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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 3 – PROPERTY INTERESTS IN INVESTMENT SECURITIES

Analysis of the need for and nature of legislation relating to
property interests in indirectly held investment securities, with
a statement of principles for an investment securities statute

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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 3 - PROPERTY INTERESTS IN INVESTMENT SECURITIES WORKING GROUP

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The FMLC has published five background papers simultaneously with this paper, all available on the FMLC website at www.fmlc.org. They are:

- The regulation of securities intermediaries by the FSA
- Research into the 1994 revisions to Article 8 of the Uniform Commercial Code (to follow)
- International overview
- The six classic priority scenarios
- Resources and materials

INTRODUCTION

The role of the Financial Markets Law Committee is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed. The Committee also acts as a bridge to the judiciary to help UK courts remain up-to-date with developments in financial markets practice.

Some element of legal uncertainty is inevitable in financial markets because practice is constantly evolving and the law is necessarily a step behind. What is important is that the major principles and rules are expressed clearly and in a readily accessible form, provide proper security for transactions and entitlements, reduce systemic risk and respond to the legitimate needs and practices of the market.

In late 2002 the FMLC considered legal uncertainties arising in the context of the intermediated securities markets. Intermediated holdings of investment securities are affected by a high level of legal risk. This has arisen because operational change has not been matched by law reform, and the application of traditional legal rules to new market arrangements is in various respects uncertain and unsatisfactory. Legal risk affects customers (including retail and pension fund customers); intermediaries; and purchasers and collateral takers. But over and above concern for their individual interests looms systemic risk: the risk that the failure of a major player in the market will have a domino effect and lead to other failures. With dealings in securities averaging a total value of £765,000,000,000 per day in CREST alone, this is a factor that cannot be ignored; indeed, the EC directives on settlement finality[1] and financial collateral[2] are specifically directed to market stability and the reduction of systemic risk. Although the legal risk is considered significant by the relatively small group of lawyers with relevant expertise, it is not widely appreciated in the markets. This is partly because of the specialism of the relevant areas of the law, and partly because (fortunately) the markets London hosts have not been affected by major custodian failures in recent years. So while we consider that the legal framework is basically sound, the relevant legal principles and rules are not readily accessible except to specialists and need to be adapted to accommodate the changes in market practice to which we have referred.

The FMLC therefore invited Professor Sir Roy Goode QC to chair a working group of experts with a remit to draft detailed proposals for legislation concerning investment securities, to explore and progress options for legislation, to explain and promote the project both in the UK and internationally, and to consult with industry, public sector and academia.[3] This paper sets out an analysis of the problems and proposals for legislation. It was developed for the FMLC by the Working Group. The views set out in this paper, however, are those of the Committee itself, as well as of the Working Group.

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[1] European Parliament and Council Directive of 19 May 1988 on settlement finality in payment and securities settlement systems (98/26/EC).

[2] European Parliament and Council Directive of 6 June 2002 on financial collateral arrangements (2002/47/EC).

[3] The background paper entitled "Resources and materials" available on the FMLC's website at www.fmlc.org itemises the bulk of existing learning in this area.

1. THE IMPLICATIONS OF CHANGING PRACTICE

1.1 The development of cross-border, electronic securities markets has affected the manner in which investors hold investment securities such as shares and bonds in three ways.

(i) Today, investment securities such as shares and bonds are commonly held by investors not directly from the issuer, but indirectly, through one or more intermediaries.

(ii) The assets held by intermediaries for investors generally comprise, not paper instruments in traditional form, but rather intangible electronic records.

(iii) Where an intermediary holds like investments for more than one customer, these are customarily not held separately but are pooled in a single client account maintained with the intermediary's own intermediary.

1.2 These three operational changes (intermediation, dematerialisation and pooling) facilitate rapid dealings in the international securities markets. However, the same changes take practice beyond the scope of settled law. Many rules of law relevant to the securities markets were developed in relation to traditional, paper-based practice. Their application in the new environment is in a number of respects both uncertain and unsatisfactory. This is a source of legal risk, including in particular systemic risk, and is also inimical to the efficient functioning of the market.

1.3 Developments elsewhere (see paragraph 5.3) illustrate the need for any country which hosts a major wholesale financial marketplace to consider law reform.[4] Given London's leading position in the financial markets, a sound legislative framework is particularly important for the United Kingdom, not only for its own domestic purposes but also as constituting a major influence on developments elsewhere in the European Union, much of whose legislation draws its inspiration from that of Member States. Under the 2002 Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held With an Intermediary the primary rule is that the applicable law governing all interests and relationships is that selected by the parties to the securities account agreement. It is therefore essential, if English law is to maintain and, indeed, enhance, its influence in this field, that it should be seen to provide a clear, up-to-date and market-responsive set of rules which will encourage parties to select English law as the governing law.

2. THE INDIRECT HOLDING SYSTEM

2.1 Investors traditionally held their securities direct from the issuer, either by registration as holders in the case of registered securities or by possession of certificates embodying title to bearer securities. There has, however, been a marked shift from direct holdings to indirect holdings through a custodian or other securities intermediary. This may result either from the arrangements for a new issue of securities or from the decision of an existing direct investor to transfer his holding into the name of an intermediary.

2.2 It is quite common for a new issue of international securities to be embodied in a single global, or jumbo, note deposited with a national central securities depository (CSD) or international central securities depository (ICSD), Euroclear in Belgium or Clearstream in Luxembourg, which through its nominee holds the note for its account holders, who may be central securities depositories, banks or corporations and whose interests in the note derive from the credit of securities to their respective securities accounts. These account holders may in turn

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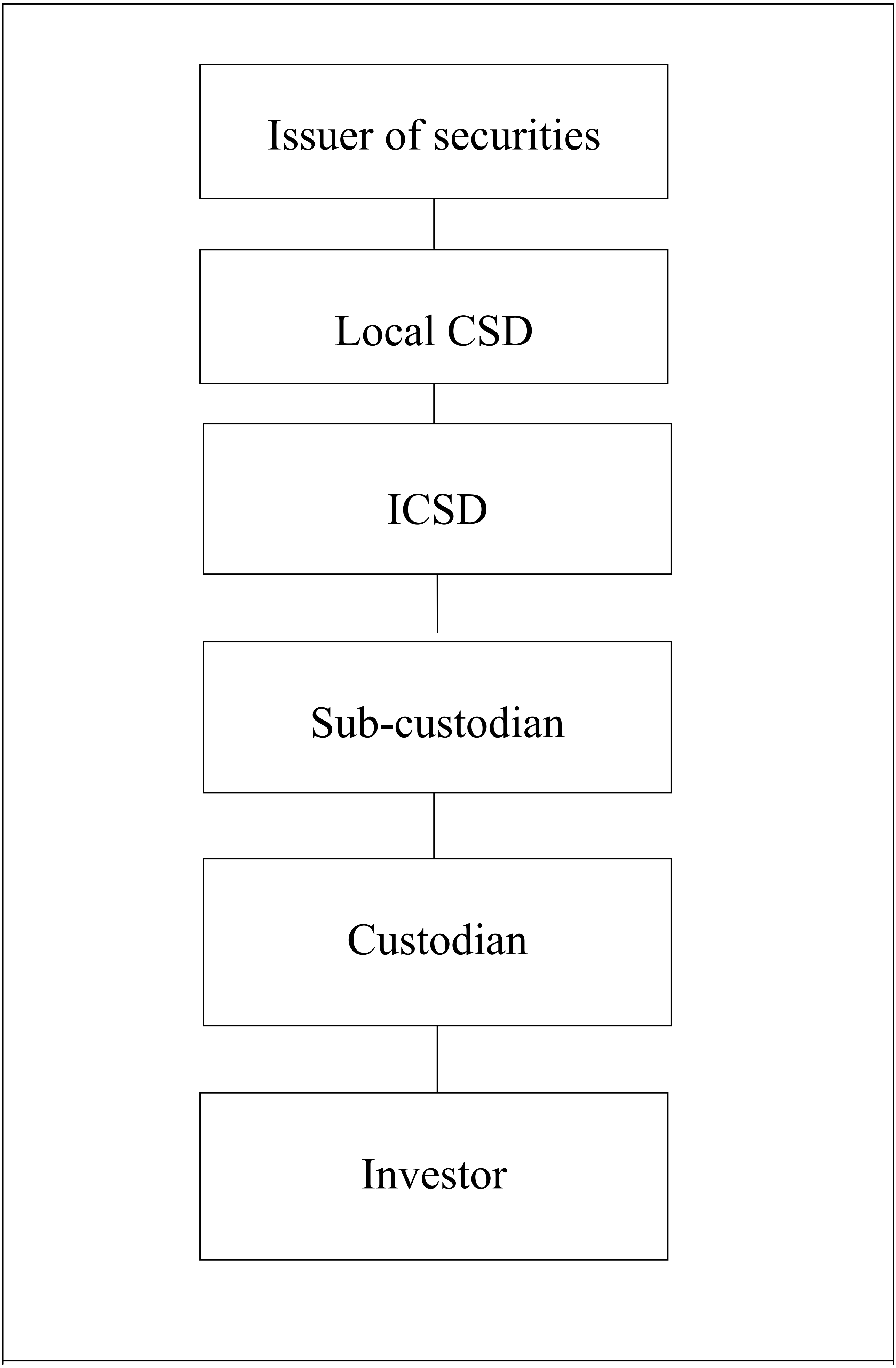
[4] For an overview of international developments, see further the background paper entitled "International Overview" available on the FMLC's website at www.fmlc.org

hold some or all of their securities entitlements on behalf of their own customers, who may also acquire them for account holders. So there may be a tier of intermediaries between the issuer and the ultimate investors. The only party having a direct relationship with the issuer is the depository acting as first-tier intermediary, through its nominee. All other interests derive from the credit of securities to a securities account, each account holder's relationship being with its own intermediary. Where the note is a permanent note investors never come into a relationship with the issuer except in extreme circumstances as provided by a contract, a deed poll or a trust deed governing the terms of issue. But the terms of issue may entitle an investor to exchange his account rights for definitive certificates and, upon such exchange, he becomes a direct holder. The indirect holding may also be initiated at the other end of the chain, as where an investor holding his securities directly deposits them with his intermediary into whose name they are transferred. The investor's relationship with the issuer then comes to an end and is replaced by a credit to his securities account as the source of his entitlement.

2.3 Though it is possible for a particular investor's holding to be segregated, the normal practice is for an intermediary to hold a particular issue of securities on behalf of all its customers investing in that issue in a single omnibus client account with its own intermediary, without differentiation as between one customer and another, so that the customers' rights are in a common pool. Securities held by an intermediary for itself are usually maintained in a separate house account and thus segregated from holdings for its customers.

2.4 Hand in hand with the shift to indirect holdings went dematerialization, the replacement of paper-based issues and transfers with electronic holdings through CREST. The effect of these two developments has been substantially to reduce the amount of paper involved in securities issues and dealings and to facilitate transfers, through electronic technology, multilateral netting and the fact that transfers between customers of the same intermediary are in-house transfers effected solely by book entry. So the credit to a securities account has replaced registration or possession as the source of the investor's rights.

2.5 The diagram shows in very simplified form a typical indirect holding structure through several tiers of intermediary. An investor has a custody account with a custodian, the custodian delegates holding to a sub-custodian, the sub-custodian holds through an ICSD, the ICSD holds through a local CSD, and title to the securities is ultimately registered in the name of the nominee for such local settlement CSD.


Issuer of securities
Local CSD
ICSD
Sub-custodian
Custodian
Investor

2.6 In practice, the chains are frequently more complex, in that each intermediary may acquire its holdings of the same issue from a variety of sources rather than a single source and the process of netting in a multilateral clearing and settlement system may make it difficult, if not impossible, to allocate any given acquisition to a particular source (see paragraph 6.5).

3. OUTRIGHT TRANSFERS AND SECURITY INTERESTS

3.1 If the investor wishes to transfer some or all of its securities to a third party, the way in which settlement occurs will depend on how the third party holds its securities. If the third party is also a customer of the same intermediary, settlement will occur by a book-entry transfer in the records of the intermediary, the transferor's account being credited and the transferee's account debited, with no record of the transfer in the books of a higher-level intermediary. Where, on the other hand, the third party holds securities with a different intermediary, and the two intermediaries hold accounts with the same upper-tier intermediary, there will be a transfer across the books of the latter in favour of the transferee's intermediary and then a credit by that intermediary to the account of the transferee,[5] with corresponding debits to the accounts of the transferor and the transferring intermediaries.

3.2 Interests in indirectly held securities may be transferred outright - for example by way of a straight sale or a sale and repurchase (repo) - or may be given in security in the legal sense.[6] A security interest in securities held through an account with an intermediary may be taken either by transfer into an account in the name of the creditor (whether with the same or a different intermediary) or by an assignment or an equitable charge perfected by notice to the intermediary or (more commonly) by transfer to a controlled escrow account.

4. WHAT THE MARKET IS ENTITLED TO EXPECT OF THE LAW

4.1 Given the sheer scale of dealings in investment securities and the importance of risk reduction, the market is entitled to expect the law:

- to be accessible;
- to have rules governing the creation, perfection and priority of interests, the duties and liabilities of intermediaries and the treatment of shortfalls, which are both clear and consistent with market practice and understanding;
- to facilitate the efficiency and stability of the market and reduce systemic risk; and
- to be sufficiently responsive to the legitimate needs of investors, intermediaries and collateral takers to encourage them to select English law as the governing law and avoid a situation in which, with long chains of intermediaries, the position under English law is seen as the weak link in the chain.

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[5] The common intermediary may be at a higher level, in which case it is necessary to go up the chain to that intermediary and then down the chain of transferee intermediaries.

[6] In the securities industry securities transferred under a repo or sell/buy-back arrangement are regarded as collateral, despite the outright transfer of title, because they fulfil a security function which is achieved by the repurchase agreement and contractual provisions for close-out and netting. But in law the normal repo is a sale and repurchase, not a security transaction.

5. IS THE PRESENT LAW ADEQUATE TO MEET THESE NEEDS?

5.1 Most legal systems outside the United States have yet to develop a coherent set of rules that accommodate the move from direct to indirect holdings and meet the above requirements. English trust law and rules of equity do, it is true, go a long way to protecting the interests of the various parties concerned. Thus there is little doubt that, in the absence of agreement to the contrary, investors holding securities accounts with an intermediary relating to interests in securities held in a pool will be considered to have co-proprietary rights in the pool as beneficiaries under a trust so as to be safeguarded against the intermediary's general creditors in the event of its insolvency. Again, intermediaries, as trustees, are subject to a range of equitable duties, including the duty to keep assets held on trust safeguarded and segregated from its own assets, to make good shortfalls in assets caused by its own wrongful acts, not to use trust assets for its own purposes without authorisation, and to maintain proper records of transactions.

5.2 Nevertheless, as in other jurisdictions which are in the course of changing their laws, there are deficiencies which need to be remedied. Much of the law is case law which can only be found by legal research and is thus inaccessible except to the expert. There is a lack of clarity as to the circumstances in which an intermediary is affected by notice of interests of those holding accounts with lower-tier intermediaries or in which an account holder or his attachment creditors may look through the account holder's intermediary to reach assets held by upper-tier intermediaries or assert claims against such intermediaries or against the issuer. The treatment of shortfalls tends to be bedevilled by complex equitable rules of tracing and the outcome of a competition between investors and an insolvent intermediary's secured and general creditors as regards claims against an intermediary's free assets is uncertain. There is no very clear protection for the bona fide purchaser of interests in securities against adverse claims. Even the rules governing the perfection of security interests are not as transparent as they might be. These problems are examined in section 6, which also identifies the principle of the proposed new statute which addresses them, while section 7 summarises our proposals for reform of the law in accordance with the principles stated in section 8. Section 9 contains a commentary on each of the principles. We have not attempted any detailed drafting. That and the working out of the principles and rules are best left to bodies such as the Law Commission, which is better equipped for the task. And the FMLC stands ready to assist as appropriate in any such process.

5.3 The importance of an up-to-date set of principles and rules governing interests in indirectly held securities is adequately attested by the intense attention being given to them in other parts of the world.[7] Belgium and Luxembourg introduced legislation many years ago to ensure that securities held by intermediaries - for example, Euroclear in Belgium and Clearstream in Luxembourg - were treated in the intermediary's insolvency as a separate estate ring-fenced from the claims of general creditors. The United States, in the 1994 revisions to Article 8 of the Uniform Commercial Code, has the most developed set of principles and rules on investment securities to be found anywhere, some of the provisions being counter-intuitive but designed to fulfil the legitimate expectations of the market.[8] The International Institute for the Unification of Private Law (UNIDROIT) has established a restricted study group to prepare an international convention containing substantive rules relating to indirectly held securities and the study group has recently produced its preliminary discussion draft.[9] There is also a proposal for a wider European Union instrument which would cover the issues discussed in this paper, set out in the EU Commission’s Communication on Clearing and Settlement in the

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7 See further the background paper entitled “International Overview” available on the FMLC's website at www.fmlc.org

8 See further the background paper entitled “Research into the 1994 revisions to Article 8 of the Uniform Commercial Code” available on the FMLC's website at www.fmlc.org

9 Draft convention on substantive rules regarding securities held with an intermediary (preliminary discussion draft, April 2004, Study LXXVIII - Doc 13, prov. 2).

European Union.[10] Given the need to keep the UK competitive in world markets, the commercial disadvantages of delay in improving the position under English law for holders of securities cannot be sufficiently emphasized.

6. ISSUES TO BE ADDRESSED

6.1 *What is the nature of the investor's rights in relation to the securities?*

Under English law, the legal result of a delivery of securities to an intermediary for the benefit of the investor (whether through deposit by the investor or by acquisition by the intermediary on the investor's behalf) may, depending on the terms agreed between the intermediary and customer, be characterised in any one of the following ways:

(1) As a purely contractual right to redelivery by the intermediary. In this case the beneficial ownership of the interest is held by the intermediary, who is free to deal with the interest as it chooses without reference to the investor. If the intermediary becomes insolvent the investor is a general creditor who is left to prove in the insolvency in competition with other unsecured creditors.

(2) As an equity of redemption (which constitutes an equitable property right) where the investor has given the intermediary a security interest in the asset. In this case the intermediary, though entitled to sub-mortgage or sub-charge its security interest on terms which enable it to return the asset to the investor when he redeems the security, is not entitled to dispose of the asset except in exercise of a power of sale in the event of default or the occurrence of some other event stipulated in the security agreement as attracting a right of sale. If the intermediary becomes insolvent the investor's equity of redemption remains effective against unsecured creditors.

(3) As bailor of physical securities such as traditional bearer bonds, delivered to the intermediary as bailee for safekeeping (legal title remains with the customer, the intermediary cannot use the assets for its own purposes, the assets are not available to general creditors of the intermediary).

(4) As beneficial owner of an interest in the securities, held by the intermediary on an express or implied trust. Where the intermediary holds the securities for its account holders in a common pool the individual investor is co-owner with other investors. The intermediary cannot use the securities for its own purposes without authorisation from the investor and the assets are not available to the general creditors of the intermediary.

In the great majority of cases the investor's entitlement will be as in (4) above. In all cases the investor, in addition to any property right he may have, will have a contractual right to the delivery or redelivery of physical certificates in the case of bearer securities or to definitive certificates exchangeable for his interest in a global note except where this is permanently immobilised with a depository, in which case his entitlement is merely to have his interest transferred to another account, whether of his own or of a third party. We believe that it would be helpful to embody a specific rule in the statute that unless otherwise agreed an investor enjoys a bundle of co-proprietary and personal rights in and to securities held by his intermediary, including income and other benefits associated with the securities. This is captured in Principle 2.

6.2 *What happens if there is a shortfall in the assets held by the intermediary?*

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[10] Communication from the Commission to the Council and the European Parliament - Clearing and Settlement in the European Union – The way forward", Brussels, 28.4.2004, COM(2004) 312 final.

At the risk of stating the obvious we would note that an investor's interest in securities held through an account with an intermediary cannot exceed a *pro rata* interest in what the intermediary actually holds. If, therefore, the intermediary never acquired title to the securities in the first place or if its rights are subject to set-off or it has wrongfully dissipated the securities the civil law can do no more than give the account holders personal remedies, which may be ineffective if the intermediary is insolvent.

An intermediary holding assets for two or more customers will usually maintain with its sub-custodian a general customer account in respect of all securities of the same type. (It would be administratively cumbersome and expensive for the intermediary to maintain an individual account with the sub-custodian in respect of each customer). A shortfall may arise in the general client account for various reasons. Clearly, if the shortfall is due to an act or omission of the intermediary for which it is liable, and the intermediary is solvent, the shortfall can be resolved by the intermediary providing further assets. But what happens if the intermediary is insolvent, or the shortfall is caused by other circumstances where no person can be identified as the culprit or such person is not available to provide additional assets?[11]

Equity has complex tracing rules for determining how shortfalls in mixed accounts should be borne, but these rules are difficult to apply in the modern markets in the context of large volumes and rapid transfers. Case law[12] has shown situations where the equitable rules have simply been considered too difficult to apply and the loss has therefore been allocated pro rata among all affected customers. It is important to note that this is usually the commercial expectation (and is, in fact, assumed in the FSA client asset rules[13]) but there is some legal doubt on this point. Although the most practical approach is for loss to be borne proportionately by all pooled customers, and this is supported by some case law, it would be open to particular customers to claim that the shortfall should be passed to other particular customers, by applying the traditional rules of equitable tracing. Such a claim may be likely where a shortfall is significant, and attributable to problems associated with one customer's transactions. The danger therefore arises that in such cases customers may face the delay and expense of litigation.

What is needed above all is clarity. Any shortfall rule must on the one hand reflect the agreement of the parties and the need to provide proper protection for investors and on the other to avoid dislocation of legitimate market operations. The Principles do not seek to work out the detail of a shortfall rule or address the question whether and to what extent any shortfall should in the first instance be attributed to the intermediary's holdings of a security in its own account and, if so, the position of secured and general creditors; those are questions for a later stage and to be resolved in the light of responses to consultation. Instead the Principles lay down the general approach to shortfalls. The normal rule is that the intermediary should at all times hold a sufficient quantity of a given security to meet the entitlements of all its account holders. But there are various circumstances in which a shortfall may arise without fault on the part of the intermediary. Accordingly the duty to hold sufficient securities to meet all entitlements is to be considered satisfied as regards any investor if the intermediary has acted in accordance with its agreement with that investor and in conformity with reasonable commercial standards of care to ensure the avoidance of a shortfall.

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[11] A shortfall might arise, for example, when a customer purchases and sells securities for settlement on the same day. If the settlement of the purchase is delayed due to operational problems, the settlement of the sale may produce a shortfall in the account. Settlement systems generally solve the problem by imposing in the terms of participation a general obligation to make good shortfalls whether or not fault is involved. This is somewhat onerous for participants but is generally considered appropriate to minimise systemic instability.

[12] *Barlow Clowes International Ltd (in liquidation) v Vaughan* [1992] 4 All ER 22

[13] CASS Rules, 2.3.3G: "firms are expected to advise the private client that … in the event of an unreconcilable shortfall after the failure *(defined to mean insolvency events)* of a custodian, clients may share in that shortfall in proportion to their original shares of the assets in the pool."

The question of prorating does not, of course, arise to the extent that the customer's entitlement is contractual only or has been properly reversed or extinguished, for example, because a credit to the customer's account was provisional and dependent on the receipt of securities by the intermediary which do not arrive or because the intermediary has disposed of the securities pursuant to a contractual right of re-use.

6.3 *Can a third party make a claim to assets in the hands of the intermediary?*

The basic position under English law is that a trustee owes its duties to the trust beneficiary and therefore is entitled to act on the instructions of its customer (or a third party duly authorised by the customer). Implementation of authorised instructions given on behalf of the customer often takes place electronically and automatically, without human intervention.

However, implementation may expose the intermediary to liability in cases where the instruction comes, not from the beneficial owner of the assets, but from another intermediary. Such arrangements are customary in relation to pension funds and other managed funds. If the instruction involves a breach of duty to the true owner of the assets, the intermediary may face a claim. Such breach of duty might involve fraud, or simply technical breach of investment restrictions. Potential liability includes liability as constructive trustee, if for example the intermediary knew of the breach. (The intermediary may be a large, multi-function financial institution, such that it would be impracticable for it to be sure that nothing known by any member of staff could be attributed to it).

The converse problem may also arise. A customer may be exposed to the risk that the custodian may prefer to risk a claim from the customer rather than risk being a constructive trustee. This in turn affects any person who is expecting a transfer of assets from the customer and who may in such circumstances not receive the assets expected, and this will cause problems for all linked transactions, causing systemic disruption.

This problem is dealt with primarily in Principle 2(f).

6.4 *Perfection of a security interest*

It is necessary to distinguish attachment of a security interest (that is, the creation of the interest so as to be effective against the debtor) from perfection of the interest, which concerns effects against third parties, including a bankruptcy trustee or liquidator. English law allows security interests in investment securities to be created informally, without need of registration, transfer or other forms of control. But an unperfected security interest is liable to be displaced in favour of a third party acquiring an interest in the subject-matter. This is addressed primarily by Principle 5. A security interest is perfected by control, for example, by transfer of the securities entitlement into the name of the secured creditor or by an undertaking by the intermediary to act on the instructions of the secured creditor. A security interest given to the intermediary itself is perfected automatically without the need for any further step (Principle 6(b)).

6.5 *The no-look-through principle*

Modern thinking is that an investor's claim should in general lie only against its own intermediary, with no look-through to upper-tier intermediaries or the issuer. This broadly reflects existing English trust law, under which the rights of a beneficiary under a sub-trust are normally exercisable only against his own trustee, not against the head trustee. But there are exceptions to this rule. The no-look-through principle is dictated as much by practicalities as by concerns for market efficiency. It might be thought relatively easy to show the chain of title between issuer and ultimate investor. In practice, it may be difficult, if not impossible, to trace through the chain of intermediaries from which the ultimate investor acquired his interest. There are several reasons for this. In the first place, an intermediary does not deal with investors other than its own customers and normally has no knowledge of lower-tier holdings. Secondly, the intermediary may have acquired its own holdings through two or more sources, so that it is impossible to match its customer's holding to any particular source. Thirdly, the difficulties of tracing back are exacerbated by the multilateral netting in settlement systems. Finally, even if the information were available it could only be extracted with considerable effort and expense, and in a fast-moving market the time available would be too limited to allow investigations of this kind. The relevance of these matters is that they show the impracticality of a "look-through" system involved in the conventional tracing exercise and the need for a rule that the account holder's rights, and those of his attachment creditors, are available only against the account holder's own intermediary, so that upper-tier intermediaries do not need to be concerned with lower-tier interests.[14]

6.6 *Upper tier attachment*

In what circumstances can a creditor of the end investor claim the relevant proportion of the assets from an intermediary higher in the chain than the investor's own intermediary? This will depend on situation under local law in the jurisdiction where the relevant intermediary in the chain is located. If, as we advocate, the principle is adopted that an investor's claim is solely against its own intermediary, so that there is no look-through, it will follow that there can normally be no upper-tier attachment. This problem is addressed primarily by Principle 2(e).

6.7 *How should priority issues be resolved?*

A priority contest may arise between two parties both claiming interest in the same assets, as where the investor grants successive security interests to two different creditors. A background paper entitled "The six classic priority scenarios"[15] shows examples of situations where there may be competing claims over the same assets and the ultimate result under the present law is uncertain, being governed by complex rules of equity, some of which are unsuited to modern trading requirements and do not necessarily produce a result anticipated by the parties involved. The new priority principles are stated primarily by Principle 7. See also paragraph 6.8.

6.8 *Protection of purchaser in good faith*

Because of the speed with which financial transactions take place, there is no possibility for purchasers of financial assets to investigate the vendor's title prior to trading. Purchasers of debt instruments have traditionally been protected by the rules of mercantile law, which protects the good faith purchaser of negotiable instruments. However, it is highly unlikely that these rules extend to electronic assets such as contemporary intermediated securities. As a result, a purchaser of the interest in, say, bonds (unlike a purchaser of a physical bond) is not protected by the rule that a holder in due course of a negotiable instrument takes free of any prior claims and is unaffected by any flaw in the title (for example, where the bond was stolen) of the transferor. Equity protects a person who in good faith acquires legal title without notice of any adverse claims, but this protection cannot apply if the purchaser only acquires an equitable interest in the securities. The distinction between legal and equitable rights should be irrelevant in this context. There should be a clear rule in favour of the bona fide purchaser for value without notice. This is the solution provided by Principle 7(e).

6.9 *Assignments of equitable interests*

Under section 53(1)(c) of the Law of Property Act 1925, an equitable interest (which an intermediary's customer has) must be transferred by a written instrument. This does not reflect the practice in the settlement of market transfers. The section is disapplied for settlement through the CREST system, but not for "internal" transfers (i.e. transfers settled across the books of a custodian). While arguments to deal with this problem can be found, the

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14 It will also be apparent that transactions at different levels may well be governed by different laws, so that, for example, English law may govern the rights of the ultimate investor against his own intermediary but that intermediary's rights against its intermediary may be subject to the rules of another legal system.

15 available on the FMLC's website at www.fmlc.org in the page marked “Work in Progress”.

reasoning is invariably complex and the parties may not always wish to take the time (or expense) to do so, thus leaving potential risks lurking in the markets. This problem is dealt with primarily by Principle 6.

6.10 *Set-off*

One consequence of the indirect holding system is that, except as provided by a deed poll or contract with the issuer or by the terms of any trust deed governing the issue, an account holder has no relationship with the issuer and no right to by-pass limitations on its entitlement vis-à-vis its intermediary by asserting a claim or right of set-off against the issuer. But in those cases where the present law does give a right of set-off, our proposals would not affect it (Principle 8).

6.10 *Is there a valid trust at all?*

For a valid trust to exist the subject-matter must be identified. A question arose some years ago as to whether a trust for a given block of shares forming part of a larger holding satisfied the requirement of certainty in the absence of segregation. The judge at first instance held that one share was indistinguishable from another and that shares of a particular issue were by their nature incapable of segregation,[16] and his decision was upheld by the Court of Appeal.[17] The issue has therefore been resolved. Nevertheless, since it took an appeal to the Court of Appeal to settle this we feel it would be helpful to make express provision for it in the statute. The Principles presented provided for investors to hold property rights in common (see Principle 3) and this will remove any lingering doubt.

7. THREE CENTRAL CONCEPTS

The legislation we propose regarding the holding of securities with intermediaries is not intended to create a whole new code but rather to build on and clarify existing law and reflect market developments. Accordingly the principles formulated in this paper do not involve sweeping changes in the law but rather a set of statutory provisions addressing a relatively small number of issues that are of central importance to the securities market. The principles embody central concepts:

(1) The root of title to securities held with an intermediary is the credit to a securities account;

(2) Unless otherwise agreed, investors in a particular issue of securities held by an intermediary in a common pool have co-proprietary interests in the pool[18];

(3) Except as otherwise provided by a contract or provision in a deed poll or trust deed an account holder's rights are solely against its own intermediary, with no look-through to an upper-tier intermediary or the issuer and in consequence no upper-tier attachment.

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[16] *Hunter v Moss* [1993] 1 WLR 934.

[17] [1994] 1 WLR 425.

[18] Whether the pool is to be confined to securities held in the intermediary's client account or is to include securities held in its own house account and, in the latter case, the position of its secured and general creditors, are issues to be determined later in the light of responses to consultation.

8. PRINCIPLES FOR INVESTMENT SECURITIES STATUTE ("THE STATUTE")

1. Application

(a) Indirectly held securities

The principles apply where investment securities are held by a customer through a securities account with an intermediary. The principles do not apply where securities are held directly by registration in a share register or possession of certificates to bearer securities.

(b) Business only

The principles do not apply to non-business arrangements, that is, arrangements under which securities are held by a person as trustee otherwise than in the course of a business, for example, a family trust.

(c) Contracting out

The intermediary and customer may contractually modify or disapply the principles, so far as they relate to their mutual rights and duties.

(d) Consistency with collateral legislation

The Statute should be consistent with the Settlement Finality Directive, the Financial Collateral Directive and with the Law Commission proposals set out in its consultation paper on company charges.[19]

(e) No effect on terms of issue

The principles do not affect the terms of issue of securities.

2. Interests in Securities

(a) *Customer's rights*

The rights of each customer in relation to securities held by it through an intermediary are together called "interests in securities". Interests in securities include both personal rights against the intermediary and property rights in relation to the securities, as follows.

(b) *Property rights in pool*

Each customer holding securities of a particular type through an intermediary has proportionate property rights in the pool[20] to the extent of its entitlement.

(c) *Intermediary's duties*

Subject to contrary agreement by the intermediary and the customer: -

(i) the intermediary must pass on to customers all income and other benefits associated with the securities held by customers through it. It must implement any voting instructions received from the customer;

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[19] *Registration of Security Interests: Company Charges and Property other than Land* (Law Com Con Paper No 164, June 2002)

[20] See n 18. The customer's interest in the securities will not normally give the customer rights against the issuer. See principle 2(d).

(ii) the intermediary must record the customer's interests in securities in the account(s) it maintains in its books in favour of each customer ("client account");

(iii) the intermediary must ensure that securities held in the pool are sufficient to satisfy all customers' interests in securities.

The duty under (iii) is satisfied as regards any investor if the intermediary has acted in accordance with its agreement with that investor and, subject to that agreement, has exercised such care to ensure the avoidance of a shortfall as accords with reasonable market standards.

(d) *Enforcement of customer's rights*

Customers (and persons claiming through them, including attachment creditors) can enforce their interests in securities only against the intermediary, and not against the issuer or any other intermediary. However, this is subject to any direct rights of action against the issuer or other intermediary provided under the terms of issue of the securities or of a deed poll or contract or arising under general law against persons not acting in good faith.

(e) *Customer instructions*

The intermediary must act, and act only, on the instructions of the customer and/or the customer's duly authorised agent in relation to interests in securities and/or securities held by customers through it. The intermediary acting honestly may rely on such instructions, notwithstanding any notice it may have of third party claims.

3. **Insolvency Immunity**

Securities held by the customer through the intermediary are not available to the creditors of the intermediary.

4. **Shortfalls**

Any shortfalls in the pool will be borne by all participants in the pool in proportion to their entitlements. A shortfall does not arise where the customer's entitlement is contractual only or where pursuant to the agreement between the customer and the intermediary a credit is provisional only and is reversed or the intermediary disposes of an interest in securities in exercise of a power of re-use.

5. **The Creation of Interests in Favour of a Third Party**

(a) *No formalities*

An interest in favour of a person (X) other than the customer in interests in securities (as where such interests are given in security) may be created without any entries on the client account, public filings or other formalities or the transfer of control, for example by the agreement of X and the customer, or by trust ("informal dealings").

(a) *Unperfected and weak priority*

However, informal dealings may not be enforceable against third parties, and may be overridden by subsequent dealings where control is transferred and/or which are indicated on the client account.

6. The Perfection of Third Party Interests

(a) *Transfer of control*

Dealings in interests in securities (including outright transfers and security interests) are made enforceable against third parties by the transfer of control. No further formalities are required.

(b) *Meaning of control*

"Control" means legal, or legal and operational, control. A person has control of interests in securities if it is entitled, or entitled and able, to direct how they shall be dealt with. For example, X may take control by having the interests in securities credited to its own account. Alternatively, it may leave them in the client's account, but obtain the agreement of the intermediary that it will deliver the interests in securities in accordance with X's instructions without further consent of the customer. Whether the customer could itself continue to operate the client account would depend on its agreement with X.[21] Where interests in securities are agreed to be given as security to the intermediary itself, no further step is required to perfect such security.

7. Priorities

(a) *Competing claim*

The following rules apply where there are competing claims to interests in securities.

(b) *Account finality*

The intermediary shall not take notice of third party claims which are not indicated on the customer's account, unless it is ordered by the court to do so.

(c) *Purchase money priority*

Where the intermediary lends to the customer the purchase price of interests in securities, its security interest over those interests in securities for the repayment of the purchase price takes priority over any competing security interests.

(d) *Control priority; account priority*

In the case of successive dealings, a person acquiring control has priority over a person not acquiring control. As between two persons acquiring control, the person whose interest is first reflected in the account has priority. As between two person acquiring control where neither interest is reflected in the account, priority is determined by the order in which control is acquired.

(e) *Good faith purchaser*

In a case of fraudulent or other wrongful disposition by the intermediary, a good faith purchaser without notice of the fraud or other wrong takes free of customer claims. (Where the purchase is settled by debits and credits to an account maintained by the same intermediary, the shortfall provisions in Principle 4 will apply).

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[21] Where by the terms of a security agreement the customer is given continued freedom to operate the account, then under the present law this would be likely to lead to the security interest being characterized as a floating charge. That would change under the Law Commission's proposals, n 12 above.

8. **Set-Off**

Where the customer holds interests in securities for its own account and has good title to such interests, free from any defences or rights of set-off of its intermediary and from the claims of third parties, and owes a debt to the issuer of the securities, the fact that the client holds such interests through an intermediary shall not prevent the exercise of any rights of set-off which would otherwise be available as between the issuer and the customer.

9. **COMMENTARY ON PRINCIPLES FOR SECURITIES STATUTE ("The Statute")**

The principles are intended to provide a framework for the drafting of the Statute. They do not themselves attempt statutory drafting.[22]

Principle 1: Application

(a) *Indirectly held securities*

Securities: The correct definition of securities is a difficult question.

It is important that, when the Statute is drafted, the term "securities" is not defined in a restrictive manner. It is desirable in the interests of the financial system that the provisions of the Statute, including the "good faith purchaser" rule in Principle 7, should apply to a wide range of financial assets. Further, assets which are not securities at present may in the future become securities through changing market practice, and it is important that the Statute should not inhibit market innovation.

The best model for drafting a definition is that contained in The Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held With an Intermediary. This provides, in article 1.1(a), that,

""securities" means any shares, bonds or other financial instruments or financial assets (other than cash), or any interest therein".

As with the Hague Convention definition, it is recommended that the only limiting factor should be intermediation, as discussed below.

Indirectly held securities: The Principles apply only where a customer holds investment securities through an intermediary. This corresponds to the scope provisions in the Hague Convention, which "…*determines the law applicable to [certain] issues in respect of securities held with an intermediary…"* (article 2.1). The Convention goes on to provide, in article 1.1(f), that

" ... "securities held with an intermediary" means the rights of an account holder resulting from a credit of securities to a securities account".

The Principles do not apply to securities held directly from the issuer in the customer's name (paragraph 1(a)). Thus, assets held by sponsored members through CREST are outside the scope of the Statute. However, assets held through CREST by CREST members as custodian for their customers are within the scope of the Statute.

[22] For an overview of the current UK regulatory regime, see further the background paper entitled "Regulation of securities intermediaries" available on the FMLC's website at www.fmlc.org

Derivatives: Derivatives are not intended to be excluded as a class. However, in accordance with current market practice, it may be unusual for an intermediary to agree for a customer to hold a derivatives contract *through* the intermediary, for the following reasons. Many derivatives contracts involve liabilities and well as rights. On exchange derivatives are in many cases concluded on a principal to principal basis. The intermediary may be unwilling to assume the potential liabilities associated with becoming a party to customers' derivatives contracts. In the future, however, market practice may develop so that derivatives are brought within the scope of the principles.

Cash: As indicated above, the Hague Convention excludes cash. Broadly speaking, cash is taken to mean a debt claim against a deposit taking institution, represented by a positive balance to a cash account maintained by that institution. Money market instruments such as CDs, which are referred to as "near cash", and all manner of cash backed securities, are included. However, claims of the customer in respect cash balances maintained by the intermediary are excluded. This is because of the requirement that securities be intermediated, i.e. held through (and not owed by) the intermediary. The key point is that the debt should be owed by someone other than the intermediary. In many cases, where customer cash is intermediated, the Client Money Rules will apply. In the drafting of the Statute, its interaction with the Client Money Rules will need to be carefully considered.

(b) *Business only*

Non-business arrangements, such as those arising under family wills and trusts, are excluded. This is in order to avoid placing inappropriate burdens on informal private arrangements. However, the precise drafting of this exclusion will need to be carefully considered.

(c) *Contracting out*

Even where the Statute applies, the parties may contractually vary or exclude its terms as they relate to the agreement between them. Thus, custodians and their customers retain commercial freedom to draft their custody agreements as they wish (subject to regulatory constraints as discussed below).[23] However, such contractual provision cannot modify the Statute as it affects third parties, e.g. upon insolvency.

(d) *Consistency with collateral legislation*

It is proposed that the Statute should accord with other existing and proposed legislation affecting financial collateral.

(e) *No effect on terms of issue*

Nothing in the Statute affects the rights and obligations of the issuer of the securities. This addresses concerns that legislation affecting the intermediation of securities should not affect the legal characteristics of the intermediated assets.

[23] See further the background paper entitled "Regulation of securities intermediaries" available on the FMLC's website at www.fmlc.org

Principle 2: Interests in Securities

(f) *Customer's rights*

The customer enjoys a bundle of personal and property rights in relation to its holding of securities through the intermediary. For ease of reference, these rights are referred to collectively as "interests in securities".

In some respects the term "interests in securities" is akin to the term "securities entitlement" used in Article 8 of the US Uniform Commercial Code.[24] Article 8 is internationally the most developed regime relating to property rights in indirectly held securities. In view of the international importance of the US capital markets, it is clearly desirable that the Statute should in its essentials be consistent with Article 8. However, while the Statute draws on Article 8, it is not exactly modelled on it, chiefly for three reasons. First, the Statute is adapted to English (including European) law and practice. Secondly it is considerably shorter than Article 8. This is because many of the provisions, which are explicit in Article 8, are implicit or expressly provided for under existing rules of English law (particularly the law of trusts). Thirdly, the Statute facilitates set off between customer and issuer, where Article 8 does not.[25]

(g) *Property rights in pool*

Segregation: The rules of English trust law and financial services regulation require an intermediary to hold customer assets separately from house assets.[26] The Statute does not additionally impose a duty of segregation.

Proportionate property rights: Each customer has property rights in the pool of securities held by the intermediary. These rights are proportionate to the entitlements of each customer. It is not provided that a customer's property rights attach to particular securities in the hands of the intermediary. This approach reflects the operational reality in most cases. Also, it permits fractional dealings. Thus, a customer may buy or sell interests in securities which are smaller than the denomination of the securities to which they relate. Of course, it would be impracticable to withdraw such a fraction from the intermediary, so as to hold it directly from the issuer of the securities.

Fungible and non fungible accounts: It is customary in practice for an intermediary through whom more than one customer holds like securities, to commingle such securities in an omnibus client account (or "pool"). This is on the basis that each customer's redelivery rights are fungible. Alternatively, but less commonly, an intermediary may segregate the assets of each customer in non-fungible accounts. Whether or not the account is fungible is an operational question, reflecting the agreement of the parties. The Principles apply to either arrangement, although the provisions relating to proportionate sharing of shortfalls in Principle 4 will only be relevant to fungible accounts.

Client account evidence of customer rights: Each customer has property rights in the pool held by the intermediary "to the extent of its entitlement". In the normal course, the extent of a customer's entitlement will be determined by the credit balance in the client account maintained in its name by the

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[24] The term "securities entitlement" is a shorthand for "the package of rights that a person who holds a securities position through an intermediary has against that intermediary and the property held by that intermediary." J. S. Rogers, Policy Perspectives on Revised UCC Article 8 (1996) 43 UCLA L. Rev. 1431, at 1450.

[25] See further the background paper entitled "Research into the 1994 revisions to Article 8 of the Uniform Commercial Code" available on the FMLC's website at www.fmlc.org

[26] i.e. assets beneficially owned by the intermediary.

intermediary. However, such client account credits are evidentiary and not constitutive of the customer's rights.

A customer's rights in relation to securities held by the intermediary currently arise in accordance with general law principles. It is understood that these provide that property passes when the parties so agree and the assets are sufficiently identified. In the case of securities delivered to the custodian by a third party to settle a customer purchase, property would normally pass to the customer as soon as the securities were received by the intermediary. As against the creditors of the intermediary, the customer would then acquire property rights in relation to the assets, whether or not the intermediary had immediately credited them to the client's account in its own books. The securities would not be available to the intermediary's creditors even if the intermediary became insolvent before making such a credit. Equally, a customer's property claim would not be defeated by any erroneous or fraudulent omission to credit the client account in full. It may be desirable for the drafting of the Statute to clarify that, as against creditors of the intermediary, property passes to the customer when (a) the parties so agree and (b) the assets are sufficiently identified in the hands of the intermediary

However, in accordance with Principle 7, property claims which are not noted on the client account may have weaker priority than claims which are so noted. Thus, entry on the client account is essential to priority, but not to property.

Contractual redelivery rights only: In some circumstances, the customer may agree with the intermediary that the customer will have only contractual rights of redelivery, and not property rights in relation to securities held by the intermediary. This might arise, for example, where the custodian acting as principal has borrowed securities from the customer, or in prime brokerage or other arrangements where the custodian exercises a right of use. Because the principles apply where securities are held by a customer through an intermediary, such stock lending or right of use takes the relevant assets outside the scope of the Principles.

Contractual settlement: In some cases, intermediaries offer a contractual settlement service to customers. This is in order to help certain customers, particularly managed funds, with their accounting requirements, so that cash associated with assets which in operational fact have not yet been received by the intermediary, can be appropriately treated by the customer. For information purposes, a credit is made to the account, with a notation that the credit is provisional. Account statements sent to the customer will indicate that the credit is "pending receipt". The customer is not able to instruct the intermediary to deliver such assets to a third party. It is understood that such provisional credits are not intended by the parties to give rise to property rights, and would not therefore serve to increase the customer's "entitlement" for the purposes of Principle 2.a. Accordingly, if the intermediary became insolvent after the making of the provisional credit and before the arrival of the relevant assets, the customer would not be entitled to the delivery of such assets as against creditors of the intermediary.

(h) *Intermediary's duties*

Three duties are specified as being owed by the intermediary to the customer.

Default rules: These are default provisions only. If different duties are specified in the contract between the customer and the intermediary, the contractual provisions will prevail. Thus, the custody contract will in most cases define the intermediary's duties.

Subject to regulation: Intermediaries safekeeping and administering customer securities in the UK are required to be authorised or exempted under the Financial Services and Markets Act 2000 (FSMA). This regime imposes detailed duties on the intermediary. However if, in breach of FSMA, a securities intermediary is not authorised or exempted, the protections for customers offered under the Statute will still apply.

Fiduciary duty: Intermediaries generally owe implied fiduciary duties to their customers which are more onerous than the duties usually owed within a commercial relationship. However, implied fiduciary duties may be effectively modified by contract to commercial levels. Financial intermediaries customarily rely on such contractual modification. The Statute will not alter the position.

Voting: Note that the principles do not impose any duty on the intermediary to exercise voting rights if it is not instructed by the customer to do so. Also, the drafting of the Statute should make it clear that the intermediary is not obliged to hold the investment securities so as to be able to pass on voting rights, unless so instructed. This is because, as indicated above, securities are often held in a commingled basis; and in some cases it is only possible to exercise voting rights in relation to a holding of securities in one way.

(i) *Enforcement of customer's rights*

It is provided that in general the customer can enforce its rights only against the intermediary.

No look-through: The provision has the object of preventing the legal uncertainty associated with property rights in customer assets being asserted at sub-custodial level ("upper tier attachment"). The same object informs recent international measures (including the Settlement Finality Directive, the Financial Collateral Directive and the Hague Convention on Indirectly Held Securities). These base the choice of law analysis of cross-border arrangements on the relevant account (or the agreement relating to it). In this way, like these international measures, the Statute seeks to promote account finality.

Reflects existing law: This reflects the existing position under trust law, whereby a beneficiary is in general able to enforce rights associated with the trust property only by suing his own trustee, not the trustee of a superior trust or another third party; the trustee is generally obliged to enforce such rights on behalf of the beneficiary. If the trustee does not do so, the only recourse of the beneficiary is in general to join the trustee in an action against third parties. So, under the Principles, the rights of the customer may include compelling the trustee to enforce rights against issuers or upper tier intermediaries in the intermediary's own name. However, the customer cannot itself sue such third parties.

(j) *Customer instructions*

Mere notice of an adverse claim from a third party will not make the honest intermediary liable to a proprietary claim from such third party. Customers are in general entitled to have their assets legally protected, but this must be balanced against the rights of third parties dealing in good faith with intermediaries. However, the intermediary will not be protected unless it acts honestly. Also, forged instructions, which do not in fact come from the customer or its duly authorised agent, will not be effective.

Principle 3: Insolvency Immunity

Because securities held by customers through the intermediary do not belong to the intermediary, the creditors of the intermediary cannot claim them. The commercial term for insolvency immunity is "insolvency ring fence". The Hague Trust Convention[27] provides for the insolvency immunity of trust assets as follows: *"...the assets constitute a separate fund and are not part of the trustee's own estate"*.[28]

Principle 4: Shortfalls

Nature of shortfall: A shortfall arises where the securities actually held through an intermediary fall short of the aggregate of customer entitlements, so that the pool is insufficient to meet such entitlements. Shortfalls can arise for a range of operational reasons; temporary shortfalls are not uncommon.

Dealings not giving rise to a shortfall: As indicated in the discussion of contractual settlement under Principle 2, contractual settlement operates for accounting purposes only, creating a purely contractual right to delivery, and does not give rise to a shortfall. Similarly, there is no shortfall as regards the crediting of an interest in securities which is provisional only and is reversed or as regards an interest disposed of by the intermediary pursuant to a contractual right of re-use.

Shortfalls borne proportionately: The general principle is that shortfalls should be borne proportionately. This excludes the application of the complex traditional "tracing" rules whereby a particular shortfall is attributed to a particular person on the basis of timing of accounts entries.[29] In turn, this reflects the better view of existing law.[30] Of course, pro-rating removes the possibility of one customer arguing that a shortfall should be borne exclusively by another customer, on the basis of evidence that the shortfall is operationally attributable to the business of that other customer. It is felt however that the risk of unfairness through such "cross subsidisation" is outweighed by the benefit of avoiding the risk of uncertainty, delay and expense in complex litigation.

Principle 5: The Attachment (Creation) of Interests in Favour of Third Parties

Following an agreement to transfer property rights, three different legal stages are identified in relation to such rights. These are: attachment, perfection and priorities.[31] Very broadly, attachment involves the creation of property rights as between the transferor and transferee; and priorities determine the order in which competing perfected rights in the same asset will be satisfied. The provisions of Principles 5, 6 and 7 respectively correspond with these three stages.

(a) *No formalities*

Informal dealings are permitted. Thus a customer may grant property rights in its interests in securities by simple agreement, and no formalities of any kind are required for such third party rights to attach. This facilitates transactions such as floating charges, securitisations and declarations of trust, and accords with the provisions of the Financial Collateral Directive.

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[27] The Convention was implemented in the UK by the Recognition of Trusts Act 1987.

[28] Article 2(a).

[29] For example under the rule in *Clayton's Case (1816) 1 Mer 572.*

[30] See *Barlow Clowes International Ltd (in liquidation) v Vaughan* [1992] 4 All ER 22 and *Russell Cooke v Prentice Ors.*

[31] See R. M. Goode, Legal Problems of Credit and Security, 3rd ed., London, Sweet & Maxwell, 2003, chapter II.

(b) *Unperfected and weak priority*

However, while informal dealings give the third party property rights as against the customer, its rights may not be perfected and may be postponed to other parties' rights taking priority, in accordance with Principles 6 and 7.

Principle 6: The Perfection of Third Party Interests

(a) *Transfer of control*

Third party interests are perfected (i.e. made enforceable against third parties) by the transfer to the third party of control. This provision is broadly equivalent to the position under Article 9 of the US Uniform Commercial Code.

(b) *Meaning of control*

In practice, control may be positive or negative. A person has positive control over assets where they are able to dispose of them. A person has negative control over assets where they are able to block any other person from disposing of them. Under Principle 6, transfer of positive and not negative control perfects a third party interest. More than one person may have positive control, as more than one person may be able to dispose of the assets. If so, priorities between them are determined in accordance with Principle 7.

Principle 7: Priorities

(a) *Competing claims*

Competing claims may arise in a range of circumstances, including the following. The customer may purport to dispose of the same interests in securities to more than one person. Where the customer is itself an intermediary, holding the interests in securities for its own customers, it may attempt to deal in them (by sale, grant of security or otherwise) in breach of its duties to its own customers. Thus, priorities disputes may arise as between owners, purchasers and secured creditors.

(b) *Account finality*

Finality: Principle 7.b provides in effect that third party interests which are not indicated on the account are not (in the absence of a court order) binding of the intermediary. The draftsperson of the Statute will need to consider the question of finality, i.e. the time when an account entry is legally treated as made.

Irrevocability: However, the Statute should be silent on the question of irrevocability for insolvency purposes, i.e. the question of when an account entry is not subject to insolvency displacement rules. The policy justification for exceptions from insolvency displacement rules given in measures such as the Settlement Finality Directive and Part VII of the Companies Act 1989 is systemic, and will not be present in all intermediated systems.

Contractual settlement: The account finality provisions of Principle 7 should not apply to provisional credits made pursuant to contractual settlement arrangements.

(c) *Purchase money priority:*

In practice, the intermediary may agree to fund the purchase of customer assets which it subsequently holds for the customer, taking a security interest over the assets for the repayment of the purchase price.

Such a security interest takes priority over any competing claim over those assets. This "purchase money" priority does not, however, extend to assets in the same account not funded by the intermediary.

(d) *Control priority; account priority:*

Three rules are given, which broadly correspond to the provisions of the US Uniform Commercial Code Article 9. First, a person taking control has priority over one not taking control. (Thus, control is relevant both for perfection and for priority.) Secondly, where two persons acquire control, the person whose interest is first reflected on the account has priority. Thirdly, where both acquire control and neither interest is reflected on the account, the first to acquire control has priority.

(e) *Good faith purchaser*:

Security of transfer: The good faith purchaser is protected from adverse claims associated with intermediary fraud or other wrongful dispositions. This favours the principle of security of transfer over the contrary principle of security of title. While in general customers are entitled to the protection of their property rights, where they entrust their assets to unreliable intermediaries, it would not be fair for the risk of intermediary fraud to be transferred to good faith purchasers.

Regulation: This rule operates in the context of the strict regulatory regime applicable to intermediaries under FSMA, which may render intermediary fraud relatively unlikely.

Account shortfalls: The good faith purchaser rule operates together with the shortfalls rule in Principle 4. Suppose the intermediary maintains an omnibus account for customers A, B, C and D, and fraudulently sells A's assets to B, who purchases the assets in good faith. Under the good faith purchaser rule, B acquires a good title, giving rise to a shortfall in the account. In turn, the shortfall is borne rateably by A, B, C and D in accordance with Principle 4.

Principle 8: Set-Off

Principle 8 may facilitate structures in which a customer holding debt securities seeks to manage the risk of issuer default by asserting rights of set off as follows. The customer arranges for the issuer to have a credit exposure to the customer (for example by entering into a swap with the issuer, and running up an uncollateralised out of the money position). In the event of the issuer defaulting on the bonds, the customer would ensure that it is in effect paid in full by setting its obligation to pay under the swap against its right to be paid under the bonds. In such structures, the availability of set-off in the insolvency of the issuer is a question of law, which must be considered on a case by case basis. However, article 8 provides that the operational fact that the bonds are held through an intermediary together with bonds held by other customers, shall not of itself prevent a right of set off that would otherwise be available.

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