

Intermediated Securities and Systems
in Substantive Law and in Private International Law

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ABSTRACT

With the advancement of intermediated systems coupled with the rapid development of information technology, securities holding patterns have drastically changed from direct holdings to intermediated holdings, which facilitated the explosive increase of securities transactions during the last half century. In intermediated systems, traditional functions of securities certificates have faded away and intermediated securities credited to securities account books play a key role in determining proprietary issues. In spite of the innovative development of intermediated systems, legal regimes for the systems have not kept up with the development of the systems. Specifically, there has been much legal hindrance in cross-border securities transactions.

In this regard, this thesis first attempts to research substantive laws for intermediated systems in the United States, the United Kingdom, Canada, Japan and Korea. The Unidroit draft convention on intermediated securities is also discussed as neutral fact-centred international substantive rules. In the substantive law analysis, this thesis suggests preparing new rules that are internally sound and internationally compatible, friendly to users and markets, and readily accessible clear, intuitive rules which satisfy basic legal needs of intermediated securities holders and ensure market efficiency and stability.

In the private international law analysis, this thesis finds the traditional *lex rei sitae* (or the *lex situs*), which calls for application of the law of the place where securities are located, is no longer a proper connecting factor in proprietary issues of an intermediated securities disposition, given that the location of securities has no meaningful function in intermediated systems. The Hague Securities Convention, which refers to the PRIMA (Place of Relevant InterMediary Approach) that localises an intermediary, went beyond the PRIMA and selected its primary rule in an account agreement between an account holder and his intermediary. This thesis examines the Convention in detail and concludes in favour of early adoption of the Convention in order to bring *ex ante* certainty and predictability in cross-border securities transactions.

RÉSUMÉ

Avec l'avancement des systèmes d'intermédiaires et les développements technologiques récents, les modèles de détentions des titres d'investissement ont changé dramatiquement au cours des cinquante dernières années. ce qui a facilité l'expansion accrue des transactions. Dans les systèmes intermédiés, la fonction traditionnelle des titres certifiées est en train de se dégrader, et ainsi les titres intermédiés crédités aux livrets de comptes sécuritaires jouent un rôle important dans la détermination des droits de propriété et des droits prioritaires. Malgré les innovations des systèmes d'intermédiaires, les régiments juridiques applicables à ces systèmes n'ont pas évolués au même rythme. Ceci affecte particulièrement les opérations transfrontalières.

Cette thèse débute donc avec un examen du droit matériel applicable aux systèmes intermédiés aux États-Unis, au Royaume-Uni, au Canada, au Japon et en Corée. Le projet de convention d'Unidroit sur les systèmes intermédiés est aussi considéré comme option neutre et centrée sur la dimension factuelle des transactions. Suite à cette analyse du droit matériel, cette thèse recommande l'adoption de nouvelles règles basées sur des fondements juridiques solides et compatibles avec la dimension transfrontalière des échanges; ces règles cherchent à être simples et accessibles, utiles aux usagers et à augmenter la prévisibilité tout en assurant la stabilité et l'efficacité des marchés.

Passant ensuite à l'analyse du droit international privé, cette thèse rejette la règle de conflit traditionnelle de la *lex rei sitae* (ou la *lex situs*), qui n'est plus adéquate pour régler les problèmes liées à la propriété en matière de disposition des titres intermédiés, puisque la localisation concrètes des titres n'a plus de fonction significative dans les systèmes intermédiés. La Convention de La Haye sur les Titres qui s'inspire plutôt de la règle PRIMA (l'approche centrée sur la situation de l'intermédiaire pertinent) qui place l'intermédiaire au centre de l'analyse; ce faisant, cette Convention va au-delà de PRIMA en préférant chercher du côté de l'entente entre le détenteur et son intermédiaire. Cette thèse examine la Convention en détails et recommande une adoption rapide de la Convention pour amener certitude et prévisibilité aux opérations de titres transfrontalières.

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I. Introduction

A. Intermediated Securities and Systems

Evolutionary growth of cross-border securities transactions has been witnessed around the globe during the past half century. According to statistics, “[t]he volume of trades and collateral transactions in OECD government and corporate securities, for example, has grown to nearly two trillion U.S. dollars (\$ 2,000,000,000,000) or more per day [and] this means that the volume of these transactions exceeds the world’s total GDP (approximately US\$36 trillion in 2003) every eighteen trading days.”¹ Such an explosive increase of international securities transactions can be attributed to such factors as the rapid advance of the information technology (“IT”) represented by the internet and the growth of financial markets in size according to the liberalisation of capital movement and the financial deregulation of a wide range of financial products and services in the global context.² However, the development of the securities settlement system,³ which is one of the fundamental infrastructures⁴ in the capital market, can also be counted as a major impetus of it. The development of the securities settlement system, which has enabled settlements⁵ of voluminous securities transactions to be efficiently processed by

¹ Roy Goode, Hideki Kanda, & Karl Kreuzer with the Assistance of Christophe Bernasconi (Permanent Bureau), *Explanatory Report on Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with Intermediary: Hague Securities Convention* (Hague: Martinus Nijhoff Publishers, 2005) (hereinafter, the “Explanatory Report”) at 4.

² See Giovannini Group, *First Report of the Giovannini Group on Cross-Border Clearing and Settlement Arrangements in the European Union* (Brussels, 2001) at 7. The Giovannini Group was formed in 1996 to advise the European Commission on issues relating to EU financial integration and the efficiency of Euro denominated financial markets. As for the international securities clearing and settlement system, they further issued the second report in April, 2003 following the first report. Both the reports are available at http://ec.europa.eu/economy_finance/giovannini/clearing_settlement_en.htm.

³ The securities settlement system is “a system which permits the transfer of securities: either free of payment (free delivery), for example in the case of pledge; or against payment.” See Bank for International Settlements, *A Glossary of Terms Used in Payments and Settlements Systems* (Basel: BIS 2000) (hereinafter, the “BIS Glossary”) at 37.

⁴ The four main pillars as the capital market infrastructure are the securities deposit system, the clearing system, the securities settlement system, and the payment system.

⁵ Settlement is defined as “an act that discharges obligations in respect of funds or securities transfers between two or more parties or the completion of a transaction, wherein the seller

electronic book entry transfers through immobilisation and dematerialisation⁶ at the central securities depository (“CSD”)⁷ of each country, avoiding traditional physical delivery of securities certificates for the settlements, has ensured an enormous volume of cross-border securities transactions.

This securities settlement system can be depicted as the functional side of an intermediated system from the perspective of settlement processes. For its part, the terminology of the intermediated system focuses on the static legal aspect of intermediated securities holding patterns. In the intermediated system, securities are held through one or more intermediaries⁸ such as banks, securities companies, and the CSDs.

transfers securities or financial instruments to the buyer and the buyer transfers money to the seller.” See the BIS Glossary at 38.

⁶ The original terminology of immobilisation and dematerialisation were set by a seminal report of the Group of 30 entitled *Clearance and Settlement in the World’s Securities Markets* (New York & London, March 1989). See Joanna Benjamin, Madeleine Yates & Gerald Montagu, *The Law of Global Custody*, 2^d ed. (London: Butterworths, 2002) at 14~15. The report defines immobilisation as “the storage of securities certificates in a vault in order to eliminate physical movement of certificates and/or documents on transfer of ownership,” while defining dematerialisation as “the elimination of physical certificates or documents of title which represent ownership of securities so that securities exist only as computer records.” Nowadays, dematerialisation has drawn much more attention throughout the world in order to improve efficiency by completely eliminating economic and legal costs related to certificates. As one of the global efforts to make an efficient paperless environment, the Group of Thirty strongly recommends as its first recommendation in the 2003 Action Plan that “Infrastructure providers and relevant public authorities should work with issuers and securities industry participants to eliminate the issuance, use, transfer and retention of paper securities certificates without delay.” See Group of Thirty, *Global Clearing and Settlement: A Plan of Action* (Washington, D.C.: Group of Thirty, 2003).

⁷ Central Securities Depository is the key player in the securities settlement system and is situated at the top of the pyramid pattern of the intermediated (or indirect) securities holding system in a country. Some examples of the CSDs are Central Depository for Securities (CDS) in Canada, Depository Trust Company (DTC) in the US, Clearstream Banking, Frankfurt (CBF) in Germany, CREST in the UK, Japanese Securities Depository Center (JASDEC) in Japan and Korea Securities Depository (KSD) in Republic of Korea (Korea). For reference, the oldest CSD is the *Wiener Giro- Und Cassenverein* founded in 1872 Austria.

⁸ The *Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary* defines intermediary as “a person that in the course of a business or other regular activity maintains securities accounts for others or both for others and for its own account and is acting in that capacity” (Art.1.1.b) and a CSD is also regarded as an intermediary according to Article 1 Paragraph 4. The *Unidroit Preliminary Draft Convention on Substantive Rules Regarding Intermediated Securities* of May 2007 (“Unidroit Preliminary Draft Convention”) has the same definition in substance (Art. 1.d).

Therefore, investors hold securities only through their immediate intermediaries, which in turn hold the securities through their own upper-tier intermediaries with other investors' securities and their own.⁹ Due to this tiered holding structure, securities are held indirectly with intermediaries between investors and the CSD which is the ultimate holder of the securities at a national level. Because of this, securities held with an intermediary are called "intermediated securities" and the holding system is known as an "intermediated system."¹⁰ Intermediated securities and intermediated systems were also called "indirectly held securities" and "indirect holding systems." With respect to the notion of indirect holdings, there have been two understandings. The first understanding is that investors can exercise their rights in securities against the issuer only through their immediate intermediaries and therefore they lose any direct relationship with the issuer. The second one, however, is that without regard to the fact that whether investors can exercise their rights directly against the issuer or not, where securities are held with an intermediary, then investors are thought to hold securities indirectly through their intermediaries. It can be observed that the first view focuses on the relationship between the issuer and investors, while the second captures the mere fact of relationship between the investors and the intermediaries. The U.S. and the U.K.'s legal concepts are based on the first understanding and Germany, Japan, and Korea's legal regimes are based on the second concept. For this reason, in this thesis, the terminology of intermediated securities and intermediated system are employed, because as it might be noticed, the terminology of indirectly held securities and indirect holding systems can give a misleading idea of the legal status of investors, not focusing on the simple fact pattern of the intermediation through an intermediary and failing to provide for a neutral concept. The Explanatory Report of the Hague Securities Convention and the Unidroit Preliminary Draft Convention of May 2005 employ the terminology of intermediated securities and intermediated systems.

⁹ Therefore, the basic components of intermediated systems can be said to be composed of a CSD, intermediaries, collective securities deposit (or registration), securities accounts, and book-entry transfer of securities.

¹⁰ See Arianna Pretto-Sakmann, *Boundaries of Personal Property: Shares and Sub-shares* (Oxford and Portland: Hart Publishing, 2005) at 49~59 for a discussion of the various nomenclatures of intermediated securities (asserting that sub-securities are more specific and desirable name).

Meanwhile, securities were originally designed to facilitate convenient assignments of intangible rights by incorporating such rights on the face of physical documents as tangible property.¹¹ However, in the intermediated system in which securities are collectively deposited and transferred by electronic book entries based on the technical mechanism of immobilisation and dematerialisation,¹² physical securities certificates themselves can be seen as having lost their original functions. As such, questions from the substantive law¹³ perspective can be raised as to whether the established legal theories and intermediated systems, which were developed and founded on the existence of physical securities certificates and on legal concepts such as deemed possession of the certificates,¹⁴ can still be applicable to dispositions of intermediated

¹¹ The definition of securities is examined in detail in chapter II. Because of the basic concept of securities is different between civil law jurisdictions like Japan and Korea and common law jurisdictions like the U.S. and the U.K., the notions of the intermediated securities also have been diverged.

¹² It can be said that dematerialisation means electronised securities in the respect that physical securities are not issued and securities are evidenced solely by electronic records. However, it does not necessarily mean the return to intangible rights which was incorporated in securities by forfeiting the concept of securities. Rather, it may be understood as the extension of securities mechanism by which the incorporated rights can be transferred in efficiency. See further on the dematerialisation and electronic securitisation, Korea Securities Depository, *Securities Deposit and Settlement System* (in Korean), 2^d ed. (Seoul: KSD, 2003) at 464~510; Korea Commercial Law Association, *Legal Issues Involved in Electronic Securities System* (in Korean), Special ed. (2003) 22:3 Commercial L. Rev; The European Securities Forum, "Better, Quicker and More Efficient Investment Arrangements for the Individual Shareholder - A proposal to dematerialise certificates and enfranchise shareholders" (2004) online: < <http://www.eurosf.com/upload/publications/Proposal%20To%20dematerialise%20certificates%20and%20enfranchise%20shareholders.pdf>>; Hideki Kanda, "Dematerialisation and the Future of Securities Theories (in Japanese)" in Masao Kishida, Akira Morita & Morimoto Shigeru ed., *Modern Corporations and Theories of Securities* (Tokyo: Yuhikaku, 1994) at 155~169; and Hiroki Morida, "Fundamental Theories of Securities Dematerialisation (in Japanese)" Discussion Paper No. 2006-J-23 (2006) online: Institute for Monetary and Economic Studies Bank of Japan < <http://www.imes.boj.or.jp>>.

¹³ In general, the term of substantive law is employed as a relative notion to procedural law, meaning that the part of the law that creates, defines, and regulates the rights, duties, and powers of parties (Black's Law Dictionary, 8th ed. 2004). However, it is a relative notion to choice of laws rules in private international law analysis and refers to a system of law, determined by choice of laws rules, governing, regulating and solving certain issues to the law suit concerned. Thus, it is natural that substantive law does not necessarily mean statutory law.

¹⁴ See e.g. the systems of Germany, Canada and Korea. Japan previously took this legal concept but they have recently fully changed the legal framework on intermediated securities (however, as for the shares, the old legal system will govern until 2009). Switzerland also prepared a new draft on intermediated system in 2006 which is expected to be enacted in 2007 or at least by early 2008. Korea is also preparing a new legal regime based on the real practices. Canada prepared a

securities, and if they are, then how efficiently do the theories and systems work by reflecting the modern securities industry practices. In this regard, legal reforms and practical discussions on intermediated systems in the U.S., the U.K., and Japan, where the major financial markets are located, suggest that traditional legal theories in respect of securities holdings and dispositions thereof have a limited role when squarely applied to intermediated securities. In addition to the legal reforms at a national level, at the international level, Unidroit¹⁵ has been pouring out huge efforts to draft up-to-date harmonised efficient international substantive rules regarding intermediated securities and systems.

Together with the substantive law reforms and discourses, even before the adoption of the Hague Securities Convention, there have been active debates whether the traditional *lex rei sitae* (or *lex situs*) rule,¹⁶ which has long been applied to proprietary aspects of securities dispositions, can still be adequate for intermediated securities' dispositions.¹⁷ The PRIMA,¹⁸ which takes an intermediary or a securities account as a connecting factor, given that securities are maintained in a securities account in an intermediated system, came to gain broad supports from scholars and practitioners in the securities industry.¹⁹ Thus, at a national level, Belgium and Luxembourg, where

new draft named the Uniform Securities Transfer Act modelled on the revised UCC Article 8 and 9 of the U.S. in April 2004 but it became enacted only in Alberta and Ontario as of 1 January 2007.

¹⁵ The International Institute for the Unification of Private Law (Unidroit) is an independent intergovernmental organisation with its seat in Rome and its purpose is to study needs and methods for modernising, harmonising and coordinating private and, in particular, commercial law as between States and groups of States (<http://www.unidroit.org/english/presentation/main.htm>). With respect to the current draft of the preliminary convention, see chapter III below.

¹⁶ The law of the place where the thing is located. In the context of securities, the *lex cartae sitae* is more accurate expression. See the Explanatory Report at 17.

¹⁷ As for the articles on the discussions, see *ibid* at 3, footnote 3.

¹⁸ It is an acronym of Place of Relevant InterMediary Approach. The term was firstly used by Randall Guynn and Richard Potok in the IBA Capital Markets Forum annual update in 1998 (See Richard Potok, ed., *Cross Border Collateral: Legal Risk and the Conflict of Laws* (Wilts: Butterworths, 2002) at 6. Benjamin interestingly extrapolates this acronym as Place of Relevant Intermediary Account (See Joanna Benjamin, Madeleine Yates & Gerald Montagu, *Supra* note 6 at 77).

¹⁹ See among other articles, Randall D. Guynn, "Modernizing Securities Ownership, Transfer and Pledging Law: A Discussion Paper on the Need for International Harmonisation, with

international central securities depositories (“ICSD”)²⁰ like the Euroclear Bank and the Clearstream Banking are located, chose the PRIMA as the connecting factor for a disposition of intermediated securities in the early 1990s.²¹ At the regional level, the European Union (“EU”) adopted the Settlement Finality Directive and the Collateral Directive²² by which the place of a securities account is recognised as the connecting factor for certain securities transactions. Finally, at the international level, as an effort to forge out uniform choice of law rules on certain proprietary aspects of a disposition of intermediated securities in order to provide legal certainty and predictability, the Hague Conference on Private International Law (“HCCH”) adopted the *Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary* (“Hague Securities Convention”)²³ on 13 December 2002. Under the primary rule of the

Responding Comments by Prof. James Steven Rogers (USA), Prof. Kazuaki Sono (Japan) and Dr Jürgen Than (Germany)” (Capital Markets Forum, Section on Business Law, IBA, 1996) available at <www.dpw.com/iba.modernization.pdf>; R.D. Guynn & N.J. Marchand, “Transfer or Pledge of Securities Held through Depositories” in Hans van Houtte ed., *The Law of Cross-Border Securities Transactions [the Law of Cross-Border Securities Transaction]* (London: Sweet & Maxwell, 1999); Joanna Benjamin, Madeleine Yates & Gerald Montagu, *Supra* note 6 at 77~81; Roy Goode, “The nature and Transfer of Rights in Dematerialised and Immobilised Securities” in Fidelis Oditah ed., *The Futures for the Global Securities Market: Legal and Regulatory Aspects* (London: Oxford University Press, 1996).

²⁰ ICSD is “a central securities depository which clears and settles international securities or cross-border transactions in domestic securities.” See the BIS Glossary at 21. SIS SegalInterSettle is also a widely known ICSD.

²¹ This approach can be seen as a corresponding measure of substantive law improvements by introducing co-ownership of notional pools of securities to sever the relationship with possession of deposited physical securities papers. The names of the law are *Belgian Royal Decree No. 62* (as amended in 1995), adopted in 1967 and *Luxembourg Grand-Ducal Decree of 17 February 1971* (as amended in 1994 and 1996).

²² The official name of the Settlement Finality Directive is the *Directive 98/26/EC of 19 May 1998 on Settlement Finality in Payment and Securities Settlement Systems* and Article 9.2 specifies the choice of law rule of the PRIMA. The official name of the Collateral Directive is the *Directive 2002/47/EC of 6 June 2002 on Financial Collateral Arrangement* and Article 9.1 provides for the conflict of laws rule of the PRIMA. See Chapter IV for the detailed discussion of conflict of laws rules in both the directives. Besides these two directives, Article 9 of the *Council Regulation (EC) No 1346/2000 of 29 May 2000 on Insolvency Proceedings* (“Insolvency Regulation”) and Articles 10 and 24 of the *Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the Reorganisation and Winding up of Credit Institutions* (“Winding up Directive”) also provide for the PRIMA rule.

²³ See Chapter V for the detailed analysis of the Convention.

Convention, the law applicable to a disposition of intermediated securities is determined by the account agreement between an account holder and his intermediary.

B. Purpose and Scope of the Thesis

Against this background, first this thesis introduces fundamentally different understandings as to the definition of securities, which would be one of the main factors that has had an effect on shaping the current legal frameworks as to intermediated systems. Subsequently, it attempts to examine the current Draft Convention of the Unidroit study on intermediated securities that is neutral fact-centred international substantive rules.²⁴ It then examines certain states' intermediated securities and systems from the view of substantive law to find out and suggest clear and efficient substantive rules which mirror the reality of intermediated securities and systems based on each state's legal tradition and industry practices. Afterwards, as the main part of this thesis, it discusses dispositions of intermediated securities from the perspective of private international law. First it unveils how uncertain is the current choice of law rule, the *lex situs* in finding a proper connection to intermediated securities dispositions. It further explores a proper way to interpret the Hague Securities Convention according to the Explanatory Report thereof.

More specifically, Chapter two, which lays a fundamental clue to explain one of the reasons of current different legal regimes of intermediated systems, analyses the definition of securities in civil law states (Korea and Japan) and common law states (the U.K. and the U.S.). It discovers that securities in the some civil law states mean securities certificates and rights that are incorporated in securities certificates are not originally thought to be securities but are deemed as securities by another legal construction to ensure and protect securities holders' rights. On the other hand, securities in the common law states include not only securities certificates but also the rights themselves in securities certificates in the definition of securities. This chapter further concludes that

²⁴ The Preliminary Draft Convention which this thesis refers to is that of May 2007.

such difference of securities definition has affected substantive legal frameworks and private international law analyses of the states.

Chapter three introduces the functions and importance of intermediated systems associated with domestic and cross-border securities transactions. First it covers the Unidroit Preliminary Draft Convention that provides the most up-to-date neutral and fact-centred international substantive rules related to intermediated securities and intermediated systems. The Unidroit Preliminary Draft Convention further furnishes important key rules which are used to evaluate the intermediated systems of the states. Then, it comparatively debates and evaluates the substantive legal frameworks of the intermediated systems of the United States, Korea, the United Kingdom, Japan and Canada (Ontario and Quebec). It finds that securities definition, legal tradition and securities industry practices have had an influence on the current legal regimes. Finally, in the substantive law analysis and conclusion section, it emphasises that there is an urgent need to establish a legally sound, reliable, and efficient intermediated system in Canada and Korea. It concludes that the new legal regime in Canada, which is embodied in the USTA modeling the UCC Article 8 and 9, is a well founded reconstruction of the Canadian intermediated system. As to the Korean intermediated system, it proposes an urgent substantive legal reform to prepare a clear, sound, intuitive, and market friendly system.

Chapter four addresses the issues of private international law in regard to proprietary aspects of an intermediated securities disposition. It identifies fundamental ways of how the four states approach the subject to determine the law applicable to a disposition of intermediated securities according to each state's current choice of law rules. This chapter shows different approaches used to characterise intermediated securities and proprietary issues of intermediated securities dispositions among jurisdictions. It discovers that according to current choice of law rules and methodologies, it is tremendously difficult or almost impossible from the perspective of a collateral taker to fix the law to meet perfection requirements or otherwise for the collateral. Then, it introduces the legal reforms in the U.S., Canada, and the EU to solve the problem of conflict of laws in an intermediated securities disposition. It also introduces recent PIL Acts reforms in Korea and Japan, and provides interpretive ways to deal with an

intermediated securities disposition under the PIL Acts in Korea and Japan. It concludes that the current Korean PIL rules for intermediated securities and their dispositions are not clear enough to render legal certainty and predictability to the parties in intermediated securities transactions.

Chapter five attempts to provide interpretive understanding of some major provisions of the Hague Securities Convention. Among other things, it explains the brief draft history and the reasons to adopt the Convention's primary rule which is the approach based on an account agreement by an account holder and his relevant intermediary, abandoning the original concept of the PRIMA. It presents some interpretive and practical issues such as the Page 37 problem, internationalisation of purely domestic securities transactions, and the legal nature of intermediated securities and application scope of substantive law. However, it proves that the critiques on those issues are not well-founded.

Chapter six finally concludes that each substantive law of intermediated securities and systems has been developed in accordance with its own legal tradition and the securities industry environments and practices. Therefore, it emphasises that those factors should be counted when evaluating an intermediated system and in this respect, each current system should be respected as long as it functions efficiently and provides legal certainty. However, it further argues that as each system also needs to be compatible with other intermediated systems in cross-border transactions, the Unidroit Preliminary Draft Convention on intermediated securities will work for that purpose. From the private international law perspective, this thesis suggests adopting the Hague Securities Convention as early as possible, along with the adoption of the complementary Unidroit convention when it is concluded, in order to bring legal certainty and predictability.

II. What are Securities?

A. Definition of Securities

1. Definition of Securities in Korea and Japan

Korea and Japan's common view defines securities as a certificate which represents a valuable private right of which issuance, exercise, and assignment shall all or in part be through the certificate.²⁵ It means that the rights which securities represent are not securities. Therefore, shares, bonds, debentures, and the like are nothing more than rights, not securities themselves in Korea and Japan.²⁶ Because of this reason, all the securities enumerated in the definition provisions of securities in the Securities Exchange Act ("SEA") in Korea²⁷ and the Financial Instruments and Exchange Law ("FIEL") in Japan²⁸ are securities "certificates" in the original texts.

²⁵ See Chulsong Lee, *Law of Bill and Check* (in Korean), 3^d ed. (Seoul: Pakyoungsa, 1997) at 9; Chanhjung Jung, *Lecture of Bill and Check Law* (in Korean), 2^d ed. (Seoul: Hongmoonsa, 1995) at 3~10; and Suzuki Takeo, *Law of Bill and Check* (in Japanese) (Tokyo: Yuhikaku, 1957) at 2. In Germany, securities are also defined as certificates representing a right, the exercise of which requires possession – and normally presentation – of the certificates. Additionally, creation of a security has to be understood under German law as producing the security certificate in print or other written form. (See European Commission, "EU Clearing and Settlement Legal Certainty Group Questionnaire Horizontal Answers" (2006) online: EC <http://ec.europa.eu/internal_market/financial-markets/docs/certainty/background/comparative_survey_en.pdf> at 5 & 48).

²⁶ Original terminology of securities is (Yooga)jeungkweon in Korean and (Yuka)shoken in Japanese, and both of the terms imply a valuable certificate. German terminology, *Wertpapier* is also composed of value and certificate. Hence, the same terminology of securities in the US and UK does not exist in Korea and Japan.

²⁷ Art. 2.1 in *Securities Exchange Act*, Act No. 2920 of 1976.

²⁸ Art. 2.1 in *Financial Instruments and Exchange Law*, Act No. 25 of 1948. The previous Securities Exchange Law was fully amended and replaced by the new FIEL in June 2006 which aims to enhance investor protection and promote the movement of individual financial assets to the securities markets by establishing a cross-sectional framework of a wide range of financial instruments and services (cross-sectional protection of investors) and introducing different rules depending on the characteristics of financial instruments or knowledge and experience of the investors (flexible regulatory structure). The new FIEL will be effective within 18 months of the promulgation of the amendments set forth in the bill. See Financial Services Agency, "New Legislative Framework for Investor Protection -Financial Instruments and Exchange Law" (2006) online: <<http://www.fsa.go.jp/en/policy/fiel/2006062>

However, the rights which can be represented in the securities certificates exhaustively enumerated and defined in the SEA and the FIEL respectively can also be deemed as securities by a separate statutory provision as if such rights are materialised for the purpose of the investor protection.²⁹ It is, however, worth noting that it is “deemed or fictitious securities,” which means that the rights are constructively regarded as securities by means of a legal fiction, though they are not originally securities.

2. Definition of Securities in the U.K. and the U.S.

In contrast to Korea and Japan, in the U.K., securities are described as a type of transferable financial asset.³⁰ Originally the term securities were used to indicate security interest securing the payment of a debt or other obligation.³¹ In the early period, corporations and government agencies commenced to raise capital from the public by issuing transferable debt obligations and the repayment of these debt obligations was secured on the assets of the issuer.³² By a process of brevity, these secured debt obligations became known as securities.³³ As the historic development of the term securities shows in the U.K., the notion of securities referred originally to debt obligations and had nothing to do with documents or certificates, unlike Korea

1.pdf> for the brief descriptions of the revision; and Christopher T. Hines, Tatsuya Tanigawa, & Andrew P. Hughes, “Doing Deals in Japan: an Analysis of Recent Trends and Developments for the U.S. Practitioner” (2006) Colum. Bus. L. Rev. 355 at 364~365.

²⁹ See Art. 2.2 in the SEA and the FIEL, respectively. Art 2.2 of the SEA according to the original text can be translated as follow: “*Such rights as shall be represented by the securities certificates referred to in Paragraph 1 of this Article shall be deemed as such securities certificates even before certificates of such securities have been issued with respect to such rights.*”

³⁰ Joanna Benjamin, *Interests in Securities: A Proprietary Law Analysis of the International Securities Markets* (New York: Oxford University Press, 2000) at 4. See also generally James Steven Rogers, “Negotiability, Property, and Identity” (1990) 12 Cardozo L. Rev. 471 at 471~478 for the history of the notion of securities.

³¹ Joanna Benjamin, *ibid.*

³² *Ibid.*

³³ *Ibid.*

and Japan. Hence, such rights as shares, stocks, debentures, bonds and so forth are naturally included in the definition of securities, as well as certificates thereof.

Similarly, in the U.S., according to *the Securities Exchange Act of 1933*, security is also defined as “any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness ... or, in general, any interest or instrument commonly known as a security, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.”³⁴

The difference of securities definition can be illustrated in Figure 1:

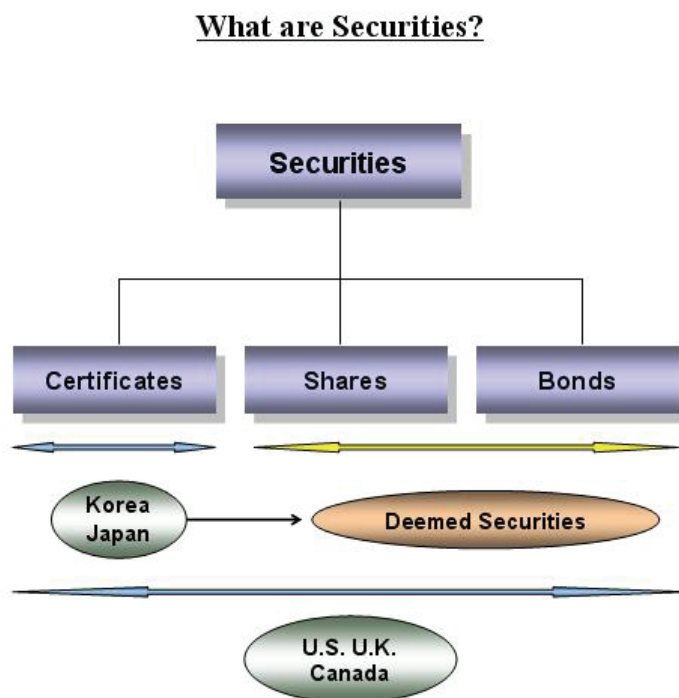


Figure 1. Differences in the Definition of Securities

³⁴ See *the Securities Act of 1933*, 15 U.S.C. § 77 (1933) § 2.a.1. *The Securities Exchange Act of 1934*, 15 U.S.C. § 78a (1934) § 3.a.10 has a similar definition of security. Securities definition in Canada is also similar to those of the U.S. See Jefferey G. MacIntosh & Christopher C. Nicholls, *Securities Law* (Toronto: Irwin Law, 2002) at 23-55.

B. Impacts of the Different Definitions

The fundamentally different approaches to defining securities underscore the different approaches to shaping legal frameworks for intermediated securities and intermediated systems in those states. This thesis starts from the premise that the fundamental differences in the legal constitution of intermediated securities and systems partially stem from the different views of securities.

In Korea and Japan, securities are originally understood as meaning materialised securities papers and the rights which are incorporated in securities certificates are not securities, though the rights are fictitiously regarded as securities by way of another legal construction in order to ensure intermediated securities holders' rights. The legal frameworks of the intermediated systems have been established such that an investor who purchases securities held with an intermediary (intermediated securities) still has direct legal possession of securities certificates, disregarding all the intermediaries up to where the certificates are ultimately deposited. However, the legal concept of co-ownership was analogously utilised by the intermediated systems in order to facilitate and ensure efficient and smooth settlements of large volumes of securities transactions in the intermediated systems. For this reason, if the intermediated systems were designed such that an investor still holds certain identified individual securities certificates, the main purpose to ensure efficient settlement could not have been fulfilled.

Likewise, in the private international law analysis of proprietary aspects of an intermediated securities disposition, where there is no specific or exceptional provision, traditionally, the straight *lex rei sitae* has indicated the place where securities certificates are located by looking through the intermediaries between an investor and the ultimate intermediary, which is usually a CSD where the securities are finally in custody, even though nowadays it has come to be a common opinion of legal scholars and practitioners in Korea and Japan that the stringent *lex rei sitae* rule

is not any more applicable to proprietary issues of intermediated securities disposition.³⁵

However, in the U.K., because of the relative leeway in viewing securities, the object that the investor holds could be analysed other than as securities certificates, because a securities certificate has no crucial meaning in defining securities. Therefore, what an investor holds through an intermediary is understood to be equitable beneficial interests in a trust (interests in securities).³⁶ As for the conflict of laws analysis, the *lex situs* locates the place where the relevant securities account is maintained according to the Collateral Directive,³⁷ because it is reasonable to say that the beneficial interests through a trust relationship are derived from securities accounts to which the securities are credited.

Similarly, in the U.S., the Uniform Commercial Code (“UCC”) Article 8 Part 5, which specifies provisions related to the intermediated securities and the intermediated system, identifies intermediated securities as a new separate relationship, a security entitlement which has nothing to do with securities

³⁵ The situation is the same in the old German regime where if securities are bearer securities or order securities with endorsement in blank, then a disposition is governed by the *lex cartae sitae* that is the law of the place of securities certificates, applying the look-through approach, and if securities certificates merely evidence ownership rights, then the German court would apply the *lex causae* which would lead to the place of the registrar of the securities issuer, the *lex societatis* of the issuer, or the *lex contractus* in the case of debt securities. See Richard Potok, ed., *Supra* note 18 at 268 (paras 12.16 and 12.17).

³⁶ Under English law, the traditional legal arrangement of the intermediated system was thought of as a bailment. However, nowadays the major view is to analyse it as a trust by which an investor holds equitable ownership (interests in securities) as a beneficiary. See further Joanna Benjamin, *Supra* note 26 at 36~59; and Financial Market Law Committee, *Issue3-Property Interests in Investment Securities - Analysis of the Need for and Nature of Legislation Relating to Property Interests in Indirectly Held Investment Securities, with a Statement of Principles for an Investment Securities Statute* (London, 2004) at 20~21.

³⁷ However, the *Macmillan* court and the *Re Havard Securities* court applied the look-through approach in 1996 and 1997, respectively before the enforcement of the Settlement Finality Directive and the Collateral Directive. See *Macmillan Inc v. Bishopsgate Investment Trust PLC* (No. 3), [1996] 1 W.L.R. 387; *Re Harvard Securities Ltd.*, [1998] B.C.C. 567, [1997] 2 B.C.L.C. 369. Because both the courts did not consider the significance of the intermediated securities and systems, one English writer maintains that “the decision of the Court of Appeal can only be authority for transaction of shares under the direct holding system.” See Maisie Ooi, *Share and Other Securities in the Conflict of Laws* (New York: Oxford University Press, 2003) at 3~12 for the introduction of both the cases.

certificates.³⁸ With respect to applicable law, the UCC goes further and introduces party autonomy even in proprietary issues³⁹ for the first time in the world, which considerably affected the draft process of the Hague Securities Convention.

³⁸ See American Law Institute, *Uniform Commercial Code* (2005) (WL), Art. § 8-102(17) and further discussion in Chapter III.B below.

³⁹ See *Ibid*, Arts. § 8-110(b)(1)~(4), (e)(1) & § 9-305(b).

III. Comparative Substantive Law Analysis of Intermediated Securities and Intermediated Systems

A. The Unidroit Preliminary Convention on Intermediated Securities

1. Background of the Unidroit Project: Importance of Intermediated Systems and Risks Involved in the Systems

The multi-tiered securities holding system, *i.e.* the intermediated system, has facilitated large a volume of securities transactions, enabling smooth and efficient settlement without delivery of physical securities coupled with clearing mechanisms.⁴⁰ In the case of secondary market transactions (*e.g.*, securities exchanges like the NYSE, the LSE, and the TSE), only net positions of whole transactions after clearing are settled by way of book-entry transfers. In the case of an over-the-counter transaction between two parties like a collateral taker and a collateral provider, book-entries occur only with their relevant intermediary without any change of upper-tier intermediaries when the parties use the same intermediary.⁴¹

However, this multi-tiered holding pattern comes to be more complicated in cross-border securities transactions. In the international dimension, there are more multi-tiered intermediaries such as the ICSDs, global custodians,⁴² and local

⁴⁰ Clearing is the process of transmitting, reconciling and, in some cases, confirming payment orders or security transfer instructions prior to settlement, possibly including the netting of instructions and the establishment of final positions for settlement (See the BIS Glossary at 7). Especially, the netting is the key benefit of clearing, considerably lowering the total settlement volume. As to the process of clearance and settlement, see generally Bank for International Settlements, *Recommendations for Securities Settlement Systems: Report of the CPSS-IOSCO Joint Task Force on Securities Settlements Systems* (Basel: BIS, 2001) at 38~40.

⁴¹ In the system like Korea where securities are just blocked on a pledgor's account, even a book-entry transfer to a pledgee's account does not occur without regard to the fact that the parties to a collateral transaction have their accounts with the same intermediary.

⁴² A global custodian provides its customers with custody services through worldwide network with the custodian located in the country in which the securities transactions and settlements occur. Examples are Citibank, HSBC, Standard Chartered Bank, Deutsche bank and State Street Bank.

custodians.⁴³ Also, there are differences in time zones, languages, currencies, practices and legal systems of each state. Therefore, the risks, especially intermediary risk⁴⁴ and systemic risk⁴⁵ associated with the intermediated system in cross-border securities transactions, geometrically increase in proportion to the number of intermediaries and states involved in the intermediated system. In the international intermediated system, among other things, legal differences between states in which securities intermediaries of every tier are located multiply legal implications of choice of law rules issues,⁴⁶ and ambiguity and incompatibility of substantive rules.⁴⁷

For example, assume that a Korean investor holds, through KSD, 300,000 common shares of Auto Incorporation (“Auto, Inc.”), which is incorporated in accordance with the Delaware Corporation Act. KSD in turn, holds through Euroclear Bank, 1,000,000 common shares of Auto, Inc., which includes 300,000 shares of the Korean investor as well as other participants’ holdings of KSD. Euroclear Bank holds 3,000,000 common shares of Auto, Inc. through its sub-custodian located in Berlin,

⁴³ A local custodian provides custody services for securities traded and settled in the country in which the custodian is located. From the international viewpoint, sometimes CSDs and global custodians also can be regarded as local custodians.

⁴⁴ See e.g. Steven L. Schwarcz (with contribution by Joanna Benjamin), “Intermediary Risk in the Indirect Holding System for Securities” (2002) 12 Duke J. Comp. & Int’l L. 309 for general information on intermediary risk. To put it briefly, intermediary risk means the risk where securities holders can lose their securities in the case of insolvency of the intermediary with which the securities are held, if the legal system does not clearly separate the securities holders’ from the intermediary’s own assets. When the legal system fails to provide a clear and sound protection, the intermediary’s general creditor can attach the investors’ securities.

⁴⁵ Systemic risk is the risk of the inability of one institution to meet its obligations when due which will cause other institutions to be unable to meet their obligations when due. Systemic risk is substantiated and spread to other financial institutions at the time of financial stress due to the web-like closely interrelated intermediaries in the intermediated system. As regards risks in securities clearing and settlement, see generally Joanna Benjamin, *Supra* note 6 at 144~154; and Bank for International Settlements, *Supra* note 38 at 41~45.

⁴⁶ See generally HCCH (Christophe Bernasconi), Prel. Doc. No 1 of November 2000, *Report on the Law Applicable to Dispositions of Securities Held Through Indirect Holding Systems* (hereinafter, the “Bernasconi Report”) at 27~42. Conflict of laws issues are discussed in Chapter IV and V.

⁴⁷ See generally Unidroit Study LXXVIII. Doc. 19 - *Explanatory Notes, Preliminary Draft Convention on Harmonised Substantive Rules regarding Securities Held with an Intermediary* (December 2004) at 7~10.

Germany, and the sub-custodian of Euroclear Bank has 5,000,000 common shares of Auto, Inc. through DTC, the CSD of the U.S. which is seated in New York. Further, assume that some of the share certificates of Auto Inc. are kept in the vault of DTC, and that the total shares in the custody of DTC are registered in the shareholders' book of the transfer agent of Auto, Inc. located in New Jersey. Further suppose that the Korean investor wants to borrow money from an investor in Canada who has his securities account with the RBC bank located in Toronto. Now finally assume the Korean investor and the Canadian investor enter into a loan agreement governed by New York law and the Korean investor provides the 300,000 common shares of Auto, Inc. to the Canadian investor as collateral by way of title transfer. The above fact pattern can be illustrated by the following Figure 2:⁴⁸

⁴⁸ This fact pattern is a variation of the fact pattern in the Bernasconi Report page 37. This fact pattern assumes it knows where the share certificates are located and by which tiers of intermediaries the Korean investor holds them. But in reality, it is not easy and many times almost impossible to know where the investor's securities certificates are located and how the securities are held in the multi-tiered web. This reality especially depicts the difficulty of the traditional *lex situs* rule application in the choice of law analysis. See James Steven Rogers, "Conflict of Laws for Transactions in Securities Held through Intermediaries" 39 Cornell Int'l L.J. 285 at a 295~298 for the example showing how difficult it is to find the *situs* of securities in the international intermediated system.

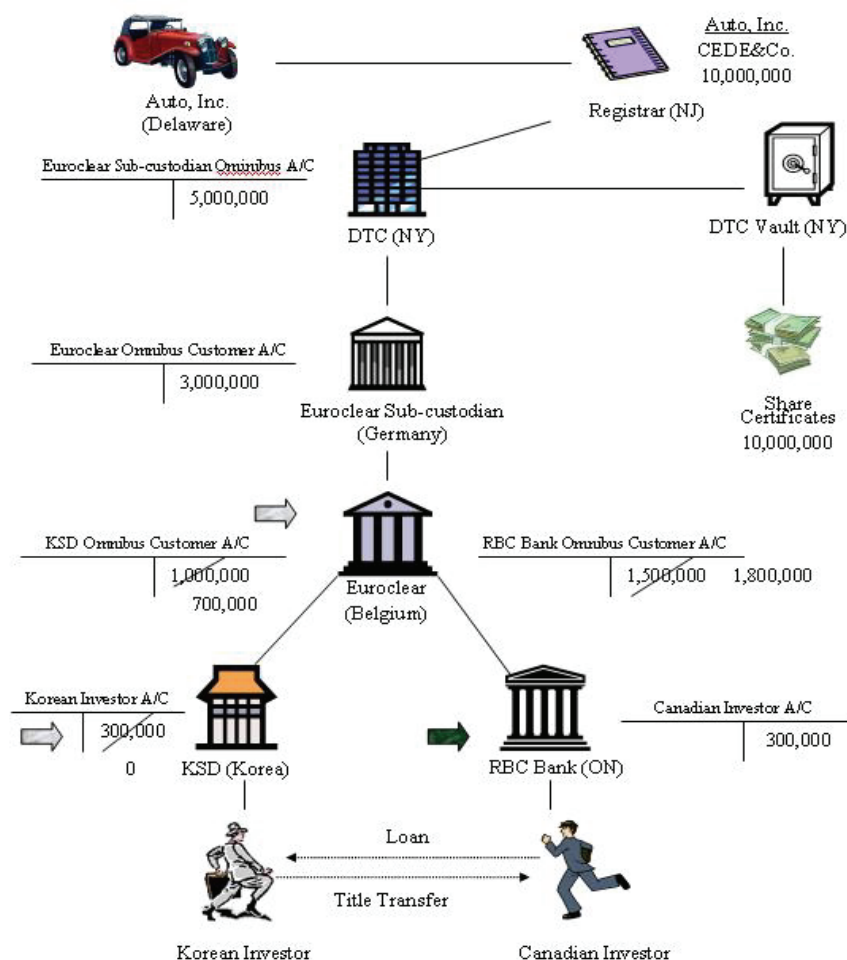


Figure 2. International Securities Holding Pattern

As can be seen from Figure 2, though it is one single collateral securities transaction, the laws of seven jurisdictions⁴⁹ are involved in this fact pattern. There might be several substantive law questions, even though the choice of law rules are determined by the Hague Securities Convention. First, for example, where there are rules in place, they could be contradictory or give rise to different interpretations.⁵⁰ In a situation where there is a lack of uniform interpretation, parties may execute a trade without recognising the specific risk they face, which they might then realise later, or

⁴⁹ Korea, Ontario, Belgium, Germany, New York, New Jersey, and Delaware.

⁵⁰ Unidroit Study LXXVIII. Doc. 19, *Supra* note 47 at 7.

parties may know the risk in advance but then have to spend time and money in overcoming the lack of clarity by way of contractual agreement.⁵¹ Secondly, where the answer provided by the applicable law does not fit the market reality, or where the law unnecessarily complicates or burdens, the consequence of imposing requirements that complicate a transaction can be time-consuming and costly, or furthermore a complicated procedure makes each process of perfection of a transaction specifically vulnerable to mistakes.⁵² Thirdly, in a cross-border transaction as Figure 2, there might be another issue of incompatibility in which the law determined by choice of law rules (let's assume that it is Article 4 of the Hague Securities Convention) cannot apply. For instance, in some countries, the special statutory framework for investment securities applies only to securities that are held with the local CSD. In this case, even though the Hague Securities Convention refers to the law of a certain state, however, the special statutory framework does not apply.⁵³

In this regard, Unidroit has worked on the preliminary Convention since 2001 and released its position paper in 2003.⁵⁴ After four sessions of the committee of governmental experts for the preparation of a preliminary convention, currently the May 2007 draft is distributed for further negotiation.

2. Key Issues of the Unidroit Preliminary Draft Convention

The purpose of the Unidroit project is to promote legal certainty and economic efficiency with respect to the cross-border holding and disposition of intermediated securities, by harmonising certain legal aspects which all the

⁵¹ See *Ibid.*

⁵² See *ibid.* and accompanying text at 8~9.

⁵³ *Ibid.* at 10. For instance, foreign shares listed on Japanese stock exchanges are not subject to the new legal framework which is a fully dematerialised intermediated system.

⁵⁴ Unidroit Study LXXVIII, Doc. 08 - *Position Paper of the UNIDROIT Study Group on Harmonised Substantive Rules Regarding Indirectly Held Securities* (August 2003). See also Philipp Peach, "Harmonising Substantive Rules for the Use of Securities Held with Intermediaries as Collateral: the Unidroit Project" (2002) *Unif. L. Rev.* 1140.

intermediated systems should contain.⁵⁵ The two main objectives which the Unidroit Preliminary Draft Convention attempt to achieve are internal soundness within the domestic legal framework (which means that each system should provide a sound legal framework for the holding and transfer of securities held with intermediaries taking into account objectives of investor protection and efficiency), and compatibility between different intermediated systems of different jurisdictions.⁵⁶ However, the Unidroit Preliminary Draft Convention does not attempt to intrude into domestic legislation of each state by implementing comprehensive rules which replace existing national legal regimes. Instead, the ways to achieve the required result in a legal system are not “decisive” and give the national legislators discretion, provided that they are compatible with the other rules of the Unidroit Preliminary Draft Convention.⁵⁷

The key issues which the Unidroit Preliminary Draft Convention deals with are intermediated securities as rights of the account holder (Art. 7), acquisition and disposition of intermediated securities by debit and credit (Art. 9), grant of security interest other than the method of simple debit and credit (Art. 10), invalidity and reversal of book-entry (Art. 11), acquisition by an innocent person of intermediated securities (Art. 14), priority among competing interests (Art. 15), rights of account holders in case of insolvency of intermediary and effects of insolvency (Arts. 17, 18 and 24), prohibition of upper-tier attachment (Art. 19), instructions to the intermediary (Art. 20), requirement of an intermediary to hold sufficient securities (Art. 21), limitations on obligations and liabilities of intermediaries (Art. 25), allocation of securities to account holders’ right (Art. 22), loss sharing rules (Art. 23),

⁵⁵ See Unidroit Study LXXVIII. Doc. 19, *Supra* note 47 at 4.

⁵⁶ See *ibid.* at 18.

⁵⁷ *Ibid.* at 19. For this reason, the Draft Convention specifies several declaration clauses and the cases where non-Convention law (which is domestic rules other than the Convention law) applies. Therefore, there still exists a necessity to have uniform conflict of laws rules and in this regard, both the Unidroit Preliminary Draft Convention and the Hague Securities Convention are complementary.

set-off (Art. 27), and special provisions with respect to collateral transactions (Arts. 28 ~ 34).⁵⁸

B. The Intermediated System in the United States

1. Overview and History⁵⁹

The legal framework of the intermediated system in the U.S. is provided by the UCC Article 8.⁶⁰ Article 8 was originally drafted in the 1940s and 1950s, and the 1962 version was widely adopted.⁶¹

The basic assumption in the 1962 version was that the possession and delivery of physical certificates were the key elements in the securities holding system because ownership of securities was traditionally evidenced by possession of the certificates and ownership changes were accomplished by delivery of the certificates.⁶² The 1962 version of Article 8 contained limited provisions relating to the transfer and pledge of intermediated securities. Nevertheless, the intermediated

⁵⁸ See Unidroit Study LXXVIII, Doc. 94 – *Preliminary draft Convention on Substantive Rules regarding Intermediated Securities* (May 2007) as for further information on the Preliminary Draft Convention.

⁵⁹ See generally James Steven Rogers, “Policy Perspectives on Revised U.C.C. Article 8” (1996) 43 UCLA L. Rev. 1431 at 1141~1449 for more information on the history of the intermediated system in the U.S. and the revision history of the UCC Article 8. See also Financial Markets Law Committee, *Issue3-Property Interests in Investment Securities – Report on Research into the 1994 Revision to Article 8 of Uniform Commercial Code* (London, 2005) at 4~6.

⁶⁰ The subject of the UCC Article 8 is about investment securities. It covers several important definitions and concepts such as adverse claim, control, choice of law, clearing corporation and securities intermediary (Part 1). It also specifies issuance of securities and issuer (Part 2), transfer of certificated and uncertificated securities (Part 3), and registration of transfer (Part 4). The main issue of Article 8, however, is a security entitlement which is the United States version of intermediated securities and is the core and essential concept of the intermediated system (Part 5).

⁶¹ See Russell A. Hakes, “UCC Article 8: Will the Indirect Holding of Securities Survive the Light of Days?” (2002) 35 Loy. L.A. L. Rev. 661 at 667.

⁶² See Prefatory Note of Article 8 at Part I. A. (hereinafter, the “Prefatory Note”).

system became widely used beginning in the late 1960s in response to the "paper-crunch" inherent in the direct holding of certificated securities.⁶³

The 1978 revisions to Article 8 introduced uncertificated securities and aimed for a paperless securities market.⁶⁴ However, the 1978 revisions primarily took the form of adding parallel provisions dealing with uncertificated securities, in addition to the existing rules of Article 8 on certificated securities.⁶⁵ The only difference from the traditional system was that ownership of securities would not be represented by physical certificates. Therefore, it could not properly reflect the practices of the securities markets and the securities industry in which transfer of securities or settlement of securities trading was performed, not by registration of transfer on the records of the issuers or their transfer agents but by computerised entries in the records of clearing corporations and securities intermediaries.⁶⁶ However, the revolutionised revision of the Article 8 was not tackled until the bitter experience of the October 1987 stock market crash which made regulators and market participants realise the importance of a well-organised clearance and settlement system. In response to the study reports on the market crash, the two sponsoring bodies of the UCC, the National Conference of Commissioners on Uniform State Laws and the American Law Institute, established a draft committee in the Spring of 1991 to proceed with the work of revising Article 8 to meet the needs identified by the studies and especially to get rid of the systemic risk.⁶⁷

Unlike the direct securities holding system contemplated by Article 8 of the 1962 and 1978 version, the current (1994) version of the UCC Article 8 adopted the intermediated system, as well as the direct holding system. It also created the new concept of a "security entitlement" which is the starting point of the revised Article 8 treatment of the intermediated system. Section 8-102(a)(17) defines the security

⁶³ See Russell A Hakes, *supra* note 61, at 668.

⁶⁴ See Prefatory Note, at Part I. A.

⁶⁵ See *ibid.* at Part I. B.

⁶⁶ See *ibid.*

⁶⁷ See James Steven Rogers, *Supra* note 59 at 5~6.

entitlement as the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5 of Article 8.

2. Basic Structure and Key Features

The basic structure of the intermediated system in the U.S. is made up of the following four key elements: an entitlement holder, a security account, a securities intermediary, and a security entitlement.

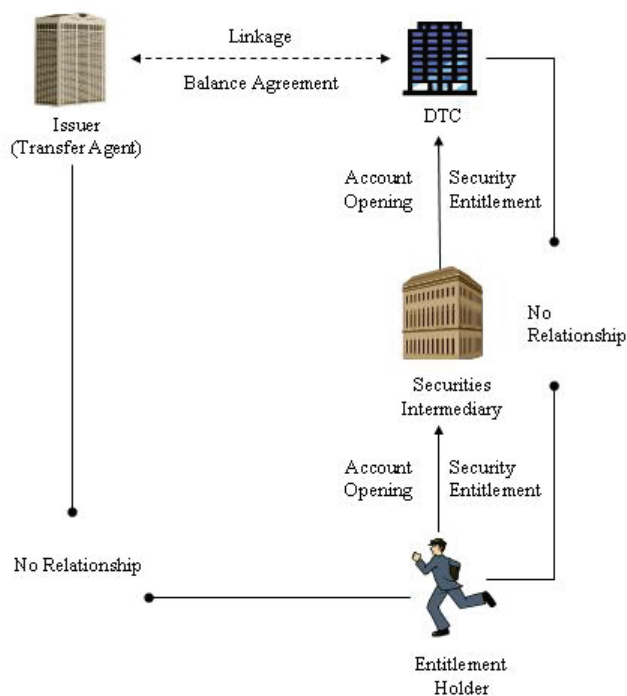


Figure 3. Basic Structure of the U.S. Intermediated System

As Figure 3 indicates,⁶⁸ an entitlement holder is the one who holds the security entitlement credited in the securities account through his securities intermediary.⁶⁹ Therefore, the securities intermediary in Figure 3 is also an entitlement holder vis-à-vis DTC as the clearing corporation⁷⁰ and holds a security entitlement. However, the crucial point is that an entitlement holder has the security entitlement only against his own immediate securities intermediary. Accordingly, the entitlement holder has no direct relationship with DTC, which is the upper intermediary of the intermediary of the entitlement holder.

The UCC Article 8 Section 5-501(a) specifies that the term securities account means “an account to which a financial asset⁷¹ is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset.” Therefore, an entitlement holder acquires a security entitlement when a financial asset is or may be credited in his securities account. It means that in the intermediated system, a book-entry on a securities account creates the right to the financial asset.

⁶⁸ The relationship between DTC and issuers is outside the scope of the UCC. However, for the purpose of understanding the industry’s practices, it is useful to review the relationship between DTC and a transfer agent. DTC enters into agreements with transfer agents by which securities are registered in the street name of DTC, “cede & co”, and securities certificates deposited with DTC are destroyed. Then, DTC and the transfer agents maintain the balance of securities which reflects DTC’s ownership interests. When DTC is asked to withdraw securities by its participants, DTC orders the transfer agent that maintains the securities to be delivered to issue securities certificates. And then, the transfer agent reduces the balance and issues the certificates in the name of the beneficial owner and delivers them to the participant directly. This system is called the FAST, Fast Automated Securities Transfer system. The FAST system relieves DTC’s operational burdens to maintain securities certificates and enables fast withdrawal of securities. This service is not for all deposit-eligible registered securities but only the securities designated by DTC.

⁶⁹ UCC §8-102(a)(8) defines entitlement holder as “a person identified in the records of a securities intermediary as the person having a security entitlement against the securities intermediary.”

⁷⁰ See UCC §8-102(a)(5) for the definition of the clearing corporation.

⁷¹ A “financial asset” is a broader concept than a “security.” Under the revised Article 8, normally, any property held by a securities intermediary for another person in a securities account is a financial asset. See the definition of a financial asset under the UCC §8-102(9) and its official comment for further understanding.

The securities intermediary is a person, including a clearing corporation, a bank or broker, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity.⁷² In the U.S. intermediated system, a securities intermediary keeps and maintains all the records and an entitlement holder can exercise his right only against his securities intermediary. Thus, the UCC imposes upon a securities intermediary several duties such as the duty to maintain a financial asset corresponding to the aggregate of all security entitlements, the duty to receive payment and distribution made by the issuer of a financial asset and to be obliged to its entitlement holder for the payment and distribution, the duty to exercise rights as directed by an entitlement holder, the duty to comply with an entitlement order, and the duty to change the entitlement holder's position to another form of security holding.⁷³ Those duties can be fulfilled if a securities intermediary acts with respect to the duty as agreed upon by the entitlement holder and the securities intermediary, or in the case of the absence of agreement, the securities intermediary should exercise due care in accordance with reasonable "commercial standards" to follow the entitlement order.

3. Intermediated Securities (Security Entitlement)

Under the revised Article 8 Part 5, therefore, the object an entitlement holder holds is legally relocated as a security entitlement rather than securities themselves. As mentioned above, a security entitlement is the *sui generis* rights and property interest of an entitlement holder with respect to a financial asset. In other words, a security entitlement can be defined as both a package of personal rights against the securities intermediary and an interest in the property held by the securities intermediary.⁷⁴ A security entitlement is a pro rata property interest in all interests in

⁷² See UCC §8-102(a)(14). It is a similar definition of an intermediary in the Unidroit Preliminary Draft Convention and the Hague Securities Convention

⁷³ See UCC §8-504~§8-509.

⁷⁴ See UCC §8-102 cmt. 17.

the financial asset held by the securities intermediary.⁷⁵ As such, a security entitlement is not a specific property interest in any financial asset held by the securities intermediary⁷⁶ and the entitlement holder cannot assert rights directly against other persons, such as other intermediaries through whom his intermediary holds the positions, or third parties to whom his intermediary may have wrongfully transferred interests, except in extremely unusual circumstances where the third party was itself a participant in the wrongdoing.⁷⁷ It means that except for highly unusual circumstances,⁷⁸ an entitlement holder has no legal rights against persons further up the intermediated holding chains or any other person other than his immediate securities intermediary under the UCC Article 8. In connection with the exceptional circumstances, under the UCC Section 5-503(d), a claimant can sue the transferee (entitlement holder) only if the following four requirements are met: 1) insolvency proceedings have been initiated by or against the claimant's intermediary; 2) the intermediary holds insufficient interest to satisfy all of its entitlement holders' security entitlements; 3) the intermediary is in violation of its duty by transferring the financial asset to the transferee; and 4) the transferee is not protected under Section 5-503(e), which specifies that the transferee's security entitlement is claimed only when the transferee does not give value, does not obtain control, and acts in collusion with the intermediary.

In accordance with the UCC Article 8 Section 5-501(b), an entitlement holder can acquire a security entitlement in one of the following three ways: 1) when the securities intermediary has credited a financial asset to the entitlement holder's securities account, 2) when the securities intermediary accepts a financial asset for credit to the entitlement holder's securities account, or 3) when the securities

⁷⁵ See UCC §8-503(b).

⁷⁶ See UCC §8-102 cmt. 17.

⁷⁷ See UCC §8-503 cmt. 2. It can be seen as an action to enhance efficiency of settlement and to reflect the security industry's practices. However, it can also be interpreted as a limitation on the rights of securities holders compared to those of the prior version of the UCC Article 8.

⁷⁸ See further Russell A. Hakes, *supra* note 61, at 689~691.

intermediary becomes obligated by other law, regulation, or rule to credit a financial asset to the entitlement holder's securities account.

Another notable concept related to a security entitlement in the UCC Article 8 is control which corresponds to the concept of constructive possession in the previous version of the UCC Article 8. Because the revised UCC Article 8 severed deposited securities from what investors hold in reality, it was necessary to eliminate uncertainty and confusion arising from similar concepts which come from other bodies of law like common law.⁷⁹ Therefore, for the purpose of supplanting the concepts of constructive possession and the like, the new definition of control was introduced with respect to a security entitlement in Section 8-106(d)⁸⁰. The key to the control concept is that the purchaser has the present ability to have the securities sold or transferred without further action by the transferor.⁸¹

4. Protection of Entitlement Holders

An entitlement holder has a security entitlement even though the securities intermediary does not itself hold the financial asset, if one of the three conditions specified in Section 8-501(b) has been met.⁸² In this regard, the UCC Section 8-502 cuts off an adverse claim against an entitlement holder who acquired his security entitlement under Section 501 for value and without notice of the adverse claim,

⁷⁹ See UCC §8-106 cmt. 7.

⁸⁰ According to UCC §8-106(d), a purchaser has control of a security entitlement by three ways, if 1) the purchaser becomes the entitlement holder; 2) the securities intermediary has agreed that it will comply with entitlement orders originated by the purchaser without further consent by the entitlement holder, or 3) another person has control of the security entitlement on behalf of the purchaser or, having previously acquired control of the security entitlement, acknowledges that it has control on behalf of the purchaser.

⁸¹ See UCC §8-106 cmt. 7.

⁸² See UCC §8-501(c).

through which the UCC protects a bona fide purchaser and ensure settlement finality.⁸³

Further more, the UCC Section 8-503(a) specifies that “[t]o the extent necessary for a securities intermediary to satisfy all security entitlements with respect to a particular financial asset, all interests in that financial asset held by the securities intermediary are held by the securities intermediary for the entitlement holders, are not property of the securities intermediary, and are not subject to claims of creditors of the securities intermediary, except as otherwise provided in Section 8-511.”⁸⁴ Also, in principle, if a securities intermediary does not have sufficient interests in a particular financial asset to satisfy both its obligations to entitlement holders who have security entitlements to that financial asset and its obligation to a creditor of the securities intermediary who has a security interest in that financial asset, the claims of entitlement holders, other than the creditor, have priority over the claim of the creditor unless the creditor has control over the financial asset.⁸⁵ However, in the case of securities shortfalls at the end, subject to insolvency law, the shortfalls are borne by the entitlement holders who hold that financial asset in proportion to their security entitlement.⁸⁶

5. Security Interest

Under the UCC Article 9, three requirements are required to grant a valid security interest; value has to be given by the secured party, the debtor must have rights in the collateral, and the secured party must have control of the investment

⁸³ See also UCC §8-510 that provides rights of a purchaser of a security entitlement from an entitlement holder. Other provisions related to the bona fide purchaser and transaction enhancement are §8-115, §8-116, §8-503(e), and §9-331(c).

⁸⁴ UCC §8-503 Comment 1 furthers that “since securities intermediaries generally do not segregate securities in such fashion that one could identify particular securities as the ones held for customers, it would not be realistic for this section to state that customers' securities are not subject to creditors' claims.”

⁸⁵ See UCC §8-511(a) & (b)

⁸⁶ See UCC §8-503(b) and accompanying cmt. 1.

property under Section 9-106(a)⁸⁷ pursuant to the debtor's security agreement.⁸⁸ Likewise, a security interest in investment property is also automatically perfected by control of the collateral under Section 9-106(a) from the time the secured party obtains control and remains perfected by control until the secured party does not have control and the debtor is or becomes the entitlement holder.⁸⁹

C. The Intermediated System in Korea

1. Overview and History

The intermediated system in Korea⁹⁰ is stipulated partially in the *Securities Exchange Act* ("SEA")⁹¹ unlike the situation in other states such as Germany and Japan which have independent legislation in the *Depotgesetz*⁹² and *Kabukentou no Hokan oyobi Hurikae ni Kansuru Houritsu*⁹³ (which provides the old legal regime of the Japanese intermediated system) respectively. However, the legal framework of the intermediated system in Korea models that of Germany and Japan.⁹⁴

⁸⁷ A person has control of a security entitlement as provided in the UCC §8-106.

⁸⁸ See UCC §9-203(b).

⁸⁹ See UCC §9-314(a) & (c). Other methods of perfection are filing and attachment (See §9-115(4)).

⁹⁰ See KSD, *Supra* note 12 at 94~188; KSD, *A Commentary of Korean Securities Exchange Act: Section 8-3, Provisions on Korea Securities Depository* (in Korean) (Research Material of 2003, Vol. 1, 2003); and Heeman Kang, *Securities Settlement System* (in Korean) (Seoul: Yookbeopsa, 1989) for more detailed information and history on the intermediated system in Korea.

⁹¹ *Jeungkweon Keorae Beop* [Securities Exchange Act], Act No. 2920 of 1976. The provisions on the intermediated system are in Article 173 through 178 (totally 23 provisions).

⁹² Deposit Act. The original full name of the *Depotgesetz* is *Gesetz über die Verwahrung und die Anschaffung von Wertpapieren* [Act on the deposit and the acquisition of securities].

⁹³ *Act on securities certificates custody and book-entry* (Act No. 30 of 1984, herein this chapter, the "old law") which is similar to the *Depotgesetz*.

⁹⁴ In particular, the *Act on Securities Custody and Book-entry* of Japan directly affected the provisions of the intermediated system in the SEA. Therefore, such basic legal concepts as deposit, withdrawal, co-ownership, and deemed possession are the same among Korea, Japan and Germany.

With the Korean government's strong initiatives and such supporting statutory enforcements as the *Act on Capital Market Development* in 1968 and the *Act on Promotion of Privatisation* in 1972 in order to raise and develop the capital market coupled with the rapid economic development of Korea, there were a great number of increases in public offerings and securities transactions.⁹⁵ However, a proper legal arrangement of the intermediated system was not made until 1973 when the fifth amendment to the SEA provided the legal ground for implementing the Korean intermediated system.⁹⁶

Although Korean securities markets continued to grow in size until the 1980's, improvement of the intermediated system alongside this growth did not keep pace with it. Particularly, in each December when most of the listed corporations' annual settlements were performed, most deposited share certificates were returned to participants of KSD to register the shares in shareholders' names on the shareholder's books of the issuers on the record date to exercise rights as a shareholder.⁹⁷ Afterwards, the returned share certificates were redeposited.⁹⁸ The main reason for this was because at that time, the Korean intermediated system was basically established based on the early intermediated system and practice in the U.S.⁹⁹ This was the case until November 1987, when the legal foundation of the current

⁹⁵ See Korea Securities Dealers Association, *2007 Securities Market in Korea* (Seoul: KSDA, 2007) at 14~20 for the details on the history of development of the Korean Securities Markets.

⁹⁶ KSD, *Supra* note 88 at 13~14.

⁹⁷ Practically, all the shares issued in Korea are registered shares. Therefore, shareholders had to register their names on the shareholders' book maintained by the issuer (or the transfer agent, as a usual case) to exercise their rights as shareholders such as voting rights and rights to receive dividends.

⁹⁸ As a result, there was a huge workload due to share certificates which were withdrawn and redeposited at the end of the fiscal year for most listed corporations. One of the main problems of this was that shareholders could not trade the returned shares until they were redeposited. Besides, while share certificates were withdrawn, they were exposed to the possibilities of damage, loss, theft or the likes.

⁹⁹ Unlike the U.S., Korea didn't have a well-organized proxy regulation and system. So, the shareholders who intended to exercise voting rights had to withdraw share certificates and register the share in their names. After the record date, the withdrawn share certificates were redeposited and registered in the street names of the securities companies again.

intermediated system in Korea was laid according to the ninth amendment to the SEA.¹⁰⁰

The ninth amendment to the SEA was made to resolve the problems and to strengthen the legal foundation of the securities deposit.¹⁰¹ The ninth amendment provided the legal effect of book-entries on participants' account books maintained by KSD and customers' account books carried out by the participants. Moreover, it also specified ways to exercise shareholder's rights by paving the way of the real shareholder system.¹⁰²

2. Basic Structure

The primary elements of the intermediated system in Korea are KSD as the CSD in Korea, participants as intermediaries, customers as investors, deposit of securities, the concepts of co-ownership and deemed possession, and issuers (or transfer agents).

KSD, as the CSD of Korea, provides various services. Among other things, such services as collective custody of securities, settlement of securities transactions

¹⁰⁰ More precisely, KSD had already implemented a similar system, the so-called consecutive deposit system on April 30, 1985, which enabled KSD to keep deposited share certificates in its custody even on record dates, and to exercise rights arising from such shares on behalf of the shareholders. The system, however, was performed on a contractual basis, by regulations of KSD and its participants. For this reason, the ninth amendment to the SEA can be regarded as the legal foundation of the current intermediated system in Korea.

¹⁰¹ See the SEA Art. 174-6 and 174-7 which are similar provisions to those of the ninth amendment to the SEA.

¹⁰² It is a literal translation of the *Siljiljujedo* in Korean. It is often translated as the beneficial owner system or the beneficial shareholder system. However, it could mislead the original meaning of the system because the term of "beneficial" can allude to a trust relationship as between an investor and an intermediary. However, it is the overwhelming opinion in Korea that the relationship is not of a trust but of a mandate. Therefore, even though the investor holds shares through the intermediary, he is still the real holder of the shares and the intermediary is regarded as a mere securities account book keeper. This is one of the biggest differences from the intermediated system in the U.S. Additionally, because this system applies only to shares, the translation of the beneficial owner system can give a worse meaning of the real shareholder system.

of the markets, book-entry transfers, and corporate actions on behalf of securities holders are the primary services.¹⁰³

The deposit of securities consists of two agreements: an agreement of bailment, which allows KSD to maintain custody of deposited securities in the commingling pool, and an agreement of mandate, which enables transfers, alterations, or terminations of the interests in the deposited securities by a book-entry.¹⁰⁴ Participants deposit securities with KSD without delay by stating on the customers' account books that the securities are deposited by customers when they receive the securities.¹⁰⁵ KSD, when it receives the securities from its participants, records the relevant information on the participants' account books by separating the participants' holdings from the customers',¹⁰⁶ and keeps the deposited securities on a fungible basis by types and items thereof.¹⁰⁷

The book-entry on the participants' account books or the customers' account books for a transfer of securities or creation of a pledge has the same effect as the actual delivery of securities certificates,¹⁰⁸ which is required for a transfer of securities or establishment of a pledge under the *Commercial Code* of Korea.¹⁰⁹

Under the Korean intermediated system specified in the SEA, the customer who deposited securities with his securities intermediary, which is usually a securities corporation, has co-ownership of the deposited securities with KSD.¹¹⁰ Accordingly,

¹⁰³ See <http://www.ksd.or.kr/eng/what/core/enacs00x00.jsp> for the services provided by KSD.

¹⁰⁴ See KSD, *supra* note 12 at 94~96.

¹⁰⁵ See the SEA Art. 174-2(2).

¹⁰⁶ See *ibid.* Art. 174(3).

¹⁰⁷ See *ibid.* Art. 174(4).

¹⁰⁸ See *ibid.* Art. 174-3(2).

¹⁰⁹ *Sangbeop* [Commercial Code], Act No. 1000 of 1962, §336(1) and §338(1).

¹¹⁰ See the SEA Art. 174-4(1), which provides that "customers of a participant and the participants shall be presumed to have a co-proprietorship to the deposited securities according to the types, items and quantities of the securities stated in customers' account books and participants' account books, respectively."

the customer (securities holder) is deemed to be the ultimate owner of the deposited securities, unlike the beneficial owner under the UCC.¹¹¹

The following Figure 4 depicts the basic structure of the intermediated system of Korea.

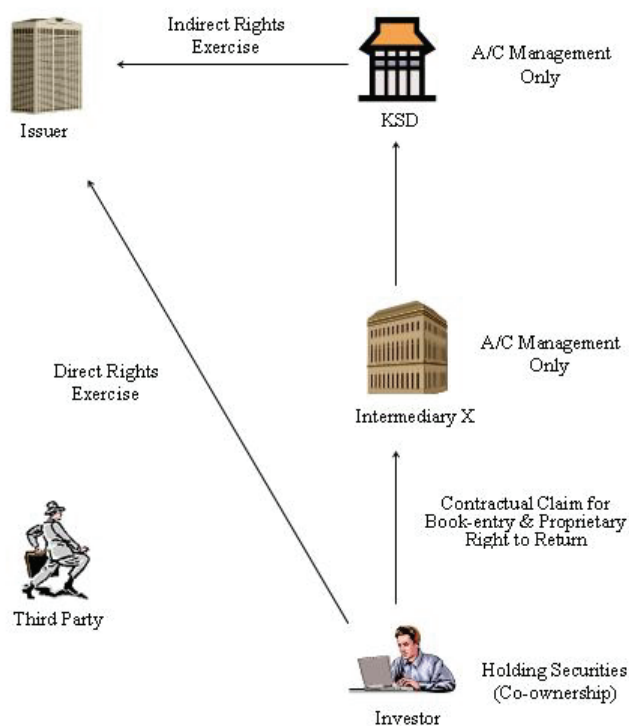


Figure 4. Basic Structure of the Korean Intermediated System

¹¹¹ If the two figures of each intermediated system are compared, this difference could be found with ease.

3. Securities Holder's Right (Co-ownership)

As discussed above, intermediated securities holders are the ultimate owners of deposited securities with KSD under the SEA, and the intermediated securities holders have a proportionate co-proprietorship over the deposited securities, which is one type of ownership under the civil law theories. Therefore, intermediated securities holders have a relationship with KSD based on the deposited securities and may even directly sue KSD when it violates its fiduciary duty or other responsibilities under the SEA.¹¹² These distinctive differences, of course, come from the different views with respect to securities. Under the SEA, the subject-matter of deposit and possession is the securities themselves, which are enumerated in Article 2. Under the UCC Article 8, Part 5, however, what an investor holds is not securities, but a new hybrid property, a security entitlement which is severed from the very securities. The other primary distinction is the possibility of the direct relationship between the issuer and the investor. Theoretically and legally, as a shareholder is the ultimate owner of shares, he may exercise his rights as a shareholder, if he can prove his eligibility to the issuer of the share. From the viewpoint of practicality and efficiency, however, it is a burden to prove it for both the issuer and the shareholder in that the issuer has to identify each shareholder and the shareholder must prepare evidence to prove his status as a shareholder. To eliminate this inconvenience, the SEA introduced the real shareholder system in 1987 which is modelled on the Japanese system.¹¹³ The real shareholder system¹¹⁴ allows the issuer and the shareholder to directly and efficiently communicate with each other. This can be illustrated by the following Figure 5.

¹¹² In contrast, as discussed, an entitlement holder can sue only his intermediate securities intermediary with the extremely rare exceptions of the adverse claim under the UCC §8-102(a)(1), §8-502.

¹¹³ The ninth amendment to the SEA on Nov. 28, 1987. There exists no real bondholder system. This was because rights exercise with respect to bonds is simple, periodical and rare, like a request of payment of principal and interest, compared to the rights exercise of shares which are rather complicated, irregular, and frequent.

¹¹⁴ See KSD, *Supra* note 12 at 145~155 for details.

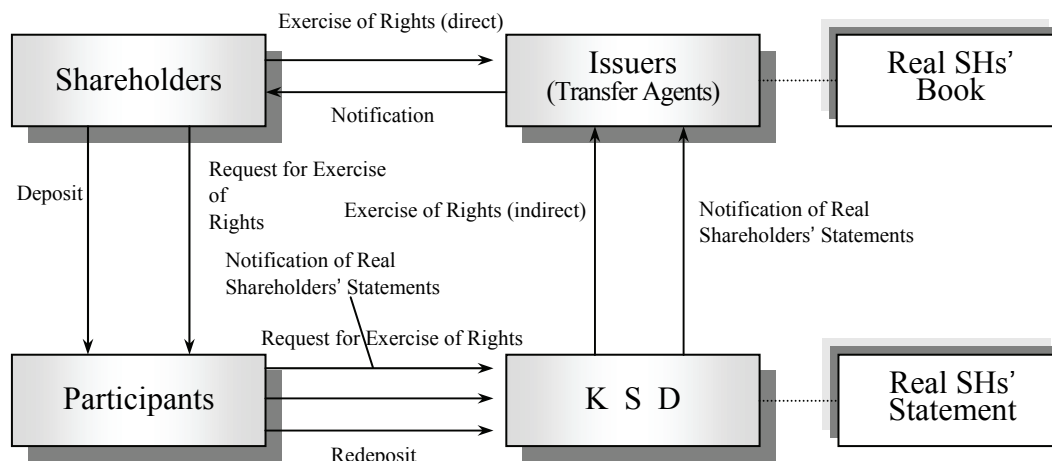


Figure 5. Illustration of the Real Shareholder System

The main elements of the real shareholder system are the real shareholders' statement, the real shareholders' book, and the direct and indirect exercise of the real shareholders' rights.¹¹⁵ The real shareholders' statement provides detailed information about the shares registered on the shareholders' book in the KSD's name.¹¹⁶ When an issuer sets a record date to determine the shareholders who can exercise shareholders' rights, participants prepare and send the real shareholders' statements, which include the information on the customers' account books as of the record date.¹¹⁷ After receiving and compiling the real shareholders' statements from each relevant participant, KSD sends these statements to the issuer (transfer agent). When the issuer receives them, the statements become the real shareholders' book.¹¹⁸

¹¹⁵ See the SEA Art. 174-6(1) which provides that "KSD may, upon a request of a participant or a customer, exercise the rights as to the deposited securities. In this case, a request of a customer shall be made through the participant."

¹¹⁶ When securities are deposited with KSD, KSD may register them in its name on the securities holders' book of the issuer for securities holders under the SEA Article 174-6(2). Pursuant to Article 174-6(2) of the SEA, KSD promptly registers all the securities deposited with it.

¹¹⁷ See the SEA Art. 174-8(3). The items which should be included in the real shareholders' statement under this provision are 1) name and address of the shareholder, and 2) type and number of the share.

¹¹⁸ It is a legal book and any statement in the real shareholders' book as to the shares deposited with KSD has the same effect as that in the shareholders' book. See the SEA Art. 174-8(2).

As mentioned above, the real shareholders' book not only provides the issuer and the real shareholders with a channel of communication, but it also enables the real shareholders to exercise their rights as shareholders directly against the issuer.¹¹⁹

The rights which a real shareholder may exercise through KSD (the indirect exercise of rights) are voting rights, rights to rights issues, rights to bonus issues, and appraisal rights.

4. Protection of Securities Holders

In the Korean legal regime of the intermediated system, there is no provision for the securities holders' protection when an intermediary becomes insolvent. This is because securities holders themselves are co-owners in proportion to their deposited securities,¹²⁰ and intermediaries including KSD are required to segregate customers' securities from their own on the customers' account books and the participants' account books.¹²¹ By this mechanism, the customers' securities are immune from general creditors in the case of insolvency of their intermediaries.

In addition, in the SEA, there is no provision of an adverse claim or a good faith purchaser which functions to ensure the finality of a book-entry. The closest provision is Article 174-3 Paragraph 2, which provides that "in the case where a book-entry on the customers' account book or the participants' account book for the purpose of a transfer of securities or creation of a pledge is made, it has the same effect of the actual delivery of securities certificates." Pursuant to this provision, an investor can hold his securities by a credit book entry on his account. It may seem as

¹¹⁹ However, in practice, almost all real shareholders exercise their rights indirectly, since they do not need to visit each transfer agent or issuer for rights exercise but can simply use their own securities corporations (intermediaries). Given that real shareholders can also exercise their rights directly against the issuer, the intermediated system of Korea is different from that of the U.S. As the real shareholder system in Japan allows shareholders to exercise their rights only directly against the issuer, the real shareholder systems of Korea and Japan are distinctively different in this respect.

¹²⁰ See the SEA Art. 174-4(1)

¹²¹ See *ibid.* Art. 174(3) & 174-2(3).

though it does not give the certainty of a book-entry. However, the majority view is that the bona fide purchaser provisions and theory in the *Civil Code* and the *Commercial Code*¹²² can be applicable to the intermediated system in order to protect investors and the system itself.¹²³

In a shortfall case, those who are responsible for the loss make up for it without delay, and if it is not fully covered, then KSD and participants who have a customer bear a joint and several strict liability for any shortage of securities in custody with KSD.¹²⁴ This liability extends to the securities credited on participants' account books but not yet delivered to KSD according to Article 174-2(4)¹²⁵ and lasts for five years even after closing the participant accounts.¹²⁶ However, KSD and the participants who remedy the shortfall are entitled to the right to indemnity from those who are liable for the shortfall.¹²⁷ Under the shortfall provisions, there is no specific rule of loss allocation. Two possible options are, first, to distribute the liability according to the number of all the participants plus KSD, and secondly, to allocate it in proportion to the deposit ratio of the same type of securities which became short. The latter solution looks reasonable but it cannot give an answer to the question of how much liability KSD bears. Furthermore, because the Enforcement Decree of the SEA Article 78-6(2) specifies only and simply that "KSD and its participants who have a customer" as the subjects who bear the responsibility, it is natural that the strict liability has nothing to do with whether or not participants hold the same type of securities in the loss.

¹²² *Civil Code* § 249~251 & *Commercial Code* § 359.

¹²³ See KSD, *Supra* note 12 at 102~104. Unlike the SEA, Article 77 of *Act on Securities Custody and Book-entry* in Japan clearly specifies a bona fide purchaser rule. However, the presuming provision of the co-proprietorship in Article 174-1(1) can be read as to open the way to acknowledge the bona fide theory.

¹²⁴ See the SEA Art. 174-5(1) & the Enforce Decree of the SEA Art. 78-6.

¹²⁵ See *Supra* note 12 at 135.

¹²⁶ See the SEA Art. 174-5(2)

¹²⁷ See *ibid.* 174-5(1)

5. Security Interest

According to Article 174-3(2) of the SEA, a pledge can be created only by a book entry. With respect to that provision, the KSD *Regulation on Securities Deposit and Settlement, etc.* provides a more specific way to attach a pledge in the intermediated system. When a participant as a pledgor requests a pledge, it can be done by the participant itself, but when a participant as a pledgee files with pledge creation, it is required to have a pledgor's agreement.¹²⁸ In the case of cancellation of a pledge, a pledgee alone can file an application for cancellation of a pledge, but a pledgor is required to receive a pledgee's agreement to cancel the pledge.¹²⁹ A pledgee can repledge the collateral to another participant of KSD.¹³⁰

D. The Intermediated Systems in the U.K., Japan and Canada

1. The Intermediated System in the U.K.

1.1 Overview and Current Law

As a representative common law jurisdiction, currently the U.K. has no statutory rules on intermediated securities and systems. English trust law and rules of equity govern the fundamental issues.¹³¹ However, the custodian with respect to traditional bearer securities is traditionally characterised as the bailee of the client and such characterisation is based on physical possession of securities.¹³² This traditional bailor-bailee application to the relationship of an investor and an intermediary in the era of intangible paperless securities has been thought to be no longer appropriate because there is no room for possession of intangible assets, and thus the

¹²⁸ See *Regulation on Deposit and Settlement, etc* of KSD Art. 11(1).

¹²⁹ See *ibid.* Art. 11(2).

¹³⁰ See *ibid.* Art. 11(4).

¹³¹ Financial Market Law Committee, *Issue3-Property Interests in Investment Securities - Analysis of the Need for and Nature of Legislation Relating to Property Interests in Indirectly Held Investment Securities, with a Statement of Principles for an Investment Securities Statute* (London, 2004) at 9.

¹³² Joanna Benjamin, Madeleine Yates & Gerald Montagu, *Supra* note 6 at 25.

contemporary custody relationship is characterised as a trust.¹³³ According to the trust relationship, in the absence of agreement to the contrary, investors holding securities accounts with an intermediary relating to interests in securities held in a commingled pool¹³⁴ will be considered to have co-proprietary rights in the pool as beneficiaries under a trust so as to be safeguarded against the intermediary's general creditors in the event of its insolvency.¹³⁵ Intermediaries, as trustees, are subject to a range of equitable duties, including the duties to keep assets held on trust safeguarded and segregated from its own assets, to make good shortfalls in assets caused by its own wrongful acts, to not use trust assets for its own purposes without authorisation, and to maintain proper records of transactions.¹³⁶

1.2 The FMLC Principles and the Law Commission Project

In spite of the generally sound English law on the intermediated system, the Financial Markets Law Committee ("FMLC") observed that there exist legal uncertainties and deficiencies with respect to intermediated securities. The FMLC pointed out that there is a need to facilitate the efficiency and stability of the market and reduce systemic risk,¹³⁷ given that not only these non-statutory rules with respect to the intermediated securities and system are not readily accessible, but also rules governing the creation, perfection and priority of interests, the duties and liabilities of

¹³³ See *ibid.*

¹³⁴ In the general rule, one cannot acquire a proprietary interest in a definite number of pooled units in the absence of specific allocation of the units to which such interest attaches (*Re London Wine Company (Shippers) Limited* [1986] PCC 121, 137). However, the *Hunter* court held that the requirement of certainty of subject matter did not necessarily entail the segregation of assets and that since the shares were indistinguishable from each other, the declaration of trust was sufficiently certain (*Hunter v. Moss* [1994] 3 All ER 215). The *Hunter* case has been followed in *Re Harvard Securities* ([1997] 2 BCLC 369) and *Re CA Pacific Finance Ltd* ([2000] 1 BCLC 494) and stands as the current law. See Law Commission, *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Updated Advice to HM Treasury* (London, 2007) at 30.

¹³⁵ See FMLC, *Supra* note 131 at 9.

¹³⁶ *Ibid.*

¹³⁷ See *ibid.* at 8.

intermediaries, and the treatment of shortfalls are not clear enough and not consistent with market practice and understanding. In this regard, the FMLC reported key principles¹³⁸ to remove uncertainty and to accommodate market practice by giving a clear and easily accessible legislative regime on intermediated securities in July 2004. The issues addressed in the principles are 1) nature of the account holder's rights (interests in securities), 2) intermediary's duties, 3) enforcement of customer's rights (principally, only against the intermediary: no look-through and no upper-tier attachment), 4) customers' instructions and intermediaries' immunity, 5) insolvency immunity of customers' securities, 6) proportionate allocation of shortfalls to all participants, 7) no formality of creation and perfection of security interest, 8) priorities (account finality, purchase money priority, control priority, account priority, and good faith purchaser), and 9) set-off between the issuer and the customer.

In keeping with the FMLC's report, the U.K. Law Commission also has had a project organised on intermediated investment securities since March 2006. This project primarily aims at establishing a list of legal issues that should be addressed when considering a harmonised legal framework for investment securities held and transferred by financial intermediaries within the European Union, examining each issue from the view point of English law.¹³⁹ The project's origins lie in the recommendation for domestic legislation made in the FMLC report.¹⁴⁰ The scope of this project is, however, much broader and reflects legislative reform in this area that will be prepared by Unidroit at the international level.¹⁴¹ In relation to this project, the Law Commission has held three seminars, each of which includes a more detailed

¹³⁸ See *ibid.* at 15~18 for the principles and at 18~25 for the commentary on the principles. Most of the principles are basically similar to the rules in the UCC Article 8 Part 5, except for the UCC Section 8-503(a) providing intermediary's own assets can be subject to security entitlements of entitlement holders. It seems because, as discussed above, intermediaries in the U.S. do not generally segregate, while intermediaries in the U.K. are obliged to do so according to CASS Rule 2.2.3 and 2.2.5.

¹³⁹ See Law Commission, *Law Commission Project on Intermediated Investment Securities Second Seminar: Issues Affecting Account Holders and Intermediaries* (June 2006) at 9.

¹⁴⁰ See Law Commission, *Supra* note 134 at 7.

¹⁴¹ See *ibid.*

analysis of the issues addressed in the FMLC report, with comparisons to the UCC Article 8 and the Unidroit Preliminary Draft Convention.¹⁴²

2. The New Intermediated System in Japan

2.1 Overview – Old and New Legal Regimes

As with the current intermediated systems in Korea and Germany, the old legal scheme in Japan was a custody system of securities certificates.¹⁴³ In this legal framework, investors are presumed to hold co-ownership and are deemed to possess the same type of securities certificates that the investors deposited with their own intermediaries, which in turn redeposit the securities certificates with the CSD in Japan *i.e.*, JASDEC, Inc.¹⁴⁴

However, the new legal framework for the Japanese intermediated system, which first began with the enactment of the *Act on Book-entry Transfers of Short-term Corporate Bonds, etc*¹⁴⁵ in April, 2002 (the Act was finally amended and completed by including shares in 2004), is a completely dematerialised system and there is no longer any co-ownership concept of securities certificates. But investors still have a direct relationship with the issuer and can exercise their rights directly against the issuer as in the old legal framework.

¹⁴² The seminar documents are available at http://www.lawcom.gov.uk/investment_securities.htm.

¹⁴³ The old legal framework was governed by the old law (See, *Supra* note 93). See generally Ichiro Kawamoto, *A Study on Securities Book-entry Transfer and Settlement System* (in Japanese) (Tokyo: Yuhikaku, 1969) for the theoretical approach of the old intermediated system; See also Hiroyuki Akakura, *A Commentary of Share Certificates Custody and Book-entry Transfer System* (in Japanese) (Tokyo: Ookura Zaimu Kyokai, 1985) for the old law scheme.

¹⁴⁴ JASDEC is the acronym of Japanese Securities Depository Center, Inc. See its webpage: <http://www.jasdec.com/en> for further information and services provided by JASDEC.

¹⁴⁵ *Tanki Shasai tou no Furikae ni Kansuru Houritsu* (Act No. 75 of 2001), which became finally amended as *Act on Book-entry Transfers of Bonds, Shares, etc* (hereinafter, referred to as the “new law” in this Section). For shares, the new law will be effective in 2009 because of some practical preparations, mainly the preparation of the IT systems. The old law still applies for shares until that time. See, Yasufumi Takahashi & Akihiro Ozaki, *A Commentary of Act on Book-entry Transfers of Bonds, Shares, etc* (in Japanese) (Tokyo: Kinyuu Zaisei Jijou Kenkyuukai, 2004) at 2~5 for further the amendment history of the Act.

2.2 New Legal Framework

As the new legal framework is based on full dematerialisation, securities certificates do not exist anymore. Accordingly, the subject matter to be credited to and debited from a securities account is composed of rights such as corporate bonds and shares that were previously incorporated in securities certificates. What investors hold through intermediaries are these rights themselves which are now evidenced on securities account books maintained by intermediaries, instead of securities certificates. These rights entered on securities account books are called book-entry bonds, book-entry shares, etc which are intermediated securities in the new Japanese intermediated system. There is no concept of co-ownership in total book-entry securities maintained in intermediaries' securities accounts, but investors directly hold each of their book-entry securities according to the amounts or numbers credited to their accounts and directly exercise these rights against the issuers and third parties.¹⁴⁶ In addition, as in the old system, intermediaries are regarded as mere book-keepers, as conduits, and thus neither intermediaries nor the CSD holds proprietary interests in the book-entry securities of investors. In the same vein, intermediated securities holders are protected in the event of insolvency of their intermediaries or the intermediaries' upper-tier intermediaries, because only the intermediated securities holders have proprietary rights on book-entry securities.

A transfer of intermediated securities becomes effective only when a credit entry to a securities account of a transferee has been made.¹⁴⁷ As a result of the credit entry, the rights of the transferor, *i.e.* a seller or a collateral provider, are

¹⁴⁶ In this respect, the new Japanese intermediated system is similar to the system of France. See Hiroki Morida, "Fundamental Theories of Securities Dematerialisation (in Japanese)" Discussion Paper No. 2006-J-23 (2006) online: Institute for Monetary and Economic Studies Bank of Japan < <http://www.imes.boj.or.jp> > for a comparative analysis of the French and Japanese intermediated systems.

¹⁴⁷ See the New Law, Arts. 73 & 148.

extinguished.¹⁴⁸ Similarly, a security interest is also created and perfected only by a credit book-entry and there is no other requirement.¹⁴⁹

As under the old law, a bona fide purchaser is protected under the new law, if the transferee acts in good faith and without gross negligence. As for interpretation of good faith and gross negligence, though it seems that there is not much debate about it, it is maintained that the requirement of good faith and gross negligence can be seen as a similar concept of the collision in the UCC Section 8-503(e) from the view point of trial practices.¹⁵⁰ Some contend that settlement finality is fulfilled to the similar extent of that in the UCC by such an interpretive approach.¹⁵¹

With respect to the method of rights exercise, book-entry securities holders are required to directly exercise their rights against the issuer as under the old regime.¹⁵²

¹⁴⁸ See Hideki Kanda, “Answers of Japan to the questionnaire of EU Clearing and Settlement Legal Certainty Group” (2006) online: EU Clearing and Settlement Legal Certain group <http://ec.europa.eu/internal_market/financial-markets/docs/certainty/japanese_law_en.pdf> at 7. Thus, it can be understood that the debit entry from the transferor’s account is a corresponding entry of the credit entry to the transferee’s account. If the transferor’s intermediary fails to debit the intermediated securities of the transferor from his account, it is of one of the shortfall cases and the intermediary bears a duty to decrease the inflated intermediated securities (See the new law Arts. 79 & 154). It looks as the result of the fundamental property law principle in civil law jurisdictions, *i.e.* the principle of one *res* one right in *rem*.

¹⁴⁹ See the new law, Arts. 74 & 149.

¹⁵⁰ See Tetsuo Morishita, “Legal Developments and Questions of International Securities Settlement (in Japanese)” (2004) 47:3 Sophia L. Rev. 214 at 194. See also *Infra* text at 46~47 as to the collision concept in the UCC Section 8-503(e) which is statutorily defined in the OSTA.

¹⁵¹ Yasufumi Takahashi, Koutarou Nagasaki & Tadashi Mawatari, *A Commentary of Act on Book-entry Transfers of Bonds, etc* (in Japanese) (Tokyo: Kinyuu Zaisei Jijou Kenkyuukai, 2003) at 23.

¹⁵² See Hideki Kanda, *Supra* note 148 at 10.

3. The New Intermediated System in Canada

3.1 Overview – Old and New Legal Regime

Canada is a federal state and each province has the power to enact laws subject to the Constitution of Canada. Except the province of Quebec, all provinces are founded on the British common law system. As a civil law jurisdiction for private law issues, however, the law of Quebec rooted originally in French law and the *Code Napoleon* which has become the basis of the current *Civil Code of Quebec*.¹⁵³

Accordingly, as to a disposition of intermediated securities, before the enactment of new legal regimes modelled on the revised UCC Article 8,¹⁵⁴ each province had scattered legislative measures, basically based on company law, property law, and securities law,¹⁵⁵ which recognised securities as tangible movables for the purpose of the intermediated system like the old versions of the UCC Article 8. For example, in Ontario, where the Canadian Depository for Securities Limited,¹⁵⁶

¹⁵³ *Civil Code of Quebec*, S.Q. 1991, c. 64.

¹⁵⁴ As of 1 January 2007, the new *Securities Transfer Act* became effective in Ontario and Alberta. Other Provinces are expected to follow suit soon.

¹⁵⁵ Unlike other provinces, Quebec put some rules of intermediated securities in a securities law. See *Securities Act*, R.S.Q. c. v-1.1 Arts. 10 to 10.5. Particularly, a normal securities transfer of ownership is deemed made upon acceptance of the subscription or of the offer of sale, but as for the assignment or hypothecation of intermediated securities, it is made by the book-entries in the accounts maintained by the clearing house (CDS). Also, except for registered security interest, the transferee or pledgee acquires possession by the book-entries against third persons even though the securities are not distinguished from other like securities. However, such book-entries in the accounts show merely the amount of securities assigned or hypothecated, or the balance of securities after clearing. This fictional possession by law is an exception to the general laws of Quebec, under which a non-possessory pledge over intangible property may be published (perfected) only by the registration of a notice of the pledge against the name of the debtor and description of the collateral. See Bradley Crawford QC, Eric Gertner & Michel Deschamps, “Canada (Ontario and Quebec)” in Richard Potok, ed., *Supra* note 18 at 163; See also Ronald C.C. Cuming, Catherine Walsh & Roderick Wood. *Personal Property Security Law* (Toronto: Irwin Law, 2005) at 47~56 for the overview of secured transactions law under *Civil Code of Quebec*.

¹⁵⁶ CDS is a private business corporation, incorporated federally in 1970 under the *Canada Corporation Act* and continued in 1980 under Section 181 of the successor *Canada Business Corporations Act* (“CBCA”). Now, CDS is the holding company for the three operating subsidiaries: CDS Clearing and Depository Services Inc., CDS Inc., and CDS Innovations Inc. See CDS, *Clearing and Depository Controls at CDS* (2006) online: CDS <

the CSD in Canada, is located and where the main securities exchange, the Toronto Stock Exchange is established, the securities transfer related rules were generally located in the *Business Corporations Act* (“OBCA”) and almost all were modelled on the old versions of the UCC Article 8.¹⁵⁷

To tackle these problems, the Uniform Securities Transfer Act (“USTA”) was drafted by the Canada Securities Administrators (“CSA”) and the Uniform Law Conference of Canada (“ULCC”) in 2004.¹⁵⁸ Since 1 January 2007, the draft USTA has been effective in Ontario and Alberta,¹⁵⁹ and it is expected that Quebec and the western provinces will introduce legislation in the first half of 2007.¹⁶⁰

3.2 New Legal Framework (Ontario)

The *Securities Transfer Act of Ontario* (“OSTA”) is based on the UCC Article 8 and 9 so that the legal framework in the new intermediated system can be said to be the same as that of the UCC at least in its contents.

Therefore, among other things, investors who hold their securities through intermediaries do not hold the securities themselves anymore but *sui generis* proportionate property rights which are security entitlements¹⁶¹ and can enjoy the same degree of protection that is provided by the UCC Article 8. Unlike the UCC, the

[http://www.cds.ca/cdsclearinghome.nsf/Downloads/-EN-ClearingandDepositoryControls/\\$File/Clearing+and+Depository+Controls+at+CDS_E.pdf?OpenElement](http://www.cds.ca/cdsclearinghome.nsf/Downloads/-EN-ClearingandDepositoryControls/$File/Clearing+and+Depository+Controls+at+CDS_E.pdf?OpenElement) at 4.

¹⁵⁷ See Canadian Securities Administrators’ Uniform Securities Transfer Act Task Force, “Proposal for a Modernized Uniform Law in Canada Governing the Holding, Transfer and Pledging of Securities” (Consultation Paper, May 28 2004) at 21.

¹⁵⁸ See *ibid.* at 1~10 for the historical development of the draft USTA.

¹⁵⁹ *Securities Transfer Act*, 2006, S.O. 2006, c 8 in Ontario and *Securities Transfer Act*, S.A. 2006, c. S-4.5 in Alberta.

¹⁶⁰ See Margaret Grottenthaler *et al.*, “Are You In Control?: Highlights of The New Securities Transfer Act” (Nov. 2006), Online: Mondaq <<http://www.mondaq.com/article.asp?articleid=44262>>. However, the USTA has not entered into force in Quebec, British Columbia and other provinces yet by the completion of this thesis.

¹⁶¹ According to OSTA Art. 1, security entitlement means “the rights and property interests of an entitlement holder with respect to a financial asset that are specified in Part VI (*“droit intermédiaire”*).” See also OSTA Art. 97.

OSTA contains a definition of collusion as acting “in concert, by conspiratorial arrangement or by agreement for the purpose of violating a person’s rights in respect of a financial asset.”¹⁶² Thus, an intermediary is not liable to a person having an adverse claim to, or a security interest in, the financial asset, if the intermediary did not act in collusion with the wrongdoer in violating the rights of the person who has the adverse claim or the person who has the security interest.¹⁶³ Likewise, an entitlement holder may not be sued if he acquired his security entitlement by giving value, obtaining control, and without acting in collusion with the intermediary in violating the securities intermediary’s obligation under Section 98.¹⁶⁴

Additionally, due to the introduction of the notion of control as a new method of perfection and priority rule, registration itself is not sufficient enough to obtain and maintain priority over other creditors. Under the new priority rules, first, a secured creditor having control of investment property has priority over a secured creditor who does not have control of the investment property.¹⁶⁵ Second, as to competing security interests, the ranking as between the secured creditors is determined by the time of obtaining control.¹⁶⁶ Third, a securities intermediary’s security interest has priority over a conflicting security interest over secured creditors.¹⁶⁷

¹⁶² See OSTA Art. 1. See also Eric T. Spink & Maxime A. Paré, “The Uniform Securities Transfer Act: Globalized Commercial Law for Canada” (2004) 19 B.F.L.R. 321 at 382 (explaining that “this definition is intended to clarify an important point that arose after [the UCC Article 8] was introduced to ensure that the USTA provisions using the term are substantively uniform with similar provisions in [the UCC Article 8]”).

¹⁶³ See OSTA Art. 54(3)2.

¹⁶⁴ See OSTA Art. 97(7)(c).

¹⁶⁵ *Personal Property Security Act* of Ontario, R.S.O. 1990, c. P.10 (“OPPSA”) s. 30.1(2).

¹⁶⁶ *Ibid.* s. 30.1(4).

¹⁶⁷ *Ibid.* s. 30.1(5).

E. Substantive Law Analysis and Conclusion

With the advancement of the modern capitalistic economy, corporations required huge amount of capital and it was provided through capital markets by issuing securities like shares and bonds. Meanwhile, investors obtained liquidity by selling the securities on the secondary markets. In line with the development of capitalism, the means of securities dispositions also evolved from deliveries of physical securities to efficient electronic book-entries between securities accounts of investors, whereby securities became held through intermediaries. It is, however, imperative that the investors who hold intermediated securities be legally protected to the same degree as physical securities holders without regard to the holding pattern. It is not investors who chose to be intermediated securities holders but securities market practices and environments that caused them to be so. If there should exist any difference, it must be derived from the speciality of the intermediated holding pattern and the legal tradition of each state, without disenfranchising the rights of intermediated securities holders.

To this end, most states have developed and improved their own intermediated systems. Some systems like Germany, Korea and the old Japanese system analogise the legal construction which was applied to securities certificates to the intermediated system, adopting the complicated mix of concepts of mandate, co-ownership of the actual pool of securities, and deemed possession. Other systems, like the U.S. and the U.K., sever intermediated securities from the notion of securities certificates and characterise them as *sui generis* property or beneficial interests based on the trust mechanism.¹⁶⁸

In Chapter two, this thesis presumed that the cleavage of legal schemes of intermediated systems in part lies in the different definitions of securities. States like Korea and Japan, where securities means securities certificates, naturally developed their intermediated systems focusing on physical securities and investors, directly hold securities certificates by the notion of deemed possession. Further, rights which

¹⁶⁸ The UCC Article 8 is also basically based on the rules of trust law.

can be incorporated in securities certificates are deemed by a legal fiction to be securities and thus those could also be included in the intermediated system. However, it is a matter of course that such legal fictions are no longer natural,¹⁶⁹ given that securities certificates have no more controlling function and meaning in the modernised computerised intermediated system in which the securities certificates are immobilised and dematerialised by issuing global securities,¹⁷⁰ or become electronic (book-entry) securities or otherwise. For this reason, focusing on the inscription on securities accounts of investors in the intermediated holding pattern, the UCC model evolutionally invented a new separate form of property, a security entitlement. The U.K. recharacterised intermediated securities similarly as interests in securities that are beneficial interests of trust in nature, while insulating intermediated securities from the underlying securities certificates themselves. In addition, more recently, Japan reformed its intermediated system through complete dematerialisation, creating the new concept of book-entry securities which are rights themselves but can be transferable by book-entry, instead of by the method of obligations assignment.¹⁷¹

As seen from the introduction of new legal concepts in the U.S., the U.K., and Japan, in common, they recognise intermediated securities from a securities

¹⁶⁹ Generally speaking, the deeming mechanism is exceptionally employed when general rules cannot subsume some legal phenomena. Therefore, the concept of deemed possession is not any more a proper way to address this matter, given that dematerialisation in the current intermediated systems is more common.

¹⁷⁰ Global securities are one of the methods of dematerialisation by issuing one single certificate which represents the whole issue of definitive securities.

¹⁷¹ Also, Switzerland has recently prepared a *draft Federal Act on the Custody and Transfer of Securities Held with an Intermediary*, which introduces the *sui generis* notion of intermediary-held securities (*bucheffekten, titres intermédies*) that are also insulated from the underlying physical securities themselves and created by crediting them to a securities account. According to Article 4 of the draft Act, securities held with an intermediary (intermediary-held securities) are monetary and voting rights of a fungible nature against an issuer which are credited to a securities account and of which the account holder may dispose pursuant to the provisions of the Act, and which may be asserted against the intermediary (depository) and any third parties, in particular, the intermediary's creditors. The English version of the Act is available at European Commission, Legal Certainty Group webpage, http://ec.europa.eu/internal_market/financial-markets/docs/certainty/swiss_law_en.pdf. The introductory overview on the Act prepared by Swiss National Bank is also available at http://ec.europa.eu/internal_market/financial-markets/docs/certainty/swiss_law_letter_en.pdf.

account where amounts or numbers of the securities are inscribed. Therefore, in the consideration of reconstructing the Korean intermediated system, it is highly recommended to sever securities themselves from amounts or numbers inscribed on a securities account *i.e.*, intermediated securities¹⁷² in order to provide simple, clear and intuitive rules which mirror the market reality. However, the abandonment of the deemed possession scheme of securities certificates by introducing the concept of modernised intermediated securities does not always mean that intermediated securities holders cannot enforce their rights against the issuers. The intermediated system of Japan still allows intermediated securities holders to enforce their rights against the issuers,¹⁷³ while the intermediated systems of the U.S. and the U.K.¹⁷⁴ do not. The Unidroit Preliminary Draft Convention addresses the account holders' rights enforcement from both angles.¹⁷⁵ As such, the methods of exercise of rights should not be a critical issue to determine efficiency and legal certainty of an intermediated system.

With respect to the legal nature of intermediated securities, one of the most important legal requirements is proprietary protection of intermediated securities holders' rights in the event of insolvency of their intermediary and it is considered that all the jurisdictions examined in this thesis provide proper protections. The legal regimes of Korea and Japan fulfil this requirement by providing direct proprietary

¹⁷² The Unidroit Preliminary Draft Convention article 1(b) defines intermediated securities as "securities credited to a securities account or rights or interests in securities resulting from the credit of securities to a securities account [underline added]." This formulation looks to include the physical securities based system as a neutral drafting (from the current Korean law perspective, the phrase "securities credited to a securities account" can still mean securities certificates which are recorded on a securities account. Hence, intermediated securities also mean securities certificates held by means of intermediation).

¹⁷³ The new Swiss draft Act also allows intermediated securities holders exercise their rights directly against the issuer.

¹⁷⁴ According the FMLC Principle 2(d), in principle, intermediated securities holders can enforce their interests in securities only against their immediate intermediaries, and not against the issuer or any other intermediary. However, this is subject to any direct rights of action against the issuer or other intermediary provided under the terms of issue of the securities or of a deed poll or contract arising under general law against persons not acting in good faith. This is one of the differences of both the U.S. and the U.K. systems.

¹⁷⁵ See Art. 5.

ownership of intermediated securities. The U.S. protects intermediated securities holders' rights by providing that security entitlements held by an intermediary are held for the entitlement holders to the extent necessary for the intermediary to satisfy all security entitlements pursuant to Article 8-503(1). In the U.K., the FMLC Principle 3 specifies that "securities held by the customer through the intermediary are not available to the creditors of the intermediary," which is a mere identification of beneficiary's status under the English trust law.¹⁷⁶ The Unidroit Preliminary Draft Convention also declares that intermediated securities are effective against the insolvency administrator and creditors.¹⁷⁷

Another important requirement for the legally sound intermediated system is the protection of intermediated securities holders who acquire intermediated securities. This is related to the matter of the protection of a bona fide purchaser and settlement finality. The UCC and the OSTA approach, which require a collusion between the transferee and the intermediary for the claimant to assert his right and put the burden of proof to the claimant, coupled with the four stringent requirements under the UCC Section 503(d),¹⁷⁸ can be seen as the most strict but the most preferable test for a bona fide purchaser (transferee). It may seem as a necessary measure given that the circumstance that it is almost impossible to trace the transferee who purchased the claimant's intermediated securities, because securities transactions in exchanges are cleared and settled in a net basis and thus the transferee has no way to investigate the transferor's interests. Hence, from the view of credibility and efficient operations of the securities market, the "forward-looking" rules could be attractive and justifiable.¹⁷⁹ However, it seems that the underlying assumption that

¹⁷⁶ See Law Commission, *Supra* note 139 at 23. See also FMLC, *Supra* note 131 at 23 (maintaining that "trust assets are immune from insolvency under the Hague Trust Convention Art. 2(a)").

¹⁷⁷ See Art. 15.

¹⁷⁸ See *Supra* text at 27.

¹⁷⁹ The official comment 3 of the UCC Section 8-503 maintains that "the commercial rules for the securities holding and transfer system must be assessed from the forward-looking perspective of their impact on the vast number of transactions in which no wrongful conduct occurred or will occur, rather than from the *post hoc* perspective of what rule might be most

securities transactions are settled in a netting system could not be the controlling fact to apply those rather stiffened rules to all securities transactions to protect a bona fide purchaser. Obviously, all the securities transactions are not settled on a net basis and there are many off-exchange transactions in which parties, transferor and transferee are identifiable such as in a collateral transaction. Therefore, although it can promote liquidity and ensure dynamic security in securities markets by requesting stringent requirements to the transferor, it is not a quite understandable legal measure to dry up almost all of the reasonable channels to protect an innocent transferor. It seems that the reason why the UCC took such a strict measure is mainly due to the legal nature of intermediated securities *i.e.*, security entitlements that are fundamentally rights in *personam* only against the entitlement holder's intermediary. In this scheme, as an investor does not acquire underlying securities themselves but the rights in *personam* against the intermediary and what the transferee acquires is not even the same rights in *personam* against the intermediary but the new rights in *personam* of the transferee against his intermediary, it is natural to allow the claim on wrongful acts only against the claimant's intermediary. While in the civil law jurisdiction, the things that the investor acquires is rights in *rem* and what the investor transfers to the purchaser is also exactly the same *res* that the investor holds through his intermediary. In this regard, the UCC approach may not be applicable to all legal traditions and it is recommended that the Korean intermediated system introduce the neutral Unidroit test which requires the transferee not to have the notice, that is actual knowledge or knowledge of facts sufficient to indicate that there is a significant probability that the adverse claim exists and of which adverse claim the transferee deliberately avoids.¹⁸⁰ The Unidroit bona fide purchaser rule can provide a balanced and softened vehicle to protect both parties in securities transactions, ensuring an efficient, credible, and predictable securities market.

advantageous to a particular class of person in litigation that might arise out of the occasional case in which someone has acted wrongfully.”

¹⁸⁰ See Art. 12 of which test can be evaluated as protecting transferees by limiting adverse claims but opening a narrow way for a claimant to recover his rights.

As to the loss sharing rule, it is the case that the current rule in Korea is not clear on how to allocate the loss. The literal interpretation of the current rule is to divide the liability according to the number of all the participants plus KSD. Another possible interpretation is to allocate the loss in proportion to the deposit ratio of the same type securities which became short, but it also has a weak point on how much KSD bears the liability. However, it is obvious that such a rigid loss allocation rule according to the literal interpretation is not reasonable and persuasive to apply it to the intermediary that did not hold the securities in the shortfall. One of the rationales for the rigid interpretation might be to ensure the whole intermediated system stability by allocating unsubstantiated risks to the system participants (intermediaries) in advance. However, such a system stability or creditability can be achieved by a different policy decision like an investor protection fund in the U.S.,¹⁸¹ because the loss sharing rule forcing even innocent system participants can promote a moral hazard for the participants by taking the adverse selection. Therefore, the risk-sharing rule should at least be limited to the participants (account holders) who hold the same description of the securities in the loss, which could be a natural and reasonable application, because what investors hold is co-ownership in the current system in Korea and the co-owners of the same type of securities are the direct interested parties in the long run. The Unidroit Preliminary Draft Convention¹⁸² and the FMLC principle¹⁸³ also take the same position.

Overall, it can be discovered that each intermediated securities and system has been established and developed on the fundamental basis of each legal tradition¹⁸⁴ to which it belongs, and on the previously well settled systemic practices of its securities

¹⁸¹ See Russell A. Hakes, *Supra* note 61 at 734~741 for the investor protection method under the Security Investor Protection Act of 1970.

¹⁸² See Art. 23.2(b).

¹⁸³ See the Principle 4.

¹⁸⁴ See generally H. Patrick Glenn, *Legal Traditions of the World: Sustainable Diversity in Law*, 2d ed. (Oxford University Press: New York, 2004) for major legal traditions in which Glenn explains at page 16 that “the main reason we are constantly addressing tradition appears to be the constraint which it imposes on our lives. That which has been captured from the past is inherently normative; it provides present lessons as to how we should act.”

industry. To put the UCC Article 8 according to the evaluation of the FMLC Report, it is internationally the most developed regime regarding property rights in intermediated securities.¹⁸⁵ However, the FMLC principle is not exactly modelled on it because of three reasons, of which the first and second reasons are notable and applicable to the Korean legal reform on intermediated securities and system. First, the FMLC principle is adjusted to English law (including European law) and practice.¹⁸⁶ Secondly, the principle is quite shorter than Article 8, because many of the provisions in the principle, which are explicit in Article 8, are implicit or expressly provided for under existing English trust law.¹⁸⁷ Besides the reasons presented by the FMLC, the recent legal reforms of Japan and Switzerland are also suggestive of the need to consider each legal tradition, market practice, and IT environment. Especially, when the Working Group for the new draft Act of Intermediary-Held Securities in Switzerland prepared the draft Act, they decided to follow established market practices if there was no clear need to depart from them because in practice an intermediated system heavily relies on IT systems and any changes in market practice could require huge costs for the change of the IT systems.¹⁸⁸ Therefore, it does not seem to be appropriate for Korea to transplant the UCC Article 8 approach when considering its existing and established legal tradition and market practices. However, the Canadian USTA can be assessed as a successful adaptation of the UCC Article 8 to the Canadian securities industry, given the considerable needs of market compatibility between Canada and the U.S. As for the Quebec position, it is understood that it is a reasonable option to prepare a new legal framework as close as possible to the USTA for the purpose of uniform applicability throughout all the provinces, unless there is a fundamental contradiction of the basic legal theories upon which the *Quebec Civil Code* stands. The new Japanese legal

¹⁸⁵ See FMLC, *Supra* note at 20.

¹⁸⁶ *Ibid.*

¹⁸⁷ *Ibid.*

¹⁸⁸ See Swiss National Bank, *Supra* note at 169. See also Janne Lauha, "Review of Recognition of Indirect and Direct Holdings" (March 2006) at 3 online: European Commission, Legal Certainty Group <http://ec.europa.eu/internal_market/financial-market/docs/certainty/background/21_3_6_lauha_en.pdf>.

framework is not attractive in that it lacks cross-border compatibility because of the hidden blind point of the new law which is not applicable to foreign shares listed on Japanese markets and to off-shore securities transactions.¹⁸⁹

There is an urgent need to establish a legally sound and reliable intermediated system in the era of IT and globalization in Canada and Korea. New substantive rules should have internal soundness and cross-border compatibility, as well as having market and user friendly rules and readily accessible clear, intuitive rules which give full *ex ante* certainty and predictability, satisfying basic legal needs of intermediated securities holders, and ensuring market efficiency and stability. At the same time, the new substantive rules should also be the rules taking into account the matter of legal tradition and rapidly changing market practices.

¹⁸⁹ Foreign shares listed on Japanese markets and off-shore transactions are covered by individual contracts entered into as between investors and their intermediaries. However, if this problem could be solved by one statutory regime, the Japanese approach to dematerialised securities could be a good candidate.

IV. Intermediated Securities and Private International Law

A. Scope of Conflict of Laws and Choice of Law Process

1. Scope of Conflict of Laws

Private international law (“PIL”), which is also called conflict of laws or choice of law in common law jurisdictions, is the law that deals with legal relations, cases or otherwise disputes containing a foreign element.¹⁹⁰ It covers the following three questions that function interactively: which court has competence for the case (a question of jurisdiction), which law governs the issue (a question of governing law), and finally what is the effect of the judgment (a question of the recognition and enforcement of the judgment adjudicated by a foreign court).¹⁹¹ Likewise, these questions are always involved in cross-border transactions of intermediated securities. However, as the first question of jurisdiction and the third question of recognition and enforcement of a foreign judgment are not unique issues in intermediated securities transactions,¹⁹² this chapter addresses only the issue of the second, choice of law

¹⁹⁰ See Albert V. Dicey, J.H.C. Morris & Lawrence Collins, *Dicey, Morris and Collins on the conflict of laws* (under the general editorship of Sir Lawrence Collins), 14th ed. (London: Sweet & Maxwell, 2006) at 3; Peter North & Fawcett J.J., *Cheshire and North’s Private International Law*, 13th ed. (London: Butterworths, 1999) at 3; Marvin Baer *et al.*, *Private International Law in Common Law Canada: Cases, Text and Materials*, 2d ed. (Toronto: Emond Montgomery Publications, 2003) at 3; Eugene Scholes *et al.*, *Conflict of Laws*, 4th ed. (St. Paul: Thomson, 2004) at 1 (as for the element, it describes that it may include the parties’ domicile, residence, citizenship, or other affiliation with a state or country, the location of the events that give rise to the dispute, or the location of the object of the dispute); Russell J. Weintraub, *Commentary on the Conflict of Laws*, 5th ed. (New York: Foundation Press, 2006) at 1; and Kwang Hyun Suk, *Commentary of Revised 2001 Korean Private International Law* (in Korean), 2^d ed. (Seoul: Jisan, 2003) at 27~30. Korean PIL Act, Section 1 directly specifies that “the purpose of this Act is to provide for the principle on international jurisdiction and to determine the applicable law with respect to a legal relation containing a foreign element [underline added].” See also Kwang Hyun Suk, “New Conflict of Laws Act of the Republic of Korea” (2001) 1:2 J. Korean L. 197 for the brief introduction of the new Korean PIL Act and an English translation of the Act.

¹⁹¹ See generally *ibid.*

¹⁹² In the future, those two questions would be subject to the new *Hague Convention on Choice of Court Agreement*, though it covers an exclusive agreement of jurisdiction in principle. In June 2005, the HCCH produced uniform conflict of laws rules on jurisdiction and on recognition and enforcement of foreign judgments in civil or commercial matters. In

question, focusing on proprietary aspects with respect to intermediated securities transactions.

2. Choice of Law Process

In order to determine the law applicable to the issue in question, in most states, three steps in the choice of law process are taken: characterisation of the issue, localisation of the issue by the use of a connecting factor,¹⁹³ and identification of the governing law. The first process of characterisation is required due to the fact that choice of law rules are expressed in terms of juridical concepts or categories and localising elements or connecting factors.¹⁹⁴ In such a system, it is always necessary to determine which is the appropriate category in any given case in order to allocate the issue to the category.¹⁹⁵

With respect to the characterisation process of a disposition of intermediated securities, preliminarily two questions can also be raised as a usual conflict of laws analysis. First, by which law should the characterisation be done? Secondly, what is the limitation on the characterisation process? In other words, to what extent can the forum court characterise the issues in question?

As for the first question, most of the civil law scholars' opinion is that, with certain exceptions like property qualified by the *lex situs*, the process of characterisation should be performed according to the *lex fori* which is the domestic

general, securities transactions can be included in the scope of the convention in accordance with Article 2. The final convention text and its explanatory report are available on the HCCH's web page.

¹⁹³ The connecting factor is a factor fixing the categorised issue by the first step of characterisation with location. It was controversial whether the connecting factor should be determined by the *lex fori* or by the *lex causae*. However, it is a common view that the determination of the connecting factor is performed by the *lex fori* because the determination of the *lex causae* depends on the determination of the connecting factor (See Albert V. Dicey, J.H.C. Morris & Lawrence Collins, *Supra* note 190 at 34).

¹⁹⁴ See *ibid.* at 37.

¹⁹⁵ *Ibid.* at 38. The problem of characterization cannot occur in the method of the American doctrine of interest analysis, which does not use categories (See, *ibid.* footnote 10).

law of the forum, instead of the *lex causae* which is the law governing the question.¹⁹⁶ Therefore, the method of characterisation could be different depending on jurisdictions. For example, as for the characterisation of the legal nature of intermediated securities, if it is put before the court of England, it will characterise the nature of each relevant issue like the scope and content of the intermediated securities holder's right under its contract with his intermediary by the contractual governing law between them, and whether those rights are purely contractual or proprietary in character, and the nature and scope of those proprietary rights, by English law as the *lex fori*.¹⁹⁷ In the jurisdictions of Germany and Austria, their courts would first look at the law of the contract (the *lex contractus*) between the intermediated securities holder and his intermediary in order to characterise the legal nature because the legal nature is dependent on the contractual relationship between them in the case of intermediated securities, and then according to the analysis result

¹⁹⁶ See *ibid.* at 38~39 and 48 for the detailed discussion on the rationale. See also Eugene Scholes *et al.*, *Supra* note at 123 (explaining that “the first step, subject matter characterisation, is controlled by practical necessity by the forum’s legal system including its conflict-of-laws rules.”). As the exceptions, it is a well settled rule that the *lex situs* must determine the characterisation as to the proprietary matter in the UK (see Janeen M. Carruthers, *The Transfer of Property in the Conflict of Laws: Choice of Law Rules Concerning Inter Vivos Transfers of Property* (New York: Oxford University Press, 2005) at 17). Under the *Quebec Civil Code* 3078, characterization is made according to the *lex fori*. However, characterization of immovable and movable property is made according to the *lex situs*.

¹⁹⁷ See Richard Potok, ed., *Supra* note 18 at 226~227 (para. 10.27). However, the same paragraph continues to explain that “this [English law application] is not to say other systems of law will not be relevant. The approach of English law will be to consider the substance and characteristics of the relevant rights under the law which would govern proprietary issues if those rights were characterised as proprietary in nature, and consider whether they correspond to rights that would be categorised as proprietary under English law [underline added].” In addition, Rule 119(1) of Dicey, Morris & Collins (14th ed.) specifies that “the law of a country where a thing is situate (the *lex situs*) determines whether the thing itself is to be considered an immovable or a movable.” As for the *situs* of things, Rule 120(1) provides that “choses in action generally are situated in the country where they are properly recoverable or can be enforced.” Specifically as to the *situs* of intermediated securities (the book titling it as immobilised securities), it locates the *situs* at “the place where the depository [meaning the intermediary] is established and where it keeps the database in which the entitlements of the depositors are recorded.” (See Albert V. Dicey, J.H.C. Morris & Lawrence Collins, *Supra* note 190 at 1124~1125)

by the *lex contractus*, the courts analyse it by the *lex fori*.¹⁹⁸ If following the majority view, however, a Japanese court would characterise the legal nature of intermediated securities as the followings by the *lex fori* without regard to the contract of the investor and his intermediary and without respect to the location of the intermediary whether in Japan or abroad.¹⁹⁹ First, what the investor holds with his intermediary is ownership of the underlying securities certificates or co-ownership interests in the pool of the certificates, if the underlying securities are certificated. Secondly, it is determined as a contractual right against the issuer, in the cases where the securities are dematerialised, or the securities certificates are merely evidence of the ownership. Finally if a Quebec court has jurisdiction, it will use its own law whenever it is required to characterise an issue for conflict of laws purpose.²⁰⁰ As ownership rights are determined by the *lex situs* under Quebec conflict of laws rules and the intermediated securities holder's interests are likely to be considered as intangible property, the legal question whether the interests are proprietary is characterised by the law where the intermediary (obligor) is located.²⁰¹ If the law does not give the intermediated securities holder proprietary rights, then a Quebec court would look to the law governing the relationship between them to determine the intermediated securities holder's contractual rights against the intermediary.²⁰² Therefore, either way, a Quebec court would refer to the law of the place of the relevant intermediary (the PRIMA).

¹⁹⁸ See *ibid.* at 280~282 (paras. 12.52~12.59 for Germany) and 99~101 (paras. 5.17~5.22 for Austria).

¹⁹⁹ See *ibid.* at 369~370 (paras. 16.9, 16.11 and 16.13).

²⁰⁰ See *ibid.* at 172 (para. 8.37).

²⁰¹ *Ibid.* (para. 8.40). In Quebec, the situs of intangible property is the place where the obligor must perform its obligations, which place is generally the place where the obligor is located (*ibid.*).

²⁰² *Ibid.* (para. 8.41). In the case where the intermediary is located in Quebec, it is said that "so far, no generally accepted theory has been developed in Quebec as to the legal character of the right of a customer to uncertificated or immobilised securities indirectly held in an account maintained with a securities intermediary, especially where the securities are not recorded in the books of CDS." (*ibid.* at 173, para. 8.43).

The second question of the extent to which the forum can characterise the issue before the court is closely related to the first question, because the characterisation is performed by the *lex fori*. But it is not clear how much discretion a forum court has. For instance, assume that according to the substantive law of Jurisdiction I, the legal nature of intermediated securities that Investor A holds through his Intermediary X is defined as co-proprietary interests in the actual bulk of the physical securities certificates. Further assume that the legal nature of the intermediated securities of Investor A becomes an issue before a court in Jurisdiction II where the legal nature of the intermediated securities is co-ownership interests in the notional pool of securities. In this case, is the court in jurisdiction II subject to the legal nature of the intermediated securities in accordance with the substantive law definition in Jurisdiction I? The answer might be “not necessarily.”²⁰³ The reason why a forum is not bound to a substantive law concept is that a characterisation process is to find the closest connection or the most significant relationship to the issue in question in a separate choice of law analysis for the purpose of determining the most appropriate law.²⁰⁴ Therefore, if a court according to the analysis of the *lex fori* finds that the classification made by the substantive law analysis has no relation with the issues before the court, then the court can classify it differently with discretion in the choice of law analysis. In the same vein, in the *Macmillan v Bishopsgate Investment Trust Plc (No.3)* case, Auld LJ held:²⁰⁵

“[C]haracterisation or classification is governed by the *lex fori*. But characterisation or classification of what? It follows from what I have said that

²⁰³ However, Japan seems to rather follow the substantive law analysis of intermediated securities in the conflict of laws analysis as discussed above.

²⁰⁴ See *Raiffeisen Zentralbank Österreich AG v. Five Star General Trading LLC*, [2001] 2 W.L.R. 1344, [2001] 3 All E.R. 257, [2001] 1 Lloyd’s Rep. 597. (holding that “the overall aim is to identify the most appropriate law to govern a particular issue. The classes or categories of issue which the law recognises at the first stage are man-made, not natural. They have no inherent value, beyond their purpose in assisting to select the most appropriate law.”). See also Janeen M. Carruthers, *Supra* note 196 at 163~169 for the comments on the *Raiffeisen Zentralbank Österreich AG* case, especially in connection with the Rome convention.

²⁰⁵ See [1996] 1 W.L.R. 387, 407.

the proper approach is to look beyond the formulation of the claim and to identify according to the *lex fori* the true issue or issues thrown up by the claim and defence. This requires a parallel exercise in classification of the relevant rule of law. However, classification of an issue and rule of law for this purpose, the underlying principle of which is to strive for comity between competing legal systems, should not be constrained by particular notions or distinctions of the domestic law of the *lex fori*, or that of the competing system of law, which may have no counterpart in the other's system. Nor should the issue be defined too narrowly so that it attracts a particular domestic rule under the *lex fori* which may not be applicable under the other system.”

As such, the legal nature of the intermediated securities that Investor A holds through Intermediary X could possibly be characterised neither as co-ownership interests in the actual pool of the securities certificates nor co-proprietary interests in the notional pool of the securities but mere beneficial interests in trust or otherwise.

B. Conflict of Laws Puzzle

As observed above, current conflict of laws analysis varies according to the *lex fori* and its analysis, which causes in many cases forum shopping. A worse problem is that it is difficult or almost impossible from the perspective of a collateral taker to know in advance how to meet all the perfection requirements of the collateral securities which the collateral taker will receive. For example, assume that a Japanese collateral provider A holds, through his intermediary X organised according to Korean law and located in Seoul, a portfolio of certificated bearer German government debt securities which are held in turn with a German bank located in Hamburg and in custody in the vault of the German central securities depository, the Clear Stream Banking, Frankfurt. Secondly, he holds dematerialised US government securities held in the Treasury/Reserve Automated Debt-Entry System, certificated equity securities issued by a Quebec issuer, which are in fact in custody in the offices of CDS in Ontario, Quebec, British Columbia and Alberta. He also holds American

Depository Receipts issued by the Bank of New York held in the Belgian CSD, Euroclear, Belgium vault in Belgium.²⁰⁶ Let's further assume that a Canadian collateral taker B tries to find legal advice in advance before the pledge collateral transaction which will be concluded in accordance with English law. In this context, the advice²⁰⁷ would not be easy to find, because first of all, it might be different depending on the forum as discussed above. In addition, from a practical point of view, it is time and cost consuming work to obtain all the information according to each type of securities, where the securities certificates are in fact located, whether the securities are dematerialised or otherwise, as well as meeting all the legal requirements and acquiring other necessary legal information for the collateral transaction.²⁰⁸

²⁰⁶ This illustration is a variation of the fact pattern presented in Richard Potok, ed., *Supra* note 18 at 49~51. The fact pattern was used for each state's conflict of laws analysis based on their conflict of laws rules (the *lex fori*).

²⁰⁷ As for the advice, refer to *ibid.* at 367~372, if we further assume that the collateral provider and the collateral taker agreed with the exclusive jurisdiction of a Japanese court. However, Guynn & N.J. Marchand, *Supra* note 19 at 60~64 provides a bit of different analysis in a similar fact pattern which Ooi also agrees with and follows (See Maisie Ooi, *Supra* note 37 at 78~83, arguing that "the theoretical underpinnings of the choice of law technique adopted by Guynn and Marchand are sound"). In this author's view, however, Guynn and Marchand's analysis has an error, failing to explain why the London broker (the Collateral provider A in the example herein)'s co-ownership interest analysis depends on the intermediaries of the London broker's intermediary (the Global custodian-semi-modern, the Intermediary X in the example herein). According to their explanation, in the semi-modern jurisdiction, the nature of the interest of the London broker is defined as a co-ownership right over the actual pool of securities or other assets the Global custodian holds for the broker (at para 3.19). However, they further explain that the *situs* becomes different depending on the fact through which intermediary the Global custodian holds the London broker's securities. The look-through approach is to disregard all the intermediaries between a securities holder and the place where the securities certificates are located or where the securities are regarded as located, for example, in the case of shares, the place of the issuer's incorporation or registrar (see Albert V. Dicey, J.H.C. Morris & Lawrence Collins, *Supra* note 190 at 1125 (para. 22-044); and Adam Johnson, "The Law Applicable to Shares" in the *Law of Cross-Border Securities Transaction* (maintaining that the *lex societatis* in the long run refers to the same *situs*)). Therefore, if the London broker's holdings are defined as traceable co-property rights in actual pools, it is unnecessary to further analyse the relationship of the Global custodian and the Global custodian's intermediaries. If there had been no London broker in their illustration, their analysis would have been accurate.

²⁰⁸ In the case where a securities account itself is disposed of as a pledge, it is almost impossible to meet all the perfection requirements of the securities portfolio, because the portfolio is not static but is changing all the time.

For the reasons of such puzzling difficulties in finding the *lex situs*, which was applied in the non-intermediated traditional direct holding system, there have been national and regional efforts to reform conflict of laws rules for intermediated securities even before the Hague Securities Convention was adopted in 2002.

C. National and Regional Conflict of Laws Rules

1. UCC and USTA Choice of Law Rules in the U.S. and Canada

The revised UCC Article 8 and 9 innovatively introduced special choice of law rules for certain proprietary issues of intermediated securities dispositions. The choice of law rules are quite similar to those of the Hague Securities Convention in content and approach, in that both allow party autonomy²⁰⁹ in the determination of the law applicable to a disposition of intermediated securities, though the Hague securities convention puts the loose Qualifying Office requirement.²¹⁰ However, both take the stage-by-stage approach which takes the position that applicable law is determined by each intermediary and account holder's agreement.

Specifically, the UCC Section 8-110 (b) and (e) and 9-305 (a)(3) stipulates that the local law of the securities intermediary's jurisdiction defined as in subsection (e) governs the following five issues: 1) acquisition of a security entitlement from the securities intermediary; 2) perfection, the effect of perfection or nonperfection, and the priority of a security interest in a security entitlement or securities account;²¹¹ 3) the rights and duties of the securities intermediary and entitlement holder arising from

²⁰⁹ To be more precise, it is not party autonomy which is usually referred to in choice of law rules in contract, because party autonomy in the UCC and the Hague Securities Convention is given to an account holder and his intermediary, instead of parties to a securities transaction. For further discussion, see Chapter V below.

²¹⁰ See *Infra* text at 88~89 for details of the requirement.

²¹¹ As an exception to the general rule, the UCC Section 9-305 (c) provides two specific cases where the connecting factor is different from the general intermediary's jurisdiction set out in the UCC Section 9-305 (a)(2). The law of the jurisdiction where the debtor is located governs 1) perfection of a security interest in investment property by filing and 2) automatic perfection of a securities interest in investment property created by a broker or securities intermediary. The location of the debtor is determined by the UCC Section 9-307.

a security entitlement; 4) whether the securities intermediary owes any duties to an adverse claimant to a security entitlement; and 5) whether an adverse claim can be asserted against a person who acquires a security entitlement from the securities intermediary or a person who purchases a security entitlement or interest therein from an entitlement holder. According to subsection (e), the choice of law rules, the securities intermediary's jurisdiction is determined by the following cascading rules: first, the particular jurisdiction expressly designated by an account agreement between the securities intermediary and its entitlement holder for the purpose of the UCC Article 8 Part 5, the UCC Article 8, or the UCC; secondly, the particular jurisdiction of the law governing an agreement between the securities intermediary and its entitlement holder; thirdly, the jurisdiction of a securities intermediary's office expressly specified by an account agreement requiring that the securities account is maintained at the office; fourthly, the jurisdiction of a securities intermediary's office identified in an account statement as the office serving the entitlement holder's account; finally, the jurisdiction of the chief executive office of the securities intermediary. As a black list, the following items are not to be considered the securities intermediary's jurisdiction: the physical location of certificates representing financial assets; the jurisdiction in which the issuer of the financial assets is organised; and the location of facilities for data processing or other record keeping concerning the account.²¹²

As to the policy of subsection (b) of Section 8-110, the official comment of the UCC adds that it is "to ensure that a securities intermediary and all of its entitlement holders can look to a single, readily-identifiable body of law to determine their rights and duties."²¹³

The USTA, Canada's parallel legislative initiative to the UCC contains²¹⁴ the same choice of law rules relating to a securities intermediary's jurisdiction in Section

²¹² See UCC § 8-110 (f)

²¹³ See UCC § 8-110 cmt. 3.

²¹⁴ There have been no choice of law rules in existing Canadian law addressing the intermediated system (See Canadian Securities Administrators' Uniform Securities Transfer Act Task Force, *Uniform Securities Transfer Act* (August, 2004) at 110).

52, which is also reflected in Section 45 of the OSTA.²¹⁵ The same choice of law rules as the UCC Article 9 on secured transactions of intermediated securities are also provided in the revised Personal Property Security Act.²¹⁶

In Quebec, there is currently no special choice of law rules squarely dealing with intermediated securities. The possible rule may be, as discussed above, the *Civil Code* Section 3097 under which real rights and their publication are governed by the *lex situs*. However, as it is likely that Quebec court characterises intermediated securities as intangible property, the *situs* would be the place where the relevant intermediary (obligor) is located.²¹⁷

2. EU Settlement Finality Directive and Collateral Directive

As the first regional instrument to introduce the original version of the PRIMA concept,²¹⁸ the Settlement Finality Directive adopted in May 1998 aims mainly to reduce the systemic risk inherent in payment and securities settlement systems which operate on the basis of several legal types of payment netting, in particular, multilateral netting by providing that transfer orders entered into such systems cannot be revoked or otherwise invalidated, and it also attempts to minimise

²¹⁵ The OSTA Section 45, however, excluded the USTA Section 52 Paragraph 4 which provides that “[t]o the extent applicable, this section is subject to the provisions of the *Act Respecting the Convention on the Law Applicable to Certain Rights in Respect of Securities Held With an intermediary*].”

²¹⁶ See e.g. the Ontario *Personal Property Security Act*, R.S.O. 1990, c. p.10, § 7.1.

²¹⁷ See *supra* note 201.

²¹⁸ Compared to the PRIMA adopted in the Settlement Finality Directive and other subsequent EU directives, the primary choice of law rule of the Hague Securities Convention is called a modified version of the PRIMA. See Richard Potok, “The Hague Securities Convention - closer and closer to a reality” (2004) 15 J.B.F.L.P. 204 at 210~215 as to the types of the PRIMA where the EU directives are classified as the Type I, the UCC Article 8 as the Type II, and the Hague Securities Convention as the modified version of the PRIMA. See also James Steven Rogers, *Supra* note 48 at 287 (maintaining that the Convention adopted a “variant of the basic PRIMA approach”).

the disruption to a system caused by insolvency proceedings against a participant in that system.²¹⁹

The Settlement Finality Directive also deals with a cross-border collateral transaction in a limited way within a designated system of the EU member states or the EU central bank. Under Article 9.2 of the Settlement Finality Directive, where securities (including rights in securities) are provided as collateral to a collateral taker who is a participant and/or a central bank of the member states or the EU central bank, the collateral taker's right as to the collateralised securities is governed by the law of a member state where such right is legally recorded on a register, account or centralised deposit system located in the member state. As noticed, however, the choice of law rule of the Settlement Finality Directive's scope is limited to the two cases where collateral is offered by a participant of a designated system to another participant and where collateral is provided to the central banks or the EU central bank. In spite of that fact, a number of the member states in the implementation process have extended the protection of Article 9.2 in order to protect financial market participants.²²⁰

However, as there have existed several unclear issues²²¹ in the application of the Settlement Finality Directive as well as the limited scope discussed above, the EU

²¹⁹ See the summary and the recitals of the Settlement Finality Directive, online: EU < http://ec.europa.eu/internal_market/financial-markets/settlement/dir-98-26-summary_en.htm >.

²²⁰ See HCCH, *Supra* note 46 at 49. For instance, the German Deposit Act (*Depotgesetz*) Article 17a expanded its scope of the application. Article 17a reads as: "dispositions relating to securities or holdings in collective securities deposits which have been entered with legal effect into a register or booked to an account shall be subject to the law of the State supervising the register, in which entry with legal effect is made directly in favour of the beneficiary or in which the head office or branch of the custodian maintaining the account is located which undertakes the credit with legal effect to the beneficiary."

²²¹ As a representative issue, an example is what kinds of rights are governed by the law, contractual rights or only proprietary rights. If the answer is the latter, then which issues are governed by the law, and whether *renvoi* is excluded. See further Maisie Ooi, *Supra* note 37 at 226~261 for detailed analysis of the Settlement Finality Directive. (However, this author does not agree with her illustration and analysis of the Directive application at 231~233, since the examples she presented can properly be interpreted under the Directive. In short, it is not a problem of the Directive itself, but a kind of interpretational matter of the Directive.)

adopted on 6 June 2002 a further improved complementary directive, the Collateral Directive, which does not limit the scope of securities collateral to a designated system,²²² and clearly enumerates to which issues it will apply. More specifically, the Collateral Directive enlarged its personal application to a collateral transaction between non-member state parties if they fall in one of the categories specified in Article 2.²²³ As for the material scope, the Collateral Directive allows even cash as financial collateral, as well as financial instruments.²²⁴

The choice of law rule set forth in Article 9.1 of the Collateral Directive succeeds to the same rule of the PRIMA in the Settlement Finality Directive, providing that “[a]ny question with respect to any of the matters specified in paragraph 2 arising in relation to book entry securities collateral²²⁵ shall be governed by the law of the country in which the relevant account²²⁶ is maintained.” The difference from the Settlement Finality Directive is that the Collateral Directive uses the wording of “maintained,” instead of “located” in the Settlement Finality Directive.

²²² Recital 7 shows one of the purposes of the Collateral Directive is to extend its application. The recital reads as “[t]he principle in Directive 98/26/EC [the Settlement Finality Directive], whereby the law applicable to book entry securities provided as collateral is the law of the jurisdiction where the relevant register, account or centralised deposit system is located, should be extended in order to create legal certainty regarding the use of such securities held in a cross-border context and used as financial collateral under the scope of this Directive [underline added].”

²²³ Article 1.2.e specifies that a natural person including unincorporated firms and partnerships is also an eligible category to the parties of a collateral transaction, if the other party is an institution as defined in points (a) to (d). Article 1.3 further specifies an opt-out mechanism of the Article 1.2.e, but ultimately only Austria decided to do so and only five EU member states have applied a partial opt-out: the Czech Republic, Slovenia, Sweden, France and Germany (See European Commission, “Report from the Commission to the Council and the European Parliament: Evaluation Report on the Financial Collateral Arrangements Directive” (2002/47/EC) COM(2006)833 final at 8).

²²⁴ See Art. 1.4.a.

²²⁵ Book entry securities collateral means “financial collateral provided under a financial collateral arrangement which consists of financial instruments, title to which is evidenced by entries in a register or account maintained by or on behalf of an intermediary (Art. 2.1.g).”

²²⁶ Under Article 2.1.h, relevant account means “in relation to book entry securities collateral which is subject to a financial collateral arrangement, the register or account - which may be maintained by the collateral taker - in which the entries are made by which that book entry securities collateral is provided to the collateral taker.”

However, the substance of the rule is the same and the reason that the Collateral Directive selected the term of “maintained” is that an account can not be physically located but more accurately is maintained.²²⁷ Additionally, as for the choice of law rule, the second sentence of Article 9.1 clearly eliminates the application of *renvoi*, which was uncertain under the Settlement Finality Directive. The Collateral Directive also specifies which issues the law determined by the choice of law rule addresses. The issues are a) the legal nature and proprietary effects, b) the requirements for perfection, c) priorities, and d) the steps required for the realisation.²²⁸

In this regards, compared to the Settlement Finality Directive, the Collateral Directive can be evaluated to provide more legal certainty in the determination of law applicable to a collateral transaction in an intermediated system. Therefore, if a collateral taker creates a valid and effective collateral arrangement based on the governing law of the state where the relevant account is maintained, then the validity against any competing title or interest and the enforceability of the collateral should be governed solely by the law of that state, thereby eliminating legal uncertainty arising from the application of other unforeseen legislation.²²⁹

However, as the EU Commission concluded in the evaluation report of the Collateral Directive,²³⁰ a sufficient level of legal certainty has not yet been attained in the current choice of law rule set out in the Collateral Directive Article 9. For example, as the first process of a conflict of laws analysis, it is still uncertain which law characterise the collateral arrangement, thereby leaving the parties with the risk of recharacterisation. In addition, there is no clear choice of law rule for a disposition of intermediated securities which is not provided as collateral in the EU, since the Collateral Directive applies only to a collateral arrangement. In this regard, the EU

²²⁷ See Ulrik Bang-Pedersen, “The impact on the European Community States” Paper presented to the International Symposium on the Hague Securities Convention in Tokyo [the Tokyo Symposium], October 2004) [unpublished] at 2. The Tokyo Symposium articles can be found at <<http://www.rikkyo.ne.jp/grp/ribis/symposium/2004hague/hague.htm>>.

²²⁸ See Art. 9.2.

²²⁹ See Recital 8 of the Collateral Directive.

²³⁰ See European Commission, *Supra* note 222 at 11.

prudently examines the possibility of the adoption of the Hague Securities Convention, which covers both collateral transactions and ordinary securities transactions with clearer legal certainty, though the primary choice of law rule is different from that of the current EU regime, the location of account formulation (the PRIMA).

3. Choice of Law Rules in Korea and Japan

Currently, there are no specific choice of law rules for intermediated securities in Korea and Japan. Therefore, a conflict of laws analysis is performed by the PIL Act in Korea and Japan. Both states have recently overhauled the old conflict of laws regimes.

Under the newly revised Korean PIL Act in 2001,²³¹ there can be three possible interpretive approaches: 1) application of the *lex rei cartae sitae* (Section 19 and 21), 2) application of the analogical *lex situs* (Section 23), or 3) application of the law of the closest connection (Section 8). The first and second approaches are dependent on the characterisation of intermediated securities.

The first method is to directly apply current choice of law rules provisions without regard to the characteristics of intermediated securities. Under Section 19 of the PIL Act, immovable and movable rights in *rem* and rights that shall be registered are governed by the law of the place of the subject matter (the *lex situs*), and acquisition, loss and change of such real rights are governed by the law of the place where the subject of such real rights was located at the time of the completion of the causal act or fact. Similarly, under Section 21 acquisition, loss and change of rights of bearer securities are governed by the law of the place where the bearer securities were located at the time of the completion of the causal act or fact. This approach was the majority opinion in Korea like Japan, but it is expected that a Korean court would not apply the *lex rei cartae sitae* rule any more under the revised current PIL Act, though that is uncertain. As analysed in Chapter II, securities mean securities certificates in

²³¹ *Conflict of Laws Act*, Act No. 6465 of 2001.

Korea and Japan and therefore, it would seem natural that intermediated securities also refer to deposited securities certificates themselves according to the analysis of substantive law. However, it is evident that the location of securities certificates is fortuitous and the *lex rei cartae sitae* rule cannot answer the question of where the location is when securities are dematerialised. More importantly, as the characterisation process is not subject to the definition of securities pursuant to substantive law analysis,²³² there is a possibility that a Korean court would take the second or third approach.

As the second approach, Section 23 in the revised PIL Act provides that a contractual security interest of claims, shares or other rights, or securities certificates representing the foregoing is governed by the law governing the subject matter of the security interest.²³³ This provision was introduced in the 2001 revision and it is a special choice of law rule for a collateral transaction. According to this rule, the law applicable to a secured transaction of securities is the law governing the subject right of the transaction. Under this provision, there is a possibility that a Korean court would categorise intermediated securities as “other intangible rights” arising from the relationship between an intermediated securities holder and his relevant intermediary in which case the applicable law would be the place of the relevant intermediary (the PRIMA).²³⁴ However, one shortcoming of this method is that Section 23 applies only to collateral transactions of securities, meaning that it is not applicable to any other cases of intermediated securities dispositions.

²³² See *supra* at 56~60.

²³³ However, a contractual security interest in bearer securities is subject to the rule in Section 21 which is the *lex rei cartae sitae* (S. 23).

²³⁴ See Kwang Hyun Suk, *Commentary of the Revised 2001 Korean Private International Law* (in Korean), 2^d ed. (Seoul: Jisan, 2003) at 185~186 (maintaining that Section 23 has no direct application of the *lex causae* of underlying securities to intermediated securities since it is most appropriate to apply the PRIMA in the multi-tiered intermediated holding system, instead of the look-through approach. However, he explains that the law applicable to disposition of account holder’s right is the governing law of a collateral provider.). See also Kwang Hyun Suk, “Applicable Law to International Securities Collateral Transactions: Related to the PRIMA (in Korean)” (2002) 3:1 Korean Journal of Securities Law 119.

The third approach, which this author prefers, is to apply Section 8 of the PIL Act which was also introduced in the revision in 2001. As an exceptional rule, Section 8²³⁵ explores the law which has the closest connection with the legal relation in question when the governing law determined by the PIL Act rules has merely a slight connection with such legal relation. The underlying rationale of this provision lies in the fact that all the connecting factors in conflict of laws rules are to determine the strongest relation to the issue concerned.²³⁶ In the multi-tiered intermediated system, it is evident that the mere location of securities certificates has no meaningful connection to a disposition of intermediated securities most of the time. Therefore, the new approach represented by the PRIMA could be considered the one most closely connected to intermediated securities.²³⁷

In 2006, Japan also reformed *Horei*,²³⁸ the previous Japanese PIL Act. The revision work of the new Japanese PIL Act²³⁹ mostly focuses on the rules for obligations, torts and unjust enrichment but does not include any special rules on

²³⁵ The translated Section 8 is “where the governing law determined by this Act has merely a slight connection with the legal relation concerned and there clearly exists a law of another country that has the closest connection with such legal relation, the law of that other country shall apply.” The purport of the *Quebec Civil Code* Section 3082 is the same as Section 8 of the Korean PIL Act. Section 3082 of the *Quebec Civil Code* provides that “[e]xceptionally, the law designated by this Book is not applicable if, in the light of all attendant circumstances, it is clear that the situation is only remotely connected with that law and is much more closely connected with the law of another country. This provision does not apply where the law is designated in a juridical act.”

²³⁶ See Kwang Hyun Suk, *Supra* note 234 at 100. See also Albert V. Dicey, J.H.C. Morris & Lawrence Collins, *Supra* note 190 at 49; Masato Dogauchi, “The Internet Transactions and Choice of Law: International Securities Transactions through Intermediaries” (Paper presented in the Tokyo Symposium, October 2004) [unpublished] at 1.

²³⁷ However, it is unlikely that Korean court will allow, under the current PIL Act, party autonomy specified in the UCC or the Hague Securities Convention (See KwangHyun Suk, *ibid.* at 177).

²³⁸ *Application of Laws Act*, Act No. 10 of 1898.

²³⁹ *General Rules for the Application of Laws Act*, Act No.78 of 2006, which came into effective on 1 January 2007. See Koji Takahashi, “A Major Reform of Japanese Private International Law” (2006) 2:2 J. P. Int’l L. 311 as for the details of the new Japanese revised PIL Act. See also Ministry of Justice, *The Explanatory Note of the Interim Draft on Modernization of Private International Law* (in Japanese) (29 March 2005) <<http://www.moj.go.jp/PUBLIC/MINJI57/refer02.pdf>>.

securities, unlike the new Korean PIL Act. Therefore, the conflict of laws analysis on intermediated securities based on *Horei* is still effective in the new Japanese conflict of laws regime.²⁴⁰

Under Section 13 of the new Japanese PIL Act,²⁴¹ which is the same choice of law rule as Section 19 of the Korean PIL Act in substance, immovable and movable real rights and rights which are subject to registration are governed by the law of the *situs*.²⁴² Consequently, all the proprietary issues of a disposition of certificated securities are governed by the actual location of the securities certificates.²⁴³ However, as to dematerialised securities other than shares, the governing law on proprietary issues is the law governing such dematerialised securities. If there is no such explicit governing law, the applicable law is the law of the place of issuance or the law of the issuer of the dematerialised securities.²⁴⁴ In the case of a disposition of dematerialised shares, the law applicable to proprietary issues is thought to be the law of the incorporation of the issuer.²⁴⁵ Because of these rigid choice of law rules, the Japanese

²⁴⁰ See Ministry of Justice, *The 15th Proceedings of the Legislation Review Committee on Indirectly Held Securities* (in Japanese) (4 July 2006), Online: <<http://www.moj.go.jp>>.

²⁴¹ Section 13 of the new Japanese PIL Act is the same as Section 10 of *Horei*.

²⁴² The translated Section 19 is “immovable and movable real rights and rights which are subject to registration shall be governed by the law of the place of immovables, movables and such rights (paragraph 1). Notwithstanding paragraph 1, acquisition, loss and change of the rights set out paragraph 1 shall be governed by the law of the place where immovables, movables and such rights were located at the time of the completion of the causal fact (paragraph 2).”

²⁴³ See Financial Law Board, *Interim Note on Legal Rules of Book-entry Securities Settlements* (April 2000) at 17, Online: <<http://www.flb.gr.jp/epage/edoc/publication06-e.pdf>>. See also Akihiro Wani, “Impact of the Hague Securities Convention on Market Practice – A Japanese Practitioner’s View” (Paper presented in the Tokyo Symposium, October 2004) [unpublished] at 2.

²⁴⁴ *Ibid.* It is also worth noting that under *Horei* Section 12, the law applicable to the perfection of security interest for dematerialised securities other than shares against third parties was the law governing the location (domicile) of the issuer. However, under the new Japanese PIL Act, it is the law governing dematerialised securities (S. 23), meaning that all the proprietary matters on dematerialised securities are governed by the law governing those dematerialised securities.

²⁴⁵ See Akihiro Wani, *ibid.*

financial board committee recommended in 2003 to adopt the PRIMA rule for intermediated securities.²⁴⁶

²⁴⁶ See Financial Law Board, *Supra* note 243 at 17~19.

V. The Hague Securities Convention

A. Purpose of the Convention

It is evident that there has been huge legal uncertainty as to which law governs cross-border dispositions of intermediated securities under the *lex rei cartae sitae* (or the *lex situs*) rule that is a traditional connecting factor of directly held securities which have carried out an adequate disclosure function. This uncertainty causes a collateral taker to hesitate to make a securities collateral transaction with a collateral provider who holds securities through an intermediary, in that from the perspective of the collateral taker, though it is a focal point to acquire security interest which is enforceable against a third party, it is not easy to determine the law applicable to the collateral transaction under the *lex rei cartae sitae* or the *lex situs* rule. Even if this is possible, it is still a cost and time consuming task which results in complex problems in practice, depreciating value of securities as collateral. In addition, especially in the global securities market where jurisdictions are closely inter-connected to and inter-dependent on each other, uncertainty in one jurisdiction can spread to another jurisdiction at a rapid rate. In this regard, the HCCH made a proposal to develop an international instrument on intermediated securities and disposition thereof in May 2000, and adopted the final draft Convention on 13 December 2002 in the second part of the Nineteenth Diplomatic Session of the Hague Conference after two Experts meetings in 2001 and 2002, and seventeen regional discussion workshops.²⁴⁷

The purpose of the Hague Securities Convention is in a sentence to set up unified conflict of laws rules which correspond to the market reality of intermediated securities systems in order to reduce legal risk, systemic risk and associated costs, and to promote efficiency in regard to cross-border intermediated securities

²⁴⁷ See the Explanatory Report at 3~8 for more detailed history of the Hague project on intermediated securities. It was possible to draft the Convention in a short time by adopting a fast track procedure. This author attended the first and second Expert meeting as a Korean delegate and two regional discussion workshops held in Hong Kong and Tokyo.

transactions, especially collateral transactions of intermediated securities by providing *ex ante* legal certainty and predictability.²⁴⁸

The Hague Securities Convention has several distinct features compared to other Hague conventions. According to Karl Kreuzer who is one of the co-authors of the Explanatory Report, the innovative features of the Convention are summarised by the following seven points:²⁴⁹ 1) The Convention is the first Hague convention concerning economic areas (financial law and proprietary issues of securities); 2) The Convention introduced a new fast track procedure so that the Convention could be drafted in a short period; 3) The Convention acknowledges for the first time Regional Economic Integration Organisations (REIO) like the EU as parties to a Hague convention; 4) The common law rule-making style had a stronger influence on the Convention than on the existing traditional Hague conventions; 5) The rule on the scope of the Convention in Article 2 is merged with the rule on the domain of the law determined by the choice of law rules of the Convention (Convention Law; the *lex causae*) these provisions being traditionally separated in Hague conventions; 6) The convention provides a broad definition of internationality in Article 3 which triggers the applicability of the Convention; 7) Most importantly, the Convention revolutionarily allows party autonomy in proprietary issues, replacing the traditional situs rule and PRIMA.

It is worth noting that the Hague Securities Convention is a pure conflict of laws convention, and thus it has no effect nor does it impose change on substantive law as to each state's intermediated securities.²⁵⁰ However, it does not guarantee that a result of application of the law determined by the choice of law rules in the Convention ("Convention Law") is justifiable, because the Hague Securities Convention is a pure conflict of laws convention, but an outcome of legal proceedings is subject to substantive law designated by choice of law rules. Hence, an

²⁴⁸ The preamble of the Convention describes such purport.

²⁴⁹ See Karl Kreuzer, "Innovative features of the Hague Securities Convention" (Paper presented in the Tokyo Symposium, October 2004) [unpublished]. See also the Explanatory Report at 21~26 as for the epitomised key features of the convention.

²⁵⁰ See the Explanatory Report at 21 (Int-49) and 45 (Para. 2-1).

analysis of conflict of laws rules should also be accompanied by that of the effect of application of the rules by which a merit or demerit of the choice of law rules can finally be determined.

The Hague Securities Convention as the first Hague instrument which addresses economic and financial issues is expected to have a considerable effect on the practice of securities industry, though only two states (the U.S. and Switzerland) signed the Convention as of October 2007. In this regard, this chapter will firstly examine major provisions of the Hague Securities Convention and then explore a proper and adequate way to interpret practical issues in accordance with the Explanatory Report.

B. Scope of the Convention

1. Material Scope: Intermediated Securities

1.1. Securities Held with an Intermediary

The Hague Securities Convention applies only to “securities held with an intermediary,” that is, intermediated securities,²⁵¹ meaning that in the case where securities are directly held, other conflict of laws rules of the forum court apply. Securities held with an intermediary are “the rights of an account holder²⁵² resulting from a credit of securities to a securities account²⁵³ (Art. 1.1.f).” Thus, in the concept of securities, whether securities can be creditable to a securities account is of utmost importance. Accordingly, by adopting the illustrative way to define securities and at the same time putting in only two limiting factors, the requirement of creditability to a securities account and the requirement of financial instruments or assets other than

²⁵¹ The Convention does not use the term of intermediated securities or indirectly held securities. Instead, it selects the terminology of “securities held with an intermediary.” However, they have no difference in substance.

²⁵² Account holder means “a person in whose name an intermediary maintains a securities account (Art. 1.1.d).”

²⁵³ Securities account refers to “an account maintained by an intermediary to which securities may be credited or debited (Art. 1.1.b).”

cash, the Convention encompasses all types of securities which can be created with developments in the securities markets.²⁵⁴ Unlike the Collateral Directive, cash is not included in the definition of securities under the Hague Securities Convention.²⁵⁵ However, as a separate matter, the matter of whether a disposition of intermediated securities extends to entitlements to dividends, income, or other distributions, or to redemption, sale or other proceeds under Article 2.1.g is included in the scope of the Convention. As a practical example, when an investor, who held 10,000 dollars of cash and 1000 shares of Auto, Inc., sold some of the shares of Auto, Inc. and repeatedly sold and bought some of the shares, the initial 10,000 dollars of cash are not within the scope of the Convention because cash is not considered securities under the Convention, but sale proceeds of the shares of Auto Inc. are within the scope of the Convention. In this case, it could be an issue how to separate the 10,000 dollars of cash from the sale proceeds. However, as the Hague Securities Convention is a pure conflict of laws rules, it only determines the law applicable to the issue and the substantive law determined by the Convention sorts out the cash from the sale proceeds, even though it is somewhat doubtful whether there is a specific substantive rule addressing this issue.

It should be also noted that as the Convention applies only to intermediated securities, *i.e.* the rights credited to a securities account maintained by an intermediary, the choice of law rules of the forum and not those of the Convention does not come in, but the choice of law rules of the forum apply if the Convention Law determines that securities were not credited to the securities

²⁵⁴ See the Explanatory Report at 30~31.

²⁵⁵ Since the Expert meeting in January 2002, the opinions that cash should expressly be excluded from the securities definition had been gathered and from the April 2002 preliminary draft convention, cash has been excluded from the definition. See HCCH Permanent Bureau. Prel. Doc. No 10 of April 2002 – *Preliminary draft Convention on the law applicable to certain rights in respect of securities held with an intermediary – Suggestions for amendment of the provisional version adopted by the Special Commission on 17 January 2002* as for the April 2002 draft. See also Report of Meeting of the first Expert meeting, No. 4; FMLC, *Supra* note 131 at 19; and Changmin Chun, “Cross-border Securities Transactions and Conflict of Laws (in Korean)” [2004] Korea Private International Law Journal Vol. 10 as for the reason why the Convention excludes cash.

account.²⁵⁶ This means that the Convention Law determines whether and when securities are legally credited to a securities account, *i.e.* whether and when securities come to be intermediated securities.²⁵⁷ It might be thought as illogical that the Convention Law comes into play even before the Convention Law is determined, since the Convention is applicable only when securities are credited to a securities account. However, the fact that the Convention becomes applicable only if securities are credited to a securities account should be interpreted to the effect that the Convention does not apply to directly held securities but only to securities which have a factual appearance of being credited to a securities account. If then, the Convention comes to be triggered and the Convention Law further examines whether and when the securities are *legally* credited to a securities account under the Convention Law.

Finally, intermediated securities are the bundle of rights resulting from the credit of securities to a securities account and the legal nature of them can be characterised as proprietary, contractual, hybrid or otherwise under the Convention Law.²⁵⁸ The Convention applies, however, even when the legal nature of intermediated securities under the Convention Law is determined to be contractual.²⁵⁹ This is because the necessity for a clear choice of law rule on intermediated securities is not related to the legal nature of intermediated securities.²⁶⁰

1.2. Disposition of Intermediated Securities

Unlike the Settlement Finality Directive and the Collateral Directive, the Hague Securities Convention applies to the case of an outright transfer, such as a sale,

²⁵⁶ See the Explanatory Report at 49 (para. 2-16).

²⁵⁷ *Ibid.* at 48~49 (para. 2-15).

²⁵⁸ Art. 2.1.a. See *ibid.* at 34 (para. 1-16).

²⁵⁹ See Art. 2.2.

²⁶⁰ See the Explanatory Report at 48 (para. 2.12). In fact, earlier drafts limited the applicability of the Convention only when the legal nature of intermediated securities is characterised as proprietary or hybrid (See the Explanatory Report at 45~46, para. 2-4).

as well as to a transfer for the purpose of collateral.²⁶¹ The Convention defines disposition as “any transfer of title whether outright or by way of security and any grant of a security interest, whether possessory or non-possessory.”²⁶² In addition, the Convention Article 1.2 provides that “a disposition of a securities account,” “a disposition in favour of the account holder’s intermediary,” and “a lien by operation of law in favour of the relevant intermediary as to any claim arising from the maintenance and operation of a securities account” are also included in the meaning of a disposition of intermediated securities. With respect to the lien, it should be noted that the law in the term of “a lien by operation of law” is also determined by the connecting factors under the Convention Articles 4, 5, and 7. Generally, an intermediary performs its business according to the law where it is located and it acquires a lien by operation of law under that law. However, as the Convention excludes *renvoi*²⁶³ and thus, law under the Convention means substantive law, it can be concluded that the law in the term of a lien by operation of “law” also refers to the Convention Law. Accordingly, where an account holder and his relevant intermediary which is located in Montreal agreed in their account agreement that New York law governs the account agreement (hereinafter, assume that the Qualifying Office requirement under Article 4.1 is satisfied, unless otherwise mentioned), the lien which the intermediary can obtain is a lien by operation of New York law, not Quebec law.

²⁶¹ See Joanna Benjamin, Madeleine Yates & Gerald Montagu, *Supra* note 6 at 79 (where Benjamin welcomes this all-inclusive approach “as a fragmented approach depending on the purpose of the transfer is conceptually and practically unsatisfactory”).

²⁶² See the Explanatory Report at 35 (para. 1-19) (“The reference to possessory security interest is directed to civil law systems like Germany, Japan, and Korea which have a concept of delivery of possession of intangibles”).

²⁶³ Article 10 specifies that “in this Convention, the term “law” means the law in force in a State other than its choice of law rules.”

2. Content Scope: Article 2.1 Issues

The content scope or application scope refers to the issues stipulated in Article 2.1, which are proprietary matters with respect to a disposition of intermediated securities. The January 2001 preliminary draft Convention, which was the outcome of the first Experts meeting, originally provided that “this Convention determines the law governing proprietary rights in respect of securities held with an intermediary.”²⁶⁴ However, some delegates like one from the U.S. where there is no sharp distinction between rights in *rem* and rights in *personam*, expressed a strong refusal to use the terms, “proprietary rights” or “proprietary aspects.” There was also an opinion that the borderline of whether an issue is proprietary or contractual is not precisely delineated.²⁶⁵ In this regard, the method which specifically specifies each issue that is considered proprietary was adopted as Article 2.1 in the final draft from the November 2001 draft Convention.²⁶⁶

The issues provided for in Article 2.1 are a) the legal nature and effect against the intermediary and third parties of intermediated securities, b) the legal nature and effect against the intermediary and third parties of a disposition of intermediated securities, c) the perfection requirements, d) priorities, e) duties of the intermediary where a third party asserts a competing interest in intermediated securities, f) the realization requirements, and g) entitlements to dividends, etc.²⁶⁷

Among other things, there are three items that should be noted in respect of the Article 2.1 issues: the characterisation process under the Convention, the

²⁶⁴ Art. 1.1 of the January 2001 preliminary draft convention. See HCCH Permanent Bureau, Prel. Doc. No 3 of July 2001 - *Tentative text on key provisions for a future Convention on the law applicable to proprietary rights in indirectly held securities*.

²⁶⁵ See Harry C. Sigman, “The Convention from the Viewpoint of the Collateral-Taker” (Paper presented in the Tokyo Symposium, October 2004) [unpublished] at 3.

²⁶⁶ See HCCH Permanent Bureau, Prel. Doc. No 6 of November 2001 - *Tentative text on key provisions for a future Convention on the law applicable to certain rights in respect of securities held with an intermediary*.

²⁶⁷ The proprietary matters can be found in the following phrases: effects against...third parties (a & b), perfection (c), priorities (d), realisation (f), and character of subrogation on entitlements (g). The “certain rights” in the official title of the Hague Securities Convention refers to these issues including the issue of intermediary’s duties in Art. 2.1.e.

application method relating to the Article 2.1 issues, and the issues not covered by the Convention.

As discussed above, the common choice of law process begins with characterisation, which is made in accordance with the *lex fori*. However, it is not the *lex fori* but the *lex causae* that characterises the issues of Article 2.1.a and 2.1.b under the Hague Securities Convention, since the legal nature of intermediated securities (Article 2.1.a) and the legal nature of a disposition of intermediated securities (Article 2.1.b) are characterised by the Convention Law. In addition, the sequence of characterisation is quite different from the general choice of law process as for the issues of the legal nature of intermediated securities and a disposition thereof. The purpose of characterisation is to classify and categorise the issue before the forum court in order to find a connecting factor which designates substantive law. So, the connecting factor would be different depending on whether intermediated securities are characterised as proprietary, contractual or otherwise.²⁶⁸ However, under the scheme of the Hague Securities Convention, the Convention Law is determined by the conflict of laws rules of the Convention where securities are factually held with an intermediary²⁶⁹ and the issues are within the Article 2.1 issues,²⁷⁰ and then the substantive law determined by the Convention characterises the legal nature of the intermediated securities and the disposition concerned before the court. Of course,

²⁶⁸ Hence under the traditional conflict of laws analysis as regards to intermediated securities as discussed above, the result of the characterisation refers to a connecting factor. See Kwang Hyun Suk, “Applicable Law to Cross-border Collateral Transactions (in Korean)” (2005) 5:1 Korean Journal of Securities Law 48 (also mentioning the same point).

²⁶⁹ For this reason, the Explanatory Report mentions that in the cases where the question arises whether an issue falls within the Article 2.1 list, this should be answered “by reference to the language of Articles 2(1) and 2(2) and not by using the Convention law itself to characterise the rights.” See the Explanatory Report at 46 (para. 2-5).

²⁷⁰ In this regard, the single fact that securities are credited to a securities account can also trigger the application of the Convention where the intermediated securities holder wants to know the legal nature of them according to Article 2.1.a (See the Explanatory Report at 48, para. 2-13). See also Maisie Ooi, “The Hague Securities Convention: A Critical Reading of the Road Map” [2005] L.M.C.L.Q. 467 at 473 (arguing that “the single fact that the securities are held by intermediaries does not trigger the application of the Convention.” Then, she continues to maintain an opposite argument that “the Convention connecting factors apply only if the issue as characterised by the court comes within Art 2.1.”).

however, where the forum court characterises the issue in question, for instance, as the validity of a collateral agreement that would be governed by the proper law of the agreement (the *lex contractus*), the Convention is not triggered for that issue.

Secondly, “all” the Article 2.1 issues are governed by the same single law with respect to a particular securities account.²⁷¹ For this purpose, Article 4, 5 and 7 expressly and purposefully use the phrase, “all the issues specified in Article 2(1).” Therefore, the governing law cannot be split depending on issues and even it cannot be designated only for some of the Article 2.1 issues by an account agreement, which will lead to the fall-back rule (Art. 5) of the Convention.²⁷² However, Ooi argues that the applicable law should be divided according to the nature of the Article 2.1 issues in the situation of the so-called page 37 problem which will be discussed in detail below. According to her opinion, the issues of the legal nature and effect of a disposition of intermediated securities (Art. 2.1.b), the perfection requirements (Art. 2.1.c), extinction of interest (Art. 2.1.d), and entitlements (Art. 2.1.g) are governed by the law agreed to by the collateral provider (transferor) and his relevant intermediary. Meanwhile, the issues of the legal nature and effect of intermediated securities (Art. 2.1.a), priorities (Art. 2.1.d), the duties of an intermediary to an adverse claimer (Art. 2.1.e), and the realisation requirements (Art. 2.1.f) are governed by the law agreed to by the collateral taker (transferee) and his relevant intermediary. She emphasises that there will be no “double interests” risk if her approaches are taken.²⁷³ However, as described below, this argument is not quite persuasive in that her approach can also trigger multiple laws and therefore much uncertainty, since there exist as many laws as the number of the collateral provider’s accounts, and it is impossible to choose the law to meet the perfection requirements from the perspective of the collateral taker, if the collateral provider has several accounts and the governing laws of the accounts are different. In addition, unlike her assertion, there exists no requirement of perfection to other intermediaries excepting the collateral taker’s position, for it is

²⁷¹ See the Explanatory Report at 23 (int-60), 47 (para. 2-10), and 69 (para 4-10).

²⁷² See *ibid.* at 69 (para 4-10).

²⁷³ See Maisie Ooi, *Supra* note 37 at 288~303. See also Maisie Ooi, *Supra* note 270 at 487~489.

common that other intermediaries involved in the disposition do not transfer securities for the purpose of collateral and have no information whether it is a collateral transaction in a cross-border securities transaction context other than the intermediaries of the collateral provider and the collateral taker.

Since the Hague Securities Convention covers proprietary issues, it does not determine the law applicable to contractual matters. Article 2.3 expressly excludes from the application of the Convention such issues as the purely contractual or otherwise purely personal rights and duties arising from the credit of securities to a securities account (Art. 2.3.a), the contractual or other personal rights and duties of parties to a disposition of intermediated securities (Art. 2.3.b), or the rights and duties of an issuer, an issuer's registrar or transfer agent (Art. 2.3.c). A noteworthy matter in relation to Article 2.3.a is the meaning of "purely contractual or otherwise purely personal rights and duties" compared to the case where the legal nature of intermediated securities is "contractual" as specified in Article 2.2. As the Explanatory Report acknowledges, the wording is not "as felicitous as it might be."²⁷⁴ For this reason, the Explanatory Report emphasises that Article 2.3 is subject to Article 2.2 as it is. Therefore, the designation of purely contractual or otherwise personal rights and duties between an account holder and its intermediary *inter se* refers to such matters as the content and frequency of account statements, the intermediary's standard of care in maintaining securities accounts, risk of loss, deadlines in giving instructions, and so forth.²⁷⁵ The Convention also has no impact on regulatory rules on securities issuance or trading, intermediary, or enforcement actions taken by regulators.²⁷⁶ Thus, the HCCH underscores that a contracting state can prohibit intermediaries from choosing any governing law ("no choice at all") or choosing a particular governing law ("no choice from X, Y or Z law"), or permit only

²⁷⁴ See the Explanatory Report at 46 (para 2-7).

²⁷⁵ *Ibid.*

²⁷⁶ *Ibid.* at 23 (int-59).

their law.²⁷⁷ However, there could still be a possibility that a forum court could disregard the regulatory measure such as “only law X” due to the public policy of the forum and Article 11.1. For instance, assume that the Korean financial supervisory commission makes a rule that all securities account agreements concluded in Korea shall be governed by Korean law and that any other designation of a governing law shall be void. Despite the regulatory rule, further suppose that Invest A and his Intermediary X secretly agreed that their securities account agreement is governed by New York law and a law suit is brought before a New York court. In this case, if the New York court decides that the Korean regulation is against the public policy of New York law (though it may be unlikely) and the account agreement is not manifestly contrary to the public policy of New York, then the regulatory rule can come to be good for nothing. Consequently, as to this matter more certain legal protections might be required from the international angle.

As practical points, practicing lawyers should note that as the Convention Law characterises the legal nature of a disposition, it could be exposed to the risk of recharacterisation, when a collateral agreement is concluded by a governing law other than the Convention Law.²⁷⁸ Secondly, as for the role of Article 2.1.a, one might be of the opinion that it is meaningless, since the Convention applies independently of whether the legal nature of intermediated securities is proprietary, contractual or otherwise hybrid. However, it has at least two roles. First, an investor may want to know the legal nature and effect of the intermediated securities in advance. Secondly, in the case of insolvency of the intermediary that maintains the investor’s securities account, the investor can be recognised as a general creditor if the legal nature is determined as contractual, since the Convention Law still governs all the Article 2.1 issues in an insolvency proceeding (Art. 8.1) but the *lex concursus* determines the ranking of categories of claim (Art. 8.2.a). Therefore, an investor should take account of this matter when concluding the account agreement with his intermediary.

²⁷⁷ See HCCH, “The Hague Securities Convention: A Modern and Global Conflict of Laws Regimes for Transactions Involving Securities Held with an Intermediary” (December 2006) at 2, online: HCCH <<http://www.hcch.net/upload/outline36e.pdf>>.

²⁷⁸ See the Explanatory Report at 52 (para 2-19 & example 2-7).

3. Territorial Scope: Internationality and General Applicability

The Convention applies in all cases involving a choice between the laws of different states (Art. 3). The Convention adopts “Internationality” as the title of Article 3. However, it does not mean that the territorial scope of the Convention is preconditioned to internationality in its application, meaning that it is not necessary for the Convention to be applicable that a disposition of intermediated securities should be done between two different states, or that the parties to the disposition should have different nationalities or domiciles. By providing that the Convention applies in all situations requiring a choice of law, the text of Article 3 deliberately does not use the term of internationality in order to prevent exclusion of the Convention due to the term “internationality,” even if the cases are intended to be addressed by the Convention.²⁷⁹ Therefore, the case where any foreign element is involved (*e.g.*, all the elements are domestic except the governing law clause of an account agreement) can give rise to the applicability of the Convention.²⁸⁰

4. Normative Scope: Insolvency and Public Policy

In relation to the normative scope of the Convention, the Convention Law does not apply in the case of an insolvency proceeding,²⁸¹ respecting the application of any substantive or procedural insolvency rules (Art. 8.2), provided that the Convention Law still governs all the Article 2.1 issues as to any event, such as credit of securities to a securities account or perfection of a disposition, which has occurred

²⁷⁹ See *ibid.* at 60 (para 3-4).

²⁸⁰ *Ibid* at 62 (para 3-9).

²⁸¹ Under the Hague Securities Convention, insolvency proceeding refers to “a collective judicial or administrative proceeding, including an interim proceeding, in which the assets and affairs of the debtor are subject to control or supervision by a court or other competent authority for the purpose of reorganisation or liquidation (Art. 1.1.k).”

before the opening of that insolvency proceeding (Art. 8.1).²⁸² In this regard, Article 8.1 relates to the matter of recognition of interests acquired before an insolvency proceeding and Article 8.1 concerns the matter of effects of such pre-acquired interests in the insolvency proceeding. As to the personal scope of Article 8, it applies to an insolvency proceeding against any party such as an account holder, a pledgee or transferee, an intermediary or the issuer, if the insolvency is relevant to the matter concerned.²⁸³

As another dimension of the normative scope of the Convention, the application of the Convention can be deterred in the case where the effect of the application of the Convention Law is manifestly contrary to the public policy (*ordre public*) of the forum, or internationally mandatory rules of the forum²⁸⁴ apply irrespective of conflict of laws rules (Art. 11), provided that perfection requirements or requirements relating to priorities between competing interests are governed by the Convention Law in spite of the public policy and internationally mandatory rules of the forum (Art. 11.3). This can be seen as a corresponding provision to Article 8.1, which prevents an insolvency court from imposing any requirements save those required under the Convention Law as for a pre-insolvency disposition.²⁸⁵ However, the writers of the Explanatory Report anticipate that application of Article 11 will be extremely rare.²⁸⁶

²⁸² The opening of the insolvency proceeding is determined by the *lex concursus*. See the Explanatory Report at 110, footnote 31.

²⁸³ See *ibid.* at 109 (para. 8-4).

²⁸⁴ Internationally mandatory rules of the forum are “such *substantive* provisions which are to be *exclusively* applied even when the forum’s rules of private international law designate a foreign legal system as applicable and irrespective of the content of the latter, that is, even when the result of the application of the (overruled) pertinent rules of the designated foreign law would have been the same as under domestic law.” (See *ibid.* at 117, para. 11-9).

²⁸⁵ See *ibid.* at 118~119 (para 11-2).

²⁸⁶ See *ibid.* at 117 (para 11-9).

C. Choice of Law Rules of the Convention

1. Background of the Choice of Law Rules

From the early Experts meeting of the HCCH, it was unanimously concluded that the traditional connecting factor, the *lex rei sitae* applying the look-through approach cannot be a viable and desirable connecting factor anymore for securities that are held through an intermediary, and it was agreed that as the new choice of law rule focusing on a relevant intermediary, the PRIMA is the appropriate connecting factor.²⁸⁷ However, the opinions were split as to the specific way of how to mould the connecting factor with respect to the PRIMA rule. Civil law states, including the EU member states that had the experience of enacting the Settlement Finality Directive maintained that a securities account should be a proper connecting factor, since securities are credited to a securities account and such a fact could be connected to the *situs* of securities.²⁸⁸ However, the U.S., which allows that an account holder and an intermediary can agree on governing law even for proprietary matters under the UCC, and some securities industry associations like the Emerging Markets Traders Association and the Financial Market Lawyers Group advocated that the connecting factor should be designated by agreement between an account holder and his intermediary in order to attain *ex ante* certainty and predictability which is one of the goals of the Convention, as the location of a securities account is not easy to be determined given that a securities account is not maintained in a certain place.²⁸⁹ The Hague Securities Convention finally took the latter approach, which allows party

²⁸⁷ See HCCH Permanent Bureau, Prel. Doc. No 2 of June 2001 - *Report on the meeting of the Working Group of Experts of January 2001 and related informal work conducted by the Permanent Bureau on the law applicable to dispositions of securities held with an intermediary* at 3.

²⁸⁸ Argentina, Australia, Austria, China, Finland, Germany, Greece, Japan, the Netherlands, Spain, Switzerland, U.K. and IBA proposed through Working Document (“WD”) No. 10 of the first Experts meeting in January 2001 that the place of the relevant intermediary be the place where the securities account of the account holder is located, and the location can be a place designated in the custody agreement or other similar agreement and the relevant intermediary has to be located in that place. Belgium and Luxembourg also proposed a similar approach based on the place of an intermediary through WD No. 11.

²⁸⁹ See WD No. 2 of the second Experts meeting at 1~4.

autonomy,²⁹⁰ but it introduced the Qualifying Office requirement which could limit the party autonomy as a compromising measure to accommodate the former opinion.²⁹¹ However, it could be said that in substance, the Convention adopted an almost full-fledged principle of party autonomy, since an account holder can change the governing law of his account agreement at any time and the restriction method of the Qualifying Office requirement is considerably mitigated with respect to the multi-unit states²⁹² (Art. 12.1.b). After all, the connecting factor of the Convention is no longer the place of the relevant intermediary approach (the PRIMA); rather it is more appropriate and intuitive to see it as the Account Agreement Approach (the AAA).²⁹³

2. Primary Rule (Article 4: Account Agreement Approach)

The Convention's primary choice of law rule is the law expressly agreed to in an account agreement. If the account agreement expressly designates a specific law as applicable to all the Article 2.1 issues, that law is the governing law. Secondly, if there is no such express designation, then the law otherwise governing the account agreement becomes the law applicable to all the Article 2.1 issues. Therefore, for

²⁹⁰ In private international law, party autonomy refers to freedom to choose governing law by "the parties of the transaction in question" especially as to matters of contract. In this regard, strictly speaking, the approach the Convention took is not the pure meaning of party autonomy. However, See James Steven Rogers, *Supra* note 48 at 307 (asserting that "[w]hen speaking of the law that governs a bilateral relationship, it is common to use a phrase such as 'party autonomy' to refer to an approach that permits the parties to that relationship specify the law that governs their rights and duties. But, the phrase 'party autonomy' is quite misleading in the context of the issues governed by the Hague Convention.").

²⁹¹ See *ibid.* at 303~316 as to the detailed history and background of the choice of law rules of the Convention. See also Daniel Girsberger, "The Hague Convention on Indirectly Held Securities – Dynamics of the Making of a Modern Private International Law Treaty" in Talia Einhorn & Kurt Siehr ed., *Intercontinental Cooperation through Private International Law: Essays in Memory of Peter E. Nygh* (Cambridge: T.M.C. Asser Press, 2004) at 146~150.

²⁹² Under the Convention, multi-unit state means that "a state within which two or more territorial units of that state, or both the state and one or more of its territorial units, have their own rules of law in respect of any of the issues specified in Article 2.1 (Art. 1.1.m)." China and Hong Kong is the example of the former statement and Canada and the U.S. is the example of the latter statement.

²⁹³ See Changmin Chun, *Supra* note 255 at 16.

instance, if a Canadian investor and his intermediary agree that their account agreement is governed by Quebec law and they further expressly agree that all the Article 2.1 issues are governed by New York law for the purpose of the Hague Securities Convention, then the New York law comes to be the Convention Law. However, either case has to meet the Qualifying Office requirement at the time of the account agreement.

The Qualifying Office test is satisfied if the relevant intermediary has an office in the agreed state, which “a) alone or together with other offices of the relevant intermediary or with other persons acting for the relevant intermediary in that or another state i) effects or monitors entries to securities accounts, ii) administers payments or corporate actions relating to securities held with the intermediary, or iii) is otherwise engaged in a business or other regular activity of maintaining securities accounts, or b) is identified by an account number, bank code, or other specific means of identification as maintaining securities accounts in that state (Art. 4.1.a and Art. 4.1.b).” However, an office is not engaged in a business or other regular activity of maintaining securities accounts provided in Article 4.1.a – “a) merely because it is a place where the technology supporting the bookkeeping or data processing for securities accounts is located, b) merely because it is a place where call centres for communication with account holders are located or operated, c) merely because it is a place where the mailing relating to securities accounts is organised or files or archives are located, or d) if it engages solely in representational functions or administrative functions, other than those related to the opening or maintenance of securities accounts, and does not have authority to make any binding decision to enter into any account agreement (Art. 4.2).”²⁹⁴ If the Qualifying Office requirement is not met, then the fall-back rule in Article 5 applies.

Assume the following three cases. First, the case where there are both the clause of governing law of an account agreement and the clause of express application of the Article 2.1 issues, both of which satisfy the Qualifying Office test.

²⁹⁴ See the Explanatory Report at 72~82 as for the further detailed interpretive explanation of the Qualifying Office requirement.

Secondly, the case where the governing law clause satisfies the Qualifying Office test but the Article 2.1 issues clause does not. Thirdly, the case where the governing law clause does not satisfy the Qualifying Office test but the Article 2.1 issues clause does. In all the three cases, the principle is that depending on the satisfaction of the Qualifying Office test, if the Article 2.1 issues clause meets the test, then, that clause has priority all the time, and if the Article 2.1 issues clause does not satisfy the test but the governing law clause does, that governing law of the account agreement becomes the Convention Law. As a similar case, if the account holder and the relevant intermediary agreed that some of the Article 2.1 issues are governed by law X and the others are law Y, then, as explained above, such split designation cannot be effective for the purpose of the Convention.²⁹⁵ However, if there is a governing law clause and it meets the Qualifying Office requirement, that law is determined as the Convention Law.

The connecting factor could be unclear when an account agreement itself is void (*e.g.*, lack of capacity to enter in to the account agreement), since the primary rule of the Convention is determined in accordance with the contents of the account agreement. In this case, the question of the validity of the account agreement is governed by the conflict of laws rules of the forum court and if that law determines the account agreement is void, the fall-back rule (more specifically Article 5.2 or Article 5.3) could apply.²⁹⁶ However, the Explanatory Report does not specify which fall-back rule might be relevant. According to this author's opinion, Article 5.1 of the fall-back rules cannot apply in the case of non-account agreement, as Article 5.1 also refers to a written "account agreement." As a similar matter, the Explanatory Report denotes that "an oral governing law clause is effective for Convention purpose even if a writing or other formality requirement would render it ineffective under any private international law or substantive writing requirement (at 71, footnote 28)." However,

²⁹⁵ See the Explanatory Report at 69 (para. 4-10). However, the Convention does not prohibit different law to a separate securities account, since the Convention rules apply separately as to each securities account (See *ibid.* para 4-11).

²⁹⁶ See *ibid.* at 72 (para. 4-19). This question was first raised by this author in the Tokyo symposium held in October 2004 and the relevant statement was reflected on the Explanatory Report.

if the oral governing law clause is rendered as ineffective according to the substantive law determined by choice of law rules of the forum, then it also should be treated as the same case as that of the non-account agreement because of lack of capacity. Therefore, such a contradicting statement needs to be corrected in the near future.

With respect to the Qualifying Office requirement, it is worth noting that the office does not need to be located in the place of a specific securities account of the account holder. This is because it is hard to find where *the* securities account is located or maintained in the global securities practice. Therefore, if any relevant intermediary's office is engaged in a business or other regular activity of maintaining securities accounts, then the requirement is satisfied. The following Figure 6 shows how the Qualifying Office can be met and how loose it is, since most of the global custodians have offices in the major financial markets such as New York, London, Luxemburg, Belgium, Tokyo, and Toronto.

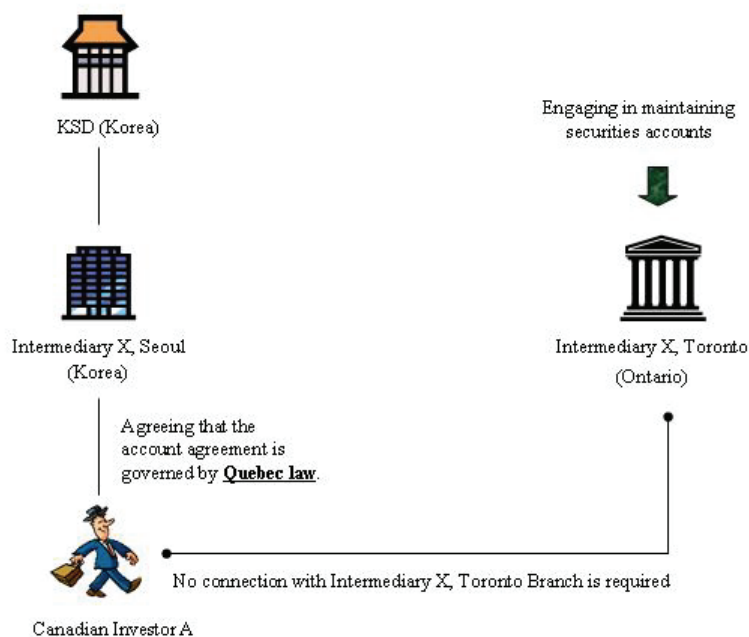


Figure 6. Governing Law and the Qualifying Office Test

Canadian investor A, domiciled in Montreal, opens a securities account with Intermediary X's Seoul branch where they agree that the account agreement is governed by Quebec law and the only branch that Intermediary X has in Canada is the Toronto branch. Assume that now Canadian investor A asks advice on whether the governing law (Quebec law) of the account agreement can be the Convention Law under the Hague Securities Convention. In this assumption, all the Article 2.1 issues are governed by Quebec law, since Intermediary X's Toronto branch is the same entity of Intermediary X's Seoul branch²⁹⁷ and the Toronto branch is engaged in regular activities of maintaining securities accounts, even though Canadian investor A has no securities account with Intermediary X's Toronto office. The reason why it is not necessary for Intermediary X to have an office in Quebec is that in the case of a multi-unit state, the qualifying office just needs to exist within any territory of the multi-unit state (Canada), instead of the specifically designated territorial unit (Quebec) by the account agreement (Art. 12.1.b).²⁹⁸

3. Fall-back Rule (Article 5: PRIMA)

As an alternative recourse for the case where the primary rule stipulated in Article 4 is not applicable, the Convention provides three fall-back rules in a cascading way, which can be regarded as the original PRIMA concept. The first fall-back rule's connecting factor is the place of a particular office of the relevant intermediary, if the fact that the relevant intermediary entered into the account agreement through the particular office is expressly and unambiguously written²⁹⁹ in

²⁹⁷ The office must be that of the intermediary itself and thus the office of a subsidiary or other affiliate of the intermediary is not an office of the intermediary for the purpose of the Convention (*ibid.* at 37, para. 1-25).

²⁹⁸ However, a multi-unit state can exclude such mitigated requirement by declaring that the office specified in the second sentence of Article 4.1 must exist in the specific territorial unit agreed as the Convention Law (Art. 12.4).

²⁹⁹ Article 5 is the only provision requiring writing throughout the Convention. In addition, under the Convention, writing does not necessarily mean physical papers, since writing and written mean "a record of information (including information communicated by teletransmission) which is in tangible or other form and is capable of being reproduced in tangible form on a subsequent occasion (Art. 1.1.n)."

the account agreement, provided that such particular office had to meet the Qualifying Office requirement in the second sentence of Article 4.1 at that time.³⁰⁰ If the first fall-back rule is not applicable, then the second fall-back rule looks for the place of incorporation or organisation of the relevant intermediary at the time³⁰¹ of entering into the written agreement or having opened the securities account.³⁰² When both the fall-back rules are not satisfied, then as a last resort, the final fall-back rule designates the (principal) place of business of the relevant intermediary at the time of entering into the written agreement or having opened the securities account.

4. Change of the Applicable Law (Article 7)

As the Hague Securities Convention chose an account agreement as the primary rule, the connecting factor can be changed easily by an amendment of the account agreement. Accordingly, it becomes crucial how to protect relevant parties who held perfected interests or others under the law (“old law”) before the change of the applicable law, since rights in *rem* have the effect against the world.

In this regard, the Convention sets out the following four points. First, if an account holder tried to change the governing law of the account agreement or the law applied to the Article 2.1 issues to another law (“new law”) but it does not satisfy the requirement of Article 4.1, that amendment is disregarded and the old law still

³⁰⁰ See the Explanatory Report at 77 (para. 4-29) as for the difference of the time factor between Article 4.1 and Article 5.1. Article 5.1 puts emphasis on the “presence of an express and unambiguous statement in a written account agreement,” so that the time when such written agreement is *first* entered into is important, while Article 4.1 regards the “existence of an agreement on governing law.”

³⁰¹ The time needs to be fixed, because the relevant intermediary may change its law of incorporation or otherwise organisation.

³⁰² In the case of the intermediary that is incorporated or organised by law of a multi-unit state itself, instead of a specific territorial unit of the multi-unit state (*e.g.*, There are some banks including CDS that were incorporated by the federal *Canada Business Corporations Act*), the connecting factor is rendered to the place of business of the intermediary or if there are more than one place of business, the principle place of business.

governs the Article 2.1 issues.³⁰³ Secondly, as Article 7 applies only if the change of the Convention Law arises from the result of a triggering amendment to an account agreement, in the case where intermediated securities are transferred from Account A to Account B, Article 7 does not apply, since in this case it is not necessary to classify the old law and the new law as the law related to Account B applies to all the Article 2.1 issues.³⁰⁴ The relevant case that Article 7 is concerned with is the one where securities are collateralised in the same collateral provider's account.³⁰⁵ Thus, it is expected that Article 7 will not frequently be referred to in practice. Thirdly, it is a matter of course that the change of the applicable law in Article 7 deals with such change only after the Convention entered into force,³⁰⁶ since Article 7 addresses a triggering amendment under the Convention.³⁰⁷ Finally, the new law governs all the Article 2.1 issues in principle (Art. 7.3). However, in respect of a person who did not consent to a change of law, the old law still governs 1) the existence of an interest in intermediated securities before the change of law (Art. 7.4.a); 2) the perfection of those securities made before the change of law (Art. 7.4.a); 3) the legal nature and effect of an interest of intermediated securities against the relevant intermediary and any party to a disposition of those securities made before the change of law (Art. 7.4.b.i); 4) the legal nature and effect of those interest against a person who attaches the intermediated securities after the change of law (Art. 7.4.b.ii); 5) the determination of all the Article 2.1 issues as to an insolvency administrator in an insolvency proceeding opened after the change of law (Art. 7.4.b.iii), and priorities between parties of which interests arose before the change of law (Art. 7.4.c),

³⁰³ See the Explanatory Report at 94-95 (para. 7-1). It should be noted that the fall-back rule of Article 5 does not apply in this case (See *ibid.*).

³⁰⁴ See *ibid.*

³⁰⁵ In Korea, securities are pledged in the pledgor's account by inscribing the purport of the pledge and locking-up any disposition by the pledgor (See Art. 174-3.2 and Art. 174-4.2 of the SEA).

³⁰⁶ The Convention enters into force on the first day of the month following the expiration of three months after the deposit of the third instrument of ratification, acceptance, approval or accession (Art. 19.1).

³⁰⁷ See the Explanatory Report at 96 (para. 7-4).

provided that the new law applies to priority over an interest which arose under the old law but perfected under the new law at later time (Art. 7.5).

D. Some Interpretative and Practical Issues

1. The So-called Page 37 Problem

The connecting factors of the Convention under Article 4 and Article 5 focus on the account agreement between an account holder and his relevant intermediary, or the place of the relevant intermediary. In the multi-tiered intermediated system, however, several intermediaries are involved in a securities transaction, which means that several account agreements in proportion to the number of securities accounts of the intermediaries involved in the transaction become meaningful. Thus, an interpretative question can be raised as to which connecting factor prevails on the transaction within the multiple connecting factors. The existence of these multi-connecting factors is the so-called Page 37 problem.³⁰⁸

Under the definition of “securities held with an intermediary” and “relevant intermediary,” it becomes clear that the Convention Law is determined according to each relevant account agreement.³⁰⁹ In this regard, the approach taken by the Convention is called a “stage-by-stage approach (or analysis),” “step-by-step analysis,” or “account-by-account analysis.” Therefore, there is no one single unitary law³¹⁰ that governs all the stages of the accounts of the intermediaries under the Convention, trumping all the PRIMAs at each level, but each Convention Law vis-à-vis each securities account governs each stage of dispositions.

Figure 7 depicts the concept of the stage-by-stage analysis and the Page 37 problem. Account holder A borrows funds from Account holder B, collateralising his

³⁰⁸ The nomenclature of the Page 37 problem came from the illustration of the transfers involving two or more intermediaries at page 37 of the Bernasconi Report.

³⁰⁹ See the Explanatory Report at 82 (para. 4-43). The report stresses that this principle is further reinforced by Article 6.d (*ibid.*).

³¹⁰ This unitary law solution is also well known as the “Super-PRIMA.”

intermediated securities by way of title transfer. The title transfer contract is governed by law Y and the account agreements of Account holder A and Account holder B are governed by law X and law Y respectively. In this one single collateral transaction, there exist four separate dispositions under the interpretation of the Convention: 1) disposition between Account holder A and Intermediary X, 2) disposition between Intermediary X and ICDS Z, 3) disposition between ICSD Z and Intermediary Y, and 4) disposition between Intermediary Y and Account holder B. In addition, each disposition is governed by a separate law: law X for disposition 1, law Z for dispositions 2 and 3, and law Y for disposition 4. Assume that Account holder B did not wire the funds even after receiving the securities and Account holder A brought a law suit against Account holder B. In this case, it can be a question of which connecting factor, Account holder A's account agreement or Account holder B's account agreement, is relevant for the transaction? Further, it may be possible that forum court A identifies Account holder A's interest is valid according to law X and forum court B identifies Account holder B's interest is valid according to law Y, causing the so-called "problem of double interests."

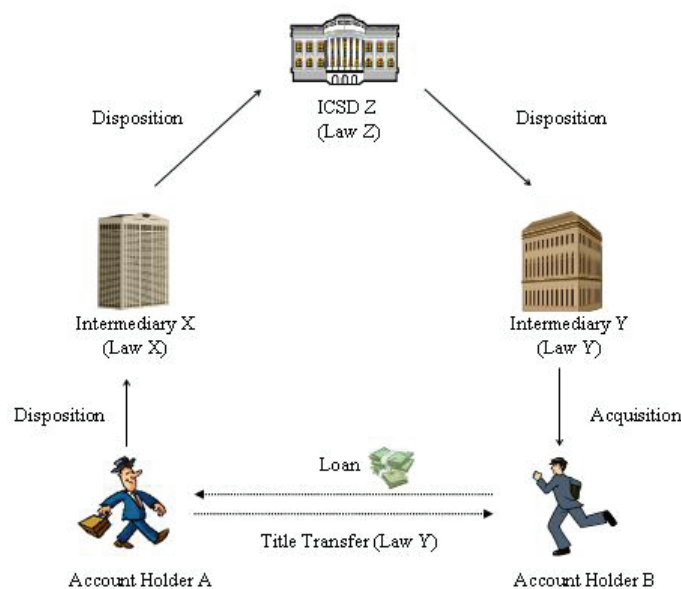


Figure 7. Illustration of the Page 37 Problem

The underlying background of the Super-PRIMA (unitary solution), which was initially raised by Japan³¹¹ and other civil law states, was that the stage-by-stage concept which recognises several dispositions in a single securities transaction is somewhat unfamiliar with the substantive law concept of civil law states³¹² such as Germany, Korea and Japan where only one single direct disposition exists between the transferor (Account holder A) and the transferee (Account holder B) in a such case. Further, proponents of the Super-PRIMA thought that the stage-by-stage approach could cause the double interests problem when both the transferor's law and the transferee's law acknowledge each one's interest regarding the same securities. As for the Super-PRIMA, the Permanent Bureau distributed a preliminary

³¹¹ At a later time, Japan explained that their assertion was not to apply one single law to all the stages of the intermediaries and that the "suggested unitary solution" was different from their intention of the Japanese delegation. See HCCH the Permanent Bureau, Prel. Doc. No 14a of May 2002 - *Comments on transfers involving two or more intermediaries: a response to Preliminary Document No 12, submitted by the Japanese delegation* at 8~9 (para. 23).

³¹² As analysed in Chapter II, in the intermediated systems of the U.S. and the U.K. where intermediated securities are classified as *sui generis* security entitlements or beneficial interests per each account relationship, and therefore, the stage-by-stage approach can be seen as the common and proper step even in the PIL analysis. However, in some intermediated systems such as those of Germany, Korea, and Japan, such step-by-step PIL analysis could be understood as an unfamiliar and even unworkable approach, since in those systems, only one disposition directly from the transferor to the transferee is recognised from the substantive law analysis perspective, viewing only securities holders as ultimate owners of underlying financial properties of intermediated securities (more precisely speaking, the underlying financial properties are intermediated securities themselves) and treating intermediaries and CSDs as mere conduits or account managers with no proprietary interests at all (See HCCH Permanent Bureau, Prel. Doc. No 12 of May 2002 - *Transfers involving several intermediaries: An Explanatory Note on the functioning of PRIMA within the framework of the preliminary draft Convention on securities* at 4~5. See also HCCH the Permanent Bureau, Prel. Doc. No 14a at 3~5 as for the different substantive views on intermediated securities). However, the concern that the stage-by-stage approach does not work and/or fit with some civil law states, is thought to be unfounded, because the Convention is pure PIL rules. If the Convention Law is determined in one of the civil law states, that law can analyse all the Article 2.1 issues of intermediated securities (See further the Explanatory Report at 87, para. 4-50). Therefore, the true issue of the Page 37 problem does not lie in whether the stage-by-stage approach is workable in the intermediated systems of some civil law states but on which account is relevant to such transfers. The answer taken by the Convention is the account to which intermediated securities are credited.

document,³¹³ stressing that the Super-PRIMA at first glance looks like it could provide clarity and simplicity, but it could trigger more uncertainty given that among other things, the parties involved in the early (Intermediary A) or middle stages (ICDS Z) of the transfer may not know or not be in a position to find out the ultimate transferee or the location of its intermediary. Furthermore, the law applicable to proprietary matters of earlier stages of the transfers is retrospectively fixed only at the later time when the ultimate transferee comes to be clear, replacing all the previous governing law.³¹⁴

In terms of the problem of double interests as well as the question of which of the two connecting factors, Account holder A's account agreement or Account holder B's account agreement, is relevant for the transaction, the Convention looks at each transferee (recipient)'s account where intermediated securities are then credited according to the general private international law rule which is applied to tangible movables.³¹⁵ For instance, in the case of a direct lawsuit between Account holder A and Account holder B in Figure 7, the account agreement between Account holder B and Intermediary Y comes to be the relevant connecting factor and therefore, law Y is determined as the Convention Law on all the Article 2.1 issues, as intermediated securities are credited to Account holder B's account. If law Y finds that Account holder B acquired overriding rights to the intermediated securities, then the interests of Account holder A in the intermediated securities are extinguished, resulting from Account holder B's acquisition of the intermediated securities. Consequently, the problem of double interests cannot exist. However, this result does not prevent

³¹³ HCCH Permanent Bureau, Prel. Doc. No 12.

³¹⁴ See *ibid.* at 6~7 and HCCH Permanent Bureau, Prel. Doc. No 3 at 5~6 for further discussion on the flaws of the Super-PRIMA.

³¹⁵ It is a well settled PIL rule that the law of the place where a tangible moveable is newly situated governs the proprietary effect of an assignment of it, when the *situs* of a tangible moveable changes to that place and the assignment takes place therein. Consequently, the previous owner can be divested of his rights in *rem* to the moveable if the transferee acquires a valid title to the moveable under the new law. See Albert V. Dicey, J.H.C. Morris & Lawrence Collins, *Supra* note 190 at 1171~1180 (Rule 125); Peter North & Fawcett J.J., *Supra* note 190 at 942~945; Marvin Bare *et al.*, *Supra* note 190 at 764; and Eugene Scholes *et al.*, *Supra* note 190 at 1080.

Account holder A from bringing another law suit against Intermediary X and Intermediary Y³¹⁶ and being determined as having valid interests on the intermediated securities according to law X.³¹⁷ Accordingly, there is an open possibility in this assumption³¹⁸ that Intermediary Y suffers a “double liability” to Account holder B according to law Y and Account holder A according to law X, if there is no relevant provision in the account agreement or regulations for the intermediated system which reallocates the risk of such double liability to Account holder B, or divides out the risk to all other account holders of Intermediary Y or other intermediaries that participate in the same intermediated system in state Y.³¹⁹ However, such risk of the double liability of an intermediary has always existed in respect of international securities transactions in the multi-tiered cross-border intermediated system. It has also been well recognised by the participants of the international intermediated system.³²⁰

As mentioned earlier,³²¹ Ooi interestingly tries to address the Page 37 problem by quite a different methodology from that adopted by the Convention and the Explanatory Report. According to Ooi’s approach, some of the Article 2.1 issues are governed by the transferor’s law and the others are by the transferee’s law based on the *lex creationis*, that is the law which created the thing. If this approach is adopted,

³¹⁶ It would be unlikely that Account holder A sues Account holder B in another court again, for the court will also examine the case according to the same law Y and render some legal opinions from a court in that state. As well, the court would also consider the previous result of the law suit raised by Account holder A.

³¹⁷ The Permanent Bureau distributed the working document which includes such view in the third Diplomatic meeting and the same explanation is reproduced in the Explanatory Report. See HCCH Permanent Bureau, Work. Doc. No 11 of the Third Commission on 4 December 2002 – *Observation by the Permanent Bureau* at 402~403 (the pages from HCCH, *Proceedings of the Nineteenth Session*, Tom II published by Martinus Jijhoff Publishers Leiden, The Netherlands, 2006). See also the Explanatory Report at 82~87.

³¹⁸ In the reality of book-entry transfer practices, however, it is hard to find a real case of the Page 37 problem happening and accordingly to find the double liability it entails. See further discussion below.

³¹⁹ See the Explanatory Report at 86 (para. 4-48).

³²⁰ See *ibid.* (para. 4-49).

³²¹ See *Supra* note 272.

she asserts that the risk of double interests should not arise.³²² As the rationale, Ooi argues that the choice of law rule for a tangible moveable is inappropriate for intermediated securities, for the facts underlying the principle in *Winkworth*³²³ is fundamentally different and interests held under the intermediated system are not transferred from person to person in the way that property rights in tangible movables are transferred.³²⁴ She also comments that the Convention can give none of the *ex ante* certainty which is part of the Convention's objectives, if the Convention Law determines that Account holder B cannot acquire greater rights than the transferor has³²⁵ and thus Account holder B should look to upper chains until rights of account holders are not derivative from any previous owner.³²⁶

As for the first matter related to the new or secondary *lex situs* rule in the case of tangible movables removed to a new place, it should be stressed that to recognise multiple dispositions in the chain of intermediaries is an indispensable measure in the private international law analysis, independent of substantive law views as to a securities transaction in the cross-border intermediated system. It is a commonly known fact that each intermediary relates only to its counterpart intermediary in the practice of international securities settlements. It means that, for instance in Figure 7, ICSD Z does not know the details of the collateral transaction between Account holder A and B. This is because an intermediary, most of the time, relays the transfer (settlement) information without particular information of the ultimate transferor or transferee, mainly because of privacy and confidentiality laws. Also, practices to send settlement orders also differ depending on intermediaries. For example, some intermediaries input settlement orders per transaction but others send transfer orders

³²² See Maisie Ooi, *Supra* note 37 at 302 & *Supra* note 270 at 489.

³²³ *Winkworth v. Christie Manson & Woods Ltd*, [1998] Ch 496.

³²⁴ See Maisie Ooi, *Supra* note 37 at 302 & *Supra* note 270 at 489.

³²⁵ This is called the *nemo potest* principle. It came from the following legal maxim: *Nemo plus juris ad alienum transfere potest, quam ispe habent* (One cannot transfer to another a right which he has not). The *nemo potest* rule is the same as the *nemo dat* principle, of which legal maxim is *nemo dat quod non habet*, meaning that no one can give what one does not have.

³²⁶ See Maisie Ooi, *Supra* note 270 at 482.

in a total amount or number basis to their upper tier intermediary. Thus, the upper tier intermediary is not in a position to know about other transactions. They treat only their immediate counterpart intermediaries below and count each settlement order as one disposition under their liability. For these reasons, such facts should be accommodated in the private international law analysis and thus the new or secondary law approach analogously employed to the interpretation of the Convention should not be devaluated, since each disposition made in each level of an intermediary are separately partitioned to other dispositions in other stages of intermediaries, as a tangible moveable is transferred separately from person to person. On the other hand, according to Ooi's assertion, the risk of the double interests should not arise, if her methodology is taken. However, a similar problem such as in the Super-PRIMA could arise. Suppose that Account holder A holds 100 shares in each Account α , Account β , and Account γ , totalling 300 shares. Each account is governed by law α , law β , and law γ , respectively. Further assume that Account holder A now transfers all 300 shares to Account holder B whose account agreement is governed by law Y as in Figure 7. According to the Convention's interpretive method, all the Article 2.1 issues are governed by law Y, since the shares are credited to the account of Account holder B. However, according to Ooi's approach, which law should be relevant to this case? What if law α says Account holder A still has a valid interest, while law β and law γ say that Account holder B holds a valid interest? Which law should then govern the dispositions in the other tiers of intermediaries? Yes, as she maintains, there would be no risk of the double liability but her methodology cannot logically explain why a certain law should govern in this case. Further, her methodology does not tell us why law A (instead of law B) as the *lex creationis* is relevant to the matter of the validity of the intermediated securities credited to the account of Account holder B in Figure 7. As Ooi herself also points out, the transfers between the intermediaries are not even of a single interest in the intermediated securities and thus the securities credited to the account of Account holder B are not the same intermediated securities as Account holder A's.³²⁷ In this case, the securities credited to Account holder B's

³²⁷ Maisie Ooi, *Supra* note 37 at 301 (para. 13.33 & 13.34).

account have nothing to do with the intermediated securities previously held by Account holder A. Thus, the *lex creationis* is only related to the relationship between Account holder B and Intermediary Y. Further, though Ooi did not address the question of which law should govern the dispositions of other tiers of intermediaries, if law X governs some issues and law Y governs others as to even such dispositions, her approach cannot surmount the critiques that ICSD Z never knows the existence of Account holders A and B. Much worse, it has exactly the same defect as the Super-PRIMA, which is that proprietary matters cannot be determined at a later time retrospectively by an unknown law to ICSD Z.

As regards the second issue related to the *nemo potest* principle, it looks as if Ooi characterises the issue as the incidental question, but does not present a solution. She simply tries to explain the principle that such an incidental issue is governed by the choice of law rules of the forum or those of the law that governs the main question, not by substantive law.³²⁸ However, this derivative interest issue is not drafted as a matter of the incidental question as many cases as to tangible movables,³²⁹ and if the issue here is not formulated as whether the transferee obtained a valid title to the securities, but as whether Account holder B's interest in the intermediated securities extinguishes or has priority over Account A's interest as in Article 2.1d, then the law as for the account to which securities are credited shall govern that issue. If the law determined by the Convention, however, has to look to the other Convention Laws in order to identify what rights others transferred to Account holder B, it is not due to the Convention but the substantive laws determined

³²⁸ See Maisie Ooi, *Supra* note 270 at 481~482 (emphasising that “none has however suggested, as the Report appears to, that the selection of the applicable law for the incidental question can be made by a substantive law, as it would be unusual for substantive law to determine a choice of law question.”).

³²⁹ See Albert V. Dicey, J.H.C. Morris & Lawrence Collins, *Supra* note 190 at 1174~1180; Peter North & Fawcett J.J., *Supra* note 190 at 945~948; and Marvin Bare *et al.*, *Supra* note 190 at 776~779. It is also worth noting that the issue of the derivative claim is different from the issue of an incidental question. See Albert V. Dicey, J.H.C. Morris & Lawrence Collins, *Supra* note 190 at 53 (para. 2-047); and Peter North & Fawcett J.J., *Supra* note 190 at 47 as to the requirements for the incidental question.

by the Convention, as the Explanatory Report well indicates.³³⁰ Furthermore, in practice, the derivative claim issue may not be a critical issue in most jurisdictions, as settlement finality is ensured in most securities markets.³³¹

2. Internalisation of Purely Domestic Securities Transactions

As the Convention allows party autonomy for the law applicable to proprietary issues, the question of multiple connecting factors, the Page 37 problem, can happen even within the same intermediary if its customers choose different laws, though it would be unusual but may be possible due to the bargaining power in the securities business. If this happens, it might cause purely domestic securities transactions, which have usually been governed by one single law where the intermediary's office is located, to be internationalised (*e.g.*, the case where all elements like account holders, securities, intermediaries, collateral agreement, etc. are of one jurisdiction except a governing law clause of an account agreement). Because of the internationalisation of domestic securities transactions, diversity of laws could disturb or impair the systemic stability of the national intermediated system in the state,³³² and the frequency of the double liability problem might increase. Therefore, it becomes important to identify in what *real* case the double liability problem can be manifested without highly unusual assumptions.

³³⁰ See the Explanatory Report at 87 (para. 4-51).

³³¹ Where the Unidroit draft convention is finalised in the near future, it is expected that the Unidroit convention on Intermediated Securities will provide more certainty on this matter.

³³² The legal assessment document of the EU as to the Hague Securities Convention identifies that this diversity of laws is the only somewhat problematic aspect of the Convention, since it is critical to systemic stability at large. However, it stresses that “the application of a diversity of laws can also be a current risk, inasmuch as the difficulties in identifying the jurisdiction whose law governs the proprietary aspects of securities” and that “diversity of laws in securities settlements systems would be avoided as it would not be possible for a system to be eligible for designation under the [Settlement Finality Directive] unless only one Convention law is used.” See European Commission, “Legal Assessment of Certain Aspects of the Hague Securities Convention” SEC(2006)910 at 17~19 & 21.

Above all, the general securities transactions through formal securities exchanges are settled after multilateral netting,³³³ (in which case, it is almost impossible to locate sellers and buyers³³⁴) instead of trade-by-trade settlement.³³⁵ Besides, it is not expected that designation of different laws would be allowed in the securities settlement system in a state, given that it can be considered to better serve the interests of all the system participants to provide system stability by regulating the system process through one law, reducing the systemic risk associated with the settlement process³³⁶ than to allow individual freedom (party autonomy) to choose multiple different laws. Consequently, a case triggering the double liability could be reduced to the cases where settlements are processed transaction by transaction in a gross settlement basis, like over the counter transactions or individual securities collateral transactions between two or more parties.

³³³ Multilateral netting means an arrangement among three or more parties to net their obligations. Netting on a multilateral basis is arithmetically achieved by summing each participant's bilateral net positions with the other participants to arrive at a multilateral net position. Such netting is conducted through a CCP, Central Counterparty, like a clearing house that is legally substituted as the buyer to every seller and as the seller to every buyer. The multilateral net position represents the bilateral net position between each participant and the CCP. See the BIS Glossary at 26.

³³⁴ There might be a case that the seller and the buyer could be identified when the sellers and the buyers of specific securities are not many. However, legally speaking, the seller and the buyer become the CCP where the CCP system is set up, since the CCP becomes the seller vis-à-vis the buyer and vice versa.

³³⁵ More commonly, it is called gross settlement in which transactions are settled per individual transaction without netting.

³³⁶ See European Central Bank & Committee of European Securities Regulators, "Standards for Securities Clearing and Settlement in the European Union" (September 2004 Report) at 18~19 (advising that "only one legal system is chosen to govern the proprietary aspects of all securities held on the participants accounts with the system, and similarly only one to govern the contractual aspects of the relationship between the system and each of its participants." Further, it suggests that "[i]deally, the law chosen should be identical to the law governing the system, in order to safeguard systemic finality, certainty and transparency."). See also European Commission, *Supra* note 332 at 18 (describing that "[i]t has been widely recognised that the common interest of both the public and the private sectors in smooth operations within systems makes it highly unlikely that any system operator would agree to different Convention laws among its members, [and] further more, there being detailed supervision at the national level of the operation of systems, any agreement to operate accounts governed by different systems of law must first be investigated as to resulting legal risks and there nature must be demonstrated to the relevant supervisor.").

The one possible case this author can find is the case where Investor A goes into insolvency and the insolvency administrator avoids the disposition made by Investor A to Investor B before the opening of the insolvency, treating the disposition as a preference or a transfer in fraud of creditors. However, it is the exact fact pattern to which Article 8.2 applies and therefore, it is governed by the *lex concursus*. As in other instances, if Investor A transferred securities to Investor B but Investor B did not pay, it is doubtful whether there exists any substantive law for intermediated securities and systems that regards Investor B's interest as valid. Further, if Bank X, which is the relevant intermediary of Investor A, transferred the securities without authority or by mistake to Investor B's account, the double liability does not matter in this case, for the transfer was made by Bank X's fault. Finally, if Investor A enters into a tri-party control agreement with Bank X and Collateral taker Z and at a later time, Investor A sells the collateralised securities to Investor B, in this case Investor B may acquire the securities by the bona fide purchase rule or the adverse claim severance rule. Again however, the double liability does not occur, since there is a fault done by Bank X, breaking the control agreement.

Therefore, it is not desirable to make an issue of the double liability problem case which is highly unlikely to happen. Rather as more certainty and predictability are brought by the Convention to cross-border securities transactions, reducing relevant costs and time, it is understood that the Page 37 problem and its by-product, the double liability problem, would not be an obstacle to cope with.

3. Legal Nature of Intermediated Securities and Application Scope of Substantive Law

The Hague Securities Convention was drafted under the supposition that it is possible to create private international law rules on proprietary issues with regard to intermediated securities without further harmonisation of substantive law rules thereon. It is quite a natural supposition, since the very reason for the necessity of conflict of laws rules lies on the fact that substantive law is different from jurisdiction to jurisdiction.

However, there are sceptical opinions as to this supposition³³⁷ and as to the effect of the application of the Convention Law³³⁸ in Korea. The instance raised is as follows:³³⁹ Investor A holds 100 shares through Bank X, and Bank X in turn holds them with KSD. The governing laws of the account agreements are New York law between Investor A and Bank X and Korean law between Bank X and KSD. As discussed in Chapter 3, the legal nature of the intermediated securities Investor X has is determined by New York law according to Article 4.1 and Article 2.1 and it is a security entitlement. However, Kim raises a question of how Investor A can obtain the security entitlements in the case where Bank X does not hold any interest in the securities according to Korean law, because an intermediary is a mere account manager or conduit and holds no interest in the underlying securities according to Korean law. Thus, Investor A holds nothing according to New York law under the basic concept of security entitlement.³⁴⁰ With respect to this fact pattern, another similar question can arise whether Bank X can then obtain co-ownership interests, or if not, who holds co-ownership rights under Korean law.³⁴¹

³³⁷ See e.g., Isu Kim, *A Study on the Reconstruction of Indirect Securities Holding Systems* (in Korean) (Ph.D. Thesis, Seoul National University Graduate School of Law, 2003) [unpublished] at 218 (asserting that “it is reasonable that the place of the securities account is to be determined by the law applicable to legal relations related to investors of intermediated securities and it is necessary and effective to reconstruct the status of intermediated securities holders based on the tiered trust structure in order to adopt the PRIMA principle.”).

³³⁸ See Kwang Hyun Suk, *Supra* note 268 at 87.

³³⁹ This illustration is a variation made by Kim. See Isu Kim, “Japan’s Response and Discussion of Japanese Substantive Law and Private International Law with Respect to the Hague Securities Convention (in Korean)” [2005] Korea Private International Law Journal Vol. 11 at 155~156.

³⁴⁰ Security entitlement is both a package of personal rights against the securities intermediary and an interest in *the property held by the securities intermediary*.

³⁴¹ See Kwang Hyun Suk, “Important Issues of the Hague Securities Convention and Impacts on Cross-border Securities Transactions (in Korean)” [2005] Korea Private International Law Journal Vol. 11 at 48~51.

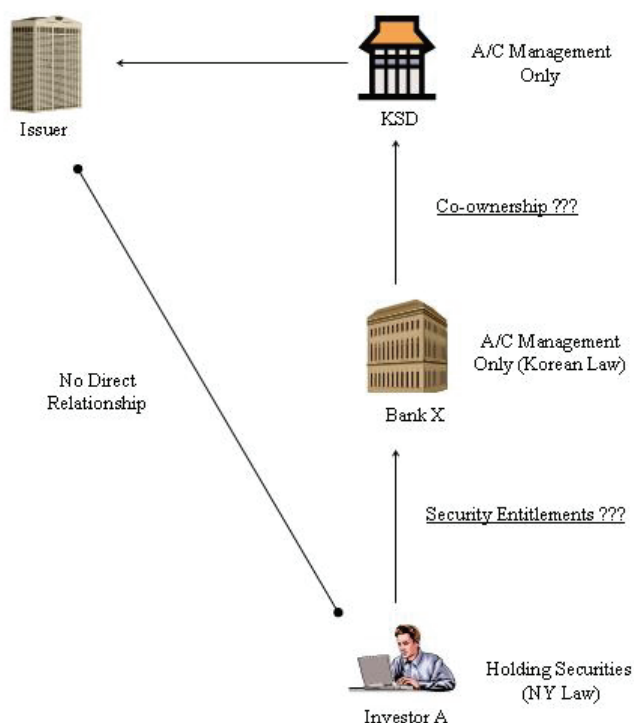


Figure 8. Illustration of Different Governing Laws

It is considered that it is not the issue of determination of the governing law (the conflict of laws issue), but the issue of the effect of the Convention Law. Nonetheless, this issue could come to be critical, when a state considers adoption of the Convention, for any litigation is after all judged by the substantive law determined by conflict of laws rules. Unlike the UCC model, the Korean legal regime of the intermediated system including that of the Japanese system is fragmented and different depending on whether a securities transaction is domestic or international.³⁴² In this situation, there would arise several issues. The first issue is which statute or regulation is relevant to the transaction. The second issue is to what extent the relevant statute or regulation should apply. In other words, this is a question of which provisions of the statute or regulation are applicable. The third issue is whether the statute or regulation should apply directly or analogically.

³⁴² International securities transactions include trades of foreign securities listed on the domestic exchanges.

According to this author's mind, these questions could broadly be answered by the standpoint of the functional approach on which the Hague Securities Convention was built up. If then, a corollary of the functional approach can result in the conclusion that the substantive rules should be analogically applicable and most of the relevant rules will be the ones related to book-entry transfers, requirements of perfection and so on. Therefore, the question of how Investor A can hold security entitlements even though his intermediary (Bank X) does not hold any property interests under Korean law can be answered as the Convention functionally approaches the issue, and identifies Investor A's interests according to New York law based on the fact that his holdings are credited on Investor A's account without further investigation of whether Investor A's intermediary, Bank X holds proprietary interests under his relevant governing law.³⁴³

E. Evaluation of the Hague Securities Convention

It has been ancient law for the *lex situs* to be a connecting factor in determining the law applicable to proprietary issues of immovable and movable property. The connecting factor, the PRIMA which is adopted in the Settlement Finality Directive and the Collateral Directive in the EU is also a fictional extension of the *lex situs* rule to intermediated securities by deeming the intermediated securities in question as located or maintained at the securities account maintained by the relevant intermediary of the account holder.

However, the Hague Securities Convention could not help but abandon the original concept of the PRIMA as its primary rule due to the practical facts that maintenance of investor's securities account is performed in various jurisdictions in

³⁴³ If this question can be regarded as an incidental question, though unlikely, the incidental question whether Bank X holds property interests satisfying Investor A's interests could be determined by *lex causae* (New York law).

practice, and further there could exist some cases where no physical locations can be determined when all the account maintenance is taken in cyber space.³⁴⁴

According to Savigny's private international law system which significantly has affected codification of each state's current PIL rules and PIL analysis methods, a legal question in private law should be governed by the law which has the closest connection to the legal issues questioned³⁴⁵ and an important exception to such a general rule is party autonomy in contract.³⁴⁶ The reason to allow party autonomy is that it is difficult to locate generally objective closest connecting factors to various kinds of contracts and party autonomy can give predictability to the parties of the contract concerned.³⁴⁷

In this vein, the move of the primary connecting factor from the *lex situs* to limited party autonomy in the Hague Securities Convention can be justified and seen as indispensable, for the intermediated system requires more factual centred conflict of laws rules which are intuitively clear and predictable in rapid securities transactions. The industry practices of securities account maintenance also reinforce the indispensability. Likewise, it seems appropriate to name the Convention's short title as the Hague Securities Convention, instead of the Hague PRIMA convention which could shed wrong information that the Convention's primary connecting factor

³⁴⁴ See e.g., the Explanatory Report at 75 (para. 4-24); Roy Goode, "Rule, Practice, and Pragmatism in Transnational Commercial Law" (2005) 54 I.C.L.Q. 539, 543 (discussing further difficulty as to the original PRIMA concept as "[t]he attribution of a *situs* to an intangible asset, which has no physical location, is a purely legal construct and, moreover, one which serves no useful purpose, for the deemed *situs* varies according to the nature of the intangible, so that the *lex situs* rule does not represent an organizing principle and is thus an unnecessary step which should be discarded in favour of a direct rule fashioned for the particular type of intangible in question.").

³⁴⁵ See Masato Dogauchi, "Private International Law on Intellectual Property: A Civil Law Overview" (January 2001, WIPO Forum), online: WIPO < http://www.wipo.int/meetings/en/details.jsp?meeting_id=4243 > at 3.

³⁴⁶ See Axel Flessner & Hendrik Verhagen, *Assignment in European Private International Law: Claims as Property and the European Commission's Rome I Proposal* (München: Sellier. European Law Publishers, 2006) at 21~36 as for advantages of party autonomy and applicability to property law.

³⁴⁷ Masato Dogauchi, *Supra* note 345 at 6 (footnote 16).

is a place of the relevant intermediary's office or a place of the relevant securities account.³⁴⁸

It is also true that there have been several somewhat sentimentally negative concerns on the Hague Securities Convention,³⁴⁹ especially on the primary rule which firstly introduces party autonomy to proprietary issues in an international instrument. However, as the legal assessment document of the Convention prepared by the European Commission objectively confirmed, the Convention was not drafted only to favour certain law, especially the UCC in the U.S. As explored above, the Convention is composed of pure conflict of laws rules and drafted neutrally, working for various types of intermediated systems including that of Canada, the U.K., the U.S., Japan, and Korea.

Overall, the Hague Securities Convention can be evaluated as a result of the compromise between the one force that tried to remain at least in the marginal border that had been drawn by Savigny's conflict of laws system and the other force that considered the special fact involved in the intermediated system cannot be contained in the traditional rule and vindicated the practically uneschewable necessity to prepare for all novel rules to proprietary matters in an intermediated system. Though the result is a defeat of the former, which succeeded in leaving just a futile tail of the Savigny's system, the Qualifying Office requirement, however, this compromise should not be underestimated and should not be thought of as a win for only one side of the forces as well. In practical reality in the securities industry, it is rather believed

³⁴⁸ For this reason, this author named the approach of the primary rule as the "Account Agreement Approach (AAA)."

³⁴⁹ See Christophe Bernasconi & Harry C Sigman, "Myths about the Hague Convention Debunked" (November 2005) *I.F.L.R.*; Karl Kreuzer, "European Responses to the Convention and Discussion of Underlying Substantive Law and Current PIL in Europe" [2005] *Korea Private International Law Journal* Vol. 11 at 82-96; Letter from HCCH, Permanent Bureau to the European Commission (26 November 2004) concerning issues raised by the European Banking Federation with regard to the Hague Securities Convention; Letter from ISDA to European Commission (26 July 2004) on the Hague Securities Convention; and Richard Potok, *Supra* note 218 at 219-220 as to the dissenting and defending opinions.

that the Hague Securities Convention will bring a synergic win-win result by providing *ex ante* certainty and predictability to all the market players.

VI. Conclusion

Intermediated systems play a pivotal role in the securities market, ensuring efficiency and stability. Without intermediated systems, today's huge volume of securities transactions could not be imaginable. Through intermediated systems, the securities holding pattern was dramatically changed from direct holdings of securities to intermediated (or indirect) holdings coupled with the methods of immobilisation and dematerialisation in which the meaning and the functions of physical securities have faded away.

The securities industry practices of intermediation systems have been developed with rapid speed with the advance of the information technology, but corresponding legal reforms have not been made in an adequate way and legal aspects of intermediated systems have been relatively neglected by scholars and lawyers except the minimal personnel who are engaged in intermediated systems.

Since the late 1980s, however, supervisory authorities and private sectors of the securities industry have come to the realisation of the importance of intermediated securities and systems, and have begun to issue recommendations to improve the intermediated system of each state. The pioneer was the recommendations of the International Securities Services Association (ISSA) in 1989, followed by the Group of Thirty's 9 recommendations in 1989 and 2003 the recommendations of the ISSA in 1995 and 2000, the recommendations of the CPSS (Committee for Payment and Settlement Systems) and the IOSCO (International Organization of Securities Commissions) in 2001 and 2005, and the standards of the CESR (Committee of European Securities Regulators) and the ESCB (European System of Central Banks) in 2004.³⁵⁰ These recommendations show how important it is to establish legally sound and reliable intermediated systems in the era of the information technology and globalisation.

³⁵⁰ See Korea Securities Depository, *The Clearing and Settlement Systems of Securities Markets* (in Korean) (Seoul: KSD, 2006) at 76~110 with respect to the details of the recommendations.

In this respect, this author first of all analysed the meaning of securities in the U.S., the U.K., Japan and Korea and found out that it was most fundamental to shape the selected state's legal frameworks of the intermediated systems in substantive law and private international law.

In the substantive law analysis, Canada's USTA, which is modelled on the UCC of the U.S., was evaluated as a well-structured wholesale revision, given that both the Canadian and U.S markets are much interlinked and both legal traditions are rooted on the common law system. Even in the case of Quebec that has a civil law tradition, this author stressed early implementation of legal regime similar to the USTA, for a harmonised rule in all the provinces in Canada is requested to bring more certainty and clarity to securities transactions in Canada. As evaluated by the Financial Market Law Committee of the U.K., on the other hand, the UCC model is the most advanced market-friendly substantive rules for an intermediated system.

However, this author concluded that the UCC model might not be the best one for restructuring the Korean intermediated system, given that legal tradition, market practice, and the IT environment of Korea are different from those in the U.S. This author also maintained that the new Japanese legal framework is not attractive, since it lacks cross-border compatibility and has fragmented rules under which foreign shares listed on Japanese markets and off-shore securities transactions are governed by a different legal regime.³⁵¹

In the private international law analysis, it was found out that the current conflict of laws rules of each state are not satisfactory to provide predictability and certainty to cross-border securities transactions. Therefore it suggests each state sign the Hague Securities Convention in its earliest time.

With respect to some interpretative and practical issues as for the Hague Securities Convention, this thesis presented three issues: 1) the Page 37 problem and the double liability problem; 2) internationalisation of purely domestic securities transactions; and 3) the legal nature of intermediated securities and application scope

³⁵¹ However, if the Unidroit draft convention on intermediated securities is adopted, many of these problems could be solved.

of substantive law. In the analyses, it was determined that all of them are not critical to prevent states from adopting the Convention, let alone the fact that the critical opinions on the Convention are not well founded.

Needless to say, there is an urgent need to establish a legally sound and reliable intermediated system from both the substantive law and private international law perspective in Canada and Korea. It can be evaluated that Canada that has prepared the USTA put a significant step towards it. The future substantive law and PIL rules of a new Korean intermediated system should also be inclusive, internally sound, and internationally compatible rules, friendly to markets and users, and the rules clearly providing *ex ante* certainty and predictability.

APPENDIX

CONVENTION ON THE LAW APPLICABLE TO CERTAIN RIGHTS IN RESPECT OF SECURITIES HELD WITH AN INTERMEDIARY

The States signatory to the present Convention,

Aware of the urgent practical need in a large and growing global financial market to provide legal certainty and predictability as to the law applicable to securities that are now commonly held through clearing and settlement systems or other intermediaries,

Conscious of the importance of reducing legal risk, systemic risk and associated costs in relation to cross-border transactions involving securities held with an intermediary so as to facilitate the international flow of capital and access to capital markets,

Desiring to establish common provisions on the law applicable to securities held with an intermediary beneficial to States at all levels of economic development,

Recognising that the “Place of the Relevant Intermediary Approach” (or PRIMA) as determined by account agreements with intermediaries provides the necessary legal certainty and predictability,

Have resolved to conclude a Convention to this effect, and have agreed upon the following provisions –

CHAPTER I – DEFINITIONS AND SCOPE OF APPLICATION

Article 1 Definitions and interpretation

1. In this Convention –

- a) “securities” means any shares, bonds or other financial instruments or financial assets (other than cash), or any interest therein;
- b) “securities account” means an account maintained by an intermediary to which securities may be credited or debited;
- c) “intermediary” means a person that in the course of a business or other regular activity maintains securities accounts for others or both for others and for its own account and is acting in that capacity;
- d) “account holder” means a person in whose name an intermediary maintains a securities account;
- e) “account agreement” means, in relation to a securities account, the agreement with the relevant intermediary governing that securities account;
- f) “securities held with an intermediary” means the rights of an account holder resulting from a credit of securities to a securities account;
- g) “relevant intermediary” means the intermediary that maintains the securities

account for the account holder;

h) “disposition” means any transfer of title whether outright or by way of security and any grant of a security interest, whether possessory or non-possessory;

i) “perfection” means completion of any steps necessary to render a disposition effective against persons who are not parties to that disposition;

j) “office” means, in relation to an intermediary, a place of business at which any of the activities of the intermediary are carried on, excluding a place of business which is intended to be merely temporary and a place of business of any person other than the intermediary;

k) “insolvency proceeding” means a collective judicial or administrative proceeding, including an interim proceeding, in which the assets and affairs of the debtor are subject to control or supervision by a court or other competent authority for the purpose of reorganisation or liquidation;

l) “insolvency administrator” means a person authorised to administer a reorganisation or liquidation, including one authorised on an interim basis, and includes a debtor in possession if permitted by the applicable insolvency law;

m) “Multi-unit State” means a State within which two or more territorial units of that State, or both the State and one or more of its territorial units, have their own rules of law in respect of any of the issues specified in Article 2(1);

n) “writing” and “written” mean a record of information (including information communicated by teletransmission) which is in tangible or other form and is capable of being reproduced in tangible form on a subsequent occasion.

2. References in this Convention to a disposition of securities held with an intermediary include –

a) a disposition of a securities account;

b) a disposition in favour of the account holder’s intermediary;

c) a lien by operation of law in favour of the account holder’s intermediary in respect of any claim arising in connection with the maintenance and operation of a securities account.

3. A person shall not be considered an intermediary for the purposes of this Convention merely because –

a) it acts as registrar or transfer agent for an issuer of securities; or

b) it records in its own books details of securities credited to securities accounts maintained by an intermediary in the names of other persons for whom it acts as manager or agent or otherwise in a purely administrative capacity.

4. Subject to paragraph (5), a person shall be regarded as an intermediary for the purposes of this Convention in relation to securities which are credited to securities accounts which it maintains in the capacity of a central securities depository or which are otherwise transferable by book entry across securities accounts which it maintains.

5. In relation to securities which are credited to securities accounts maintained by a person in the capacity of operator of a system for the holding and transfer of such securities on records of the issuer or other records which constitute the primary record of entitlement to them as against the issuer, the Contracting State under whose law those securities are constituted may,

at any time, make a declaration that the person which operates that system shall not be an intermediary for the purposes of this Convention.

Article 2 Scope of the Convention and of the applicable law

1. This Convention determines the law applicable to the following issues in respect of securities held with an intermediary –

- a)* the legal nature and effects against the intermediary and third parties of the rights resulting from a credit of securities to a securities account;
- b)* the legal nature and effects against the intermediary and third parties of a disposition of securities held with an intermediary;
- c)* the requirements, if any, for perfection of a disposition of securities held with an intermediary;
- d)* whether a person's interest in securities held with an intermediary extinguishes or has priority over another person's interest;
- e)* the duties, if any, of an intermediary to a person other than the account holder who asserts in competition with the account holder or another person an interest in securities held with that intermediary;
- f)* the requirements, if any, for the realisation of an interest in securities held with an intermediary;
- g)* whether a disposition of securities held with an intermediary extends to entitlements to dividends, income, or other distributions, or to redemption, sale or other proceeds.

2. This Convention determines the law applicable to the issues specified in paragraph (1) in relation to a disposition of or an interest in securities held with an intermediary even if the rights resulting from the credit of those securities to a securities account are determined in accordance with paragraph (1)(a) to be contractual in nature.

3. Subject to paragraph (2), this Convention does not determine the law applicable to –

- a)* the rights and duties arising from the credit of securities to a securities account to the extent that such rights or duties are purely contractual or otherwise purely personal;
- b)* the contractual or other personal rights and duties of parties to a disposition of securities held with an intermediary; or
- c)* the rights and duties of an issuer of securities or of an issuer's registrar or transfer agent, whether in relation to the holder of the securities or any other person.

Article 3 Internationality

This Convention applies in all cases involving a choice between the laws of different States.

CHAPTER II –APPLICABLE LAW

Article 4 *Primary rule*

1. The law applicable to all the issues specified in Article 2(1) is the law in force in the State expressly agreed in the account agreement as the State whose law governs the account agreement or, if the account agreement expressly provides that another law is applicable to all such issues, that other law. The law designated in accordance with this provision applies only if the relevant intermediary has, at the time of the agreement, an office in that State, which –

a) alone or together with other offices of the relevant intermediary or with other persons acting for the relevant intermediary in that or another State –

i) effects or monitors entries to securities accounts;

ii) administers payments or corporate actions relating to securities held with the intermediary; or

iii) is otherwise engaged in a business or other regular activity of maintaining securities accounts; or

b) is identified by an account number, bank code, or other specific means of identification as maintaining securities accounts in that State.

2. For the purposes of paragraph (1)(a), an office is not engaged in a business or other regular activity of maintaining securities accounts –

a) merely because it is a place where the technology supporting the bookkeeping or data processing for securities accounts is located;

b) merely because it is a place where call centres for communication with account holders are located or operated;

c) merely because it is a place where the mailing relating to securities accounts is organised or files or archives are located; or

d) if it engages solely in representational functions or administrative functions, other than those related to the opening or maintenance of securities accounts, and does not have authority to make any binding decision to enter into any account agreement.

3. In relation to a disposition by an account holder of securities held with a particular intermediary in favour of that intermediary, whether or not that intermediary maintains a securities account on its own records for which it is the account holder, for the purposes of this Convention –

a) that intermediary is the relevant intermediary;

b) the account agreement between the account holder and that intermediary is the relevant account agreement;

c) the securities account for the purposes of Article 5(2) and (3) is the securities account to which the securities are credited immediately before the disposition.

Article 5 *Fall-back rules*

1. If the applicable law is not determined under Article 4, but it is expressly and unambiguously stated in a written account agreement that the relevant intermediary entered into the account agreement through a particular office, the law applicable to all the issues specified in Article 2(1) is the law in force in the State, or the territorial unit of a Multi-unit State, in which that office was then located, provided that such office then satisfied the

condition specified in the second sentence of Article 4(1). In determining whether an account agreement expressly and unambiguously states that the relevant intermediary entered into the account agreement through a particular office, none of the following shall be considered –

- a)* a provision that notices or other documents shall or may be served on the relevant intermediary at that office;
- b)* a provision that legal proceedings shall or may be instituted against the relevant intermediary in a particular State or in a particular territorial unit of a Multi-unit State;
- c)* a provision that any statement or other document shall or may be provided by the relevant intermediary from that office;
- d)* a provision that any service shall or may be provided by the relevant intermediary from that office;
- e)* a provision that any operation or function shall or may be carried on or performed by the relevant intermediary at that office.

2. If the applicable law is not determined under paragraph (1), that law is the law in force in the State, or the territorial unit of a Multi-unit State, under whose law the relevant intermediary is incorporated or otherwise organised at the time the written account agreement is entered into or, if there is no such agreement, at the time the securities account was opened; if, however, the relevant intermediary is incorporated or otherwise organised under the law of a Multi-unit State and not that of one of its territorial units, the applicable law is the law in force in the territorial unit of that Multi-unit State in which the relevant intermediary has its place of business, or, if the relevant intermediary has more than one place of business, its principal place of business, at the time the written account agreement is entered into or, if there is no such agreement, at the time the securities account was opened.

3. If the applicable law is not determined under either paragraph (1) or paragraph (2), that law is the law in force in the State, or the territorial unit of a Multi-unit State, in which the relevant intermediary has its place of business, or, if the relevant intermediary has more than one place of business, its principal place of business, at the time the written account agreement is entered into or, if there is no such agreement, at the time the securities account was opened.

Article 6 Factors to be disregarded

In determining the applicable law in accordance with this Convention, no account shall be taken of the following factors –

- a)* the place where the issuer of the securities is incorporated or otherwise organised or has its statutory seat or registered office, central administration or place or principal place of business;
- b)* the places where certificates representing or evidencing securities are located;
- c)* the place where a register of holders of securities maintained by or on behalf of the issuer of the securities is located; or
- d)* the place where any intermediary other than the relevant intermediary is located.

Article 7 Protection of rights on change of the applicable law

1. This Article applies if an account agreement is amended so as to change the applicable law under this Convention.
2. In this Article –
 - a) “the new law” means the law applicable under this Convention after the change;
 - b) “the old law” means the law applicable under this Convention before the change.
3. Subject to paragraph (4), the new law governs all the issues specified in Article 2(1).
4. Except with respect to a person who has consented to a change of law, the old law continues to govern –
 - a) the existence of an interest in securities held with an intermediary arising before the change of law and the perfection of a disposition of those securities made before the change of law;
 - b) with respect to an interest in securities held with an intermediary arising before the change of law –
 - i) the legal nature and effects of such an interest against the relevant intermediary and any party to a disposition of those securities made before the change of law;
 - ii) the legal nature and effects of such an interest against a person who after the change of law attaches the securities;
 - iii) the determination of all the issues specified in Article 2(1) with respect to an insolvency administrator in an insolvency proceeding opened after the change of law;
 - c) priority as between parties whose interests arose before the change of law.
5. Paragraph (4)(c) does not preclude the application of the new law to the priority of an interest that arose under the old law but is perfected under the new law.

Article 8 Insolvency

1. Notwithstanding the opening of an insolvency proceeding, the law applicable under this Convention governs all the issues specified in Article 2(1) with respect to any event that has occurred before the opening of that insolvency proceeding.
2. Nothing in this Convention affects the application of any substantive or procedural insolvency rules, including any rules relating to –
 - a) the ranking of categories of claim or the avoidance of a disposition as a preference or a transfer in fraud of creditors; or
 - b) the enforcement of rights after the opening of an insolvency proceeding.

CHAPTER III – GENERAL PROVISIONS

Article 9 General applicability of the Convention

This Convention applies whether or not the applicable law is that of a Contracting State.

Article 10 Exclusion of choice of law rules (renvoi)

In this Convention, the term “law” means the law in force in a State other than its choice of law rules.

Article 11 Public policy and internationally mandatory rules

1. The application of the law determined under this Convention may be refused only if the effects of its application would be manifestly contrary to the public policy of the forum.
2. This Convention does not prevent the application of those provisions of the law of the forum which, irrespective of rules of conflict of laws, must be applied even to international situations.
3. This Article does not permit the application of provisions of the law of the forum imposing requirements with respect to perfection or relating to priorities between competing interests, unless the law of the forum is the applicable law under this Convention.

Article 12 Determination of the applicable law for Multi-unit States

1. If the account holder and the relevant intermediary have agreed on the law of a specified territorial unit of a Multi-unit State –
 - a) the references to “State” in the first sentence of Article 4(1) are to that territorial unit;
 - b) the references to “that State” in the second sentence of Article 4(1) are to the Multi-unit State itself.
2. In applying this Convention –
 - a) the law in force in a territorial unit of a Multi-unit State includes both the law of that unit and, to the extent applicable in that unit, the law of the Multi-unit State itself;
 - b) if the law in force in a territorial unit of a Multi-unit State designates the law of another territorial unit of that State to govern perfection by public filing, recording or registration, the law of that other territorial unit governs that issue.
3. A Multi-unit State may, at the time of signature, ratification, acceptance, approval or accession, make a declaration that if, under Article 5, the applicable law is that of the Multi-unit State or one of its territorial units, the internal choice of law rules in force in that Multi-unit State shall determine whether the substantive rules of law of that Multi-unit State or of a particular territorial unit of that Multi-unit State shall apply. A Multi-unit State that makes such a declaration shall communicate information concerning the content of those internal choice of law rules to the Permanent Bureau of the Hague Conference on Private International Law.
4. A Multi-unit State may, at any time, make a declaration that if, under Article 4, the applicable law is that of one of its territorial units, the law of that territorial unit applies only if the relevant intermediary has an office within that territorial unit which satisfies the condition specified in the second sentence of Article 4(1). Such a declaration shall have no effect on dispositions made before that declaration becomes effective.

Article 13 Uniform interpretation

In the interpretation of this Convention, regard shall be had to its international character and to the need to promote uniformity in its application.

Article 14 Review of practical operation of the Convention

The Secretary General of the Hague Conference on Private International Law shall at regular intervals convene a Special Commission to review the practical operation of this Convention and to consider whether any amendments to this Convention are desirable.

CHAPTER IV – TRANSITION PROVISIONS

Article 15 Priority between pre-Convention and post-Convention interests

In a Contracting State, the law applicable under this Convention determines whether a person's interest in securities held with an intermediary acquired after this Convention entered into force for that State extinguishes or has priority over another person's interest acquired before this Convention entered into force for that State.

Article 16 Pre-Convention account agreements and securities accounts

1. References in this Convention to an account agreement include an account agreement entered into before this Convention entered into force in accordance with Article 19(1). References in this Convention to a securities account include a securities account opened before this Convention entered into force in accordance with Article 19(1).
2. Unless an account agreement contains an express reference to this Convention, the courts of a Contracting State shall apply paragraphs (3) and (4) in applying Article 4(1) with respect to account agreements entered into before the entry into force of this Convention for that State in accordance with Article 19. A Contracting State may, at the time of signature, ratification, acceptance, approval or accession, make a declaration that its courts shall not apply those paragraphs with respect to account agreements entered into after the entry into force of this Convention in accordance with Article 19(1) but before the entry into force of this Convention for that State in accordance with Article 19(2). If the Contracting State is a Multi-unit State, it may make such a declaration with respect to any of its territorial units.
3. Any express terms of an account agreement which would have the effect, under the rules of the State whose law governs that agreement, that the law in force in a particular State, or a territorial unit of a particular Multi-unit State, applies to any of the issues specified in Article 2(1), shall have the effect that such law governs all the issues specified in Article 2(1), provided that the relevant intermediary had, at the time the agreement was entered into, an office in that State which satisfied the condition specified in the second sentence of Article 4(1). A Contracting State may, at the time of signature, ratification, acceptance, approval or accession, make a declaration that its courts shall not apply this paragraph with respect to an account agreement described in this paragraph in which the parties have expressly agreed that the securities account is maintained in a different State. If the Contracting State is a Multi-unit State, it may make such a declaration with respect to any of its territorial units.

4. If the parties to an account agreement, other than an agreement to which paragraph (3) applies, have agreed that the securities account is maintained in a particular State, or a territorial unit of a particular Multi-unit State, the law in force in that State or territorial unit is the law applicable to all the issues specified in Article 2(1), provided that the relevant intermediary had, at the time the agreement was entered into, an office in that State which satisfied the condition specified in the second sentence of Article 4(1). Such an agreement may be express or implied from the terms of the contract considered as a whole or from the surrounding circumstances.

CHAPTER V – FINAL CLAUSES

Article 17 Signature, ratification, acceptance, approval or accession

1. This Convention shall be open for signature by all States.
2. This Convention is subject to ratification, acceptance or approval by the signatory States.
3. Any State which does not sign this Convention may accede to it at any time.
4. The instruments of ratification, acceptance, approval or accession shall be deposited with the Ministry of Foreign Affairs of the Kingdom of the Netherlands, Depositary of this Convention.

Article 18 Regional Economic Integration Organisations

1. A Regional Economic Integration Organisation which is constituted by sovereign States and has competence over certain matters governed by this Convention may similarly sign, accept, approve or accede to this Convention. The Regional Economic Integration Organisation shall in that case have the rights and obligations of a Contracting State, to the extent that that Organisation has competence over matters governed by this Convention. Where the number of Contracting States is relevant in this Convention, the Regional Economic Integration Organisation shall not count as a Contracting State in addition to its Member States which are Contracting States.
2. The Regional Economic Integration Organisation shall, at the time of signature, acceptance, approval or accession, notify the Depositary in writing specifying the matters governed by this Convention in respect of which competence has been transferred to that Organisation by its Member States. The Regional Economic Integration Organisation shall promptly notify the Depositary in writing of any changes to the distribution of competence specified in the notice in accordance with this paragraph and any new transfer of competence.
3. Any reference to a “Contracting State” or “Contracting States” in this Convention applies equally to a Regional Economic Integration Organisation where the context so requires.

Article 19 Entry into force

1. This Convention shall enter into force on the first day of the month following the expiration of three months after the deposit of the third instrument of ratification, acceptance, approval or accession referred to in Article 17.

2. Thereafter this Convention shall enter into force –

- a) for each State or Regional Economic Integration Organisation referred to in Article 18 subsequently ratifying, accepting, approving or acceding to it, on the first day of the month following the expiration of three months after the deposit of its instrument of ratification, acceptance, approval or accession;
- b) for a territorial unit to which this Convention has been extended in accordance with Article 20(1), on the first day of the month following the expiration of three months after the notification of the declaration referred to in that Article.

Article 20 Multi-unit States

1. A Multi-unit State may, at the time of signature, ratification, acceptance, approval or accession, make a declaration that this Convention shall extend to all its territorial units or only to one or more of them.
2. Any such declaration shall state expressly the territorial units to which this Convention applies.
3. If a State makes no declaration under paragraph (1), this Convention extends to all territorial units of that State.

Article 21 Reservations

No reservation to this Convention shall be permitted.

Article 22 Declarations

For the purposes of Articles 1(5), 12(3) and (4), 16(2) and (3) and 20 –

- a) any declaration shall be notified in writing to the Depositary;
- b) any Contracting State may modify a declaration by submitting a new declaration at any time;
- c) any Contracting State may withdraw a declaration at any time;
- d) any declaration made at the time of signature, ratification, acceptance, approval or accession shall take effect simultaneously with the entry into force of this Convention for the State concerned; any declaration made at a subsequent time and any new declaration shall take effect on the first day of the month following the expiration of three months after the date on which the Depositary made the notification in accordance with Article 24;
- e) a withdrawal of a declaration shall take effect on the first day of the month following the expiration of six months after the date on which the Depositary made the notification in accordance with Article 24.

Article 23 Denunciation

1. A Contracting State may denounce this Convention by a notification in writing to the Depositary. The denunciation may be limited to certain territorial units of a Multi-unit State

to which this Convention applies.

2. The denunciation shall take effect on the first day of the month following the expiration of twelve months after the date on which the notification is received by the Depositary. Where a longer period for the denunciation to take effect is specified in the notification, the denunciation shall take effect upon the expiration of such longer period after the date on which the notification is received by the Depositary.

Article 24 Notifications by the Depositary

The Depositary shall notify the Members of the Hague Conference on Private International Law, and other States and Regional Economic Integration Organisations which have signed, ratified, accepted, approved or acceded in accordance with Articles 17 and 18, of the following –

- a) the signatures and ratifications, acceptances, approvals and accessions referred to in Articles 17 and 18;
- b) the date on which this Convention enters into force in accordance with Article 19;
- c) the declarations and withdrawals of declarations referred to in Article 22;
- d) the notifications referred to in Article 18(2);
- e) the denunciations referred to in Article 23.

In witness whereof the undersigned, being duly authorised thereto, have signed this Convention.

Done at The Hague, on the day of 20..., in the English and French languages, both texts being equally authentic, in a single copy which shall be deposited in the archives of the Government of the Kingdom of the Netherlands, and of which a certified copy shall be sent, through diplomatic channels, to each of the Member States of the Hague Conference on Private International Law as of the date of its Nineteenth Session and to each State which participated in that Session.

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