates the importance of the protection of the customer as the governing principle. Only if the depositor, i.e., the customer, is granted a legal status in respect of the securities held in collective safe custody that is equal to the legal status provided for by the *Depotgesetz*, may DKV enter into the account relationship. The status under the *Depotgesetz* is co-ownership of the securities held in collective safe custody.

What are the characteristics of an “equal legal status”? The German legislature had the following in mind: If the foreign central securities depository goes bankrupt, the customer must be entitled - directly or indirectly through his custodian bank - to separate securities corresponding to his holding (right of *revendication*). The customer must be protected against seizure of securities by third-party creditors of the depository. In addition, the foreign central securities depository must not have a security interest, pledge or retention right in respect of the securities for claims other than those resulting from the safe custody of the securities. Such prerequisites are fulfilled, if

- the investor in Germany becomes (beneficial) co-owner of the securities held in safe custody by the foreign central securities depository,
- such securities are not subject to compulsory measures of third-party

creditors and

- the foreign central securities depository is not entitled to a security interest, pledge or retention right in respect of the securities held in safe custody for claims that do not result from the safe custody itself.

Based on section 5 paragraph 4 of the *Depotgesetz*, the *Deutscher Kassenverein* has established account relationships with SICOVAM (France), NECIGEF (The Netherlands), SEGA (Switzerland), *Österreichische Konfrollbank* (Austria) and the Depository Trust Company (New York). In each case, Professor Dr. Ulrich Drobniq, Director at the Max-Planck-Institut for Foreign and International Private Law, Hamburg, carefully reviewed the legal situation in such countries (see U. Drobniq, *Vergleichende und kollisionsrechtliche Probleme der Girosammelverwahrung von Wertpapieren im Verhältnis Deutschland, page 73 (Frankreich, Festschrift für Konrad Zweigert, 1981)*).

I do mention this development in Germany, as it shows that cross-border safe custody and settlement of securities transactions may be possible on the basis of existing laws. Of course, there are limits which are mainly due to the high standard of protection of customers which is required under section 5 paragraph 4 of the *Depotgesetz* and which is based on co-ownership of securities whether in physical or dematerialized form. On the other hand, such development demonstrates that it is not a *conditio sine qua non* that the laws of the different countries be absolutely identical for the ownership, transfer and pledging of securities in order to meet the wishes of the market.

If we look at the difficulties of harmonizing laws within the European Union, we can foresee how difficult it would be to harmonize the rules for safe custody, transfer of ownership and pledging of securities in the most important countries with financial markets. Undoubtedly, there will be support from organizations like the Group of Thirty, the Group of Ten and the International Society of Securities Administrators (ISSA). On the other hand, we should bear in mind that basically there is no difference between the beneficial ownership, transfer or pledge of a certificate and beneficial ownership, transfer or pledge of a book or another tangible asset.

I think that it would cause considerable problems to a national legislature to set up rules for the transfer of ownership of securities in a totally different way than for the transfer of ownership of other movables. Nevertheless, I concur with Mr. Guynn that it is necessary to reach as much harmonization as possible in respect of the legal rules for safe custody and settlement of securities transactions. Any country that is part of the international capital

market or intends to become part of it must have a central securities depository which provides for sufficient protection of the investor. I believe that it would be unrealistic to further promote cross-border safe custody and settlement of securities transactions without such a central depository system and without such customer protection.

Mr. Guynn favors a uniform and new type of title to a security. Whether this is necessary, may be questioned. It is clear that a central safe custody and settlement system may not be built on title to individual securities but only on a collective holding and the title of the investor to such holding. I am also not in favor of a concept which is limited to a contract relationship. The protection of the customer in case of insolvency of the custodian might be too weak. The German *Depotgesetz* distinguishes between sole ownership, which is maintained in case of separate safe custody of securities, and co-ownership in case of collective safe custody. The co-owner enjoys the same protection as the sole owner, not only as far as the right of *revendication* is concerned, but also in respect of the exercise of rights resulting from the securities, i.e., voting rights, claims for payment, etc. Such protection has to be provided for by national legislation.

The German *Depotgesetz* lives up to the standard which is the essence of Guynn's modern approach. Compared to some other countries it seems also rather easy to grant valid pledges of interests in securities in Germany. Finally, I do not believe that the rules of the German *Depotgesetz* are too strict in order to be counted among those countries which form already today part of a cross-border safe custody and settlement system. Of course, the concept of the *Depotgesetz* follows the established *lex rei sitae* rule in the sense that the laws of the country in which the securities are physically held govern the transfer of ownership and all rights relating to such securities (not necessarily out of such securities). Guynn's proposal to have the laws of the country where the account is maintained govern the rights of the customer may be the future only if it is combined with a title to the securities wherever they are actually held. Otherwise I fear that the creditors of the central securities depository or any intermediary may have better rights in case of insolvency of any of them than the investor himself. No insurance for customer protection may be regarded as an equivalent to the protection afforded by co-ownership of the respective securities.

Improvement and rationalization of cross-border safe custody and settlement should not lead to a weakening of customer protection. The repu-

tation of a financial market depends to a great extent on the confidence and trust of the investor into the soundness and safety of a safe custody and settlement system. The safety of the system protects the market participants against claims for damages from their customers who consider sound custody and settlement systems - domestic, foreign or cross-border - to be a prime duty and target of the market professionals.

CAPITAL MARKETS FORUM

The Issues

The increasing internationalisation of the world's capital markets which has been evident in the past decade has generated a bewildering number of economic, social and legal issues. Simultaneously the nature of these markets has changed and the monetary value of the transactions being conducted on them has grown dramatically. Many aspects of these markets merit study and reform:

- the problems facing the corporation or government raising finance around the world
- the regulation of the markets and all the participants
- the use and regulation of derivative products
- the need to protect Investors without stifling the markets
- related corporate governance issues and cross-border mergers
- the benefits of competition between markets
- the development of financing methods in emerging markets

The Forum

The health of the world's capital markets is of deep concern to all, and this fact has been recognised by market professionals, investors and regulators. The law has an important role to play in providing a framework in which market forces can work and in setting the parameters of fair behaviour. The Section on Business Law (SBL) of the International Bar Association has therefore established the Capital Markets Forum as a private sector initiative in order to monitor and assist in the orderly development of capital markets.

Six SBL Committees interested in capital markets are represented on the Executive Committee.

As part of its activities the Forum is the focus of the SBL's participation in the International Capital Markets Group.

Activities

The Forum's Activities include:

- the publication of papers on matters of current importance
- the holding of seminars and discussion groups in various financial centres to assemble comments on issues of concern to market participants. Some of these are held jointly with other interested groups and, where appropriate, include regulators as well as corporate

Continued overleaf

CAPITAL MARKETS FORUM

issuers, accountants, bankers, economists, underwriters, analysts and market professionals • the publication of an annual yearbook which includes papers published by the Forum, reports of discussion groups, seminar proceedings, and a section on developments internationally in securities laws during the year • responding to proposals facilitating international transactions in securities made by regulators and others and making practical recommendations for the reform of existing regimes.

Membership of the Forum is open to non-lawyers as well as lawyers who are members of the Section on Business Law of the International Bar Association. Application forms may be obtained from the Forum Administrator.

Section on Business Law

The International Bar Association's Section on Business Law, established in 1970, is a unique worldwide organisation with some 13,000 individual lawyer members from 163 nations experienced in advising their clients on all aspects of international business.

Business lawyers are required by their clients to produce innovative solutions to dissolve barriers to enterprise and the internationalisation of business. They are the first to recognise that archaic laws, and a consequently uncertain and therefore potentially litigious climate, are likely to prevent their clients from prospering and hinder the international capital markets in serving the world's needs.

The Forum provides an opportunity, in conjunction with other market participants, to show the best constructive attitudes of the good business lawyer.

If you would like to receive further information regarding the Forum please send your business card or write to the Capital Markets Forum Administrator.

The International Capital Markets Group

The ICMG is a co-operative venture of the IBA-SBL, the Fédération Nationale des Bourses de Valeurs (FIBV) and the International Federation of Accountants. The ICMG considers developments in the world capital markets, proposals for the regulation of the markets and matters which affect opportunities for transnational investment and acquisition of capital. Projects and research are led by each organisation to suggest ways to achieve harmonisation among other subjects. Issues addressed include international accounting standards; regulation of electronic securities markets, OTC derivatives, auditor liability, registration of securities in depositaries and corporate governance. ICMG also issues its own papers.