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Core Issues under the UNIDROIT (Geneva) Convention on Intermediated Securities: Views from the United States and Japan

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Core Issues under the UNIDROIT (Geneva) Convention on Intermediated Securities:

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I. Introduction

This paper examines the proposed legal regime under the International Institute for the Unification of Private Law (UNIDROIT) Convention on Substantive Rules for Intermediated Securities (also to be known under its short title, the Geneva Securities Convention).[1] After more than two years of study and

* We wish to thank Yumiko Ishii, LLM (2008), LLCM (2009), University of Pennsylvania Law School, for research assistance. Any errors, of course, are ours. This paper reflects in part research undertaken by Mooney (with assistance from Kanda) while in residence in Tokyo as a Visiting Scholar at the Bank of Japan, Institute for Monetary and Economic Studies (IMES), Law, Accounting, and Central Banking Section, from September to December 2006. It also draws on CW Mooney, Jr, 'Law and Systems for Intermediated Securities and the Relationship of Private Property Law to Securities Clearance and Settlement: US, Japan, and the UNIDROIT Draft Convention', IMES Discussion Paper Series 2008-E-7 (May 2008), available at http://www.imes.boj.or.jp/english/publication/edps/fedps2008_index.html (hereafter, Mooney, *Law and Systems*).

[1] Final Act of the final session of the diplomatic conference to Adopt a Convention on Substantive Rules Regarding Intermediated Securities, UNIDROIT 2009, CONF 11/2 – Doc 41, available at http://www.unidroit.org/english/workprogramme/study078/item1/conference2009/main.htm (hereafter, Final Act), Appendix, 'Convention on Substantantive Rules for Intermediated Securities' & Resolution No 1. Note that the Convention text and the resolutions adopted at the conference 'are subject to verification within a period of 120 days from the date hereof [9 October 2009] as to the linguistic changes required to make the texts in the two official languages consistent with one another.' Final Act at 1. A preliminary word about terminology may be useful. In general we adopt the terminology employed and defined in the Convention (such as 'intermediary', 'securities account', 'account holder', 'securities' and 'intermediated securities'). See below text at n 36 *et seq* (discussing certain Convention definitions). Exceptions are made, in particular with respect to US law, when discussing particular defined terms and texts of statutes that use such terms.

work,[2] beginning in 2005 UNIDROIT held four meetings of a Committee of Governmental Experts to develop further the text of the draft Convention.[3] The first session of a diplomatic conference under the auspices of UNIDROIT and hosted by the government of Switzerland was held in Geneva on 1–12 September 2008.[4] A second and final session was held on 5–9 October 2009, at which the final text of the Convention was adopted.[5] The final session of the diplomatic conference had before it the draft Convention that emerged from the first session as well as Draft Official Commentary[6] and proposed revisions of the Convention

[2] In 2001 the Governing Council and General Assembly of UNIDROIT authorised work on a project on 'Harmonised Substantive Rules regarding Securities Held with an Intermediary': UNIDROIT 2004, Study LXXVIII – Doc 19, 'Explanatory Notes to the Preliminary Draft Convention' (December 2004) at 1, available at unidroit.org/english/documents/2004/study78/s-78–019-e.pdf.

[3] The author Kanda served as a member of the Japanese delegation and the author Mooney served as a member of the US delegation at the four meetings of experts in Rome (May 2005, March 2006, November 2006, and May 2007) and at the 2008 first session and the 2009 final session of the diplomatic conference. Also, Kanda served as chair, and Mooney served as a member, of the drafting committee at each of the experts' meetings and both sessions of the diplomatic conference. However, the views expressed in this paper do not necessarily reflect the position of the US or Japan or any other member of the US or Japanese delegations.

[4] See First Session of the Diplomatic Conference to adopt a Convention on Substantive Rules regarding Intermediated Securities (Geneva, 1–13 September 2008), available at http://www.unidroit.org/english/workprogramme/study078/item1/conference2008/main.htm. For the text of the draft Convention as it emerged from the 2008 diplomatic conference, see UNIDROIT 2008, CONF 11 – Doc 48, 'Draft Convention on Substantive Rules regarding Intermediated Securities' (October 2008), available at http://www.unidroit.org/english/conventions/2009intermediatedsecurities/conference/conferencedocuments2008/conf11–048rev-e.pdf (citations to the Convention are to 'Convention Art __'; unless otherwise noted, citations to all UNIDROIT documents relating to the diplomatic conference are to 'UNIDROIT 2008, CONF 11 – Doc __' (first session) or 'UNIDROIT 2009, CONF 11/2 – Doc __' (final session) and are available at http://www.unidroit.org/dynasite.cfm?dsmid=93945 (first session) or http://www.unidroit.org/english/conventions/2009intermediated securities/conference/conferencedocuments2009/main.htm (final session). Unless otherwise noted, citations to all preparatory documents are to 'UNIDROIT 200_, Study LXXVIII – Doc __' and are available at http://www.unidroit.org/english/conventions/2009intermediatedsecurities/study78-archive-e.htm.
While the Convention addresses important aspects of private law for intermediated securities on an international platform, another significant effort is underway in the European Union. See generally Legal Certainty Group (LCG), 'Second Advice of the Legal Certainty Group (Solutions to Legal Barriers related to Post-Trading with the EU)' (August 2008) (hereafter, LCG, *Second Advice*). The recommendations contained in the *Second Advice* were similar in substance to the Convention draft that was submitted to the first session of the diplomatic conference. At the first session the delegations took the recommendations in the *Second Advice* into account and the Convention was modified in one respect to conform in substance to those recommendations. See below n 197.

[5] See generally Final Session of the Diplomatic Conference to adopt a Convention on Substantive Rules regarding Intermediated Securities (Geneva, 5–7 October 2009), available at http://www.unidroit.org/english/workprogramme/study078/item1/conference2009/main.htm; Final Act, above n 1, Appendix.

[6] UNIDROIT 2009, CONF 11/2 – Doc 5, 'Draft Official Commentary on the draft Convention on Substantive Rules regarding Intermediated Securities' (July 2009) (hereafter, Draft Official Commentary). The first session of the diplomatic conference adopted a resolution calling for the preparation of a draft Official Commentary for consideration at the final session: UNIDROIT 2008, CONF 11 – Doc 47 Rev, 'Final Act' (October 2008), Resolution No. 2. The author Kanda (as Chairperson of the Drafting Committee) and the author Mooney (as one of the three members of the drafting committee selected by the Chairperson) served as principal authors and editors of the Draft

text submitted by the Editors of the Draft Official Commentary and by various delegations and observers.[7] At the final session the conference resolved to request UNIDROIT to arrange for the preparation of a final version of the Official Commentary.[8]

The paper focuses primarily on some core issues addressed by the Convention and the related application of the Convention. The principal focus is on the 'property-related' provisions of the Convention, primarily its provisions on innocent acquisition, priority rules for competing interests, and the relationship between the Convention and insolvency law. In some (but not all) cases, the paper addresses provisions of the Convention along with corresponding aspects of US and Japanese law. In some cases it also approaches the Convention as if it were in force under US and Japanese law and as if US or Japanese law were the non-Convention law.[9] Viewing the Convention through the lenses of US and Japanese law is particularly useful.[10] Both states have well developed and sophisticated securities and financial markets and both have legal regimes designed specifically for intermediated securities holding. However, the relevant legal regimes in the two states differ greatly in doctrine and structure, thereby providing useful contrasts and comparisons. This is especially so because the Convention defers to the non-Convention law and other applicable law in so many respects.

Official Commentary. The initial drafts of the Draft Official Commentary relating to former draft Convention Arts 7, 10, 14, 17–21 and 28 borrowed from earlier drafts of this paper. This explains any remaining similarities between the discussion of those articles in this paper and the corresponding discussions in the Draft Official Commentary.

[7] See UNIDROIT 2009 CONF 11/2 – Doc 6 Corr, 'Memorandum regarding suggestions for revision of the text of the draft Convention (submitted by the Editors of the Draft Official Commentary)' July 2009 (hereafter, Editors' Proposals).

[8] Final Act, above n 1, Resolution No 2. That resolution provides, in part:
'*1. REQUESTS* the finalisation of the Official Commentary on the Convention by the Chairperson of the Drafting Committee, in close co-operation with no more than three members of the Drafting Committee as well as with the UNIDROIT Secretariat;
2. REQUESTS a Steering Committee consisting of the Vice-Presidents elected at the final session of the diplomatic Conference, the Chairperson of the Commission of the Whole, the Chairperson of the Final Clauses Committee, the Chairperson of the Credentials Committee, the Co-Chairpersons of the Committee on Emerging Market Issues, Follow-up Work and Implementation, the Chairperson of the Working Group on Insolvency, the Co-Chairpersons of the Working Group on Settlement and Clearing Systems and the members of the Drafting Committee, to co-ordinate the work on the Official Commentary, to take into account the comments made by all negotiating States and participating observers and resolve any issue arising in this process.'

[9] 'Non-Convention law' is defined to mean 'the law in force in the Contracting State whose law is referred to in Article 2, other than the provisions of this Convention': Convention Art 1(m). Art 2, captioned 'Sphere of application', provides: 'This Convention applies where: (a) the applicable conflict of laws rules designate the law in force in a Contracting State as the applicable law; or (b) the circumstances do not lead to the application of any law other than the law in force in a Contracting State.'

[10] The paper addresses the Convention in more detail than is the case for US and Japanese law. It is not a comprehensive comparative analysis or description. For a more comprehensive treatment see Mooney, 'Law and Systems', above n *.

II. Structure and Background

This section introduces the subject of intermediated securities and provides background. Section III provides a brief overview of the legal regimes for intermediated securities under the Convention and under US and Japanese law. Section IV discusses rules for the innocent acquisition (for example, good faith purchase) of intermediated securities and priority rules that apply among competing claimants to intermediated securities. Section V addresses the relationship between the Convention and insolvency law. Section VI concludes the paper.

A. Intermediated Securities Holding Systems

In developed financial markets the control of securities[11] by financial intermediaries (such as a central securities depository (CSD), a securities firm, or a bank) for the benefit of investors—account holders—is ubiquitous. In many (probably almost all) legal regimes and securities market systems this phenomenon of intermediation necessarily imposes at least some risk on account holders. This risk is over and above the risk that the investor intends to assume, the *issuer* risk that the issuer of the securities will enjoy success or failure, that the value of securities will rise or fall, or that debt securities will or will not be paid when due. Specifically, the additional risk is *intermediary* risk as opposed to issuer risk. Intermediary risk includes the risk that the intermediary will become financially distressed and, in addition, the risk that the intermediary will not have available sufficient securities to satisfy its account holders who hold those securities in their securities accounts with the intermediary.[12] It also includes the risk that an intermediary may make errors of omission and commission that work to the detriment of one or more of its account holders.

Given this intermediary risk, the pattern of intermediated securities holding raises a preliminary question: Why does this pattern of intermediation persist (indeed flourish)? The short answer is that intermediation is necessary for investors to buy and sell securities in organised markets. An investor must establish a securities account with an intermediary, such as a securities firm in

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

[12] This discussion passes over, for now, insurance-like programmes in some jurisdictions that provide limited protection against this risk for non-institutional, 'retail' investors. As to such programmes in the US and Japan, see below nn 279–80.

Japan[13] or a securities broker-dealer in the US. These intermediaries are generally regulated by law and are licensed to trade on the relevant exchanges on behalf of others. An investor's 'buying' broker would buy securities on an exchange[14] (a 'trade') from a 'selling' broker. A typical investor's need to retain the services of an intermediary for the purpose of trading on an exchange should be obvious even to the uninitiated.[15]

A second question then arises. What happens next *after* a trade is made on the exchange between the two brokers (to continue with our simplified example)? This may not be so obvious. A system is necessary to verify between the brokers that the trade was in fact made on the exchange and that they agree on the terms (for example, the particular issue of securities, the price, and number of units); this is the 'clearance' function.[16] Next, on a date subsequent to the trade date (in some markets, even on the trade date), the selling broker must 'deliver' (that is make available) the securities to the buying broker and the buying broker must pay the selling broker; this is the 'settlement' function of a system.

We may reasonably assume that these brokers (along with many others) engaged in many exchange transactions in the relevant securities on the relevant trade date. Indeed, on the trade date the selling broker may have bought more relevant securities for its customers than it sold on behalf of other customers, entitling it to receive (in some systems) the securities on a 'netted basis' on the relevant settlement date without having to 'deliver' any securities of the relevant issue on that day. The buying broker may be in an analogous situation. It may have sold more of the securities than it bought and will be a net transferor of the relevant securities without receiving any such securities on the settlement date.

[13] In Japan, a securities firm is a 'financial instruments trading firm' (*kinyu shohin torihiki gyosha)* under the Financial Instruments and Exchange Act, Act 65 of 2006, (FIEA) which took effect on 30 September 2007 and which replaced the former Securities and Exchange Act. See FIEA Art 2(9) (defining 'financial instruments trading firm'). For 'foreign securities firm', see FIEA Art 58 (defining 'foreign securities firm'). In this paper we use the term 'securities firm' for convenience.

[14] We use the term 'exchange' here in its broadest sense to include all trading platforms employed in organised markets generally.

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

[16] This process is streamlined in 'straight through processing' systems in which trade information (buyer, seller, security issue, number or amount, etc) is automatically and electronically transmitted to the settlement system and the separate steps of comparison and matching have been eliminated. See, eg, The Depository Trust & Clearing Corporation (DTCC), 'New York Stock Exchange Trade Processing', available at http://www.dtcc.com/products/cs/equities_clearance/tcr_nyse.php (description of the Online Comparison System operated by the New York Stock Exchange); Japan Securities Depository Center, Inc (JASDEC), 'STP for Securities Settlement Environment Typical in Japan', available at http://www.jasdec.com/en/finance/s02.html (description of JASDEC's Pre-Settlement Matching System for straight through processing).

For present purposes, the point is straightforward—securities must be 'in the system' (whatever the details of the particular system's structure) for transactions to be settled.

Under some legal regimes an investor may elect to withdraw from the intermediated system altogether by requesting that it be placed in a direct relationship with the issuer, ending any further involvement with the intermediary.[17] In other regimes, the investor must continue to hold the securities in its securities account with its intermediary (or another intermediary of its choosing).[18] Even when investors are entitled to withdraw securities from the intermediated system, many investors choose to continue to maintain the securities credited to their accounts with an intermediary.

Some investors may not appreciate the existence of intermediary risk or may believe that the risk is so slight as to be immaterial. Convenience also figures in the analysis. Recall that securities must be 'in the system' for settlement to take place. If securities are withdrawn from the system then some delay and transaction costs will occur should an investor wish to reintroduce them so as to permit a sale. Moreover, at least with paper, certificated securities, withdrawal poses additional risks. Paper can be lost, stolen or destroyed. For now, however, it is sufficient to note that *in fact* many investors choose to maintain securities in securities accounts with intermediaries even when they have the option not to do so.

B. Goals and Approach

The principal goal of this paper is to examine critically the Convention by focusing on the application of certain core provisions. In some cases it will proceed on the alternative assumptions that US or Japanese law is the non-Convention law. As with any comparative legal study, the paper also aspires to increase and deepen knowledge and understanding of the relevant aspects of the respective US and Japanese legal regimes. This study is informed as well by developments in related law reforms and clearance and settlement systems around the world.[19] But it does not promise a complete comparative analysis of the relevant US and Japanese law or these international developments. The principal focus is on the Convention's core property-related provisions.

This paper takes a 'functional approach' to its analysis of the regimes addressed here. This approach is, not coincidentally, the overarching approach taken by the

[17] In the US, for example, for many types of securities the investor could request the intermediary to request the issuer to issue a security certificate in her name as the registered owner.

[18] As noted below, some 'direct' or 'transparent' systems discussed in connection with the Convention *do* involve holding through intermediaries but *also* afford the account holder a (more or less) direct relationship with the issuer. See UNIDROIT 2007, Study LXXVIII – Doc 88, 'Report of the Transparent Systems Working Group (prepared by Chairs of the Working Group)' May 2007.

[19] See, eg, LCG, *Second Advice*, above n 4.

Convention. This functional approach[20] is based on the idea that the Convention should specify the operative results that arise in transactions and settings within its scope, but should not attempt to override (and harmonise among states) the whole of the underlying domestic legal doctrine that is the vehicle for producing those results. For example, Article 9 of the Convention (discussed in section III.C below) spells out the rights that are conferred on an account holder by the credit of securities to a securities account. However, it leaves the legal characterisation of those rights—such as the nature of any property interest acquired by the account holder—to the non-Convention law. This paper's comparative approach likewise emphasises functional result. The result-oriented features of the relevant legal landscapes are more significant than doctrinal differences.

The functional approach offers a useful and effective method for harmonisation of private laws around the world. First, by definition, the approach does not require harmonisation of all relevant legal doctrine. Legal doctrines vary from jurisdiction to jurisdiction, and it is extremely difficult to seek harmonisation over different legal doctrines—and cultures—around the world. Secondly, harmonising results is exactly what is needed to ensure less costly, safe, and certain cross-border securities transactions and the integrity of post-trade securities clearing and settlement (discussed below in connection with systemic risk concerns).[21] Thirdly, the functional approach, in the context of the Convention, for example, does not demand *identical* results under every applicable non-Convention law; it permits some deference to non-harmonisation—even as to result. To date the functional approach has proven to be a realistic and useful heuristic in the negotiation of the Convention by the participating delegations.

Notwithstanding the generality of the foregoing description of the functional approach taken by the Convention, the approach actually is more nuanced. For example, Article 9 (mentioned above) specifies the results of a credit to a securities account in terms of both economic benefits (such as the receipt of dividends) and legal entitlements to those (and other) benefits. Moreover, the Convention offers a spectrum of approaches from the purely functional approach to a more complete harmonisation of legal doctrine. Article 9 embodies a functional approach that eschews the details of legal doctrine. Article 18 (discussed in section IV.A., below), on the other hand, provides harmonised and detailed legal doctrine concerning innocent acquisition. Article 19, on priorities, lies somewhere in between. It specifies priority rules for competing claims but does not address the doctrinal or peripheral implications of priority (for example, whether a senior claimant owes any duties to a junior claimant and vice versa or a whether a junior claimant has the right to enforce its interest in the absence

[20] For an excellent analysis of many provisions of an earlier draft of the Convention and an examination of the Convention's functional approach, see L Thévenoz, 'Intermediated Securities, Legal Risk, and the International Harmonisation of Commercial Law' (2008) 13 *Stanford Journal of Law, Business and Finance* 384 (hereafter, Thévenoz, *Intermediated Securities*).

[21] See below section II.C.

of the senior's consent). Moreover, the Convention is no less 'hard law' merely because it accommodates many aspects of the non-Convention law. It would provide clear and binding rules for Contracting States.

Where functionally harmonised results and non-Convention law coexist, the net results may or may not be optimal. The economic results may differ in some respects from jurisdiction to jurisdiction. If the differences are within a reasonable range, the most important goals may be obtained, but there is no guarantee that in all cases the range of differences will be reasonable. This situation illustrates the utility of comparing US and Japanese law in the Convention context in order to identify examples of different legal doctrines reaching similar functional results in some cases as well as differing results in others.

C. Significance of Relevant Legal Doctrine and Relationship to Systemic Risk

This paper addresses primarily private law issues related to intermediated securities. It considers the rights (legal and contractual), interests (that is property interests or real rights), and obligations of account holders, intermediaries and transferees of interests in intermediated securities. But the relevant legal regimes carry much more water than the regulation of private rights among economic actors—as important as those rights may be. They are a crucial component of the infrastructure—the 'plumbing', if you will—of the financial markets. And they can play a significant role in reducing not only legal risks of market participants but *systemic risk* as well.[22] For example, draft recommendations prepared by a joint group organised by the European System of Central Banks and the Committee of European Securities Regulators take account of this relationship:

> [T]he draft ESCB-CESR recommendations provide that the reliable and predictable operation of a securities settlement system also depends on the *laws, rules and procedures that support the holding, transfer, pledging and lending of securities and on how these laws work in practice*. If the legal framework is inadequate or its application uncertain, it can give rise to credit or liquidity risks for system participants and their customers or to systemic risks for financial markets as a whole.
>
> For this reason, ESCB-CESR recommend that in addition to the need for legal systems to demonstrate internal coherence and transparency, it is necessary, for systemic risk

[22] Steven Schwarcz recently explained that three commonly understood meanings of 'systemic risk' are actually inconsistent. S Schwarcz, 'Systemic Risk' (2008) 97 *Georgetown Law Journal* 193, 196–198. Schwarcz then offered, at 204 'a working definition of systemic risk: the risk that (i) an economic shock such as market or institutional failure triggers (through a panic or otherwise) either (X) the failure of a chain of markets or institutions or (Y) a chain of significant losses to financial institutions, (ii) resulting in increases in the cost of capital or decreases in its availability, often evidenced by substantial financial-market price volatility'.

> purposes, that the relevant public authorities support the harmonisation of rules so as to minimise any discrepancies stemming from different national rules and legal frameworks.[23]

Various studies of securities clearance and settlement[24] systems over the past several years have addressed the reduction of risk in these systems.[25] These studies have taken note of the importance of the legal regimes governing intermediated securities systems to the reduction of risk. Consider, for example, a recommendation made by the International Securities Services Association:

> Local laws and regulations should ensure that there is segregation of client assets from the principal assets of their custodian; and no possible claim on client assets in the event of custodian bankruptcy or a similar event.
>
> Regulators and markets, to further improve investor protection, should work:
>
> —to ensure clarity on the applicable law on cross-border transactions
>
> —to seek international agreement on a legally enforceable definition of finality in a securities transaction
>
> —to *ensure that local law fully protects the rights of beneficial owners*
>
> —to strengthen securities laws both to *secure the rights of the pledgee and the protection accorded to client assets held in Securities Systems.*[26]

Note another example:

> Each jurisdiction should take the attributes of its securities holding system into account in judging whether its legal framework includes appropriate mechanisms to protect a custodian's customer against loss upon the insolvency of, or the commission of fraud by, a custodian.[27]

[23] LCG, *Second Advice*, above n 4, at 27 (emphasis added).

[24] 'Clearance' refers generally to a system and process in which market transactions (usually referred to as 'trades') between securities market professionals are confirmed and compared in order to establish that trades were made between parties and the terms of the trade. See Committee on Payment and Settlement Systems (CPSS), Bank for International Settlements & Technical Committee, International Organization of Securities Commissions, 'Recommendations for Securities Settlement Systems' (November 2001) at 45. 'Settlement' refers generally to a system and process in which securities that were the subject of a trade are transferred (eg by a seller) to the appropriate recipient (eg to a buyer; these transfers usually are referred to as 'deliveries') and in which funds corresponding to the trade (eg a buyer's payment of the purchase price for securities) are transferred to the appropriate recipient (eg to a seller): ibid, at 48 (defining '[s]ettlement' as '[t]he completion of a transaction through final transfer of securities and funds between the buyer and the seller').

[25] See, eg, Group of Thirty, 'Global Clearing and Settlement: Final Monitoring Report' (2006); 'Global Clearing and Settlement: A Plan of Action' (2003); CPSS, ibid; International Securities Services Association (ISSA), 'ISSA Recommendations 2000' (2000); International Federation of Stock Exchanges, 'Clearing and Settlement Best Practices' (1996); CPSS, 'Delivery Versus Payment in Securities Settlement Systems' (September 1992).

[26] See, eg, ISSA, ibid, Recommendation 8, at 29 (emphasis added).

[27] CPSS, above n 24, at 19.

A detailed examination of the relationship between the private law regimes for intermediated securities and systemic risk in the financial markets is beyond the scope of this paper. But that relationship and its significance clearly raise the stakes for law reform in this field. The various crises that have arisen in the financial markets in recent months could have been exacerbated considerably in the US had there not been in place a sound legal regime for securities credited to account holders' securities accounts with intermediaries.[28] Even so, the liquidation proceeding of Lehman Brothers, Inc (LBI) has not been without problems in connection with securities accounts maintained at LBI that are governed by US law. But in general the problems arise from the complexity of the relationships between LBI and its customers and not from uncertainty concerning the underlying legal regime.[29]

Even clear and undisputed rights and interests in intermediated securities are vulnerable in the absence of an effective means of enforcement and realisation in an intermediary's insolvency proceeding. In the LBI case in the US, the trustee has taken unprecedented steps to return claimants' property outside of the formal claims process (indeed, even before the formal claims process had begun). The trustee established a 'protocol' to facilitate an informal, consensual means for certain customers to obtain the return of assets carried in LBI accounts.[30] But the

[28] One critic of the approach of Uniform Commercial Code (UCC) Art 8 questioned the central role of certainty of perfection and priority rules (and in particular the Art 8 regime) both for settlement systems and for the related liquidity necessary to avoid systemic risk: 'Professor Charles W Mooney, Jr, the legal academic whose ideas form the intellectual underpinnings of Revised Article 8, is no more convincing on the empirical issues. In discussing 'the potentially severe consequences of prevailing uncertainties in the legal regime', he cites to the October 1987 market crash and the 1990 bankruptcy of Drexel Burnham Lambert Group, Inc. (DBL Group)'. FJ Facciolo, 'Father Knows Best: Revised Article 8 and the Individual Investor' (2000) 27 *Florida State University Law Review* 615, 635 (quoting CW Mooney, Jr, 'Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries' (1990) 12 *Cardozo Law Review* 305, 315). Facciolo then proceeds to criticise Mooney's reliance on the cited authorities. The foregoing discussion is a sufficient rebuttal of Facciolo's claims for present purposes.

[29] See, eg, 'Open Letter To Prime Brokerage Customers And Other Interested Parties', available at: chapter11.epiqsystems.com/clientdefault.aspx?pk=978bd245–11be-4d4b-83db-d6a3283b2962&l=: 'It is also essential to understand that [Prime Brokerage Accounts'] PBAs' own contractual and business relationships with LBI and other Lehman entities often interfere with claims for the return of property by many remaining PBAs. Some PBAs may sign agreements allowing property to be rehypothecated so that it may not be held in segregation and might be commingled as collateral to banks or other lenders. Many PBAs in the Lehman proceeding signed agreements specifically cross-collateralizing their accounts for indebtedness to other Lehman entities, such as the European entity, Lehman Brothers International (Europe) ('LBI(E)'). Some of these PBAs had significant transactions with LBI(E) (and sometimes other Lehman entities) and have incurred indebtedness that exceeds the value of the property at LBI available to return to them (net of their indebtedness to LBI itself). In these cases the Trustee has no authority to return the property against which one or more other Lehman entities has a lien until and unless the indebtedness is fully satisfied. This problem is a function of the legal relationship that PBAs chose to enter. Many of the PBAs that have not yet been transferred are subject to this legal impediment and may have no unencumbered property available for immediate return.'

[30] Ibid: 'The Trustee initiated the protocol, with the support of the Securities Investor Protection Corporation ('SIPC'), in an effort to allow PBAs to seek return of property to the extent that, under their contractual arrangements and transactions with LBI and other Lehman entities, LBI held

administration of Lehman entities under English law has encountered considerably more problems in this context. English insolvency law does not permit the level of flexibility that the LBI trustee has exercised under US law.[31] But US insolvency law in general requires improvement as it relates to large, complex, systemically important financial firms such as the Lehman entities.[32]

III. Overview of Convention and United States and Japanese Legal Regimes

A. Background on Legal Frameworks

The background of the formulation of the Convention project and its history are provided above.[33] The UNIDROIT Secretariat has described the rationale and goals of the Convention as (i) 'improving the legal framework for securities

property for them free of liens, in segregation and otherwise available for return. The process is a consensual one and is also predicated on the PBA's agreement with the Trustee's approach to an account based on careful review of LBI's books and records. … Despite legal infirmities faced by PBAs and the practical problems and verification steps discussed below, the process has thus far returned over $2 billion of property to scores of PBAs in a matter of weeks—an extraordinary achievement for a SIPA [Securities Investor Protection Act] liquidation or any insolvency proceeding.'

[31] See, eg, *Financial Times*, 29 November 2008: 'The UK regime has no special provisions for investment firms, causing frustration for Lehman clients who have found their assets trapped in the collapsed entity as the administrators work to untangle the bank's holdings. Hedge funds have since moved billions to US-based accounts to avoid the risk of similar problems accessing assets should another large broker collapse.

The FSA's [Financial Services Authority, UK] New York talks come after Alistair Darling, chancellor of the exchequer, said last month that the Treasury would review insolvency arrangements for investment firms. Specifically the FSA team will examine broker-related issues including the provisions in the US bankruptcy code that allow some securities trading to be settled even in bankruptcy protection, and the Securities Investor Protection Corporation. 'The problems the administration would cause the financial system were not fully understood by the financial community prior to the collapse of Lehman', said Hector Sants, chief executive of the FSA in a recent interview with the Financial Times. 'We need a more flexible and appropriate administration process in the unlikely event we get into the same situation again.' In May 2009 the UK Treasury issued a report calling for, inter alia, reform of insolvency regimes for resolving distressed investment banks. HM Treasury, 'Developing effective resolution arrangements for investment banks' (May 2009), available at http://www.hm-treasury.gov.uk/d/consult_investmentbank110509.pdf. The Executive Summary notes, in part, at 3: This report lays out the Government's initial thinking as to the reforms which may need to be considered in developing effective resolution arrangements for investment banks. It responds directly to the issues that were highlighted in the Lehman Brothers case; including the treatment of investment banking clients after default, the future of their assets, and the treatment of their open or unreconciled trading positions. It also examines what can be done to make the process of insolvency itself more effective, and limit the damage that may be done by a failing investment bank.'

[32] Recently the Obama Administration proposed an extensive overhaul of the US regulatory framework for financial institutions, markets, and products. Department of the Treasury, 'Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation' 17 June 2009. One of the proposals calls for the creation of a new insolvency regime for the resolution of financial firms, including large systemically important firms. Ibid, at 76–78.

[33] See above nn 1–8 and accompanying text; Draft Official Commentary, above n 6, at para 2–6.

holding and transfer, with a special emphasis on cross-border situations'; (ii) adapting the legal framework to the prevalent system of holding through intermediaries; (iii) overcoming legal risks arising from reliance of the legal framework on traditional methods of holding through physical custody and from holding and transferring across borders in the presence of incompatible legal systems; and (iv) the need for a comprehensive substantive legal framework on a global basis.[34]

The Convention applies if 'the applicable conflict of laws rules designate the law in force in a Contracting State as the applicable law'[35] or if 'the circumstances do not lead to the application of any law other than the law in force in a Contracting State'.[36] It deals primarily with 'intermediated securities',[37] which are 'securities'[38] that are credited to a 'securities account'[39] maintained with an 'intermediary'[40] in the name of an 'account holder'.[41] The Convention does not generally exclude from its coverage relationships with the issuers of securities, but there are very few provisions that affect issuers.[42]

US law relating to intermediated securities is both federal law and the laws of the various states.[43] The principal relevant state law consists of Articles 8

[34] UNIDROIT, 'Substantive Rules Regarding Intermediated Securities' (Study 78), Overview, http://www.unidroit.org/english/workprogramme/study078/item1/overview.htm, visited on 18 January 2007, copy on file with publisher.

[35] Convention Art 2(a).

[36] Convention Art 2(b). Art 2(b) would appear to be superfluous as the same result would obtain under Art 2(a), but Art 2(b) probably does no harm.

[37] Convention Art 1(b).

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

[39] A 'securities account' is 'an account maintained by an intermediary to which securities may be credited or debited': Convention Art 1(c).

[40] 'Intermediary' is defined as 'a person (including a central securities depositary) 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': Convention Art 1(d).

[41] An 'account holder' is 'a person in whose name an intermediary maintains a securities account, whether that person is acting for its own account or for others (including in the capacity of intermediary)': Convention Art 1(e).

[42] See Convention Arts 29 ('Position of issuers of securities') and 30 ('Set-off'). The Convention does contain an express exclusion for certain relationships between a CSD (and other persons) and issuers. Art 6 provides: 'This Convention does not apply to the performance of functions of creation, recording or reconciliation of securities, *vis-à-vis* the issuer of those securities, by a person such as a central securities depository, central bank, transfer agent or registrar'. See Draft Official Commentary, above n 6, paras 5–5 to 5–8.

[43] The principal relevant federal laws deal with (i) securities regulation (largely related, directly or indirectly, to investor protection) (see, eg, Securities Exchange Act of 1934, 15 USC §§ 78a *et seq*), (ii) insolvency proceedings of intermediaries (both banks and securities firms) (see, eg, Bankruptcy Code Subchapter III (stockbroker liquidation), 11 USC §§ 741 *et seq*; Securities Investor Protection Act, 15 USC §§ 78aaa *et seq* (liquidation of registered broker-dealers)), and (iii) US federal government debt securities and debt securities issued by federal agencies (see, eg, 12 CFR Part 615, Subpart O (Farm Credit System securities); 31 CFR Part 357, Subpart B (US Treasury securities)).

(Investment Securities) and 9 (Secured Transactions) of the Uniform Commercial Code (UCC).[44] The focus here is primarily on the UCC. The federal regulations for US government and agency securities follow essentially the same rules.[45]

UCC Article 8 and related provisions in Article 9 were revised in 1994, following several years of study and drafting.[46] The revision process was in part a response to the proposals by the US Department of Treasury to revise the regulations that then governed the transfer of, and security interests in, book-entry US government securities.[47] The chief innovation in the revision was the comprehensive codification of a regime for securities controlled by intermediaries (that is securities held in the 'indirect' system, to use the informal terminology used in the US).[48] The revisions recognised that the attributes of receiving a credit in an account with an intermediary—holding in the indirect system—differ considerably from having a possessory interest in a security evidenced by a certificate and from an interest that is recorded directly on the books of the issuer of a security (holding in the 'direct' system, generally without the involvement of an intermediary).[49]

Japan also has modernised its laws relating to intermediated securities in the past few years. The Act for Book Transfers of Bonds, Shares and other Securities (Book-Entry Transfer Act, or BETA),[50] provides a unified regime for all types of securities in the Japanese intermediated system. As originally enacted in 2001, the BETA applied only to short term corporate debt (that is commercial paper).

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

[45] See above n 43.

[46] For an intellectual history of the background and process resulting in the UCC Art 8 revisions, see CW Mooney, Jr, 'The Roles of Individuals in UCC Reform: Is the Uniform Law Process a Potted Plant? The Case of Revised UCC Article 8', (2002) 27 *Oklahoma City University Law Review* 553. A revised UCC Art 9 was promulgated in 1998 and was in force in every state of the US by 2002. Revised UCC Art 9 reorganised and revised some provisions that were adopted in connection with the 1994 UCC Art 8 revisions, but with little change in substance.

[47] Those proposals, in turn, had been prompted by uncertainties demonstrated by litigation arising out of the failure of some government securities dealers in the US.

[48] In an earlier study, Mooney proposed major reforms of the law relating to securities held in the indirect system and the revision of UCC Art 8 embraced the results advocated by those proposals in all material respects: CW Mooney, Jr, 'Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries' (1990) 12 *Cardozo Law Review* 305. Much of the intellectual foundation of that article was developed during the period when Mooney was conducting comparative research at the Bank of Japan, IMES, during September to December 1988.

[49] For a brief overview of the UCC Art 8 revisions, see CW Mooney, Jr, SM Rocks and RS Schwartz, 'An Introduction to the Revised UCC Article 8 and Review of Other Recent Developments with Investment Securities', (1994) 49 *Business Lawyer* 1891, 1891–1902.

[50] Act No 75 of 2001, as amended in 2002 (Act 65 of 2002) and 2004 (Act 88 of 2004). For English materials explaining the background and the legislation, see Reform Promotion Center for Securities Clearing and Settlement System, Japan Securities Dealers Association, available at http://www.kessaicenter.com/index_e.html.

Amendments enacted in 2002 extended its scope to cover all debt securities, including corporate bonds and Japanese Government Bonds (JGBs).[51] These amendments became effective on 6 January 2003 with an implementation deadline of within five years.[52] The Bank of Japan (BOJ) began operation of its JGB system under the BETA in January 2003[53] and the Japan Securities Depository Center, Inc (JASDEC) began operation of its new system under BETA for corporate debt securities in January 2006.[54] Additional amendments enacted in 2004 extended the application of BETA to equity securities.[55] The new book-entry system became fully operational for equity securities in January 2009.[56]

B. Dematerialisation

The Convention is strictly agnostic as to whether the underlying securities credited to a securities account are dematerialised or evidenced by paper certificates under the applicable law.[57] US law is in accord. Under UCC Article 8 'securities' may be either 'certificated' or 'uncertificated' and either may be credited to a securities account in the indirect system.[58]

Under Japanese law, the securities covered by the BETA are all dematerialised and are all credited to accounts with intermediaries. The BETA regime features an integrated system involving a single CSD, that is JASDEC,[59] for shares of stock and other equity securities, corporate bonds, corporate commercial paper and investment funds (that is mutual funds as they are known in the US). The BOJ remains the CSD for JGBs.[60] The name of the BETA itself (Book-Entry Transfer Act) suggests an important feature of the new system: all of the securities in the system are dematerialised and are transferred and pledged by book entries

[51] Act No 65 of 2002.

[52] Ibid, Supplemental Provision 1, § 2.

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

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

[55] Act No 88 of 2004.

[56] Cabinet Ordinance No 350 of 2008.

[57] For example, the definitions of 'securities' and 'intermediated securities' make no mention of this issue. See Convention Arts 1(a) (defining 'securities') and 1(b) (defining 'intermediated securities').

[58] UCC §§ 8–102(a)(4) (defining 'certificated security'), (18) (defining 'uncertificated security'), (15) (defining 'security'), (9) (defining 'financial asset' as including a security); UCC § 8–501(a) (defining 'securities account' to mean 'an account to which a financial asset may be credited').

[59] The BETA does not mandate a single CSD: BETA Art 3–43. JASDEC is expected to serve as such, however, for securities other than JGBs.

[60] BETA Art 47–50 (permissible for BOJ to act as CSD for JGBs and related special provisions).

exclusively.[61] (Indeed, it seems anomalous to refer to a 'central securities *depository*' in a dematerialised world, although the term has become an accepted term of art in the industry.)

C. Basic Attributes of Intermediated Securities

Article 9 of the Convention illuminates and specifies the core attributes of intermediated securities. It describes what it is that is conferred on an account holder by the credit of securities to a securities account. It first provides that the account holder receives 'the right to receive and exercise any rights attached to the securities, including dividends, other distributions and voting rights'.[62] But an account holder that is an intermediary receives these economic benefits only if it 'is acting for its own account', or 'if so provided by the non-Convention law'.[63]

Article 9(1)(a) illustrates well two significant characteristics of the Convention. First, it reflects the Convention's 'functional' approach of providing for

[61] This eliminates inter alia the need for JASDEC to return share certificates for registration in the names of the beneficial owners before each issuer's record date. See T Shimizu, 'Settlement System of Tokyo Stock Exchange' (1988) (unpublished manuscript) 1–5. Since January 2003, when the new system was first applied to JGBs, those securities have been issued only in paperless form and almost 100% of the outstanding JGBs are now in the new book-entry system. In January 2009, 98% of JGBs were included in the book-entry system. (Raw data about 'Issuance, Redemption and Outstandings of Government Bonds' can be downloaded from http://www.stat-search.boj.or.jp/index_en.html.) It also was necessary for corporate debt securities to be issued or converted to dematerialised form in order to become subject to the BETA system: BETA Art 67 and supplementary provisions. Most physical bonds and registered bonds were converted to book-entry by 2007: Japan Securities Research Institute, *Securities Market in Japan 2006* 101. The process of conversion required the issuer to apply to JASDEC for conversion and also required the consent of bondholders; some bondholders of an issue may consent and some may retain the registered or physical bonds: various interviews and email exchanges with K Sakaba, H Tomita, T Sano, and Y Sato, of JASDEC, October–December 2006, and interviews with T Hosomura and T Kaneko, of Japan Securities Clearing Corporation (JSCC), and T Hirano and M Minoguchi, of Tokyo Stock Exchange, October 2006. Bonds that were not converted prior to year-end 2007, however, may not be converted thereafter: ibid. Bondholders had a strong incentive to convert to book-entry form in timely fashion, inasmuch as certain preferential tax treatment applies only to book-entry bonds that were converted before 6 January 2008: Income Tax Act, Act 33 of 1965, Arts 10, 11 (amended 2002) and related supplementary provisions; Special Taxation Measures Act, Act 26 of 1957, Arts 4, 4(2), 4(3), and 8 (amended 2002) and related supplementary provisions. Under the 2004 amendments to the Japanese Commercial Code (*SHŌHŌ*) (Act 88 of 2004) and subsequent enactment of the new Companies Act of Japan (Act 86 of 2005) (hereafter, Companies Act), which became effective in May 2006, corporations now need not issue share certificates. The issuance of dematerialised shares was made the default rule under the Companies Act: Companies Act Art 121. The amendments to the BETA (Act 88 of 2004) provided the legal mechanism for a book-entry system for transactions relating to dematerialised shares. Upon implementation of the BETA for equity securities, publicly traded shares automatically became dematerialised as a matter of law, without going through the process of amending articles of incorporation and making corresponding entries in the issuer's register: Reform Promotion Center for Securities Clearing and Settlement System, Japan Securities Dealers Association (JSDA), 'The Transition to the Dematerialization of Stock Certificates in Japan' (September 2004) (hereafter, JSDA, *Transition to Dematerialisation*) 5–6, available at http://www.kessaicenter.com/kisha/stock_e.pdf.

[62] Convention Art 9(1)(a).

[63] Convention Art 9(1)(a)(i), (ii).

results that are not imbedded in any particular non-Convention legal doctrine or concept.[64] Secondly, it is an example of the many provisions in the Convention which defer to the non-Convention law or other applicable law, usually because a consensus emerged that harmonisation is either unnecessary or impossible to achieve.[65] In this case, for example, Article 9(1)(a) accommodates Japanese law, which provides that only the account holder in the lowest tier of the chain has a property interest (and the only property interest) in the underlying securities,[66] as well as US law, which recognises that all entitlement holders, even an intermediary acting in its capacity as such and not for its own account, acquire a pro rata property interest vis-à-vis other account holders of the same intermediary.[67] The account holder also receives the right to instruct its intermediary to dispose of or transfer an interest in the intermediated securities[68] and to instruct the intermediary to cause the holding of the securities other than through a securities account.[69]

Finally, Article 9(1)(d) provides that a credit to an account holder's securities account confers 'such other rights, *including rights and interests in securities*, as

[64] See Draft Official Commentary, above n 6, paras 9–2 and 9–3.

[65] Ibid.

[66] By 'account holder in the lowest tier in the chain' we mean the 'ultimate' account holder that holds the 'beneficial ownership' of the securities. For example, a JASDEC participant-intermediary is an account holder inasmuch as JASDEC has credited its customer securities account on JASDEC's books. But if that participant-intermediary credits the account of its account holder and that account holder is not itself acting in the capacity of an intermediary, then that account holder is in the 'lowest tier' and is the 'ultimate' account holder. The account holders to whom securities are credited are presumed to hold ownership of the securities: BETA Arts 76 (corporate debt securities); 101 (JGBs); 143 (corporate equity securities). That ownership confers on them the right to the payment of principal and interest on debt securities and the right to receive dividends, vote and exercise other rights in the case of equity securities. In that sense the new system is a form of 'direct' holding. Within the book-entry system itself, the Act is consistent with the principles of possessory rights under the general principles of the Civil Code of Japan (*MINPŌ*), including a presumption of the rights exercised—here, ownership (or pledge, discussed below): *MINPŌ* Art 188. JASDEC and other intermediaries in the chain of tiers function as keepers of accounts but have no ownership interest in securities credited to their account holders.

[67] UCC Art 8 is grounded on a package of carefully defined terms. The conceptual foundation for its indirect system is the securities account. The person that maintains a securities account for entitlement holders in the regular course of its business is a 'securities intermediary': UCC § 8–102(a)(14) (defining 'securities intermediary'). The account holder is an 'entitlement holder': UCC § 8–102(a)(7) (defining 'entitlement holder'). The entitlement holder's rights and interest in respect of a securities account is a 'security entitlement': UCC § 8–102(a)(17) (defining 'security entitlement'). Contrary to the possible implication of the term 'entitlement', the entitlement holder acquires a present property interest. It is a property interest in all financial assets of the relevant type held by the securities intermediary and it is a pro rata property interest held with all other entitlement holders with respect to that type of financial asset: UCC § 8–503(b). The pro rata property interest is calculated, moreover, 'without regard to the time the entitlement holder acquired the security entitlement or the time the securities intermediary acquired the interest in that financial asset': ibid.

[68] Convention Art 9(1)(b).

[69] Convention Art 9(1)(c). This right is provided only if 'permitted under the law under which the securities are constituted, the terms of the securities, the non-Convention law and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system': ibid.

may be conferred by the non-Convention law'.[70] The emphasised text corresponds to similar language in the definition of 'intermediated securities', which are defined as 'securities credited to a securities account or *rights or interests in securities* resulting from the credit of securities to a securities account'.[71] These two provisions as currently drafted offer a consensus compromise between two starkly competing visions of intermediated securities, based on non-Convention law, which proved to be highly controversial in the meetings of the Committee of Governmental Experts.

One doctrinal approach views an account holder in the lowest tier of the chain as *the* owner of a property interest in the underlying securities with attributes of ownership essentially similar to those of owning securities directly, without the participation of an intermediary. Japanese law may be so classified.[72] Another doctrinal approach views securities holding through an intermediary as a *sui generis* form of holding that is quite distinguishable from direct, non-intermediated holding. US law fits this category. Although an entitlement holder acquires a pro rata property interest in a fungible bulk of financial assets under US law,[73] the only significant role of the property interest is to insulate the financial assets from the claims of an intermediary's general creditors to the extent necessary to satisfy entitlement holder claims.[74] Other legal regimes may not fit nicely into either category. The upshot of the current formulation is to defer to the non-Convention law with respect to both the nature and extent of the account holder's property interest.

D. Acquisition of Intermediated Securities

Article 11 of the Convention provides that '[s]ubject to Article 16, intermediated securities are acquired by an account holder by the credit of securities to that account holder's securities account'.[75] As to what constitutes a credit and the validity and liability of a credit to be reversed, the Convention defers to the non-Convention law and, to the extent permitted by that law, the account agreement and the rules of a securities settlement system.[76] UCC Article 8 also provides that one acquires intermediated securities—that is one becomes an entitlement holder and acquires a security entitlement with respect to a securities account—by a book entry indicating that a financial asset has been credited to a securities account.[77]

[70] Convention Art 9(1)(d) (emphasis added). These rights are conferred 'unless otherwise provided in this Convention': ibid. See Draft Official Commentary, above n 6, paras 9–24 to 9–26.
[71] Convention Art 1(b) (emphasis added).
[72] See above text at n 66.
[73] See above text at n 67.
[74] Ibid.
[75] Convention Art 11(1).
[76] Convention Art 16; see Draft Official Commentary, above n 6, paras 16–10 to 16–14.
[77] UCC § 8–501(b)(1).

Under certain circumstances one can become an entitlement holder and acquire a securities entitlement under UCC Article 8 even in the absence of a credit book entry. If the securities intermediary receives a financial asset from a person or acquires a financial asset for the person, and if the intermediary accepts the financial asset for credit to that person's account, the person acquires a security entitlement in the financial asset.[78] Moreover, a person will also acquire a security entitlement if the securities intermediary 'becomes obligated under other law [that is under law other than UCC Article 8], regulation, or rule to credit a financial asset to the person's securities account'.[79] For example, if an entitlement holder instructs an intermediary to buy a particular financial asset and pays (or authorises the intermediary to charge its account to cover) the cost of the financial asset, the entitlement holder may acquire a security entitlement in the financial asset *even if the intermediary does not acquire the financial asset.*

The acquisition of securities under the Japanese BETA can be made *only* by book entries in the securities account maintained by an intermediary, that is by a debit to a transferor's account and a credit to a transferee's account.[80] The BETA system contemplates a 'matched book' under which the number of units of securities of each issue credited by an intermediary on its books to its account holders must be strictly matched to the identical number of units of that issue in the intermediary's customer account on the books of JASDEC or another upper-tier intermediary.[81]

[78] UCC § 8–501(b)(2).

[79] UCC § 8–501(b)(3).

[80] BETA Arts 73 (corporate debt securities); 98 (JGBs); 140 (corporate equity securities). Under the BETA, an intermediary other than a CSD is an 'account keeping entity' (*koza kanri kikan*) (Art 2(4)), and a CSD is a 'book transfer entity' (*furikae kikan*) (Art 2(2)). An account holder in the lowest tier of the chain is a 'participant' (*kanyusha*) (Art 2(3)). Each securities account must have two sections, an 'ownership section' and a 'pledge section'. Full ownership of intermediated securities is acquired by crediting to the ownership section and a pledge to an account holder arises by crediting to the pledge section of the account holder's securities account. Also, an intermediary normally will carry at least two separate accounts with JASDEC or another upper-tier intermediary: BETA Arts 68 (corporate debt securities); 91 (JGBs); 129 (corporate equity securities). One would be its 'proprietary' or 'own' account, to which securities owned by the intermediary (and not maintained for its account holders) will be credited. The other will be its 'customer' account, to which securities it manages for its account holders will be credited. This form of 'segregation' of account holder securities is required by the BETA: BETA Arts 68 (corporate debt securities); 91 (JGBs); 129 (corporate equity securities). Segregation of 'assets' also is required by the FIEA: FIEA Art 43(2). Funds held by an intermediary on behalf of account holders (eg, as proceeds of securities sold by account holders and not yet reinvested) must in the aggregate be 'segregated' as well in an account with a trustee held in trust for the account holders: FIEA Art 43(2)(ii).

[81] The customer account normally will not reflect the individual holdings of each of the intermediary's account holders but, instead, will be held in an aggregated 'omnibus' account maintained for all account holders.

E. Duties of Intermediary

Article 9(1) of the Convention provides the package of rights conferred on an account holder by a credit.[82] Article 9(2) (subject to limitations discussed below) then provides that these rights may be exercised (by the account holder, implicitly) against the 'relevant intermediary'.[83] Article 10(1) reflects the mirror image of Article 9(1); it requires the intermediary to take appropriate measures so that its account holders will enjoy the rights provided in Article 9(1).[84] Article 10(1) describes the results that the intermediary must achieve but does not specify the measures that the intermediary must take.[85] This is consistent with the Convention's functional approach.

The measures that an intermediary must take pursuant to Article 10(1) may vary substantially in different jurisdictions because of differences in the applicable law and variations in the structure of intermediated securities systems.[86] Consider the rights specified in Article 9(1)(a) as an illustration. In some systems dividends and voting rights are passed down through tiers of intermediaries.[87] In others, an account holder may enjoy a more direct relationship with the issuer in receiving distributions and exercising voting rights. Article 9(b) and (c) expressly refer to 'instructions to the relevant intermediary' as the method by which an account holder may exercise its right to dispose of or grant an interest in intermediated securities or to cause securities to be held other than through a securities account (when that option is available under the applicable law, account agreement, or the uniform rules of a securities settlement system). To reiterate, the Convention does not harmonise the measures that an intermediary must take in order to comply with those instructions, reflecting the Convention's functional approach.

In advance of the final session of the diplomatic conference a few delegations, including France, called for an expansion of Article 10 so as to provide a more detailed and positive set of core intermediary duties.[88] But not all European Union member states supported such revisions. The representatives of the European Commission, working with the Swedish Presidency of the European Union, developed a common (albeit not unanimous) position of the member states on Article 10 (among other issues). This common position facilitated the addition of Article 10(2). Article 10(2) lists several core duties of intermediaries

[82] See above section III.C (discussing Convention. Art 9(1)).
[83] Convention Art 9(2)(b), (c). Convention Art 9(2)(a) provides that 'the rights referred to in paragraph 1 are effective against third parties'.
[84] See Draft Official Commentary, above n 6, para 10–7.
[85] Ibid.
[86] Ibid, para 10–8.
[87] See M Kahan and EB Rock, 'The Hanging Chads of Corporate Voting' (2008) 96 *Georgetown Law Journal* 1227.
[88] UNIDROIT 2009 – CONF 11/2 – Doc 8, at 3–4, Comments (*submitted by the Government of France*). In addition, the European Banking Federation made a similar proposal. UNIDROIT 2009 – CONF 11/2 – Doc 14, at 2–3, Comments (*submitted by the European Banking Federation*).

by way of reference to duties provided elsewhere in the Convention, in the non-Convention law, in the account agreement and in uniform rules of a securities settlement system. However, Article 10(2) is essentially a menu of these duties. It does not, of itself, create any additional duties or enhance any duties provided elsewhere.

The obligations of an intermediary under Article 10 are not absolute.[89] For example, Article 10(3) specifies two types of actions that the Convention does not require an intermediary to take. Note that Paragraph 3 addresses what the *Convention* does not require and in that respect it has a broader reach than an intermediary's Article 10(1) duties. First, the Convention does not require an intermediary 'to establish a securities account with another intermediary'.[90] Secondly, it does not require an intermediary 'to take any action that is not within its power'.[91] Moreover, the Article 10(1) obligations also must be interpreted and applied by taking into account the provisions of Article 28.[92]

Subject to several exceptions, '[a]n intermediary is neither bound nor entitled to give effect to any instructions with respect to intermediated securities' given by any person other than its account holder in respect of those intermediated securities.[93] Stated otherwise and subject to the exceptions, the intermediary must obey its account holder's instructions and is prohibited from acting on another person's instructions. This is so, for example, even if a third party informs the intermediary that it has an adverse claim that is traceable to the intermediated securities and demands that the intermediary not act on its account holder's instructions.[94] The intermediary's failure to act on the adverse claimant's demand and the intermediary's subsequent action on the account holder's instructions are protected under Article 23(1). It follows that the intermediary would incur no liability to the adverse claimant even though it acted on its account holder's instructions after being informed of the adverse claim. Article 23(1) necessarily implies this result.[95]

Article 24(1)(a) requires an intermediary to hold securities and intermediated securities of each description sufficient to cover securities of that description credited to the securities accounts of its account holders (other than itself).[96] If

[89] See Draft Official Commentary, above n 6, para 10–9.

[90] Convention Art 10(2); see Draft Official Commentary, above n 6, para 10–10 and Example 10–1.

[91] Convention Art 10(2); see Draft Official Commentary, above n 6, para 10–10 and Example 10–2.

[92] See below text at n 103 *et seq*.

[93] Convention Art 23(1). Convention Art 23(2) provides exceptions for variation by agreement, holders of effective security interests, judgments and the like, rules of the non-Convention law, and rules of a securities settlement system (if the intermediary is the operator of the system).

[94] See, eg, Draft Official Commentary, above n 6, Examples 17–1 and 17–2.

[95] Draft Official Commentary, above n 6, Example 23–3.

[96] Convention Art 24(1)(a); see Draft Official Commentary, above n 6, paras 24–9 and 24–10 and Examples 24–1 and 24–2. Note that Art 24(1)(b) was added during the final session at the request of a few delegations. It requires the intermediary to hold sufficient securities and intermediated securities so as to cover credits made by the intermediary to securities accounts that it maintains for

the intermediary at any time does not hold sufficient securities and intermediated securities, it must take actions necessary to cause it to hold sufficient securities and intermediated securities.[97]

Consistent with an intermediary's duty to hold sufficient securities, Article 25(1) requires an intermediary to allocate securities (directly or through another intermediary) to its account holders as necessary to comply with Article 24(1)(a) (that is so as to cover securities credited to securities accounts of its account holders other than itself).[98] Securities allocated to an intermediary's account holders are not property available to be reached by creditors of the intermediary.[99] An intermediary's arrangements for allocation may include an intermediary's holding 'securities and intermediated securities in segregated form' for 'account holders generally' or for 'particular account holders or groups of account holders'.[100] A Contracting State may declare that the allocation under Article 25 applies only to securities that an intermediary holds in segregated accounts for its account holders, provided that all securities and intermediated securities allocated to account holders are in segregated form.[101] The effect of such a declaration normally would be that securities not segregated for account holders (that is held by the intermediary for its own account) would be available for the intermediary's general creditors, even in the face of a shortfall in securities segregated for account holders.[102]

Article 28(1) deals with Convention obligations generally. Article 28(1) generally defers to the non-Convention law with respect to the manner of an intermediary's compliance with its Convention obligations.[103] It provides that the non-Convention law may specify the content of and manner in which an

itself. However, it is only the intermediated securities covered by Art 24(1)(a) (ie, those credited to accounts of account holders other than itself) that must be allocated under Art 25 and that are the subject of the loss-sharing rule of Art 26. This ensures that any shortfall in available securities arising out of an intermediary's noncompliance with Art 24(1)(b) will not in any way be to the detriment of account holders other than the intermediary itself.

[97] Convention Art 24(3); see Draft Official Commentary, above n 6, paras 24–22 and 24–23. It must take these actions 'within the time provided by the non-Convention law': ibid. Convention Art 24(2) addresses the methods by which an intermediary may 'hold or have available' securities for this purpose. These obligations do not override non-Convention law or (to the extent permitted by that law) provisions of securities settlement system uniform rules or of an 'account agreement' dealing with the method of compliance with those obligations, the allocation of costs of compliance, or otherwise with respect to the consequences of noncompliance with those requirements: Convention Art 24(4); see Draft Official Commentary, above n 6, para 24–24 and Example 24–7.

[98] Convention Art 25(1). The allocation is to be effected by the non-Convention law 'and, to the extent required or permitted by the non-Convention law, by arrangements made by the relevant intermediary': Convention Art 25(3).

[99] Convention Art 25(2).

[100] Convention Art 25(4).

[101] Convention Art 25(5).

[102] See below section V.C (discussing segregated account holder securities and rights of the intermediary's creditors under US and Japanese law).

[103] Convention Art 28(1); see Draft Official Commentary, above n 6, para 28–10 and Example 28–1. The Convention imposes express obligations on intermediaries in the following articles: Arts 10

intermediary is to comply with its Convention obligations.[104] For example, the non-Convention law would govern the procedures that an intermediary would follow in providing account holders with distributions and voting rights with respect to intermediated securities as required by Article 10(1).[105]

Article 28(2) provides that an intermediary's compliance with a provision of the non-Convention law that specifies the substance of an obligation under the Convention also satisfies the intermediary's Convention obligation.[106] This provision recognises that the Convention lays down very general obligations and duties that are likely to be the subject of more detailed laws and regulations under the non-Convention law. Moreover, it relieves intermediaries from the prospect of being subjected to a double standard: a treaty standard and the standard provided or permitted under the non-Convention law. By way of example, the non-Convention law and applicable regulations of a Contracting State generally may require an intermediary to hold and have available sufficient securities to match the outstanding credit balances of its account holders. But that law also may permit temporary shortfalls in the securities and provide protections for account holders by way of capital and collateral requirements, mark-to-market rules, reporting requirements and so on.[107] Notwithstanding the existence of these shortfalls, an intermediary's compliance with the non-Convention law of the Contracting State constitutes compliance with its obligations under Article 24.[108]

(measures to enable account holders to receive and exercise rights), 23 (instructions to the intermediary), 24 (holding or availability of sufficient securities), and 25 (allocation of securities to account holders' rights).

[104] This is consistent with the Convention's functional approach: Draft Official Commentary, above n 6, para 28–9. The Convention identifies the results that an intermediary is to achieve (reflected by the specified obligations) but does not specify the details of how an intermediary is to accomplish those results: ibid, para 28–10 and Example 28–1.

[105] Ibid, Example 28–1.

[106] During the final session of the diplomatic conference the second sentence of the former Art 28(1) was renumbered as Art 28(2) and the term 'specified' was added to replace the term 'addressed'. See Draft Official Commentary, above n 6, para 28–11. The former second sentence was added at the fourth session of the Committee of Governmental Experts based on a proposal by the US: see UNIDROIT 2007, Study LXXVIII – Doc 91, 'Observations on Transparent Systems submitted by the delegation of the United States of America' (May 2007), proposing a new Art 20(1*bis*): 'If the substance of an obligation of an intermediary under this Convention is the subject of any provision of the non-Convention law or, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system, compliance with that provision satisfies that obligation.' The language of Art 28(21) is identical in substance.

[107] Many modern securities markets afford participants and regulators the flexibility to adjust the obligations of intermediaries to fit various circumstances. For example, it is not unusual for an intermediary to disclaim responsibility for risks attendant to holding through foreign intermediaries.

[108] As explained in the Draft Official Commentary, if a provision of the non-Convention law, account agreement, or uniform rule relating to the subject of a Convention obligation materially contradicts a Convention obligation, or if a provision is so minimal that it consists of no material obligation in substance, then that provision would not address (or specify) 'the substance of any such [Convention] obligation' within the meaning of the former second sentence of Art 28(1) or Art 28(2). Draft Official Commentary, above n 6, para 28–13. Discussions during the final session suggest that the discussion in the Draft Official Commentary should be expanded to explain that such a provision

Article 28(1) and Article 28(2) defer to the account agreement and the uniform rules of a securities settlement system, but only to the extent that the non-Convention law so permits.[109] The agreement or rules would determine the manner of compliance and compliance with the terms of the agreement or rules would constitute compliance with the intermediary's Convention obligations.

Article 28(3) deals with an intermediary's liability with respect to its Convention obligations.

> Like Article 28(1), … [Article 28(3)] defers to the non-Convention law as to the intermediary's liability and, to the extent permitted by the non-Convention law, to the account agreement or the uniform rules of a securities settlement system. Liabilities for noncompliance with a Convention obligation may take a variety of forms under the non-Convention law. These may include such liabilities as civil or criminal fines, civil liability to a government or regulatory authority, or civil liability to an account holder that has suffered damages resulting from the noncompliance.[110]

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

Under UCC Article 8 a securities intermediary generally is obligated to maintain sufficient financial assets to cover its entitlement holders' security entitlements.[111] For registered broker-dealers, however, the principal requirement—and exceptions—are found in regulations issued by the Securities

would specify the substance of a Convention obligation only if the provision (i) requires intermediary conduct or a result that is substantially similar to that required by the Convention obligation and (ii) is aimed at a substantially similar purpose and function as the Convention obligation. Properly interpreted and applied, Art 28(2) would not permit the the non-Convention law, account agreement, or uniform rule to expose account holders to materially greater risks.

[109] Draft Official Commentary, above n 6, para 28–12 and Examples 28–5 and 28–6.

[110] Draft Official Commentary, above n 6, para 28–14. As was mentioned concerning Art 28(2), if under the non-Convention law, account agreement, or uniform rules there is virtually no material liability for noncompliance with a Convention obligation, such a result would not be consistent with the Convention obligations: ibid, para 28–15.

[111] UCC § 8–504(a).

and Exchange Commission (SEC) under the Securities Exchange Act of 1934.[112] Shortfalls in securities maintained by intermediaries for account holders routinely occur in the normal operation of the back offices of broker-dealers in the US.[113] Clearance and settlement systems provide additional protections in these situations for system participants and, in effect, for entitlement holders as well.[114] Another provision of the UCC prohibits an intermediary from creating a security interest in the financial assets it is required to maintain for entitlement holders, except with the agreement of the relevant entitlement holders.[115] Such agreements with entitlement holders are common, however, inasmuch as intermediaries often need to use financial assets held on behalf of entitlement holders as collateral for borrowings of funds in order to fund loans by intermediaries to their entitlement holders (often called 'margin' loans).[116]

[112] See, generally, E Guttman, *Modern Securities Transfers*, 3rd edn (St Paul Minnesota, Thomson/West, 2004) § 4.10 (hereafter, Guttman, *Securities*).

[113] See, eg, UCC § 8–504, Comment 5, which states in pertinent part:
In certain circumstances, these rules permit a firm to be in a position where it temporarily lacks a sufficient quantity of financial assets to satisfy all customer claims. For example, if another firm has failed to make a delivery to the firm in settlement of a trade, the firm is permitted a certain period of time to clear up the problem before it is obligated to obtain the necessary securities from some other source.

[114] For example, many clearing and settlement systems involve a clearing entity that assumes the role of a 'central counter-party' (CCP). A CCP normally assumes the obligations of its participants to deliver and pay for securities. In effect, the CCP comes between those entitled to receive securities and those entitled to receive payments. National Securities Clearing Corporation (NSCC) and JSCC each functions as a CCP in its respective netting operations for exchange traded securities: see NSCC, 'Clearance and Settlement', Overview, available at http://www.dtcc.com/about/subs/nscc.php ('Through CNS [Continuous Net Settlement], NSCC becomes the contra-party to each compared trade and guarantees settlement for eligible transactions as of midnight of the day the trade is reported to the member as compared.'); JSCC, 'Basic Structure of Clearance & Settlement System', available at http://www.jscc.co.jp/en/index.html. ('The JSCC guarantees settlements of each transaction for all exchange-traded cash products and TSE-traded derivatives by functioning as a central counter-party, by which the JSCC novates the debts of the clearing participants, ie the obligations of payment or delivery, whilst acquiring credits to the other parties.') Their participants are, of course, obliged to make deliveries and payments to the CCP (NSCC or JSCC, as the case may be). A CCP, then, assumes its participants' delivery and payment obligations to pay and deliver to other participants and, correspondingly, becomes the beneficiary of participants' entitlements to receive deliveries and payments. This protects participants against ultimate losses for failures to deliver or pay.

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

[116] Such a loan by an intermediary to its entitlement holder normally is secured by the borrower's security entitlements. Federal regulations also regulate and restrict the creation of security interests by broker-dealers. See, generally, Guttman, *Securities*, above n 112, § 4.10.

There are additional, complementary obligations imposed on intermediaries as well. For example, an intermediary must obtain and pass on to an entitlement holder payments and distributions made by an issuer of a financial asset,[117] exercise rights with respect to financial assets if directed by the entitlement holder,[118] comply with its entitlement holders' entitlement orders,[119] re-establish a security entitlement if the intermediary transfers a financial asset under an ineffective entitlement order,[120] and obey directions of its entitlement holders to convert security entitlements to other forms of holding, such as a certificated security or a securities entitlement with another intermediary.[121]

There are exceptions to these UCC duties, however. In general, an intermediary satisfies these duties if it acts in accordance with its agreement with the entitlement holder or if, in the absence of such an agreement, the intermediary acts with 'due care in accordance with reasonable commercial standards'.[122] Moreover, compliance with analogous regulatory law that addresses 'the substance of a duty imposed upon a securities intermediary by Sections 8–504 through 8–508' constitutes compliance with the duty.[123]

The BETA does not by its terms impose a 'duty', as such, on an intermediary to maintain a matched book for its account holders, but it reaches that result implicitly and practically by imposing strict liability. If for any reason any intermediary fails to hold securities in its customer account on the books of JASDEC or the books of another upper-tier intermediary sufficient to cover the credits it has made to its account holders, the intermediary is required to rectify the shortfall.[124] Stated from another perspective, the aggregate units credited to underlying owners in the book-entry system (including credits to the proprietary accounts of intermediaries) should not exceed the total number of units issued by the issuer.

If an imbalance occurs (a 'shortfall' from the perspective of the intermediary or an 'overbooking' from the perspective of the issuer's books) the intermediary might cause the books to match by purchasing securities from account holders or acquiring additional securities in the market for credit to its upper-tier customer account (or in the case of JASDEC, for credit to its participants). JASDEC or an intermediary that has suffered the shortfall or overbooking is primarily liable. In addition, any lower-tier intermediary in the chain, including the intermediary that maintains an account with an account holder who has been damaged, is a

[117] UCC § 8–505(a).
[118] UCC § 8–506.
[119] UCC § 8–507(a).
[120] UCC § 8–507(b).
[121] UCC § 8–508.
[122] UCC §§ 8–504(c), 8–505(a), 8–506, 8–507(a), 8–508.
[123] UCC § 8–509(a). This provision was the inspiration for the US proposal resulting in Convention Art 28(2), discussed above at n 106.
[124] BETA Arts 78, 79 (corporate debt securities); 103, 104 (JGBs); 145, 146 (corporate equity securities).

guarantor of that liability.[125] This 'partitioned' strict liability differs from the generally applicable strict liability under the former Custody Act of 1984, which imposed liability on JASDEC and all of JASDEC's participants, even those not in the chain of holding in which a shortfall has occurred.[126]

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

IV. Innocent Acquisition and Priorities

This section examines two sets of rules that address competing or conflicting interests in intermediated securities. Subsection A addresses the first set of rules. Roughly speaking, they fill the role traditionally played by the concept of good faith purchase. We refer to this set of rules as 'innocent acquisition rules' and to their beneficiaries as those entitled to 'innocent acquisition protection'. In general, qualifying beneficiaries of the innocent acquisition rules are protected completely from those who assert claims based on competing property interests. Subsection B considers the second set of rules, which are 'priority' rules. They provide for a rank-ordering of competing interests in intermediated securities credited to the same securities account. Under these priority rules, depending on the value of the underlying financial asset, a junior interest may be fully protected or there may be insufficient value to satisfy (or even to provide any benefit at all) to the holder of the junior interest.

[125] BETA Art 11 (2) (CSD must have regulations requiring a guarantee of payment of damages for upper-tier overbooking in the contract between an intermediary and its account holder). Both the JASDEC and BOJ regulations impose this requirement: JASDEC, 'Business Regulations Relating to Corporate Bonds, Etc. [Translation]' (January 2009) (hereafter, JASDEC, *Bond Regulations*), available at http://www.jasdec.com/en/download/sb/10.pdf, Art 26(1)(5); Bank of Japan, 'Bank of Japan Regulations concerning the JGB Book-entry System', available at http://www.boj.or.jp/en/type/law/furiketsu/fyoryo01.htm, Arts 20(1)(12), (13).

[126] Act for Custody and Book Transfers of Shares (Act 30 of 1984), Art 25.

A. Innocent Acquisition of Intermediated Securities ('Good Faith Purchase')

i. Background and Policy

Most legal regimes contain protection from adverse claims[127] for good faith purchasers[128] of securities in the intermediated securities system. Some are designed to address specifically the context of intermediated securities, such as the 'innocent acquisition' protection in the Convention[129] and the provisions of UCC Article 8 providing immunity from liability in the US.[130] The Japanese version is a hybrid of sorts. The BETA makes provision for the protection of a good faith purchaser to whose securities account securities are credited.[131] But the Act contains no special test for what constitutes 'good faith', relying instead on judge-made precedents that apply to movables more generally as well as to negotiable instruments and securities.[132]

Innocent acquisition in the intermediated securities system is best understood as a particular and specialised adaptation of an important goal of negotiability—assurance that the acquisition of an interest in intermediated securities will not be subject to conflicting claims. Negotiability historically has been understood as an attribute of written, paper instruments and securities in which delivery of the token (for example, a share certificate) serves to transfer the underlying abstract rights and, where the appropriate requisites are met (for example, proper indorsements) the transferee acquires the token and the underlying rights free of adverse claims. The conceptual and formal niceties of negotiability in the strict sense are not observed, or even relevant or useful, in the context of intermediated securities systems.[133] But the goal of negotiability, free from conflicting claims and liability, is enormously important for the intermediated securities systems.[134]

[127] By 'adverse claim' we mean a person's (ie an adverse claimant's) claim (i) in or against securities or intermediated securities; and (ii) that another person's acquisition of intermediated securities violates the rights of the adverse claimant.

[128] By 'good faith purchase' we refer generically to the protection of innocent purchasers from conflicting claims to intermediated securities. We do not intend to suggest that the term 'good faith' is or should be an appropriate term for statutory use or the proper standard of innocence.

[129] See below section IV.A.ii.

[130] Ibid.

[131] Ibid.

[132] Ibid.

[133] See, generally, JS Rogers, 'Negotiability, Property, and Identity' (1990) 12 *Cardozo Law Review* 471.

[134] See UCC § 8–502, Comment 2: 'Section 8–502 ensures that no such [adverse] claims can be asserted against a person … who acquires a security entitlement under Section 8–501 for value and without notice, regardless of what theory of law or equity is used to describe the basis of the assertion of the adverse claim.' Consider also Grant Gilmore's famous article in which, more than 25 years ago, he expressed repentance and leveled harsh criticism at himself, Karl Llewellen, and other legal realists for pushing the concepts of negotiability and good faith purchase to an excess in the UCC: G Gilmore, 'The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a

The importance of a workable system for innocent acquisition has been recognised and asserted regularly throughout the process of developing the Convention.[135] The existence and assertion of actual adverse claims to intermediated securities are relatively rare.[136] But the protection of purchasers in the intermediated system nonetheless is of enormous importance in establishing finality and repose in the financial markets.[137]

ii. Comparison of Convention, United States Law, and Japanese Law

This section describes and compares the Convention, US, and Japanese regimes for innocent acquisition of intermediated securities. It also explains how the Convention's rules would be applied under both US and Japanese law as the non-Convention law.

Article 18 of the Convention protects an 'acquirer' of intermediated securities if the acquirer meets the relevant test of innocence. An 'acquirer' is defined to mean a person that obtains an interest in intermediated securities by a credit to the acquirer-account holder's securities account or a person to whom an interest in intermediated securities is granted under Article 12.[138] The protections are provided in two related but different circumstances.

Repentant Draftsman' (1981) 15 *Georgia Law Review* 605, 611–612. For a discussion of the development of negotiability of securities in the US, see G Gilmore, 'The Commercial Doctrine of Good Faith Purchase' (1954) 63 *Yale Law Journal* 1057, 1072–1076, 1088–1093. It was only the adoption of UCC Art 8 that finally brought true negotiability to all securities: ibid, at 1093 n 107. Although Gilmore criticised in particular the good faith purchase rules of UCC Arts 2 (goods) and 3 (negotiable instruments) in his 1981 article, the article never mentioned (much less criticised) Art 8.

[135] UNIDROIT 2008, CONF 11 – Doc 8, 'Informal Working Group on Article 14 of the draft Convention Summary Report (submitted by the Chair of the informal Working Group)' (March 2008) at 2: 'Article 14 seeks to offer an adequate protection to the innocent acquirer (IA) of intermediated securities. The principle underpinning this rule has received strong support. During the discussions in the Committee of Governmental Experts, there has been general agreement on the necessity to provide an adequate level of protection to IAs.' For an overview of the drafting history of the Convention's innocent acquisition-related provisions, see Draft Official Commentary, above n 6, paras 17–2 to 17–4, 18–2 to 18–3.

[136] See below text at n 170.

[137] See, eg, Thévenoz, *Intermediated Securities*, above n 20, at 447: 'An effective title system for negotiable assets also requires protecting *bona fide*—or innocent—acquirers against competing claims by previous holders. What is true in the physical world of certificated securities is also needed in the intangible world of intermediated securities, which are massively traded in the near total anonymity of regulated exchanges.'

[138] Convention Art 17(a). The acquisition of interests under Convention Art 12 is considered in more detail in the discussion of priorities: see below section IV.B.i. Until the first session of the diplomatic conference the predecessor provisions of Convention Art 18(1) protected only account holders who acquired intermediated securities by way of a credit. The US proposed an extension of the innocent acquisition protections to persons who acquire interests other than by a credit, but only in situations in which the Convention's priority rules in Art 19 do not apply. This extension to protect all acquirers was adopted at the first session: see Convention Art 18(6) ('This Article does not modify the priorities determined by Article 19.'). For a discussion of the relationship among the Convention Art 18 innocent acquisition protections, Convention Art 12 interests, and the Convention Art 19 priority rules, see Draft Official Commentary, above n 6, para 18–16 and Examples 18–6 to 18–8.

First, Article 18(1) protects an acquirer from competing claims of another person. The protection applies unless, at the 'relevant time':

> [T]he acquirer actually knows or ought to know … that another person has an interest in securities or intermediated securities and that the credit to the securities account of the acquirer or the interest granted to the acquirer violates the rights of that other person with respect to the interest of that other person.[139]

The 'relevant time' for this purpose is the time that a credit is made or the time specified in Article 19(3) for ranking interests granted under Article 12.[140] Article 18(1) provides three forms of protection to a qualifying account holder. First, the acquirer's interest in intermediated securities 'is not subject to' the other person's adverse claim.[141] In addition, 'the account holder is not liable to' the adverse claimant (that is a provision for immunity from liability).[142] Finally, 'the credit, designating entry or interest granted is not invalid or liable to be reversed on the ground that the credit, designating entry or interest granted violates the rights of that other person'.[143] There is one further condition to protection under Article 18(1). It is inapplicable to an acquisition 'made by way of gift or otherwise gratuitously' (that is the protection generally is afforded only to acquirers for value) unless the acquirer is acquiring a security interest.[144]

Secondly, Article 18(2) offers protection to acquirers from risks attendant to a 'defective entry'.[145] Article 18(2) addresses the concern that a credit on the books

[139] Convention Art 18(1).

[140] Convention Art 17(e) (defining 'relevant time'); see below nn 191–94 and accompanying text (discussing timing in the application of the Convention Art 19 priority rules).

[141] Convention Art 18(1)(a). For convenience, we sometimes refer to the other person's interest as an 'adverse claim' and to the other person as an 'adverse claimant', although neither term is used in the Convention. For examples of circumstances in which adverse claims to intermediated securities may arise, see Draft Official Commentary, above n 6, Examples 18–1 to 18–4.

[142] Convention Art 18(1)(b).

[143] Convention Art 18(1)(c).

[144] Convention Art 18(3). This curious exception for gratuitous security interests was thought necessary to avoid an inadvertent denial of protection in the case of security interests granted by one corporate affiliate to secure the obligations of another affiliate. In advance of the fourth session the US proposed a clarification to ensure that when an intermediary receives a credit on the books of another intermediary and, in turn, the first intermediary credits the account of its account holder, the first intermediary does not acquire its interest gratuitously: see UNIDROIT 2007, Study LXXVIII – Doc 74, 'Comments by Governments and International Organisations (submitted by the Delegation of the United States of America) – Observations on Innocent Acquisition and Immunity' (April 2007), at 2. At the first session of the diplomatic conference it was determined that the Official Commentary should clarify this point. The Draft Official Commentary makes this clarification: Draft Official Commentary, above n 6, para 18–13.

[145] Convention Art 18(2). A 'defective entry' is defined as 'a credit of securities or designating entry which is invalid or liable to be reversed, including a conditional credit or designating entry which becomes invalid or liable to be reversed by reason of the operation or non-fulfilment of the condition': Convention Art 17(d). As to validity, reversibility and conditionality, Convention Art 16 provides: '[T]he non-Convention law, and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system determine whether and in what circumstances a debit, credit, designating entry or removal of a designating entry is invalid, is liable to be reversed or may be subject to a condition, and the consequences thereof.'

of an intermediary or an Article 12 grant of an interest in favour of an acquirer may be rendered invalid or reversible by virtue of an earlier defective entry. As a simplified example, an intermediary might debit the account of A and credit the account of B. If the debit were not valid and if the intermediary were entitled to reverse it, Article 18(2) would, if B qualifies, protect the credit to B's account that was valid in all other respects. The test of innocence under Article 18(2) is similar to Article 18(1). B would qualify for protection '[u]nless the acquirer [B] actually knows or ought to know, at the relevant time, of an earlier defective entry'.[146] If B qualifies, the credit would not be invalid, ineffective, or reversible as a consequence of the defective entry[147] and B would not be 'liable to anyone who would benefit from the invalidity or reversal of … [the] defective entry'.[148] Article 18(5) provides a limitation on Article 18(2): 'To the extent permitted by the non-Convention law, paragraph 2 is subject to any provision of the uniform rules of a securities settlement system or of the account agreement'.[149]

The protections afforded (or not) by paragraphs (1) and (2) of Article 18 turn on whether an acquirer 'actually knows or ought to know' of an interest or fact. This test was adopted at the diplomatic conference based primarily on a proposal by the US.[150] The proposal received strong support from European Union member states and met virtually no opposition. The US conditioned the 'ought to know' component of the proposal on the clarification of the concept in both the Convention text and in draft Official Commentary that the US delegation presented to the diplomatic conference.[151] The relevant Convention text provides:

> In this Chapter:
>
> …
>
> (b) in determining whether a person ought to know of an interest or fact:
>
> (i) the determination must take into account the characteristics and requirements of securities markets, including the intermediated holding system; and
>
> (ii) the person is under no general duty of inquiry or investigation;

[146] Convention Art 18(2).
[147] Convention Art 18(2)(a).
[148] Convention Art 18(2)(b).
[149] Convention Art 18(5). For a discussion of the relationship between paras 2 and 5, see Draft Official Commentary, above n 6, paras 18–8, 18–9 and Example 18–5.
[150] UNIDROIT 2008, CONF 11 – Doc 23, 'Observations on the Standard for Innocent Acquisition/Proposed Revised Article 14(1), (2) and (4)(b) and Draft Official Commentary (submitted by the delegation of the United States)' (September 2008) (hereafter, US Proposal on Innocent Acquisition).
[151] Ibid.

(c) where a person is an organisation, such person actually knows or ought to know of an interest or fact from the time when the interest or fact is or ought reasonably to have been brought to the attention of the individual responsible for the matter to which the interest or fact is relevant.[152]

The Draft Official Commentary explains:

17–10. Sub-paragraph (b)(ii) further makes it clear that the 'ought to know' standard imposes on an acquirer no general duty of inquiry or investigation. In most acquisitions by way of a credit or designating entry, it would be impossible for the acquirer to discover any conflicting claims or defective entries, because the acquirer must rely entirely on the intermediary. Similarly, in most acquisitions by way of a control agreement, or by an intermediary by agreement with its account holder, the acquirer will ordinarily have no practicable and conclusive way of discovering the interests or facts with which Articles 18(1) and 18(2) are concerned. It follows that requiring an acquirer to somehow undertake due diligence by way of inquiry or investigation would undermine the very efficiencies that intermediated systems are intended to capture. Accordingly, innocent acquisition protection is generally available under this article even to an acquirer who is concededly oblivious, ignorant, and uncurious—subject to the standards of honest behaviour and wrongful knowledge discussed below.

17–11. By no means does the 'ought to know' standard protect a person who fails to observe appropriate standards of honest behaviour. Indeed, the 'ought to know' standard is expressly designed to hold a dishonest person responsible for any interest or fact of which an honest person would have actually known. For example, if a person actually knows of very suspicious circumstances, and consciously decides not to make any inquiry, and that decision is made so that the person will avoid actual knowledge of a fact, then the person 'ought to know' of that fact. However, the nature of transactions in intermediated securities is such that this standard will rarely apply outside of an acquirer's actual collusion with a wrongdoer, or in highly suspicious circumstances when the acquirer's knowledge falls just short of 'actual knowledge'.

EXAMPLE 17–1: Wife (W) informs the relevant intermediary that (i) the securities credited to the securities account of her Husband (H) are jointly owned by W and H (although the account is in the name of H alone), (ii) that they are parties to a divorce proceeding, and (iii) that her husband moved the securities into his sole account from their joint account with another intermediary. In the meantime, however, H granted a security interest in the intermediated securities to a lender (L) to secure a new loan and the securities have been credited to L's account with another intermediary. L was aware (from a credit application) that H is married but was unaware of the pending divorce proceeding. L is an innocent acquirer, as he had no wrongful knowledge and was not aware of any suspicious circumstances. L's knowledge that H is married is not a highly suspicious circumstance that would be a sufficient basis to conclude that L purposefully failed to make inquiry in order to avoid wrongful knowledge. (Note that the facts of Example 17–1 would not occur under a system in which W, not being an account holder, would not have a property interest in the securities credited to H's account or in a system in which joint accounts are not permitted.)

[152] Convention Arts 17(b), (c).

EXAMPLE 17–2: The facts of Example 17–1 apply except that L's loan officer handling the transaction knew (i) of the divorce proceeding, (ii) that it is typical in such proceedings that the transfer of an interest in assets other than in routine transactions is prohibited, and (iii) from documentation provided to L's loan officer, that prior to the security interest being granted the securities were transferred from a joint account in the name of H and W to the account in the sole name of H. L's failure (i.e., the loan officer's failure) to make any inquiry that might have revealed W's proprietary claim and the wrongfulness of the grant of a security interest to L make it plausible that L ought to have known about the claim and the violation of W's rights. If that is so, then L would not be protected under Article 18(1). (Of course, no simple example that does not assume actual knowledge can be sufficiently rich in factual detail to support a definite conclusion on the 'ought to know' issue.)[153]

The emergence at the first session of the diplomatic conference of this strong consensus on a standard of innocence may be surprising, inasmuch as delegations were deeply divided on the issue during the meetings of the Committee of Governmental Experts that preceded the diplomatic conference. Some delegations expressed serious concerns that judges in some states simply could not deal with the text contained in the drafts that emerged from the governmental experts' meetings.[154] Those drafts each contained a version of the so-called 'wilful blindness' test, applicable when a person 'deliberately' (that is intentionally) avoids actual knowledge.[155] But in another sense the consensus was not surprising. This is so because the disagreement among delegations was not one of actual

[153] Draft Official Commentary, above n 6, paras 17–10 to 17–11, Examples 17–1 and 17–2. Paras 17–10 and 17–11 are substantially in accord with the draft commentary proposed by the US: see US Proposal on Innocent Acquisition, above n 150, at 2. The draft commentary proposed by the US attracted no material opposition during the discussions at the diplomatic conference.

[154] See, eg, UNIDROIT 2008, Study LXXVIII – Doc 107 Rev, 'Informal Working Group on Article 14 of the draft Convention—Response to the questionnaire concerning acquisition by an innocent person (submitted by the delegation of France)' (January 2008) at 4: 'The French delegation remains most unsupportive of the insertion of a test as referred to in Art 14(4)(b) [ie the former 'wilful blindness' test].

We're not against the substance: the content of the notion of bad faith insofar as it results from French case law is close to the idea expressed in the UNIDROIT project—it is bad faith for someone who knew of a defect or who had or could not be supposed not to have, taking account of the circumstances, suspicions about the nature or the quality of the right of the other party.

We're opposed to the form:

1. The insertion of such a test is incompatible with our legal system.

(a) The French legal system is built on general principles and concepts laid down by the legislator, and interpreted by courts. This generality gives our legal system some flexibility and allows it to evolve easily to adapt to new realities. The insertion of the test would appear like a wart, an aberration'.

[155] Those drafts provided that a person has knowledge if the person has 'actual knowledge' or 'has knowledge of facts sufficient to indicate that there is a significant probability that the interest or fact exists and deliberately avoids information that would establish that this is the case': see, eg, UNIDROIT 2007, Study LXXVIII – Doc 94, 'Preliminary Draft Convention on Substantive Rules Regarding Intermediated Securities' (May 2007), Art 4(b). Subparas (4)(b) and (c) (dealing with knowledge of an organisation) were placed in square brackets at the fourth session of the Committee of Governmental Experts in order to indicate the absence of a consensus as to the appropriate test for knowledge of an interest or fact: ibid. The test under the text contained in those drafts was similar to the test under US law (UCC §§ 8–105(a)(2) and 8–502), discussed in the following paragraph.

substance or result but instead a disagreement over the appropriate Convention text. For example, there was no substantial support for a standard that generally would require an acquirer to undertake investigation or other due diligence. Moreover, as the Draft Official Commentary quoted above indicates, proper application of the 'ought to know' standard essentially captures the substance of the 'wilful blindness' test.

Because US law incorporates the 'wilful blindness' test, results under the Convention and US law should not differ in any material respect. UCC section 8–502 provides the operative rule:

> An action based on an adverse claim to a financial asset, whether framed in conversion, replevin, constructive trust, equitable lien, or other theory, may not be asserted against a person who acquires a security entitlement under Section 8–501 for value and without notice of the adverse claim.[156]

UCC section 8–105(a) explains when one has 'notice of an adverse claim'. Under that section, a person has notice if the person 'knows of the adverse claim'—that is has 'actual knowledge' of the adverse claim.[157] Even in the absence of actual knowledge, under the 'wilful blindness' test, a person who 'deliberately avoids information' about an adverse claim while aware of suspicious circumstances, or a person who has a statutory or regulatory duty to investigate but fails to do so also may obtain the requisite notice.[158]

Another innocent acquisition rule, similar to section 8–502, is found in section 8–510. It provides immunity from liability to 'a person who purchases a security entitlement or any interest therein, from an entitlement holder'.[159] A typical example of such a purchaser is a person who obtains a security interest in a security entitlement under UCC Article 9 (discussed in more detail below in connection with priority rules). Note that the person protected under section 8–510 need not be an entitlement holder itself, but must be a 'purchaser from an

[156] UCC § 8–502. The normal method by which a person acquires a security entitlement is by a credit to the person's securities account: UCC § 8–501(b)(1). But a person also acquires a security entitlement if the intermediary acquires or receives a financial asset and accepts it for credit to the person's account (even if the credit is not actually made) or if the intermediary is obligated by law (other than UCC Art 8), regulation, or rule to credit a financial asset to the person's account: UCC § 8–501(b)(2), (3). 'A person gives value for rights if the person acquires them … in return for any consideration sufficient to support a simple contract': UCC § 1–204(4). UCC § 8–116 provides additional rules on when value is given in the context of the indirect holding system.

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

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

[159] UCC § 8–510(a).

entitlement holder'; entitlement holders generally are protected by section 8–502, discussed above.[160] The purchaser may be a buyer or one who acquires a security interest.[161] The immunity provided by section 8–510(a) is available only 'if the purchaser gives value, does not have notice of the adverse claim, and obtains control'.[162] Finally, if the transferor-entitlement holder itself is protected from an adverse claim under section 8–502, a purchaser from the entitlement holder is likewise immune from liability to the adverse claimant under a version of the 'shelter' principle.[163]

Note that these innocent acquisition rules provide immunity from liability and do not provide that an acquirer 'takes free' of a competing claim, as traditionally has been the case in the good faith purchase context. As stated in the UCC official

[160] Ibid.

[161] UCC § 1–201(a)(29) (defining 'purchase' as 'taking by sale, lease, discount, negotiation, mortgage, pledge, lien, security interest, issue or reissue, gift, or any other voluntary transaction creating an interest in property'), (30) (defining 'purchaser' as 'a person that takes by purchase'). Note that the innocent acquisition rule of UCC § 8–510(a) applies only when otherwise applicable temporal (ie first-in-time) priority rules are not applicable: see below text at n 219 *et seq*.

[162] UCC § 8–510(a). 'Control' of a security entitlement typically is achieved when 'the securities intermediary has agreed that it will comply with entitlement orders originated by the purchaser without further consent by the entitlement holder' (a 'control agreement', to use common terminology): UCC § 8–106(d)(2). Of course, the intermediary would act at its peril if it made such an agreement without the consent or permission of the entitlement holder. Control also may be obtained if the purchaser itself becomes the entitlement holder or if another person who has control 'acknowledges that it has control on behalf of the purchaser': UCC §§ 8–106(d)(1), (3).

[163] UCC § 8–510(b). UCC § 8–503(e) is a third innocent acquisition-related provision, which provides immunity from liability to an entitlement holder based on the entitlement holder's pro rata property interest. The immunity is granted to 'any purchaser of a financial asset or interest therein who gives value, obtains control, and does not act in collusion with the securities intermediary in violating the securities intermediary's obligations under Section 8–504' (ie the obligation, inter alia, to maintain sufficient financial assets to cover an intermediary's entitlement holder claims to security entitlements). By making it so difficult for an entitlement holder to base a claim on its property interest, the statute recognises de facto that in most cases it is virtually impossible for an entitlement holder to trace its interest to the hands of a purchaser of a financial asset.

A final innocent acquisition-related rule is *sui generis*. UCC § 8–115 provides immunity from liability to an adverse claimant for an intermediary that transfers a financial asset in response to an effective entitlement order. An 'entitlement order' is a notification by an entitlement holder to its securities intermediary which directs the disposition or redemption of a financial asset: UCC § 8–102(a)(8). Such immunity is implicit under Convention Art 23(1) which provides that 'an intermediary is neither bound nor entitled' to act on instructions other than those of its account holders. UCC § 8–115 contains three exceptions from the otherwise applicable immunity. The first applies when the intermediary acts after it has received judicial process, such as a court order, restraining its act and after it has had a reasonable time to act on the process: UCC § 8–115(1). The second applies when the intermediary acts 'in collusion with the wrongdoer' to violate the rights of the adverse claimant: UCC § 8–115(2). The third applies to the limited case of a stolen security certificate when the intermediary acts with notice of an adverse claim: UCC § 8–115(3).

Note that UCC §§ 8–502 and 8–510 incorporate the 'notice of adverse claim' test that is similar to traditional notions of good faith purchase, although the term 'good faith' is not used. UCC §§ 8–503 and 8–115, on the other hand, apply the more protective (of the person asserting immunity) standard of 'collusion' with a wrongdoer (except that UCC § 8–115(3) applies the 'notice of … adverse claim' standard in the case of a stolen security certificate).

comments, '[t]his section [8–502] does not use the locution "takes free from adverse claims" because that could be confusing as applied to the indirect holding system'.[164]

The Japanese BETA provides that an innocent account holder acquires complete ownership of the securities, that is will take free of competing property claims.[165] To qualify, the account holder receiving the credit must do so in good faith and without gross negligence.[166] Unlike under the Convention regime and US law, under the Act, the *only method* of transfer or delivery of an interest that is effective to qualify a purchaser as an innocent acquirer is a credit on the books of JASDEC or another intermediary.[167] A credit to an account holder's account presumptively confers ownership. And it is clear that one who satisfies the test for innocence under Japanese law (good faith and absence of gross negligence) would incur no liability in tort or otherwise. For this reason, there is no apparent need to provide an explicit immunity from liability as such for acquirers (who, under the BETA, necessarily are account holders), unlike under the Convention regime and under US law.

As they are essentially standards of culpability, the substantially similar standards of 'ought to know' under the Convention and 'wilful blindness' under US law appear to be more protective of an acquirer than the gross negligence standard under Japanese law. The gross negligence test clearly is one of prudence. But the Japanese gross negligence standard also bears some close similarity to the 'ought to know' and 'wilful blindness' test. Gross negligence also can arise out of the failure to investigate in the face of suspicious circumstances.[168] One hopes that the Japanese courts would apply the gross negligence standard while keeping in mind the needs of the market participants in the intermediated system and the

[164] UCC § 8–502, Comment 1; see also UCC § 8–503, Comment 2 (to similar effect). This approach follows a trenchant critique of the approach of the pre-1994 UCC Art 8, which employed a traditional property law construct for the resolution of competing claims in the indirect (ie intermediated) system for holding securities: see CW Mooney, Jr, 'Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries' (1990) 12 *Cardozo Law Review* 305.

[165] BETA Arts 77 (good faith purchase of corporate debt securities); 102 (same for JGBs); 144 (same for corporate equity securities).

[166] Ibid.

[167] BETA Arts 73 (corporate debt securities); 98 (JGBs); 140 (corporate equity securities).

[168] The language in the statute (BETA Arts 77 (good faith purchase of corporate debt securities); 102 (same for JGBs); 144 (same for corporate equity securities)) for book entry securities is the same as provided for certificated securities under Companies Act Art 131(2). Under the Commercial Code (which was replaced by the Companies Act), the statutory provision for share certificates referred to the corresponding provision about checks, and the rule was understood to be the same for certificated shares and negotiable instruments (such as promissory notes and checks). There are many cases involving stolen promissory notes, such as the Supreme Court Judgment on 20 June 1977, 873 Hanreijiho 97. Several cases also are found for certificated shares: Tokyo District Court Judgment on 18 January 2001, 1073 Hanreitimes 194; Tokyo District Court Judgment on 16 September 2004, 1906 Hanreijiho 164 (in both cases, a finance company purchased a stolen share certificate in a face to face transaction and was held to be grossly negligent). We have found no case involving intermediated securities transferred or pledged under the BETA or under earlier Japanese law.

system's underlying goals and policies. If that is so, one would expect that the Japanese innocent acquisition regime would produce results that would be essentially identical to those produced by the Convention and US regimes.

Consider now the operation of the innocent acquisition regime of the Convention first under US law as the non-Convention law and then under Japanese law. Assume for purposes of illustration that an acquirer would not be protected under the Convention's 'ought to know' standard but would qualify for protection under the 'wilful blindness' standard of US law.[169] The result would be that that the acquirer could avail itself of the US law and would be protected. The Convention protects qualified acquirers, but it says *nothing* about the effects of an acquirer's failure to qualify. In particular, it does *not* provide that an acquirer that fails to qualify for the Convention's protection is somehow liable to an adverse claimant or that the acquirer takes its interest subject to the adverse claimant's interest. Those matters are left to the non-Convention law. Now assume that an acquirer would not be protected under the Japanese gross negligence standard but would qualify for protection under the Convention's 'ought to know' standard. In this case the Convention's rule prevails and it provides a safe harbour for the acquirer, even if the acquirer would not be protected under the non-Convention law.

The existence and assertion of adverse claims in the intermediated securities system is rare. One significant reason for this is the typical implausibility of 'tracing' and matching a debit to a securities account of one person and a credit to the securities account of another.[170] This is especially so in anonymous, high volume securities markets in which ultimate buyers and sellers do not transact business directly but through brokers and agents. But, as the examples given in the Draft Official Commentary illustrate, adverse claims can arise.[171] Moreover, reported judicial decisions demonstrate that adverse claims sometimes actually *do* arise in the intermediated system. In *SEC v Credit Bancorp, Ltd*,[172] for example, the Court of Appeals affirmed the District Court, which had found that an acquirer (a securities intermediary) of a security interest from a debtor (the intermediary's account holder) had notice of an adverse claim and consequently was not protected from an adverse claimant's claims. Applying the 'wilful blindness' test, the Court of Appeals concluded that the evidence supported the

[169] We use this illustration and the one that follows it while mindful that it is highly unlikely that such different results would actually occur.

[170] See, eg, UCC § 8–502, Comment 2: 'Because securities trades are typically settled on a net basis by book-entry movements, it would ordinarily be impossible for anyone to trace the path of any particular security, no matter how the interest of parties who hold through intermediaries is described.'

[171] See Draft Official Commentary, above n 6, Examples 18–1 to 18–4.

[172] *SEC v Credit Bancorp, Ltd* 386 F3d 438 (2d Cir 2004). For another example of the assertion of adverse claims in the context of intermediated securities, see *Macmillan Inc v Bishopsgate Investment Trust Plc (No 3)* [1996] 1 All ER 585 (CA).

District Court's finding that the acquirer deliberately avoided easily available information in the face of suspicious circumstances.[173]

In summary, innocent acquisition rules play an important role in any coherent legal regime for intermediated securities.[174] The Convention affords Contracting States the opportunity to adopt harmonised Convention tests for innocent acquisition. The Convention does not override innocent acquisition rules that are more protective under the non-Convention law. But it does provide a safe harbour that affords protection to acquirers of intermediated securities even when the non-Convention law would not.

iii. Observations

The previous subsection explained the operation of the Convention's innocent acquisition rules under both US and Japanese law and compared those rules with their US and Japanese counterparts. This subsection considers some questions, issues, and puzzles raised by that discussion.

a. Scope of Protection for Innocent Acquirers

Article 18(1) of the Convention and UCC sections 8–502 and 8–501 protect acquirers only against adverse claims that derive from a third party's *property* rights.[175] Although this approach is traditional, it may not be broad enough. A third party may have a claim against an acquirer that does not arise from a property interest of the third party but as to which an innocent acquirer may deserve protection. For example, intermediated securities may be the subject of a covenant under which an account holder promises not to transfer, create or suffer to exist any interest, lien or encumbrance in or on intermediated securities.[176] The beneficiary of such a covenant might sue an acquirer under a tort or similar theory.[177] Should an acquirer who meets the Convention's test of innocence (or the applicable tests under US or Japanese law) be protected in that situation?

[173] Ibid, at 386 F3d 451–453.

[174] We are unaware of any serious controversy about the statement in the text. But we also are unaware of any efforts to measure or model how financial market participants actually perceive and take account of the risks addressed by innocent acquisition rules. We suspect that in general the market participants may have internalised years of consistent advice from lawyers about the significance of these rules.

[175] See Convention Art 18(1): 'another person has an interest in securities or intermediated securities'; UCC §§ 8–502; 8–510(a), (b); 8–102(a)(1) (defining 'adverse claim' as necessarily including 'a property interest'). However, the adverse claimant's claim may be based on any theory.

[176] This is the so-called 'negative pledge' covenant typically found in loan or credit agreements entered into by borrowers with their lenders.

[177] See, eg, *First Wyoming Bank v Mudge* 748 P2d 713 (Wyo 1988) (following Restatement (Second) of Torts § 766, secured party held liable for intentional interference with contractual relations because it took collateral with knowledge that transaction violated a negative pledge agreement in favour of another (unsecured) creditor); Restatement (Second) of Torts § 766 (Intentional Interference with Performance of Contract by Third Person), which provides: 'One who intentionally and improperly interferes with the performance of a contract (except a contract to marry) between another and a third person by inducing or otherwise causing the third person not to

Many knowledgeable professionals would answer this question in the affirmative. The more controversial issue probably is whether this protection is within the proper domain of the Convention (or UCC Article 8 or the analogous Japanese good faith purchase rule). Many might see the issue as one best left to other law, including tort law, and not an appropriate target for a regime that deals with commercial transactions.[178] Along the same lines, it is likely that one who meets the Convention test of innocence would not face any liability under many legal regimes. But if the goal of the Convention, at least, is harmonisation for the sake of certainty, there is much to commend a harmonised rule of protecting innocent acquirers from liability based on any theory and even to those whose rights do not arise out of a conflicting property interest in the relevant intermediated securities. Article 18(2), which immunises an innocent acquirer from liability 'to anyone who would benefit from the invalidity or reversal of . . . [a] defective entry' is an important step in this direction as it is not targeted solely to protect against aggrieved property claimants.[179]

Expanding innocent acquisition rules beyond protection from holders of property claims also would be more congenial to the Convention's functional approach. Whether an adverse claimant is asserting an 'interest in securities or intermediated securities'[180] will be a matter for the non-Convention law or other applicable law. In this way non-Convention legal doctrine effectively dictates the scope of the Convention's innocent acquisition protection. But the functional approach generally calls for harmonised results that do not turn on the vagaries of doctrinal differences outside the Convention. As noted above, however, the functional approach does not demand results that are identical in every state that adopts the Convention.

b. The 'Ought to Know' Standard and the Role of Official Commentary

The US proposal of the 'ought to know' standard was a calculated risk. The language itself implies that an acquirer did not know of an interest or fact but would have known if it had behaved appropriately—as by investigating and inquiring. But the risk of making no effort to forge a consensus may have been a more serious one. Failure to reach a consensus on a standard of innocence might

perform the contract, is subject to liability to the other for the pecuniary loss resulting to the other from the failure of the third person to perform the contract.'

178 This observation is based in part on the opposition to the US proposals for an express Convention immunity for an intermediary that acts on proper instructions of its account holder, based generally on UCC § 8–115.

179 One matter that the Convention probably should not address is the relationship between an innocent acquirer and an issuer of securities arising in the case of an overissue or invalidity of securities, as the Convention generally does not address such issuer-related issues. Two cases decided in the US erroneously applied the 'notice of an adverse claim' standard to issuer related issues of invalid securities and mistakenly issued securities under UCC §§ 8–502 and 8–115, respectively. These courts should have applied UCC § 8–202(2), which applies to purchasers for value of securities without notice of a defect when an issuer asserts the invalidity of a security.

180 Convention Art 18(1).

have proved a fatal blow for the entire Convention project. Or, there may have been a movement to make the standard 'simply' one of 'good faith'.

As explained above, the language is buffered by the instruction in Article 17(b) of the Convention that in determining whether a person 'ought to know' a court must 'take into account the characteristics and requirements of securities markets' and further that a 'person is under no general duty of inquiry or investigation'.[181] These are the substantive hooks on which the Official Commentary must rest.

c. Eliminating Adverse Claims Through System Structures: Beyond the Convention

Certain types of adverse claims that may arise in intermediated systems may be eliminated by the structure of an intermediated securities system. As noted above, in a system in which all securities are dematerialised and in which account holders must hold through intermediaries, for example, adverse claims arising out of fraudulent transfers on the books of issuers or stolen security certificates cannot occur.[182] Of course, these structural questions are not an appropriate goal or subject of the Convention. Under the functional approach, the Convention must coexist with a wide variety of structures and doctrine.

The Convention highlights both explicitly and implicitly areas of legal doctrine that it leaves to other law. These doctrinal areas are either outside the plausible scope of the Convention (for example, mandatory dematerialisation of all securities or requiring that all holdings be through intermediaries) or ones on which harmonisation would be difficult or impossible (for example, the nature of the rights and interests acquired by an account holder upon a credit). But for states that wish to improve and modernise their legal and structural systems for intermediated securities holding, the development (perhaps by UNIDROIT) of a legislative guide or model law for intermediated securities would be a worthwhile project.[183] Modification of systems so as to eliminate the possibility that certain

[181] See above text at n 150 *et seq*.

[182] See Draft Official Commentary, above n 6, Examples 17–3 and 18–4.

[183] The UNIDROIT Governing Council has proposed consideration of a similar project: see UNIDROIT, Study LXXVIII – 'Preparation of Principles and Rules Capable of Enhancing Trading in Securities on Emerging Markets', Overview, available at http://www.unidroit.org/english/workprogramme/study078/item2/main.htm:

'Regarding the type of instrument envisaged, it is obvious that a binding instrument (convention) and even a model law is not only an unrealistic objective but also undesirable, especially from the point of view of the many emerging securities markets, their varied stage of evolution and their interest in building their individual competitiveness. On the other hand, the formulation of *benchmark principles*, developed in a *legislative guide* that focuses on the private law aspects would appear to be very challenging yet feasible.'

A committee was established at the first session of the diplomatic conference to consider emerging market issues among other things: see UNIDROIT 2008, CONF 11 – Doc 32, 'Report of Committee on Emerging Markets Issues, Follow-Up and Implementation (submitted by the Co-Chairs of the Committee)' (September 2008). A legislative guide would fill a gap that was purposely created in the scope of the United Nations Commission on International Trade Law (UNCITRAL) Legislative Guide adverse claims could arise would be one among many matters that such a project could contemplate. Any legislative guide or model law project would have to recognise, as noted above, that many matters are not addressed in the Convention because of the difficulty or impossibility of reaching agreement on a harmonised rule. It follows that either approach would need to contemplate menus of choices in recognition of the many doctrinal issues that are not capable of strict harmonisation.

B. Priority Rules

i. Comparison of Convention, United States Law, and Japanese Law

Article 19 contains the Convention's basic priority rules for competing interests in intermediated securities.[184] It applies only to interests acquired *other* than by way of a credit to a securities account, that is primarily to interests that 'become effective against third parties under Article 12' (Article 12 interests).[185] Consequently it applies to any type of interest in intermediated securities.[186] Moreover, Article 19 appropriately applies only to competing 'interests in the same intermediated securities', that is intermediated securities credited to the same securities account.[187] Interests become effective against third parties under Article 12 based on a 'control agreement',[188] 'designating entry'[189] or the acquisition of the interest by the relevant intermediary, in each case provided that the relevant Contracting State has made an appropriate declaration.[190]

Article 19(3) contains the Convention's first-in-time priority rule. It provides that Article 12 interests 'rank among themselves according to the time of

on Secured Transactions: see UNCITRAL, *UNCITRAL Legislative Guide on Secured Transactions* (Pre-edited version of the Guide, subject to final editing by UN editors, 2007), available at http://www.uncitral.org/uncitral/en/uncitral_texts/payments/Guide_securedtrans.html, Part I.B.5 (Securities), 40: 'The Guide does not cover security rights in securities because the nature of securities and their importance for the functioning of financial markets raise a broad range of issues that merit special legislative treatment.'

[184] Convention Art 20(1) provides that the Convention does not address priority between an interest granted by an intermediary under Convention Arts 12 or 13 and the intermediary's account holders. Convention Art 20(2) provides a priority rule that is an exception to Convention Art 20(1). Because these priority contests normally would arise in connection with an insolvency proceeding of the intermediary, Convention Art 20 is addressed below in section V.C.

[185] Convention Art 19(1). Convention Art 19 also applies to interests that are effective against third parties under the non-Convention law, which are not invalidated by the Convention: ibid; Convention Art 13.

[186] Convention Art 12 applies to the grant of 'an interest in intermediated securities, including a security interest or a limited interest other than a security interest': Convention Art 12(1). This means that Convention Art 12 applies to a full ownership interest as well as a limited interest, such as a *usufruct*. The issue of competing ownership interests is addressed below in section IV.B.ii.a.

[187] Convention Art 19(1).

[188] Convention Art 1(k) (defining 'control agreement').

[189] Convention Art 1(l) (defining 'designating entry').

[190] Convention Art 12(5)–(7).

occurrence of the following events'.[191] It then specifies the time that an agreement is entered into granting an interest to the relevant intermediary, the time that a designating entry is made, and the time that a control agreement is entered into.[192] It follows that priority rankings are based on the times that the steps are taken for causing Article 12 interests to become effective against third parties under Article 12.[193] The following example illustrates the operation of Article 19(3).

> EXAMPLE 19–1: On 15 January, Account Holder (AH) agreed to grant an interest in intermediated securities to Collateral Taker 1 (CT-1) and on that date AH, CT-1 and AH's intermediary (IM) entered into a control agreement covering the intermediated securities. On 1 March, AH agreed to grant an interest in the same intermediated securities to CT-2 and on that date IM made a designating entry covering the intermediated securities in favour of CT-2. On 15 April, AH agreed to grant an interest in the same intermediated securities to CT-3 and on that date IM made a designating entry covering the intermediated securities in favour of CT-3.
>
> Under the first-in-time priority rule of paragraph 3, CT-1 is first priority, CT-2 is second, and CT-3 is third.[194]

Article 19(4) provides an exception to the first-in-time priority rule of Article 19(3). It deals with an intermediary that acquires an interest in intermediated securities as to which the intermediary is the relevant intermediary (that is an interest in its own account holder's intermediated securities). Under paragraph (4) the interest of such an intermediary is subordinated to any other Article 12 interest that subsequently becomes effective by way of a designating entry or control agreement. This means that the intermediary's interest could be junior to an earlier Article 12 interest under the first-in-time rule of Article 19(3), but under Article 19(4) it could never be senior based on first-in-time. The rationale behind this priority rule is the subordinated intermediary's direct participation in the designating entry or control agreement for the benefit of the other Article 12 interest holder, who would have no way of knowing about the intermediary's interest absent full disclosure. This is precisely the opposite approach of UCC section 9–328(3), which affords priority to the intermediary, even over the

[191] Convention Art 19(3). However, interests that are effective against third parties under the non-Convention law, but not under Convention Art 12, are subordinated to Convention Art 12 interests: Convention Art 19(2).
[192] Ibid.
[193] Because Convention Art 19(3) addresses '[i]nterests that become effective against third parties under Article 12', it contemplates that application of the priority rule is to be made only in situations in which Convention Art 12(1)(a) has been satisfied, ie in which the account holder and the transferee of the interest have entered into an agreement relating to the interest involved. However, once that agreement exists, even if entered into after, eg, a control agreement, it is the timing of the specified events, not the timing of the effectiveness of the agreement satisfying Convention Art 12(1)(a) that determines priority: Convention Art 19(3).
[194] Draft Official Commentary, above n 6, Example 19–1.

beneficiary of an *earlier*-in-time control agreement.[195] Under the Convention regime the burden is on the intermediary to bargain for a subordination of a competing interest; that burden is on the non-intermediary competing interest holder under the US regime. The following example illustrates the operation of Article 19(4).

> EXAMPLE 19–4: On 15 January AH agreed to grant an interest in intermediated securities to its relevant Intermediary (IM) and the interest became effective against third parties under Article 12. On 1 March AH agreed to grant an interest in the same intermediated securities to CT-1 and on that date IM made a designating entry covering the intermediates securities in favour of CT-1.
>
> Pursuant to paragraph 4 IM's interest is subordinate to the interest of CT-1. CT-1 is first priority and IM is second. In order to ensure first priority IM should have refused to make the designating entry unless CT-1 subordinated its interest to that of IM.[196]

A declaration mechanism permits a Contracting State to apply a 'super priority' in favour of interests that become effective against third parties based on a designating entry. Article 19(7) provides:

> A Contracting State may declare that under its non-Convention law, subject to paragraph 4, an interest granted by a designating entry has priority over any interest granted by any other method provided by Article 12.[197]

The following example illustrates the operation of Article 19(7).

> EXAMPLE 19–7: The facts of Example 19–1 apply except that the Contracting State whose law is the non-Convention law has made an effective declaration under paragraph 7.
>
> As a result of the declaration under paragraph 7, the interests of both CT-2 and CT-3 have priority over the interest of CT-1. The priority as between CT-2 and CT-3 is governed by paragraph 3. CT-2 has first priority, CT-3 is second, and CT-1 is third.[198]

Several of the complexities raised by the Article 19 priority rules arise from the possibility that a Contracting State could make a declaration under Convention Article 12(5)(a) to the effect that all three of the conditions to effectiveness specified in Article 12(3) may be utilised when that state's law is the non-Convention law.[199] Moreover, such a Contracting State also could make a

[195] See below text at n 217. When the UCC Art 9 priority rules do not apply, UCC § 8–510(d) provides a rule consistent with UCC § 9–328(3).

[196] Draft Official Commentary, above n 6, Example 19–4.

[197] This change to the priority rules was added at the first session of the diplomatic conference and was inspired by the Legal Certainty Group's *Second Advice*: see LCG, *Second Advice*, above n 4, 65–66.

[198] Draft Official Commentary, above n 6, Example 19–7.

[199] We think it unlikely that a Contracting State would choose both the control agreement and the designating entry methods for achieving effectiveness of a Convention Art 12 interest. Note also that

declaration under Article 19(7) that would afford a special priority to interests granted by designated entry, making possible still additional complex priority contests.

UCC Article 9 provides a comprehensive legal framework for security interests in personal property, including 'investment property',[200] which consists of 'a security, whether certificated or uncertificated, security entitlement, securities account, commodity contract, or commodity account'.[201] Certain formal requisites must be met for the enforceability and 'attachment' of a security interest to 'collateral'.[202] Enforceability and attachment require that 'value has been given', and that 'the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party'.[203] In addition, in the case of certain collateral, including investment property, enforceability and attachment also require that either 'the debtor has authenticated a security agreement that provides a description of the collateral' or the secured party has 'control'.[204]

The priority rules of UCC Article 9 turn largely on the *time* that a security interest is 'perfected', the *manner* of perfection, or *both the time and manner* of perfection.[205] The three principal methods of perfection of a security interest in investment property are 'control',[206] filing a financing statement in the proper filing office,[207] and, in the case of a certificated security, delivery of the security certificate to the secured party.[208] In general, a security interest has priority over the interest of a 'lien creditor'[209] only if the security interest is perfected at the time the lien creditor acquires its rights.[210] Under the US federal Bankruptcy

additional complexities could arise in the case of a contractual variation of priorities (ie a subordination agreement) permitted under Convention Art 19(6) but which would not affect the rights of third parties.

200 UCC § 9–102(a)(49) (defining 'investment property').

201 See above nn 58, 67 (citations to selected UCC Art 8 definitions); UCC §§ 9–102(a)(15) (defining 'commodity contract'), (14) (defining 'commodity account').

202 UCC §§ 9–203(a), (b).

203 Ibid.

204 A person has control of a security or security entitlement if the person has control under UCC § 8–106: UCC §§ 9–106; 8–106. See above n 162.

205 Perfection takes place when a security interest has attached and all applicable requirements under UCC §§ 9–310 to 9–316 have been satisfied: UCC § 9–308(a).

206 UCC § 9–314(a); see above n 162 ('control' in context of 'security entitlement').

207 The UCC Art 9 filing regime is contained in Pt 5: UCC §§ 9–501 *et seq*.

208 UCC § 9–313(a). 'Temporary' perfection for 20 days also is a method of perfection for certificated securities in certain circumstances: UCC §§ 9–312(e), (g). In addition, a security interest in investment property that is created by a broker or securities intermediary is perfected upon attachment, ie is automatically perfected: UCC § 9–309(10).

209 UCC § 9–102(a)(52) defines 'lien creditor' as: '(A) a creditor that has acquired a lien on the property involved by attachment, levy, or the like;(B) an assignee for benefit of creditors from the time of assignment; (C) a trustee in bankruptcy from the date of the filing of the petition; or (D) a receiver in equity from the time of appointment'.

210 The rights of a lien creditor are subordinate to a perfected security interest: UCC § 9–317(a)(2)(A). There is a minor exception when a secured party has filed a financing statement and one of the conditions in UCC § 9–203(1)(b) has been satisfied at the time a lien creditor becomes

Code, a trustee in bankruptcy has the rights of a lien creditor and can use that power to avoid (invalidate) a security interest that is unperfected.[211]

The baseline priority rule for competing security interests is the so-called 'first-to-file-or-perfect' rule.[212] For example, if secured party 1 (SP-1) files on day 1, secured party 2 (SP-2) perfects (for example, by possession, giving value, and obtaining an adequate security agreement) on day 2, SP-2 has the only security interest and SP-1 has no interest as yet. But if SP-1 acquires a security interest on day 3, SP-1 has priority as the first to file. If the timing is reversed and SP-2 acquires its perfected security interest on day 1, SP-1 files on day 2, and SP-1 acquires its interest on day 3, SP-2 has priority as the first to perfect (although it did not file). Under a companion priority rule, a perfected security interest has priority over an unperfected security interest.[213]

Special non-temporal priority rules apply to investment property. A security interest perfected by control has priority over a security interest perfected by any other method (such as filing, in the case of collateral consisting of a security entitlement).[214] With one important exception, security interests in security entitlements perfected by control rank in priority according to the time that control was obtained.[215] The exception applies when the secured party is the securities intermediary with which the security entitlement is maintained. In such a case the secured party intermediary has control automatically[216] and its security interest has priority over any other security interest.[217] (As explained above, control also may afford innocent acquisition protection.[218]) Consistent with the generally applicable temporal (that is first-in-time) priority rule for security interests perfected by control, as among the holders of such security interests the innocent acquisition protection of section 8–510(a) does not apply.[219]

Outside of the context of the priority of competing security interests (and certain other competing interests[220]), section 8–510(a) does provide innocent acquisition protection for purchasers of intermediated securities (including secured parties) who acquire control.[221] In addition to security interests, it

such. In that case, when the security interest becomes perfected upon attachment, it will have priority over the intervening lien creditor's interest even though it was unperfected at the time the lien creditor became such.

211 11 USC § 544(a)(1).

212 UCC § 9–322(a)(1).

213 UCC § 9–322(a)(2).

214 UCC § 9–328(1). A control-perfected security interest also would have priority over a security interest that is temporarily perfected or automatically perfected: ibid.

215 UCC § 9–328(2)(B).

216 UCC §§ 8–106(e); 9–106.

217 UCC § 9–328(3).

218 See above text at n 159 *et seq* (discussing innocent acquisition under UCC § 8–510(a)).

219 UCC § 8–510(a).

220 See below text at n 222 (discussing priorities under UCC § 8–510(c)).

221 See above text at n 159 *et seq* (discussing innocent acquisition under UCC § 8–510(a)).

applies to the purchase of an interest in a security entitlement from an entitlement holder in which the interest purchased is either a full ownership interest or a limited interest *other than a security interest* in the relevant securities.[222]

The concept of control in this context is agnostic as to whether the interest in a security entitlement is a security interest, another form of limited interest, or the full ownership interest. However, the concept of 'perfection'—an important concept in the operation of UCC Article 9—plays no role outside of the realm of security interests. The principal attribute of perfection of a security interest, as we have seen, is that it affords the perfected security interest protection against judicial lien creditors of the debtor and in the debtor's insolvency proceedings. But the purchase of an interest other than a security interest in a security entitlement need not be perfected in order to achieve such status. To the extent that the interest has been effectively transferred to the purchaser, the interest is no longer property of the transferor and there is nothing for a creditor to reach or an insolvency administrator to administer.[223] That said, there are nonetheless compelling reasons under US law or the Convention for a purchaser other than a secured party to obtain control over the relevant security entitlement.

Control of a security entitlement affords two important benefits to a purchaser of an interest other than a security interest. First, under UCC section 8–510(c), a purchaser with control has priority over purchasers who do not have control and purchasers with control rank in priority according to the time control is obtained.[224] Secondly, control confers eligibility on the purchaser for the innocent acquisition protection against the holders of adverse claims.[225]

The Japanese BETA also addresses pledges of securities credited to a securities account.[226] Credit to the 'pledge section' of the securities account of a secured party effects a pledge. Credit to the 'ownership section' of the securities account of a secured party also can effect a security interest by way of outright assignment (*jouto tanpo*).[227] The credit to the pledge section of the securities account of a creditor on the books of the creditor's intermediary (which may be JASDEC) is both a necessary and sufficient step to render the pledge effective against other creditors of a debtor and in the insolvency of the debtor (that is to render the

[222] For example, the purchaser could obtain control of a security entitlement to financial assets, but the interest transferred as between the parties could be more limited. Or, the purchaser could buy outright the entitlement holder's interest as the first step in a repurchase transaction (or 'repo') in which the entitlement holder is obligated to repurchase the relevant financial assets at a later time: see generally DM Weiss, *After the Trade is Made: Processing Securities Transactions*, 3rd edn (rev) (New York, Penguin Group (USA), 2006) 345–352 (discussing repos as financing devices).

[223] As explained below, however, in some circumstances the entitlement holder may retain the *power* to transfer an interest: see below section IV.B.ii.a.

[224] UCC § 8–510(c). This priority rule is analogous to the UCC § 9–328(2)(B) rule for security interests and applies to the interests of purchasers who do not hold security interests.

[225] See above text at n 159 *et seq* (discussing innocent acquisition under UCC § 8–510(a)).

[226] BETA Arts 74 (corporate debt securities); 99 (JGBs); 141 (corporate equity securities).

[227] JSDA, *Transition to Dematerialisation*, above n 61, at 5.

pledge 'perfected', to borrow UCC Article 9 terminology).[228] The same is true for a credit to the ownership section of the securities account of a creditor in the case of *jouto tanpo*.[229] In either case the credit is effective as a perfection step. In its effect, the credit is recognised as the precise analogue of the delivery of a discrete security certificate.

A creditor has the option of choosing to have a pledge of shares of stock notified to the issuer or choosing to remain anonymous (except, of course, as to its debtor and the intermediary involved in the transaction) in a non-registered pledge.[230] An assignee creditor in a *jouto tanpo* transaction has a similar choice.[231]

As to priority contests, there is little that need be said concerning the Japanese BETA. Inasmuch as the BETA contemplates a credit to a single creditor, it leaves no room on its face for a priority contest among competing secured creditors. Were a pledgee or an assignee by way of *jouto tanpo* in actual physical possession of a security certificate, acting in part as a representative, it could declare that it holds for its own behalf as well as for another, junior creditor under the applicable provisions of the Japanese Civil Code (*MINPŌ*) relating to possessory rights.[232] However, if the pledgee or assignee were the recipient of a credit in the book-entry system, the BETA does not by its terms recognise those methods of creating property interests outside of the book-entry system.[233] On the other hand, one acting as a trustee under a trust arrangement can receive a credit in the book-entry system in that capacity for the benefit of its trust beneficiary.[234]

ii. Observations

a. 'Priorities' among 'Ownership' Claimants

Recall that the Convention's priority rules in Article 19 may apply to outright sales of full ownership interests in intermediated securities and security entitlements, respectively.[235] The same issues arise under US law. Consider official comment 4 to UCC section 8–510, Example 4 (Section 8–510 Example 4), which addresses section 8–510(c):

> Example 4. Dealer holds securities through an account at Alpha Bank. Alpha Bank in turn holds through a clearing corporation account. Dealer transfers securities to RP1 in

[228] BETA Arts 74 (corporate debt securities); 99 (JGBs); 141 (corporate equity securities). The use of pledge accounts is traditional and also serves as a weak form of public notice that the securities are pledged to the account holder and are not the proprietary asset of the account holder.
[229] JSDA, *Transition to Dematerialisation*, above n 61, at 5.
[230] Ibid.
[231] Ibid.
[232] See *MINPŌ* Art 181.
[233] See above section III.D.
[234] BETA Arts 75 (corporate debt securities); 100 (JGBs); 142 (corporate equity securities); see also JASDEC, *Bond Regulations*, above n 125, Art 18(3) (provision for 'Trust Account').
[235] Convention Art 19 applies to interests granted under Convention Art 12, and Convention Art 12 interests are not limited to security interests: see above n 186.

a 'hold in custody' repo transaction. Dealer then transfers the same securities to RP2 in another repo transaction. The repo to RP2 is implemented by transferring the securities from Dealer's regular account at Alpha Bank to a special account maintained by Alpha Bank for Dealer and RP2. The agreement among Dealer, RP2, and Alpha Bank provides that Dealer can make substitutions for the securities but RP2 can direct Alpha Bank to sell any securities held in the special account. Dealer becomes insolvent. RP1 claims a prior interest in the securities transferred to RP2.

Section 8–510 Example 4 first posits a non-secured party purchaser, RP1, which does not obtain control.[236] As a non-secured party, and inasmuch as the comment explicitly states that subsection (c) primarily addresses repos, RP1 presumably acquires a full ownership interest.[237] As a non-security interest, it is not subject to UCC Article 9's perfection rules and if it is effective between the parties it ought to be effective against third parties. Then, another non-secured party purchaser, RP2, enters the picture with respect to the same security entitlement. Because RP2 obtained control, section 8–510(c) awards RP2 priority (implicitly, even if RP2 knew of the sale to RP1 and even if RP2 knew that its purchase violated the rights of RP1).

One question is how the seller-entitlement holder, Dealer, had any interest to transfer to the second purchaser, having already sold its interest to RP1. Implicitly, the section 8–510(c) priority rule gives Dealer power to transfer the interest to RP2 even though it has no interest to transfer.[238] It follows that if a buyer obtaining control were first in time, its seller would have nothing left to transfer to a subsequent buyer and the subsequent buyer would acquire no rights or

[236] A 'hold in custody' (or 'HIC') repo is a transaction in which the repo seller retains the securities that are sold in its own securities account, no transfer is made to an account of the repo buyer, and the repo seller's relevant intermediary is not obliged to act on any instructions of the repo buyer: see M Choudhry, *The REPO Handbook* (Oxford, Butterworth-Heinemann, 2002) 113–114.

[237] This assumes 'true sale' treatment for the first step of a repo and that for private law and insolvency law purposes it would not be recharacterised as a secured transaction: see, eg, JL Schroeder, 'Repo Madness: The Characterization of Repurchase Agreements Under the Bankruptcy Code and the UCC' (1996) 46 *Syracuse Law Review* 999.

[238] See UCC §§ 9–317, Comment 6 (purchasers take free of unperfected security interests so that debtor transfers greater rights than it has); 9–318, Comment 4 (purchaser of promissory note who takes possession may obtain priority over earlier buyer under UCC §§ 9–330 or 9–331); 9–330, Comment 7 (after sale of an instrument to a buyer who achieved automatic perfection, the seller retained the power to sell the instrument to another buyer who takes possession and gives value and meets the other requirements of UCC § 9–330(d)). This is similar to the analysis of Example 6 on Convention priorities based on a super-priority for designating entries under a Convention Art 19(7) declaration. An analogous analysis would be appropriate if, following a sale to a buyer who takes control, the entitlement holder then sells the same interest to its intermediary. The intermediary would claim the same implicit power for the entitlement holder under the priority rule of UCC § 8–510(d), under which the intermediary would have priority. Under the Convention, an opposite approach would be appropriate. Assume that an account holder first sold an interest in its intermediated securities to the relevant intermediary and that under an appropriate declaration the intermediary's interest was effective under Convention Art 12 with no further steps being required. If the account holder subsequently sells the interest to another person, the second buyer would claim priority based on Convention Art 19(4) and an implicit power retained by the account holder by virtue of the priority rule.

interest. In effect, RP2's control functioned as a 'cut-off' rule as to RP1's rights. But, one also might argue that section 8–510(c) is merely a straightforward priority rule, and concepts of nemo dat[239] play no role in the analysis. On that view, the temporal priority rules in section 9–510(c) might contemplate that a seller of an interest in a security entitlement may sell its interest repeatedly with all later-in-time buyers being subordinate to all earlier-in-time buyers who have control.

Otherwise, the argument would continue, it would be impossible to have competing control buyers.

The better conclusion is that nemo dat does play at least some role. Surely a stranger could not sell an entitlement holder's interest even if the intermediary foolishly and carelessly entered into a control agreement with the buyer. Following a sale of an interest in a security entitlement to a buyer that takes control, the seller should have no more rights to sell (at least so long as the buyer maintains control), even though the seller remains the entitlement holder.[240] Following such a sale, the priority contests among coequal control parties, as contemplated by the second sentence of section 8–510(c), could not occur. The lesson is this: As a result of including buyers as purchasers to which section 8–510(c) applies, some priority contests contemplated by the provision cannot occur. Consequently, that subsection (c) applies by its terms to a priority context does not support an inference that the priority contest necessarily could arise. When one person has a senior full ownership interest resulting from control, the priority rule should be understood to refute the potentially unintended mischief that could arise from any recognition that someone else also has an interest.[241] The nemo dat doctrine is not entirely absent from the setting of this priority rule, but it does precious little work. And that is as it should be.

Now vary the facts of Section 8–510 Example 4 by assuming that after RP2 obtained control RP1 achieved control under a control agreement among Alpha, Dealer and RP1. Under the foregoing analysis, RP1 continues to have no interest at all. Assume further that subsequently RP2 ceases to have control of the security entitlement (perhaps because it inadvertently released Alpha from its obligations under the control agreement). In this situation, RP1's ownership interest would have priority over (that is cut off) RP2's interest as the priority rule would have once again given effect to Dealer's power to transfer what it does not have.

[239] This is the familiar common-law rule of 'nemo dat quod non habet (one cannot give what one does not have), [which] appears to flow from the broader principle that, in a regime of private property, the law should keep property rights secure': SL Harris and CW Mooney, Jr, *Security Interests in Personal Property*, 4th edn (New York, Foundation Press, 2006) 26.

[240] This argument is explained in somewhat more detail in Mooney, *Law and Systems*, above n *, at 98: 'Admittedly, in this case, it is somewhat infelicitous to refer to L-1's "priority" over L-2, inasmuch as L-2 has no property interest whatsoever'.

[241] For example, if RP1 were the subject of an insolvency proceeding, it could be argued that the entitlement should be dealt with in the proceeding because RP1 has an interest, albeit a junior one.

Consider another variation. After RP2 obtained control, Dealer sold the same security entitlement to Alpha, Dealer's intermediary. Under the priority rule of section 8–510(c), second sentence, in the absence of a contrary agreement (subordination) Alpha's ownership interest has priority.[242] Once again, the implication from the priority rule is that Dealer could effectively sell to Alpha the security entitlement in which Dealer no longer had an interest.[243] It follows that Alpha's interest would 'cut off' the interest of RP2.

The same lessons apply to the priority contests contemplated by Article 19 of the Convention. The Convention's priority rules should not be read to create inferences about the non-Convention law. After a sale of full ownership made effective by one of the Article 12 Convention methods, non-Convention law may provide that the account holder has no power to make further effective sales of the interest already sold. At that point, no subsequent senior or junior interest could arise. It also is possible that under the non-Convention law the priority contest envisioned by Section 8–510 Example 4 could not arise. This would be so, for example, if under the non-Convention law a person in the position of RP1, a buyer that did not receive the benefit of any of the Article 12 steps, would not obtain any property rights for failing to take some evidentiary or public notice step under that law. Under that assumption concerning the non-Convention law, such a person would not obtain an interest contemplated by Convention Article 13. The following example illustrates the Convention's approach.

> EXAMPLE 19–2: On 15 January AH agreed to grant a full ownership interest in intermediated securities to Buyer and on that date AH, Buyer and AH's intermediary (IM) entered into a control agreement covering the intermediated securities. (Although a buyer conventionally would take its interest by way of a credit, this sale may be the first leg of a short-term 'repurchase' or 'repo' transaction, for example, and taking by control agreement may be a more efficient structure for the parties.) On 1 March AH agreed to grant an interest in the same intermediated securities to CT-1 and on that date IM made a designating entry covering the intermediated securities in favour of CT-1.
>
> The full ownership interest of Buyer became effective against third parties on 15 January. Consequently, if under the applicable law on 1 March AH had no rights or interests that it could grant to CT-1, CT-1 received no interest whatsoever. If the grant of an interest to Buyer was the first leg of a repo transaction, then upon payment of the repurchase price and termination of the control agreement the intermediated securities will revest in Seller, Buyer's interest will cease to exist, and at that point CT-1's interest will become effective, if such after-acquired collateral is recognised by the applicable law.[244]

[242] This could not occur under the Convention regime because Alpha would not obtain priority: see above section IV.B.i.

[243] One would hope that a well-drafted control agreement among Dealer, Alpha and SP2 would have made this transaction a breach on the part of Alpha, even if there was not a general subordination by Alpha.

[244] Draft Official Commentary, above n 6, Example 19–2.

b. Implications for Japanese Law

This discussion raises the possibility of some adjustments in Japanese legal doctrine in and related to the BETA. Two of these are closely related to priority issues.

The first possible adjustment would be the recognition of a property interest held by one or more persons who hold through an account holder in the Japanese book-entry system when the account holder is acting as a nominee or agent.[245] While this would not bear solely on priority contests, it would allow the principals of a nominee or agent to agree *inter se* as to their relative priorities. Under the BETA this result could be achieved through the formality of a trust.

A second possible adjustment is somewhat more ambitious, but it nonetheless would leave the basic principles embodied in the BETA intact. This would be the adoption of a control agreement method of acquiring an interest in intermediated securities in the Japanese book-entry system.[246] This approach would maintain the integrity of the book-entry system, while allowing an account holder the opportunity to create effective interests, including senior and junior interests in favour of multiple parties, without being removed as the account holder (by debits) with respect to the relevant intermediated securities. Moreover, the control agreement approach would be especially useful for the creation of an effective interest in a securities account—that is in all securities from time to time credited to the account. This feature would permit a 'floating lien' (although the effective interests need not be limited to 'liens' or other interests for security purposes) in after-acquired property, which is a technique that has been found useful in other contexts as well.[247] And the interest could be made effective without the need for book entries (debits and credits).

In considering such adjustments to Japanese law there is a necessary threshold consideration. It is whether there are financing patterns that actually exist (or are

[245] See Mooney, *Law and Systems*, above n *, at 35 and 121.

[246] Ibid, at 35.

[247] See Act No 104 of 1998 (as amended by Act No 148 of 2004) (recognising a recording system for the perfection of movables and personal claims, including future arising accounts and after-acquired inventory to the extent specified). For an explanation of the Act, see M Ueno (ed), 'Registration System for Perfection of Assignment of Personal Property and Accounts Receivable by Corporate Entities' 17 *Journal of Banking & Finance Law & Practice*, Tokyo, No 2 (June 2006) (discussing future arising accounts and after-acquired inventory). The Act introduces the legal framework for after-acquired property by corporate entities in the context of goods such as inventory and personal obligations such as accounts receivable. UCC Art 9 has provided for a security agreement to cover after-acquired property of all types—including intermediated securities—from its inception: see UCC § 9–204(a) (security agreement may provide for after-acquired collateral); see also UCC § 9–204(c) (security interest may secure future advances). As indicated in the text, Japanese law might benefit from the adoption of an after-acquired property regime for intermediated securities through the control agreement approach and the concept of an interest in a securities account.

needed) as to which Japanese law applies and that would benefit from these or other adjustments with the same or similar goals.[248]

V. Relationship of Convention to Insolvency Law

A. Background

The draft Convention submitted to the first session of the diplomatic conference[249] (as well as earlier drafts of the Convention) addressed insolvency issues in an odd fashion. Article 17(1) of that draft provided:

> 1.The rights of an account holder under Article 7(1) [now, 9(1)], and an interest that has become effective against third parties under Article 10 [now, 12], are effective against the insolvency administrator and creditors in any insolvency proceeding *in respect of the relevant intermediary or in respect of any other person responsible for the performance of a function of the relevant intermediary under Article 5* [now, 6].[250]

Article 21(1) of the final text of the Convention is substantially the same.[251] As the emphasised text in paragraph 1 indicates, under that provision interests made effective by the Convention were explicitly protected only in the insolvency of the relevant intermediary or other person responsible for performance under Article 5 (now Article 7). However, many readers of the draft and its predecessors had assumed that an insolvency administrator or the like was included within the meaning of 'third parties' as that term was used in former Articles 7(2)(a), 9(2) and 10 (and as is now used in Articles 9(2)(a), 11(2), and 12(2)). But given the explicit reference in Article 17(1) (now Article 21(1)) to the relevant intermediary's insolvency proceeding, the US delegation raised concerns about the ambiguity. Accordingly, the US delegation proposed that Convention interests expressly be made effective in *any* insolvency proceeding.

[248] Mooney, *Law and Systems*, above n *, at 35. As Mooney observed, 'I make no definitive claim that any of these adjustments should be adopted, but only that they warrant consideration and discussion'.

[249] UNIDROIT 2008, CONF 11 – Doc 3, 'Draft Convention on Substantive Rules regarding Intermediated Securities' (February 2008).

[250] Ibid, Art 17(1) (emphasis added). The effectiveness was qualified by Art 18 of that draft, which provided in pertinent part that:
'[N]othing in this Convention affects:
(a) any rules of law applicable in insolvency proceedings relating to the avoidance of a transaction as a preference or a transfer in fraud of creditors; or
(b) any rules of procedure relating to the enforcement of rights to property which is under the control or supervision of an insolvency administrator.'
The substance of former Arts 17 and 18 is now found in Convention Arts 21(1) and (3).

[251] Convention Art 21(1) no longer refers to the successor to former Art 7(1), Convention Art 9(1), but instead provides: 'Rights and interests that have become effective against third parties under Article 11 or 12 are effective'. No change is substance was intended.

In submitting its proposal to the diplomatic conference,[252] the US delegation reiterated some points made in an earlier submission.[253] First, insolvency proceedings of relevant intermediaries are relatively rare. The insolvency proceedings more likely to affect intermediated securities would be those of transferors of interests in intermediated securities, such as sellers, lenders, and debtors granting security interests, or the insolvency proceedings of an account holder—not those of the relevant intermediary. Secondly, explicitly providing that such interests are effective in any insolvency proceeding would not reflect any material change in the expectations and assumptions of the participants in the process. Such a modification would be consistent with the effectiveness of such interests 'against third parties' under Articles 11 (formerly 9) and 12 (formerly 10). Thirdly, even taking into account these underlying assumptions, the limited scope of Article 21(1) (formerly 17(1)) raises some doubts that an insolvency administrator would be considered a 'third part[y]'. Surprisingly, the US proposal turned out to be controversial. The controversy had its origins in a paper prepared by the chair of the Informal Working Group on Insolvency-related Issues.[254]

B. Convention Interests in an Insolvency Proceeding: In General

A compromise of sorts was adopted at the very end of the first session of the diplomatic conference resulting in the addition of new Articles 7 and 14 to the

[252] UNIDROIT 2008, CONF 11 – Doc 10, 'Comments (submitted by the Government of the United States of America' (May 2008).

[253] UNIDROIT 2008, Study LXXVIII – Doc 113, 'Informal Working Group on Insolvency-related Issues – Comments on the Paper of the Chairman (Doc 97) (submitted by the delegation of the United States of America)' (February 2008). The US proposed that the Convention adopt the general approach taken in Art 30 of the Convention on International Interests in Mobile Equipment (Cape Town, 2001) (Cape Town Convention, hereafter cited as 'Cape Town Convention Art 30'), available at http://www.unidroit.org/english/conventions/mobile-equipment/mobile-equipment.pdf. That approach made registered international interests in aircraft effective in insolvency proceedings, subject to avoidance powers and procedural rules relating to enforcement. The Cape Town Convention also provided a declaration mechanism for Contracting States to preserve the priority of non-consensual rights or interests: Cape Town Convention Art 39. See below n 263 *et seq* (discussing incorporation of a similar approach for the Convention).

[254] UNIDROIT 2007, Study LXXVIII – Doc 97, 'Informal Working Group on Insolvency-related Issues – Paper (prepared by the Chairman of the informal Working Group)' (December 2007) (hereafter, Insolvency Paper). This informal working group was to be created by, and the chair was appointed by, the Chair of the Committee of Governmental Experts at the fourth meeting. The Insolvency Paper was prepared by the chair and it did not mention any consultations with interested delegations. The chair of the working group subsequently submitted a report that took account of comments on the Insolvency Paper: UNIDROIT 2008, CONF 11 – Doc 9, 'Informal Working Group on Insolvency-related Issues – Report (Submitted by the Chairman of the informal Working Group)' (April 2008) (hereafter, Insolvency Report). Both the Insolvency Paper and the Insolvency Report offered an interpretation of Art 18 of the draft Convention submitted to the diplomatic conference: see above n 250 (quoting former Art 18). The submissions suggested that because that article provided that nothing in the Convention affects avoidance powers and procedural rules in an insolvency proceeding, it implicitly provided as well that in other respects the whole of applicable insolvency law was 'over-ridden/disapplied' by the Convention: ibid.

draft Convention.[255] In the process of preparing the Draft Official Commentary, however, the Editors noted a number of problems with the new Articles 7 and 14.[256] This prompted the Editors to propose that the final session consider an alternative approach.[257] At the final session of the diplomatic conference Article 7 was deleted, as the Editors had proposed, and Article 14 was revised. One difficulty that the Editors identified with respect to Article 7 was that other analogous international instruments and proposals for domestic law reforms do not contain provisions creating such a hierarchy between substantive rules of law and rules applicable in insolvency proceedings. As the Editors of the Draft Official Commentary noted:

> Article 7 is novel, extraordinary, and even pathbreaking in at least two respects. First, no other analogous international instrument that addresses property interests, third-party rights, and effectiveness in insolvency proceedings contains a provision similar to Article 7. … Second, not only is such a hierarchical provision unprecedented in international instruments, but analogous domestic laws relating to the effectiveness of property interests and related matters normally also do not contain such a provision on the hierarchy of insolvency law.[258]

Article 14(1) now provides a general rule—Convention interests are effective in *any* insolvency proceeding.[259] But this general rule is subject to an important caveat. Article 14(2) provides that Article 14(1) 'does not affect the application of any substantive or procedural rule of law applicable by virtue of an insolvency proceeding'.[260] Article 14(2) then goes on to provide a non-exclusive list of examples of such rules, including the ranking of claims, the avoidance of

[255] Art 7 provided: 'Unless otherwise provided in this Convention, nothing in this Convention affects any substantive or procedural rules of law applicable in any insolvency proceeding'. Art 14 offered, for the first time in the drafting process, a general rule for the effectiveness of Convention interests in insolvency proceedings *other than* insolvency proceedings of the relevant intermediary, which continued to be governed by Art 21. Under Art 14 rights and interests that were effective under Artis 11 and 12 would be effective in an insolvency proceeding 'to the same extent as comparable interests in that insolvency proceeding'.

[256] Draft Official Commentary, above n 6, fn 5:
Note of the Editors: because of the difficulty to apply the 'comparable interest' test and because of more significant concerns regarding Art 7, the Editors have suggested a revision of the Convention text that would address these problems. See Editors' Proposals, above n 7.

[257] See Editors' Proposals, above n 7, at 1–3.

[258] Draft Official Commentary, above n 6, para 7–6, fn 3 (*Note of the Editors*). As to the first point, the Editors further noted, ibid: 'Consider in this respect, for example, the UNIDROIT Convention on International Interests in Mobile Equipment (Cape Town, 2001 . . .) and the Protocols thereto on Matters specific to Aircraft Equipment (Cape Town, 2001) and Railway Rolling Stock (Luxembourg, 2007); the UNIDROIT Model Law on Leasing (2008); the United Nations Convention on Assignments of Receivables in International Trade (New York, 2004); the UNIDROIT Convention on International Financial Leasing (Ottawa, 1988); and the UNIDROIT Convention on International Factoring (Ottawa, 1988). As to the second point, they noted, ibid: 'For example, the UNCITRAL Legislative Guide on Secured Transactions (2007) makes no recommendation or mention of any similar provision'.

[259] Convention. Art 14(1).

[260] Convention. Art 14(2).

preferences or fraudulent transfers, and the enforcement of rights against property in the control of an insolvency administrator. Article 14(3) makes it clear that in the case of an insolvency proceeding of the relevant intermediary, the interests of that intermediary's account holders, and the interests granted by those account holders under Article 12, are governed by Article 21(1), not by Article 14(1).[261]

Note the carefully chosen language in Article 14(2), which refers to rules of law 'applicable by virtue of an insolvency proceeding'. The intended scope of the words 'by virtue of' is to subject the effectiveness of Convention interests only to rules of law that are applicable in an insolvency proceeding but not to rules that would be generally applicable outside of an insolvency proceeding. One of the problems with the now-eliminated Article 7 was that its broad language arguably would have substituted, in an insolvency proceeding, such generally applicable rules (for example, a good faith purchase rule under the non-Convention law) for the Convention rules (for example, Article 18).[262] The final text of Article 14(2) substantially narrows the deference to rules applicable in insolvency proceedings.[263]

C. Convention Interests in the Relevant Intermediary's Insolvency Proceeding

Article 21 addresses the treatment of Article 11 and Article 12 interests in the relevant intermediary's insolvency proceeding. It provides strong protection for the holders of these interests, which are the account holders of the intermediary that take under Article 11 by way of a credit and the holders of Article 12 interests

[261] Convention. Art 14(3); see below text at n 264 *et seq* (discussing Art 21).

[262] See Draft Official Commentary, above n 6, Examples 7–2 to 7–4 and para 7–5. As the Draft Official Commentary further notes, the first session failed to 'revisit provisions such as Arts 11, 12, 18, and 19 and the like to explicitly "otherwise provide" where such provisions must override the rules [otherwise] applicable in insolvency proceedings' in order to overcome the mandate of Article 7.

[263] While Art 14(2) exposes Convention interests to the vagaries of the applicable insolvency law, it does so without the ambiguity and interpretive problems presented by the previous version of Art 14, which required a determination of the treatment of 'comparable interests' in the relevant insolvency proceeding. But Art 14(2) does not embrace the advantages of transparency and flexibility that would have been afforded by the Editors' proposal for a Cape Town Convention-like declaration proposal. See UNIDROIT 2009, CONF 11/2 – Doc 6 Corr. 2, 'Memorandum regarding suggestions for revision of the text of the draft Convention relating to insolvency provisions (submitted by the Editors of the draft Official Commentary)' (August 2009). The declaration mechanism proposed by the Editors is similar to the approach taken by Cape Town Convention Art 39: see above n 253. However, the application of the declaration regime for categories of 'non-consensual right or interest[s]' in Cape Town Convention Art 39 is not limited to insolvency proceedings as is the declaration mechanism that the Editors proposed. Cape Town Convention Arts 1(s) (defining 'non-consensual right or interest'); 39 (declaration mechanism for non-consensual right or interest). There appeared to be little interest in the declaration mechanism on the part of most delegations participating in the final session of the diplomatic conference, apparently out of concerns about introducing additional complexity into the Convention text at such a late stage.

granted by the intermediary's account holders.[264] Article 21(1) provides in part that Convention interests that are 'effective … under Article 11 or Article 12 are effective against the insolvency administrator and creditors in any insolvency proceeding in respect of the relevant intermediary'.[265] This is a proper recognition of the well-accepted principle that, to use a metaphor from the physical world, the intermediary is merely 'holding' property that belongs to others and this property should not be available to the intermediary's creditors. Appropriately, this protection does not apply when an account holder has given an interest under Article 12 to its own intermediary (for example, a secured margin loan).[266] Note that the effectiveness of Convention interests in insolvency proceedings of the relevant intermediary is subject to avoidance powers (preference and fraudulent transfers) and procedural rules.[267] Even so, this treatment is considerably more favourable than that afforded Convention interests under Article 14 in insolvency proceedings other than those of the relevant intermediary. Moreover, it also may be more favourable than that given other interests in the relevant intermediary's insolvency proceeding. During the final session one delegation expressed concern about this favourable treatment, but there was a strong consensus in support of the idea that account holders and the holders of interests granted by account holders deserve special treatment in the relevant intermediary's insolvency proceeding. Article 25(2) complements Article 21 by providing that securities allocated to an intermediary's account holders do not constitute the intermediary's property and are not available for distribution or realisation for the benefit of the intermediary's creditors.[268]

[264] Convention Art 21(1). Including explicit protection for Convention Art 12 interests adds clarity, but Convention Art 21(1) should protect such an interest in any event inasmuch as the interest is derivative of the interest of the account holder granting the Convention Art 12 interest. Note that Convention Art 21 does not apply to the case in which an intermediary grants an interest under Convention Art 12 in intermediated securities credited to the intermediary's account with another intermediary. In that case the intermediary would not be the 'relevant intermediary' with respect to those intermediated securities: see Convention Art 1(g); Draft Official Commentary, above n 6, Example 21–1. Consequently, the Convention Art 12 interest would be effective in the intermediary's insolvency proceeding only to the extent provided by Convention Art 14(1): ibid; see above section V.B. If, on the other hand, an intermediary credits the securities account of an account holder that acquires a security interest granted by the intermediary and made effective by way of a credit, Convention Art 21 does apply to the account holder's interest: Draft Official Commentary, above n 6, Example 21–2. Such an account holder normally would not be entitled to retain value in excess of the obligation secured by the intermediated securities, however: ibid.

[265] Ibid. Convention Art 21 also applies in the insolvency proceeding of a 'person responsible for the performance of a function of the relevant intermediary under Article 6'. Convention Art 21(4) contains another important protection for non-Convention interests contemplated by Convention Art 13. It makes it clear that Convention Art 21 does not impair the effectiveness of such interests in the relevant intermediary's insolvency proceeding. It is based on Cape Town Convention Art 30(2).

[266] Convention Art 21(2); Draft Official Commentary, above n 6, para 21–7.

[267] Convention Art 21(3). This is essentially the approach taken for international interests under the Cape Town Convention, but without the possibility of a declaration concerning non-consensual rights and interests: see above n 254; Draft Official Commentary, above n 6, para 21–8.

[268] Convention Art 25(2), which is '[s]ubject to Article 20', thereby recognising that special priority rule, discussed below: see below text at n 287 *et seq*.

The interests of account holders that are effective under Article 21 may not be fully protected if the relevant intermediary subject to insolvency proceedings does not have available sufficient securities to satisfy their claims. Article 26(2) provides a pro rata sharing regime for allocating losses to account holders in the relevant intermediary's insolvency proceeding in case of such a shortfall.[269] The sharing rule applies on an issue-by-issue basis to a shortfall in 'securities and intermediated securities of any description allocated under Article 25'.[270] Article 25 requires the intermediary to allocate to the rights of its account holders 'securities of each description held by an intermediary as described in Article 24(2)'.[271] Moreover, Article 25(5) permits a Contracting State to declare that under its non-Convention law securities held by an intermediary for its own account are not subject to the sharing rule of Article 26(2).[272]

Note that the Article 26(2) loss sharing rule is *not* a generally applicable rule governing property rights. It applies only in an intermediary's insolvency proceeding.[273] That generally is consistent with the Convention's functional approach of leaving the characteristics and nature of an account holder's property interest to the non-Convention law.[274] Moreover, even in an intermediary's insolvency proceeding, the Convention's loss sharing rule applies 'unless otherwise provided by any conflicting rule applicable in that [intermediary's] proceeding'.[275] Note the careful wording of the carve-out: 'applicable in that proceeding'. The point is that the conflicting rule need not be a part of any insolvency law per se.[276] For example, in Japan and in the USs (for banks), non-insolvency law property law principles (that is the pro rata sharing rules) are 'applicable in' insolvency proceedings.[277] The loss sharing rule for broker-dealers in the US, however, is part of a special insolvency law, the Securities Investor Protection Act (SIPA) and varies substantially from the issue-by-issue pro rata sharing rules under Article 26(2) and US and Japanese property law principles.[278] SIPA also

[269] See Draft Official Commentary, above n 6, para 26–7.

[270] Convention Art 26(2). Where securities of an issue are allocated to only one account holder, however, that account holder bears the shortfall: Convention Art 26(2)(a).

[271] Convention Art 24(1) requires an intermediary to 'hold or have available for the benefit of its account holders' sufficient securities and intermediated securities of each description so as to cover all of the credits to the accounts of its account holders. Convention Art 24(2) then describes the various means by which an intermediary may comply with Convention Art 24(1) (ie the means to 'hold or have available' securities and intermediated securities), including 'any other appropriate method'.

[272] Convention Art 26(5). Even in the absence of a declaration under Convention Art 26(5), if an intermediary credits securities to a securities account in its own name (ie if it is an account holder of itself and is its own relevant intermediary), the intermediary would not share with the other account holders under Convention Art 26 and all relevant securities would be allocated to the other account holders: see the immediately following paragraphs (discussing segregation and Convention Art 26).

[273] Convention Art 26(1); see Draft Official Commentary, above n 6, para 26–8.

[274] See above text at n 64 *et seq*.

[275] Convention Art 26(1); see Draft Official Commentary, above n 6, para 26–10.

[276] See Draft Official Commentary, above n 6, para 26–10.

[277] Convention Art 26(2)(b); see above section III.E.

[278] Under SIPA 15 USC §§ 78aaa–111, the value of all financial assets of types claimed by a firm's entitlement holders are pooled for the benefit of all account holders based on the aggregate value of

provides an insurance-like protection for non-institutional investors.[279] Similar protections for investors are in place in Japan.[280]

A declaration by a Contracting State under Article 25(5) of the Convention would have the effect that securities not segregated for account holders would instead be held by the intermediary for its own account and consequently would be available for the intermediary's general creditors, even in the face of a shortfall in securities segregated for account holders.[281] In the absence of such a declaration, the effect of Article 25(1) is that even securities and intermediated securities segregated as proprietary to the intermediary would be allocated to and shared by the account holders.[282] The same results obtain whether or not the intermediary is subject to an insolvency proceeding.[283] UCC Article 8 dictates the same results; the US would be unlikely to make a declaration under Article 25(5).[284]

Under Japanese law, intermediated securities held in segregated accounts with JASDEC (or another intermediary) for the benefit of account holders are owned by the account holders and are not subject to the intermediary's creditors' claims or the insolvency estate of the intermediary. In contrast, intermediated securities held in the proprietary account of an intermediary are subject to creditors' claims and are a part of the intermediary's insolvency estate. Consequently, such proprietary securities are not available for the satisfaction of account holder

all such financial assets. The value of each entitlement holder's claim is equal to the value of the financial assets that are *or should be* credited to its account, and the aggregate value of the financial assets is allocated proportionately among the entitlement holders. Actually the calculation is a bit more complicated, inasmuch as each customer's 'net equity' must be calculated by taking into account indebtedness of the customer to the debtor on margin loans: 15 USC § 78fff-2(b) (claims based on 'net equity'); lll(11) (defining 'net equity'). Under this formulation, the fortuity that there may be a shortfall in X securities but not in Y securities does not result in a windfall for Y securities entitlement holders and the X securities account holders do not bear the entire burden of the shortfall. Similarly, the risk that a firm improperly (and probably fortuitously) failed to acquire securities for, or to credit securities to, any particular entitlement holder's account is not borne by that account holder alone. Under this formulation for distribution and eligibility for participation as an entitlement holder, each entitlement holder has a higher likelihood of a lower potential loss.

279 SIPA protects eligible non-institutional account holders of insolvent registered broker-dealers against losses up to $500,000: 15 USC § 78fff-3(a). SIPA does not apply to banks and their entitlement holders, however: 15 USC § 78eee(a) (protection of customers of broker or dealer subject to regulation by the SEC under the Securities Exchange Act of 1934).

280 The FIEA established an Investor Protection Fund to carry forward protections under the superseded Securities and Exchange Act for non-institutional investors holding accounts with an insolvent securities firm for losses up to ten million yen: FIEA Arts 79–20 to 79–80. The BETA established another Investor Protection Fund that applies to securities credited to accounts in the book-entry transfer system and which also covers losses of non-institutional investors up to ten million yen: BETA Arts 51 to 65−2. Unlike the fund applicable to account holders of securities firms under the FIEA, the protections of the fund under the BETA extend to account holders of all intermediaries—ie those of banks as well as securities firms. The losses covered by the fund under the BETA are those caused by overbooking: BETA Art 60(1). See above text at n 125.

281 See Draft Official Commentary, above n 6, para 25–19 and Example 25–6.

282 Convention Art 25(1); see Draft Official Commentary, above n 6, paras 25–11, 25–18 and Example 25–5.

283 Convention Art 25(6); see Draft Official Commentary, above n 6, para 25–20.

284 UCC § 8–504(1).

claims. Given this policy choice, Japan would be likely to make a declaration under Article 25(5). A policy justification for the Japanese approach would recognise that general creditors of the intermediary may include public investors (such as bondholders) and claims arising out of the intermediary's regulatory violations. These claims plausibly might be viewed as being on a par with those of the intermediary's account holders.

As explained above, under the Japanese BETA one can acquire an interest in intermediated securities only by way of a credit to the acquirer's securities account.[285] Under that approach, an account holder who has, for example, instructed its intermediary to buy securities (and who has paid for the securities) may acquire nothing other than a claim against the intermediary if for any reason a credit entry is not made to the account holder's account. Such a claimant would not be entitled to share pro rata with other account holders in the intermediary's insolvency proceeding. It may be worth considering a change in Japanese law that would permit such a claimant to share in the pool of account holder securities of the same description.[286]

As mentioned above, the protections of Article 21 do not apply to an account holder that has granted an Article 12 interest *to* its intermediary. Article 20 addresses the situation in which an interest is granted *by* an intermediary. Although Article 20 relates to priorities and is not by its terms applicable only in an insolvency proceeding, its principal relevance is for an intermediary's insolvency proceeding. The baseline rule is set out in Article 20(1): the Convention does not determine priority as between an intermediary's account holders and the holders of Article 12 or Article 13 interests granted by the intermediary. Normally such priority contests will not arise. However, in the case of an insolvent intermediary and the presence of a shortfall in securities necessary to cover account holder interests, such a conflict may occur.[287]

Article 20(2) provides an exception to the general rule of Article 20(1). Article 20(2) confers priority on a holder of an effective Article 12 interest granted by an intermediary over the rights of the intermediary's account holders, 'unless, at the relevant time, the person to whom the interest is granted actually knows or ought to know that the interest granted violates the rights of one or more account holders'.[288] This standard essentially is identical to the innocent acquisition test

[285] See above section III.D.

[286] This would bring Japanese law generally in line with the relevant US law on this point.

[287] There are several contexts in which an intermediary may grant a Convention Art 12 or Convention Art 13 interest. For example, an account holder sometimes agrees to give its intermediary a 'right of use' or 'right to rehypothecate' securities credited to the account holder's account. In a common example, an intermediary may need to use securities allocated to account holders to secure borrowings necessary for the intermediary to extend credit to its account holders (eg so-called 'margin loans'). Also, in some legal regimes, securities credited to an intermediary's proprietary account are allocated as a matter of law to account holders to the extent necessary to cover a shortfall. But in the meantime the intermediary may have granted Convention Arts 12 or 13 interests in some of its proprietary securities.

[288] Convention Art 20(2).

applicable under Article 18. Given the protection that Article 18 affords to effective Article 12 interests, Article 20(2) may be redundant, at least in part. But taking into account the special treatment given to account holders in the insolvency proceedings of an intermediary under Article 21 and under the non-Convention law of many jurisdictions, a specific rule provides needed certainty. The Article 20(2) priority rule supplements and complements Article 21(1). This priority rule should be controlling notwithstanding any contrary rule under the law applicable in the insolvency proceeding.[289] For example, Article 26 on loss sharing in the intermediary's insolvency proceeding and any such contrary rule under the applicable law should be applied only after first giving effect to the priority established by Article 20(2).[290]

D. Special Provisions for Collateral Transactions

Chapter V of the Convention contains several special provisions relating to collateral transactions.[291] It applies to transactions in which a 'collateral provider'[292] provides 'collateral securities'[293] to a 'collateral taker'[294] to secure the performance of the 'relevant obligations'.[295] A collateral provider may provide collateral securities pursuant to a 'security collateral agreement'[296] under which the collateral taker receives a 'grant of an interest other than full ownership' in the collateral securities.[297] Alternatively, the collateral provider may provide the collateral securities pursuant to a 'title transfer collateral agreement'[298] under which the collateral taker receives 'full ownership' of the collateral securities.[299]

It is important to note that Chapter V is 'optional' in several respects. First, a Contracting State may declare that it does not apply when the law in force in that Contracting State is the non-Convention law.[300] Alternatively, a Contracting State may declare that it does not apply to collateral agreements when entered into by a natural person or another specified category of person,[301] that it does not apply 'to intermediated securities that are not permitted to be traded on an exchange or regulated market',[302] or that it does not apply to collateral agreements that

[289] See Draft Official Commentary, above n 6, paras 20–6, 26–9 and Examples 20–1 to 20–3.
[290] Ibid.
[291] A review of the Financial Collateral Directive alongside Convention ch V reflects the obvious influence of the former on the latter.
[292] Convention Art 31(3)(g) (defining 'collateral provider').
[293] Convention Art 31(3)(e) (defining 'collateral securities').
[294] Convention Art 31(3)(f) (defining 'collateral taker').
[295] Convention Art 31(3)(d) (defining 'relevant obligations').
[296] Convention Art 31(3)(b) (defining 'security collateral agreement').
[297] Ibid.
[298] Convention Art 31(3)(c) (defining 'title transfer collateral agreement').
[299] Ibid.
[300] Convention Art 38(1).
[301] Convention Art 38(2)(a).
[302] Convention Art 38(2)(b).

secure relevant obligations of specified categories.[303] Perhaps this 'optional' aspect accounts for the fact that Chapter V has received relatively scant attention during the process of developing and drafting the Convention text.

A detailed survey of Chapter V is beyond the scope of this paper. However, the following discussion identifies some provisions that are particularly important when a collateral provider (and in one case, the collateral taker) may be the subject of an insolvency proceeding. Article 33 permits a collateral taker to exercise remedies by realising on collateral securities or by operating a 'close-out netting provision'.[304] These remedies are triggered by the occurrence of an 'enforcement event'.[305] Significantly, these remedies are available 'notwithstanding the commencement or continuation of an insolvency proceeding in respect of the collateral provider or the collateral taker'.[306]

Article 36 addresses the obligation of a collateral provider to deliver additional collateral securities as a result of a change in collateral value, an increase in credit risk, or as agreed by the collateral provider (a so-called 'top-up collateral arrangement'). It also addresses a collateral provider's right to withdraw collateral securities upon delivering and substituting other collateral securities (a so-called 'substitution arrangement').[307] It provides that such deliveries are not 'invalid, reversed or declared void solely' because they were 'delivered during a prescribed period before, or on the day of but before, the commencement of an insolvency proceeding' of the collateral provider 'or after the relevant obligations have been incurred'.[308] In some insolvency regimes a so-called 'zero hour rule' applies to give the commencement of an insolvency proceeding retroactive effect to the beginning of the day on which the commencement occurred. Article 36 is intended in part to ensure that such a rule has no effect in the situation of the protected top-up and substitution arrangements. Top-up collateral arrangements triggered by deteriorating credit risks are controversial and are not protected from attack in an insolvency proceeding in some jurisdictions. For this reason, a Contracting State may declare that Article 36(1)(a)(ii) does not apply.[309] Finally, Article 37 applies when Article 36 does not apply. Article 37 provides a general protection against zero hour rules based on the timing of a collateral agreement or the delivery of securities.[310]

[303] Convention Art 38(2)(c). A Contracting State also may declare that one provision of Convention Art 36 does not apply, as discussed below. See below text at n 309.
[304] Convention Arts 33(1); 31(3)(j) (defining 'close-out netting provision').
[305] Convention Arts 33(1); 31(3)(h) (defining 'enforcement event').
[306] Convention Art 33(3)(b).
[307] Convention Art 36(1).
[308] Ibid.
[309] Convention Art 36(2).
[310] Convention Art 37.

VI. Conclusion

The Convention has demonstrated the wisdom, benefits and success of its functional approach as a novel and promising approach to the international harmonisation of private law. Although the final session of the diplomatic conference is the remaining hurdle, the merits of the Convention's functional approach are nonetheless already apparent. A remarkable consensus has been reached on the harmonisation of a host of substantive issues. These include the fundamental rights of account holders and duties of intermediaries, a test of innocence for innocent acquirers, a priority regime for conflicting interests in intermediated securities credited to the same securities account, and a number of issues that are presented in insolvency proceedings. Financial markets demand legal certainty and the harmonisation provided by the Convention would be an important step.

The flip side of the Convention's successful functional harmonisation reveals the various aspects of the law of intermediated securities which the Convention does not harmonise. The many instances in which the Convention defers to the non-Convention law or other applicable law testify to these limitations of the Convention's scope. This deference recognises that in many cases strict harmonisation is either unnecessary or would not be practical or feasible. This is not surprising given the context of intermediated securities. Legal doctrine, market structures, and holding patterns vary enormously from state to state.[311]

These limitations in the Convention's coverage should not be understood to mean that the non-Convention law is not in need of modernisation and improvement—it is. Indeed, states adopting the Convention may be expected to compete with one another as well with as non-Convention states in the context of providing a modern, efficient and predicable legal framework. Nor do these limitations indicate that nothing further need be done by the international law reform community to improve the non-Convention law in this area. As we suggested above, for example, consideration should be given to the development of a legislative guide for areas of related non-Convention law that are not harmonised by the Convention.[312]

The difficulty lies in determining where to draw the line between matters that should be harmonised and those for which competition among states and non-harmonisation international law reforms should be applied. We believe that the Convention generally has drawn an appropriate line.

How should the Convention's success or failure be measured? Following final issuance of the Official Commentary in 2010, presumably the next steps would

[311] Moreover, during the not-too-distant past and in recent years several states have enacted new legal regimes for intermediated securities and in many cases the approaches of these regimes differ substantially from one another.

[312] See above text at n 183.

involve efforts to interest states in becoming parties to the Convention. Certainly one appropriate measure of success for a multilateral international convention would be its entry into force and widespread adoption. By that measure, instruments such as the Vienna Sales Convention,[313] with 74 parties,[314] and the Cape Town Convention, which has 34 parties even though it was only completed in 2001,[315] have been quite successful. But adoptions are not the only appropriate measure of success. And strict harmonisation is not the only appropriate aspiration of law reform efforts. The Second Advice of the Legal Certainty Group is a strong indication that the development of European law on intermediated securities may be highly influenced by the Convention's text and policies.[316] To be sure, we believe in the wisdom and prospects for the Convention *as such* and at the proper time will support its adoption by states. But were the Convention to have a powerful influence on European law and the law of other jurisdictions, it would represent an enormous success for the Convention process even in the absence of widespread adoption of the Convention itself.

Beyond the Convention, the Official Commentary, and even a legislative guide for the relevant non-Convention law, other important future steps must be considered for the legal environment affecting intermediated securities. For example, we have identified a few issues on which Japanese law might be reconsidered.[317] And we have also noted the importance of appropriate insolvency regimes for financial firms, and especially those that act as intermediaries.[318]

[313] United Nations Convention on Contracts for the International Sale of Goods (CISG) (Vienna, 1980), available at http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG.html.

[314] See http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG_status.html.

[315] See http://www.unidroit.org/english/implement/i-2001-convention.pdf

[316] LCG, *Second Advice*, above n 4.

[317] See above text at n 245 *et seq* (discussing recognition of nominee or agent holding under the BETA and the possibility of control agreement perfection under Japanese law); text at n 286 (discussing a possible change in Japanese law that would allow a would-be account holder to share as such even in the absence of an actual credit to its account).

[318] See above section II.C.