

THE LAW OF INTERMEDIATED SECURITIES: U.C.C. VERSUS UNIDROIT

I. INTRODUCTION

The International Institute for the Unification of Private Law, commonly known as UNIDROIT, has been working since 2002 to draft a treaty that would establish a common system of laws governing intermediated securities throughout the world.¹ Indirectly holding securities through an intermediary has become the most common way securities are held,² with approximately 60%-80% of securities traded over-the-counter or on U.S. exchanges held by intermediaries.³ However, the international legal structure governing the holding of securities has not kept pace with changes in the industry.⁴

Securities can be held in either a direct or an indirect system. In a direct holding system, investors have a direct relationship with the issuer who keeps a record of the securities' owner.⁵ Alternatively, in an indirect holding system, there are various levels of brokers and banks that serve as intermediaries between the issuer and the investor.⁶ The issuer corporation issues a jumbo certificate representing a large amount of capital to the first-tier intermediary, usually a clearinghouse or large brokerage firm.⁷ Increasingly smaller interests in the issue are transferred to lower-tier intermediaries until the interest reaches an individual investor, but the interest remains held in bulk with the intermediary.⁸ The United States is currently one of the few countries with a developed system of laws governing intermediate securities.⁹ If ratified, the UNIDROIT treaty would modernize the laws governing

1. INT'L INST. FOR THE UNIFICATION OF PRIVATE LAW [UNIDROIT], Study Group for the Preparation of Harmonised Substantive Rules on Transactions on Transnational and Connected Capital Markets, *Restricted Study Group on Item 1 of the Project: Harmonised Substantive Rules for the Use of Securities Held with Intermediaries as Collateral*, Study LXXVIII—Doc. 5, at 1 (Oct. 2002), available at <http://www.unidroit.org/english/publications/proceedings/2002/study/78/s78-05-e.pdf>.

2. *Id.* at 2.

3. U.C.C. art. 8, Prefatory Note, pt. I.C (1994).

4. UNIDROIT, The UNIDROIT Study Group on Harmonised Rules Regarding Indirectly Held Securities, *Position Paper*, Study LXXVIII—Doc. 8, at 5 (Aug. 2003) [hereinafter UNIDROIT *Position Paper*], available at <http://www.unidroit.org/english/publications/proceedings/2003/study/78/s-78-08-e.pdf>.

5. CARL S. BJERRE & SANDRA M. ROCKS, *THE ABCS OF THE UCC* 4 (2d ed. 2004).

6. *Id.* at 5.

7. Mohamed F. Khimji, *Intermediary Credit Risk—A Comparative Law Analysis of Property Rights in Indirectly Held Securities*, J. BUS. L., May 2005, at 287, 287.

8. *Id.*

9. See *infra* note 48 and accompanying text.

intermediated securities throughout the world and replace the current legal system governing intermediated securities in America, the Uniform Commercial Code (U.C.C.) Article 8.

To date, the drafters have prepared and twice revised a preliminary draft of the treaty. They have also taken comments from the nations who are parties to the treaty and other interested parties, issued reports, and held seminars explaining the provisions of treaty.¹⁰ A final draft is expected to be completed by early 2007.¹¹ This Comment introduces the treaty and points out some of the critical differences if the treaty were to supplant Article 8. Part II gives an overview of U.C.C. Article 8. Part III explains the need for such a system throughout the world by analyzing the concept of systematic risk in the international system and outlining some of the variances in the current international law governing the indirect holding system. Part IV gives an overview of the provisions of the treaty as provided in the second revised preliminary draft and directly compares these provisions to the analogous provisions of the U.C.C. Part V discusses a few issues that the drafters are still facing. Finally, Part VI concludes.

II. THE INDIRECT HOLDING SYSTEM IN THE UNITED STATES: AN OVERVIEW OF U.C.C. ARTICLE 8

In 1994, Article 8 of the U.C.C. was revised mainly to provide specific rules governing indirect holding and to eliminate the uncertainty that surrounded the intermediated holding system.¹² Article 8 was designed to protect investors from the intermediary's creditors by assigning property rights to the securities even though the property is unallocated and indirectly held.¹³ Each investor has an account with the intermediary and has an entitlement right to the assets credited to their account; however, the investor does not own any specific assets.¹⁴ The entitlement holder receives a fractional share or a "pro rata property interest in all [of the] interests in that financial asset held by the securities intermediary."¹⁵ For example, if the investor is entitled to 500 shares of Lockheed-Martin stock and the intermediary holds 50,000 shares of Lockheed-Martin stock, the investor is entitled to a 1/100 interest in each share of Lockheed-Martin stock held by the in-

10. See UNIDROIT Proceedings and Papers, <http://www.unidroit.org/english/publications/proceedings/main.htm> (last visited Dec. 8, 2006), for all documents that have been issued in connection with the preparation of the treaty.

11. UNIDROIT, UNIDROIT Committee of Governmental Experts for the Preparation of a Draft Convention on Harmonised Substantive Rules Regarding Securities Held with an Intermediary, *Final Report*, Study LXXVIII—Doc. 23 rev., at 2 (Aug. 2005) [hereinafter UNIDROIT *Final Report*], available at <http://www.unidroit.org/english/publications/proceedings/2005/study/78/s-78-23rev-e.pdf>.

12. See Russell A. Hakes, *UCC Article 8: Will the Indirect Holding of Securities Survive the Light of Day?*, 35 LOY. L.A. L. REV. 661, 669 (2002).

13. Steven L. Schwarcz & Joanna Benjamin, *Intermediary Risk in the Indirect Holding System for Securities*, 12 DUKE J. COMP. & INT'L L. 309, 313 (2002).

14. Hakes, *supra* note 12, at 680-81, 687-88.

15. U.C.C. § 8-503(b) (1994).

intermediary.¹⁶ Section 503(a) states that the financial assets held by the intermediary are “not property of the securities intermediary,” and thus, they are exempt from the claims of the intermediary’s general creditors.¹⁷ Also, the intermediary is prohibited from granting a security interest in any assets to which entitlement rights have attached.¹⁸

In the event of a dispute, the investor who owns an entitlement right must go back against the intermediary with whom they have an account. The investor has no rights against the issuer or against higher-tier intermediaries.¹⁹ This has the effect of making the lowest-tier intermediary a guarantor of any upper-tier intermediaries.²⁰ The justification for such a system is that none of the upper-tier intermediaries are in privity with the investor; in fact, the lowest-tier intermediary is the only organization in the chain that has any way to know that the investor has an entitlement right in the assets.²¹

Under Article 8, however, the entitlement holder has several specific rights against its own intermediary. The duties owed by the intermediary to the entitlement holder are enumerated in Part 5 of Article 8. They are designed to give the entitlement holder the rights associated with direct ownership of a security.²² First, an intermediary is required to maintain enough shares to satisfy the demands of every investor,²³ which is usually accomplished by holding through a high-tier intermediary.²⁴ Second, the intermediary has an absolute obligation to obtain any payments, such as dividends, made by the issuer and an obligation to turn these payments over to the entitlement holder.²⁵ Third, an intermediary is required to exercise the ownership rights, such as voting rights, conversion rights, and the right to enforce legal obligations of the asset if directed to do so by the entitlement holder.²⁶ Next, the intermediary has a duty to comply with entitlement orders from the entitlement holder if the order is given by an authorized party and the intermediary has a reasonable opportunity to ascertain the authenticity of the order and to comply.²⁷ An entitlement order instructs the intermediary to “transfer or [redeem] a financial asset to which the entitlement holder has a security entitlement.”²⁸ Finally, an intermediary is obligated to change an entitlement into another available form of holding, usually direct holding, or to transfer the entitlement holder’s account to another security intermediary

16. See Hakes, *supra* note 12, at 688.

17. U.C.C. § 8-503(a).

18. U.C.C. § 8-504(b).

19. Hakes, *supra* note 12, at 688-90.

20. *Id.* at 686.

21. *Id.* at 690.

22. BJERRE & ROCKS, *supra* note 5, at 41.

23. U.C.C. § 8-504(a).

24. Joseph H. Sommer, *A Law of Financial Accounts: Modern Payment and Securities Transfer Law*, 53 BUS. LAW. 1181, 1202 (1998).

25. U.C.C. § 8-505; Hakes, *supra* note 12, at 692-93.

26. U.C.C. § 8-506; BJERRE & ROCKS, *supra* note 5, at 46.

27. U.C.C. § 8-507(a); Hakes, *supra* note 12, at 694-95.

28. Hakes, *supra* note 12, at 694 (quoting U.C.C. § 8-102(a)(8)) (internal quotation marks omitted).

if instructed to do so by the entitlement holder.²⁹ However, all of these obligations can be altered by an agreement between the entitlement holder and the intermediary.³⁰

In addition to the five personal rights enforceable against the relevant intermediary, the entitlement holder also has property rights in the securities.³¹ But such property rights can only be enforced through the five personal duties.³² The intermediary's duty to comply with entitlement orders and directions is the investor's strongest property interest.³³ All Article 8 obligations have been met if the intermediary has exercised "due care in accordance with reasonable commercial standards, or by performing its duties as specified by agreement," and it has complied with other legal requirements.³⁴

The entitlement holder has superior property rights to the intermediary. However, the entitlement holder does not have superior rights to a subsequent entitlement holder if the intermediary has not maintained a sufficient supply of stock to satisfy the demands of all of its investors because the later investor has the same pro rata share in the securities.³⁵ While the interests of entitlement holders are protected from general creditors, secured creditors with control of the disputed assets have priority over the claims of investors regardless of whether the investor has authorized the intermediary to repledge his shares.³⁶ Such priority is necessary to encourage lenders to make loans to the intermediaries, who can then make margin loans to investors, and to add liquidity to the market.³⁷

Article 8 specifically protects an entitlement holder from adverse claims if they gave value for an asset and did not have notice of the adverse claim.³⁸ An adverse claim is limited to a "claim that a claimant has a property interest in a financial asset and that it is a violation of the rights of the claimant for another person to hold, transfer, or deal with the financial asset."³⁹ Under specified circumstances, holders of derivative rights, such as lenders with an interest in the securities or lower-tier intermediaries, are also protected from adverse claims.⁴⁰ Because the intermediary owes duties only to its entitlement holders and those who derive rights from the entitlement holder, an intermediary can avoid adverse claims by meeting its five duties.⁴¹

29. U.C.C. § 8-508; Hakes, *supra* note 12, at 695.

30. Hakes, *supra* note 12, at 693.

31. BJERRE & ROCKS, *supra* note 5, at 52.

32. *Id.*

33. Hakes, *supra* note 12, at 696.

34. *Id.*

35. BJERRE & ROCKS, *supra* note 5, at 52.

36. *Id.* at 58.

37. *Id.* at 59.

38. U.C.C. § 8-502 (1994).

39. Hakes, *supra* note 12, at 697 (quoting U.C.C. § 8-102(a)(1)) (internal quotation marks omitted).

40. U.C.C. § 8-510(a)-(b); BJERRE & ROCKS, *supra* note 5, at 64.

41. BJERRE & ROCKS, *supra* note 5, at 65-66.

Finally, Article 8 provides that the local law in the jurisdiction where the intermediary is located governs any disputes.⁴² The contract between the investor and the intermediary determines the intermediary's jurisdiction when there is a debate.⁴³

III. THE NEED FOR A UNIFORM SYSTEM IN THE INTERNATIONAL MARKET

A harmonized system of laws governing intermediated securities is needed because the current national laws are very diverse and do not adequately protect the interests of international investors. This lack of certainty results in increased systematic risk that impairs the international financial markets. Subpart A of this section will describe the systematic risk that results from uncertainty in investment. Subpart B will then detail the uncertainty of the current indirect holding system in the international context.

A. *The Risk of Systematic Risk*

The drafters of U.C.C. Article 8 stated that the reason for revising the law governing securities in 1994 was the development of the indirect holding system.⁴⁴ The pre-revision version of Article 8 did not adequately address holding of securities through an intermediary, and the absence of such regulations was increasing uncertainty and risk in the market.⁴⁵ The type of risk the drafters were addressing is known as systematic risk, which is "the real or theoretical risk that the financial failure of one participant in the securities markets could have a domino effect on other participants (due to intricate interrelationships) and threaten the entire system."⁴⁶ Article 8 has been effective in eliminating much of the uncertainty of the indirect holding system by delineating the relationships and rights of the participants in the market.⁴⁷

This systematic risk caused by uncertainty in the relationships between intermediaries and entitlement holders still exists in the international market. The United States is one of the few countries in the world that has resolved the issue of intermediary risk.⁴⁸ As of 1997, the largest market for U.S. foreign investment was the United Kingdom.⁴⁹ Even though this is a developed market, the ability of an English intermediary's creditors to reach

42. Hakes, *supra* note 12, at 706.

43. *Id.*

44. U.C.C. art. 8, Prefatory Note (1994).

45. *Id.*

46. Hakes, *supra* note 12, at 665.

47. *Id.* at 670.

48. Schwarcz & Benjamin, *supra* note 13, at 314. In 2001, only two other countries, Belgium and Luxembourg, had adequate regulations governing intermediated security risk. Benjamin Geva, *Promoting Stability in International Finance—Legislative and Regulatory Reform of Payment and Settlement Systems*, in *THE REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE* 247, 277 (Rosa M. Lastra ed., Kluwer Law Int'l 2001).

49. Alan G. Ahearne et al., *Information Costs and Home Bias: An Analysis of U.S. Holdings of Foreign Equities*, 62 J. INT'L ECON. 313, 319 (2004).

the assets of investors depends on whether the intermediary keeps its own assets separate from those of its clients.⁵⁰ The failure to protect entitlement holders in the event an intermediary does not keep its assets separate adds unneeded uncertainty to the English holding system, thereby increasing intermediary risk.

Over the last two decades, U.S. investment in foreign equities has grown from around one percent of U.S. equity portfolios to approximately twelve percent of such portfolios.⁵¹ While this is a considerable portion of investments, some economists predict that if it were not for the risk and uncertainty associated with disclosure requirements, accounting standards, and regulatory environments, foreign equities would make up a more significant portion of U.S. investments.⁵² Investing in global markets can have significant economic benefits because it allows capital to be put to its most productive use, it better distributes risk internationally, and it allows countries to better exploit their comparative advantages.⁵³

Despite the overall increase in international investment, the net equity flows to developing countries decreased from 1996 to 2004.⁵⁴ While there are likely many causes for this decline, one factor that may come into play is the systematic risk that results when the roles and responsibilities of the parties to the transaction are not spelled out and investors are not protected from the creditors of securities intermediaries. Detailed laws governing the tiered holding of securities in international trading are a necessary component to modernize the financial system and eliminate transaction uncertainty.⁵⁵

B. The Uncertainty of International Intermediaries

International central securities depositories (ICSDs) facilitate the trade of intermediated securities in the international market by functioning as a clearinghouse for transfers.⁵⁶ The ICSDs are a global custodian of securities certificates; they deposit certificates issued in a foreign currency with a sub-custodian located in the appropriate country.⁵⁷ The ICSD serves as the first-tier intermediary.⁵⁸ A security entitlement is then transferred to lower-tier intermediaries just as in the U.C.C. system.⁵⁹

50. Schwarcz & Benjamin, *supra* note 13, at 315.

51. Ahearne et al., *supra* note 49, at 314.

52. *See, e.g., id.* at 314-16.

53. René M. Stulz, *The Limits of Financial Globalization*, 60 J. FIN. 1595, 1595 (2005).

54. *Id.* at 1596. According to data from the World Economic Outlook of the International Monetary Fund, investment in less developed countries decreased by \$67.4 billion during this period. *Id.* at 1596 n.1.

55. Geva, *supra* note 48, at 281.

56. *See* Roy Goode, *The Nature and Transfer of Rights in Dematerialized and Immobilized Securities*, in *THE FUTURE FOR THE GLOBAL SECURITIES MARKET* 107, 113 (Fidelis Oditah ed., Oxford University Press 1996).

57. *Id.*

58. *Id.* at 115.

59. *See id.*

The difference between holding intermediated securities in the U.S. and in other legal systems is the rights that an investor has in the securities held by an intermediary. Some common law legal regimes require the intermediary to hold the asset in trust for its customer instead of granting an ownership entitlement as is done under the U.C.C.⁶⁰ Where assets are held in trust, the investor will be only an unsecured creditor, possibly with priority rights, if the intermediary becomes insolvent.⁶¹ This stands in stark contrast to the co-ownership system of the U.C.C. where the securities are unreachable by the intermediary's unsecured creditors.⁶² In the trust relationship, the customer has only contract principles to require the custodian to collect and credit dividends, exercise voting rights, and perform other ownership rights.⁶³ In civil law systems, the rights of the investor can be even more precarious. Many of these jurisdictions do not recognize the trust and may not recognize co-ownership of the pool of shares by investors.⁶⁴ If this is the case, and no other special legislation applies, an investor's share of assets must be specified and separated from the general fund held by the intermediary in order to be protected from creditors.⁶⁵

To determine which system of holding applies, first it must be determined which country's laws apply to the transaction.⁶⁶ The governing law could be determined by the physical location of the security, which is generally the first-tier intermediary, but the tangible assets are generally irrelevant as ownership is determined by book entries.⁶⁷ The governing legal system could also be determined by where the book entry or physical delivery is made.⁶⁸ Such a system poses problems where the intermediary is an international corporation with offices in different jurisdictions connected by a computer network because the place where the entry is made may be arbitrary or unknown to the customer.⁶⁹ Finally, the governing law could be determined by the jurisdiction where the intermediary is incorporated or has its headquarters.⁷⁰ Not knowing which law will govern the relationship between an intermediary and an entitlement holder, in addition to not knowing what rights an investor will have in the event of intermediary insolvency, adds uncertainty to international investing, thereby increasing systematic risk.

60. *See id.* at 116.

61. *Id.*

62. U.C.C. § 8-503(a) (1994).

63. Goode, *supra* note 56, at 118.

64. *Id.* at 119.

65. *Id.*

66. *Id.* at 123.

67. *Id.* at 123. This is the system applied in Belgium. Thus, Belgium law governs all shares held by their ICSD even though they may be owned by lower-tier intermediaries outside Belgium. *Id.*

68. *Id.* at 124.

69. *Id.*

70. *Id.*

IV. THE PROPOSED UNIDROIT TREATY VERSUS THE CURRENT U.C.C.

The UNIDROIT treaty attempts to reduce the risk associated with cross-border trading by setting minimum international standards governing the holding of intermediated securities.⁷¹ The treaty explicitly provides that the national law of participating countries must allow all securities that may be traded on an exchange or regulated market to be held through an intermediary, although issuers of stock are still permitted to limit the ways their securities may be held.⁷² National law must also permit the holder or his nominee to exercise all rights attached to the security.⁷³ However, the treaty does not attempt to implement a comprehensive system of laws that will be identical in all of the participating countries.⁷⁴ Instead, the treaty focuses on addressing specific, minimum standards while leaving other issues to be resolved by the laws of each member country.⁷⁵ Thus, the treaty frequently refers to “domestic non-Convention law” or the law of the Contracting State.⁷⁶

A. Rights of Account Holders and Obligations of Intermediaries

The UNIDROIT treaty grants rights to entitlement holders and imposes obligations on intermediaries similar to the rights and obligations of the U.C.C. Article 9 of the treaty provides that an account holder who is not an intermediary or is an intermediary acting for its own account is entitled to receive any dividends associated with the shares and to exercise the shares’ voting rights.⁷⁷ They have the right to instruct the intermediary through an

71. UNIDROIT, UNIDROIT Study Group on Harmonised Substantive Rules Regarding Securities Held with an Intermediary, *Preliminary Draft Convention on Harmonized Substantive Rules Regarding Securities Held with an Intermediary: Explanatory Notes*, Study LXXVIII—Doc. 19, at 17 (Dec. 2004), available at <http://www.unidroit.org/english/publications/proceedings/2004/study/78/s-78-19-e.pdf>.

72. UNIDROIT, UNIDROIT Committee of Governmental Experts for the Preparation of a Draft Convention on Substantive Rules Regarding Intermediated Securities, *Preliminary Draft Convention on Substantive Rules regarding Intermediated Securities*, Study LXXVIII—Doc. 42, art. 13, § 1 (Mar. 2006) [hereinafter UNIDROIT *Preliminary Draft*], available at <http://www.unidroit.org/english/publications/proceedings/2006/study/78/s-78-42-e.pdf>; see also UNIDROIT, UNIDROIT Committee of Governmental Experts for the Preparation of a Draft Convention on Substantive Rules Regarding Intermediated Securities, *Second Session Report*, Study LXXVIII—Doc. 43, app. 12, at 15 (May 2006) [hereinafter UNIDROIT *Report*], available at www.unidroit.org/english/publications/proceedings/2006/study/78/s-78-43-e.pdf.

73. UNIDROIT *Preliminary Draft*, *supra* note 72, art. 13, §§ 1-2.

74. See UNIDROIT, “Legal Risk and Market Efficiency”: UNIDROIT Seminar on Harmonised Substantive Rules Regarding Securities Held with an Intermediary, Study LXXVIII—Doc. 12, at 2 (Feb. 2004), available at <http://www.unidroit.org/english/publications/proceedings/2004/study/78/s-78-12-e.pdf>.

75. *Id.*

76. See, e.g., UNIDROIT *Preliminary Draft*, *supra* note 72, art. 4, § 6; art. 5, §§ 4-8; art. 6, §§ 4-6; art. 8, § 1(b); art. 8, § 2; art. 9, § 1(a-b); art. 9, § 3; art. 16, § 2; art. 17, § 3; art. 18; art. 19, §§ 3-4; art. 24, § 4; and art. 27, §§ 1-2.

77. UNIDROIT *Preliminary Draft*, *supra* note 72, art. 9, § 1(a). *But c.f.* U.C.C. §§ 8-505 to -506 (1994) (providing that an entitlement holder may direct a securities intermediary to exercise rights with respect to a financial asset or may collect payment or distribution made by the issuer of a financial asset that is received by the securities intermediary).

authorized party to dispose of the securities⁷⁸ and the right to withdraw the securities so as to be held in a different form to the extent permitted under domestic law governing the securities, the terms of the securities, and the account agreement.⁷⁹ Domestic law can also grant an entitlement holder additional rights.⁸⁰

Intermediaries are required to take appropriate measures to enable account holders to enjoy the rights granted to them by Article 9 of the treaty.⁸¹ However, they are explicitly not required to “take any action that is not within its power or to establish a securities account with another intermediary.”⁸² The drafters feared that forcing an intermediary to establish an account in another country, possibly where the legal framework was not sound, would place an undue burden on intermediaries.⁸³ Article 18 of the treaty makes all obligations and duties of an intermediary subject to the account agreement to the extent permitted by domestic law; thus, the treaty concedes that this standard of care could be altered by an agreement between the parties.⁸⁴

While the current standard of care could lead to differing interpretations from jurisdiction to jurisdiction of what is reasonable, the only alternative is to impose strict liability on intermediaries if the Article 9 rights are not provided regardless of the intermediary’s ability to provide the right.⁸⁵ The reasonableness standard should adequately protect account holders in the majority of situations without overburdening intermediaries. This standard is also in line with the U.C.C. standard of care that imposes a burden upon intermediaries to act in accordance with the agreement between the parties or to exercise due care in accordance with reasonable commercial standards.⁸⁶

Under both the U.C.C. and the UNIDROIT treaty, intermediaries are required to hold a sufficient number of each security to meet the claims of their account holders.⁸⁷ There is, however, a difference in the standard of care. The treaty requires that if an intermediary does not have a number of securities of a particular description equal to the number of that type of se-

78. UNIDROIT *Preliminary Draft*, *supra* note 72, art. 9, § 1(b). *But cf.* U.C.C. § 8-507(a) (requiring a securities intermediary to comply with an entitlement order).

79. UNIDROIT *Preliminary Draft*, *supra* note 72, art. 9, § 1(c). *But cf.* U.C.C. § 8-508 (requiring a security intermediary to change a security to another form at the discretion of the entitlement holder, if such form is available to the holder).

80. UNIDROIT *Preliminary Draft*, *supra* note 72, art. 9, § 1(d).

81. *Id.* art. 10, § 1.

82. *Id.*

83. UNIDROIT *Report*, *supra* note 72, at 6.

84. UNIDROIT *Preliminary Draft*, *supra* note 72, art. 18.

85. *See* UNIDROIT, UNIDROIT Committee of Governmental Experts for the Preparation of a Draft Convention on Substantive Rules Regarding Intermediated Securities, *Preliminary Draft Convention on Harmonised Substantive Rules Regarding Intermediated Securities*, Study LXXVIII—Doc. 24 (June 2005) [hereinafter UNIDROIT *First Revised Draft*], available at <http://www.unidroit.org/english/publications/proceedings/2005/study/78/s-78-24-e.pdf>.

86. U.C.C. §§ 8-504 to -508 (1994).

87. U.C.C. § 8-504; UNIDROIT *Preliminary Draft*, *supra* note 72, art. 17.

curity credited to the accounts of the intermediary's customers, then it must promptly or immediately take action to cure the deficiency.⁸⁸ There is no reasonableness standard that limits the actions an intermediary must take to make up the deficiency. Under the U.C.C., the securities intermediary and the entitlement holder may alter this duty by agreement, or the securities intermediary may fulfill it by exercising due care.⁸⁹ Under both frameworks, a shortfall in the number of a particular security held by an intermediary is distributed among all of the owners of that security in proportion to the number of shares owned by the investor.⁹⁰

If a right of an account holder has been violated, the treaty makes the rights guaranteed in Article 9 effective against the intermediary with whom they have an account, as well as against third parties.⁹¹ The right to receive dividends and exercise voting rights and other rights attached to the security may also be exercised against the issuer of the securities "in accordance with this Convention, the terms of the securities and the law under which the securities are constituted."⁹² These provisions are in contrast to the U.C.C., which only allows enforcement actions to be brought against the intermediary with whom the account holder has an account and not against any third parties such as upper-tier intermediaries or issuers.⁹³ The treaty system thereby better enables investors to protect their rights of ownership such as voting and access to information.

B. Unauthorized Transfer of Securities from an Account

If an intermediary transfers securities from an account pursuant to an unauthorized order, the transfer is deemed to be ineffective under the treaty.⁹⁴ Domestic law determines when an order is unauthorized and the effect of an unauthorized transfer against third parties.⁹⁵ Under the U.C.C., when an unauthorized transfer is made, the intermediary "shall reestablish a security entitlement in favor of the person entitled to it, and pay or credit any payments or distributions that the person did not receive as a result of the wrongful transfer."⁹⁶ Under both the U.C.C. and the treaty, the intermediary would be forced to re-credit the entitlement holder's account, and it would be left to recover from the individual who made the fraudulent transfer. However, the UNIDROIT treaty does not expressly require the intermediary to compensate the account holder for any dividends that may have been paid between the unauthorized transfer and its discovery. This will

88. UNIDROIT *Preliminary Draft*, *supra* note 72, art. 17, § 2.

89. U.C.C. § 8-504(c).

90. U.C.C. § 8-503(b); UNIDROIT *Preliminary Draft*, *supra* note 72, art. 20, § 1.

91. UNIDROIT *Preliminary Draft*, *supra* note 72, art. 9, § 2(a)-(b).

92. *Id.* § 2(b).

93. U.C.C. § 8-503(c).

94. UNIDROIT *Preliminary Draft*, *supra* note 72, art. 8, § 1.

95. *Id.* § 3.

96. U.C.C. § 8-507(b).

force the account holder to bear the loss or to attempt a recovery via more complex theories.

Under U.C.C. Article 8, an intermediary has fulfilled their duty to make only authorized transfers if they act “with respect to the duty as agreed upon by the entitlement holder and the securities intermediary.”⁹⁷ If there is no agreement between the parties, the intermediary must exercise “due care in accordance with reasonable commercial standards to comply with the entitlement order.”⁹⁸ The treaty does not impose a similar standard of care for the intermediary in carrying out an order.⁹⁹ Courts could read in a standard of reasonable care similar to the standard of the U.C.C., but it is likely that, because the drafters have laid out the standard of care for other articles of the treaty, courts would interpret this duty under a strict liability standard, making the intermediary liable for any wrongful transfer no matter how much care was devoted by the intermediary in executing the transaction.

Per U.C.C. mandate, any person who issues an order to an intermediary warrants that the order is made by an appropriate person and, if they are acting as an agent for the entitlement holder, that they have the authority to do so.¹⁰⁰ This requirement gives the intermediary an additional cause of action against anyone who orders an unauthorized transfer, and breach of warranty is often a less complicated theory to prove because it requires only a showing that the person issued the order and that they were not authorized to do so. The UNIDROIT treaty provides no such warranties, and absent non-convention law imposing such a warranty, an intermediary who acts pursuant to an unauthorized order would be forced to recover from the wrongdoer through theories such as fraud, conversion, unjust enrichment, and other more complicated causes of action.

C. Miscellaneous Article 8 Provisions

Both the U.C.C. and the UNIDROIT treaty address the effectiveness of settlement system rules when they conflict with the rules of the relevant legislation. The treaty provides some “rules or agreements governing the operation of a securities settlement or clearing system” will prevail when there is an inconsistency between these rules and the treaty.¹⁰¹ It has not been determined whether the settlement system rules will prevail only over an enumerated list of articles, including Article 8 that governs ineffective transfers, or whether they will prevail any time the settlement system rules are “directed to the stability of the system or the finality of transactions ef-

97. *Id.*

98. *Id.*

99. The standard of care in Article 10 applies only to the rights listed in that Article 9, Section 1. UNIDROIT *Preliminary Draft*, *supra* note 72, art. 10. Article 8 does not delineate its own standard of care. *Id.* art. 8.

100. U.C.C. § 8-109(a).

101. UNIDROIT *Preliminary Draft*, *supra* note 72, art. 21.

fectured through the system.”¹⁰² If the treaty were to grant supremacy over rules governing the stability of the system or the finality of dispositions, then it will be left to courts to determine which clearing system rules concern the stability of the system. The U.C.C. gives much broader deference to the rules of the clearing system, providing that any rules that govern any rights and obligations among the clearing system and its participants are superior if they are inconsistent with any part of the U.C.C.¹⁰³

Both bodies also prohibit an upper-tier intermediary from seizing the securities of an account holder. The treaty does so by prohibiting attachment of a security by any intermediary other than the intermediary who holds the account.¹⁰⁴ The U.C.C. prohibits an intermediary from granting an interest in any security of an intermediary that is required to be held for an entitlement holder.¹⁰⁵

The treaty and the U.C.C. grant similar protection to purchasers who acquire securities for value and without notice of an adverse claim against the security.¹⁰⁶ Both state that the person is not subject to such a claim.¹⁰⁷

D. Use of Intermediated Securities as Collateral

The UNIDROIT treaty also lays out the rules regarding the use of intermediated securities as collateral to secure a debt. However, most of these provisions are not mandatory.¹⁰⁸ Under the current system in America, the rules governing all types of collateral, including securities held by an intermediary—also known as investment property¹⁰⁹—are laid out in U.C.C. Article 9.

Under the treaty, the two requirements for granting a valid security interest are an agreement and delivery of the intermediated securities to the secured party.¹¹⁰ In contrast, the U.C.C. has three requirements. First, value has to be given by the secured party,¹¹¹ a requirement that is virtually always satisfied as value includes a commitment to extend credit and any previously advanced money.¹¹² Second, the debtor must have rights in the collateral.¹¹³ Finally, the secured party must be given control of the investment property pursuant to a security agreement.¹¹⁴ Generally, the requirements of the two provisions will be in line because, as stated, the value re-

102. *Id.*

103. U.C.C. § 8-111.

104. UNIDROIT *Preliminary Draft*, *supra* note 72, art. 15, § 1.

105. U.C.C. § 8-504(b).

106. U.C.C. § 8-502; UNIDROIT *Preliminary Draft*, *supra* note 72, art. 7.

107. U.C.C. § 8-502; UNIDROIT *Preliminary Draft*, *supra* note 72, art. 7, § 1(a).

108. *See* UNIDROIT *Preliminary Draft*, *supra* note 72, art. 5, § 5; *id.* art. 27, § 1.

109. U.C.C. § 9-102(a)(49) (1999).

110. UNIDROIT *Preliminary Draft*, *supra* note 72, art. 5, § 1(a)-(b).

111. U.C.C. § 9-203(b)(1).

112. U.C.C. § 1-204 (2001).

113. U.C.C. § 9-203(b)(2).

114. U.C.C. § 9-203(b)(3)(D).

quirement is rarely unsatisfied and, implicitly, a party has rights in the property if she is granting a security interest in it. However, the U.C.C. requirement that the debtor has rights in the collateral prevents a party from taking a valid security interest in any property that has been fraudulently obtained, a possibility that the UNIDROIT treaty fails to address.

The U.C.C. also provides that a security interest attaches and thus is automatically enforceable in favor of a securities intermediary if the intermediary has advanced the price of the securities, with the money being due at purchase, and the intermediary credits the assets to the entitlement holder's account before she receives payment.¹¹⁵ The UNIDROIT treaty will not automatically grant such a security interest to the intermediary absent an agreement and delivery. However, the treaty explicitly allows the relevant state law to treat the collateral securities as delivered when the intermediary is the secured party.¹¹⁶

For a secured party other than the intermediary to have taken delivery of the securities under the treaty, the securities serving as collateral must be credited to the account of the secured party unless domestic law provides that delivery can be accomplished by a designating entry made by the intermediary or by a control agreement providing that under certain circumstances the intermediary will not act without the consent of the secured party or that the intermediary will comply with any instructions given by the account holder.¹¹⁷ The U.C.C. focuses on the ability of the secured party to seize the securities without any consent of the debtor.¹¹⁸ Thus, the secured party has control if the securities are transferred to their account, making the secured party the entitlement holder, or if the "securities intermediary has agreed that it will comply with entitlement orders originated by the [secured party] without further consent by the entitlement holder."¹¹⁹ While the treaty provides only one rigid method of taking delivery, it endorses national law setting up a system in line with the U.C.C.¹²⁰ It is likely that the U.S. will retain the U.C.C. standards, but secured parties taking securities held by a foreign intermediary as collateral may need to take additional steps to obtain a valid security interest.

The treaty dispenses with the concept of perfection that is required for priority under the U.C.C. However, under the U.C.C., a secured party is perfected when it has control over the investment property,¹²¹ thus making the perfection requirement moot in the case of intermediated securities.

115. U.C.C. § 9-206(a).

116. UNIDROIT *Preliminary Draft*, *supra* note 72, art. 5, § 3.

117. UNIDROIT *Preliminary Draft*, *supra* note 72, art. 5, § 2; *id.* art. 1, § m.

118. U.C.C. § 9-106; U.C.C. § 8-106(d) (1994).

119. U.C.C. § 8-106(d)(2).

120. *See* UNIDROIT *Preliminary Draft*, *supra* note 72, art. 5, § 4.

121. U.C.C. § 9-314(a).

E. Priority Among Creditors in Account Holder Insolvency

The priority of claims to intermediated securities in the event that an entitlement holder becomes insolvent is one provision relating to the use of intermediate securities as collateral that is not optional under the treaty.¹²² Under such circumstance, the U.C.C. grants priority status to an intermediary who has a security interest in an account maintained by the intermediary regardless of the time when the interest was created.¹²³ UNIDROIT does not offer the same protection to intermediaries who sell securities to an account holder on margin. If the account holder agrees to give the intermediary a security interest in the account pursuant to Article 5 of the treaty, the intermediary's claim will be superior to any claim by a creditor who does not take their security interest in the account pursuant to Article 5.¹²⁴ They will also have priority over any security interest in the account that becomes effective after the collateral agreement is entered into with the intermediary.¹²⁵ However, the intermediary will lose their priority if they enter into a control agreement with the other secured party or make a designating entry in their favor.¹²⁶ They will also not have priority over security interests in the account that become effective before the agreement with the intermediary.¹²⁷ The treaty does not affect the laws or procedure that govern in an insolvency proceeding;¹²⁸ it only affects the priority of creditors' claims.

V. ISSUES STILL TO BE ADDRESSED

Even after two revisions to the preliminary draft of the treaty, there are still many issues to be resolved. This Part will discuss three of those issues: priority in the event of an intermediary's insolvency, choice of law provisions, and the extent to which the treaty attempts to harmonize the laws of the individual countries.

A. Priority Between Account Holders and Creditors of an Intermediary

The U.C.C. prohibits an intermediary from granting its creditors a security interest in assets that have been credited to an account holder.¹²⁹ It then goes on to deal with the contingency of an intermediary becoming insolvent without leaving a sufficient quantity of securities to satisfy both the claims of its creditors and its entitlement holder.¹³⁰ Generally, the U.C.C. grants the

122. See UNIDROIT *Preliminary Draft*, *supra* note 72, art. 5, § 4.

123. See U.C.C. § 9-314(b) (2003).

124. UNIDROIT *Preliminary Draft*, *supra* note 72, art. 6, § 2.

125. *Id.*

126. *Id.* art. 6, § 3.

127. *Id.* art. 6, § 2.

128. *Id.* art. 14.

129. See U.C.C. § 8-504(b) (amended 2003).

130. See *id.* § 8-511.

entitlement holder a superior interest in the intermediary's assets.¹³¹ However, a creditor will have priority over the claims of an entitlement holder when the creditor has control over a financial asset or, in the case of a clearing corporation, when the creditor has a security interest in a financial asset.¹³² Finally, the U.C.C. ranks secured parties who have control according to the time they obtained control.¹³³

The second revised version of the UNIDROIT treaty fails to adequately address this issue. Nowhere does the treaty prohibit an intermediary from granting creditors a security interest in shares credited to an account holder. The treaty does provide that securities credited to an account holder cannot be subject to the claims of unsecured creditors in the event the intermediary enters insolvency proceedings,¹³⁴ but it does not deal with the priority of secured creditors and entitlement holders.

The first revised draft of the treaty arguably always granted the account holder, or a creditor of the account holder who has taken a security interest in the account, a superior claim to the assets of an intermediary.¹³⁵ The draft provided that any interest "acquired by an account holder by the credit of securities to that account holder's securities account"¹³⁶ or any security interest that the account holder had granted in her securities had priority over any interest created in another manner.¹³⁷ After the claims of account holders are met, superiority of creditor's claims would be left to domestic non-Convention law.¹³⁸ Additionally, the first revised draft provided that the securities required to be held by an intermediary to meet the claims of account holders would not be not subject to the claims of creditors in the event of insolvency or otherwise.¹³⁹ However, these protections were eliminated by the latest revisions to the treaty.

The drafting committee needs to address priority in the event of an intermediary's insolvency instead of leaving it to be decided by varying domestic law. The initial goals of the treaty included to "improv[e] legal certainty to all market participants" and to "ensure the protection of investor's assets against intermediary insolvency."¹⁴⁰ To meet these goals, it is imperative that the treaty defines, at minimum, uniform priority status in the event of intermediary insolvency. The drafters could choose a regime similar to that of the U.C.C., where creditors are given priority when they have control of the securities, but the U.C.C. priority scheme is based on the idea that investors are protected by the domestic Securities Investor Protection Act against the risk of loss from an intermediary wrongfully pledging securities

131. *Id.* § 8-511(a).

132. *Id.* § 8-511(b)-(c).

133. U.C.C. § 9-328, ¶ 2 (amended 2003).

134. UNIDROIT *Preliminary Draft*, *supra* note 72, art. 19, §§ 1-2.

135. *See* UNIDROIT *First Revised Draft*, *supra* note 85, art. 10, § 1.

136. *Id.* art. 5, § 1.

137. *Id.* art. 10, § 1.

138. *Id.* art. 10, § 3.

139. UNIDROIT *Preliminary Draft*, *supra* note 72, art. 19, §§ 1-2.

140. UNIDROIT *Position Paper*, *supra* note 4, at 5.

as collateral.¹⁴¹ The drafters could also choose a system similar to that in the first draft of the treaty where entitlement holders always have a superior claim. The original UNIDROIT rule offers more consumer protection, but it may limit an intermediary's ability to obtain financing¹⁴² and, thus, the ability of investors to buy securities on margin because the creditor's claim could be subordinated to account holders in the event of bankruptcy. Because all countries that are or may become a party to the treaty may not have a statute similar to the Securities Investor Protection Act, the treaty's goals would be best achieved by giving investors priority.

B. Choice of Law Provisions

The UNIDROIT treaty does not designate the choice of law provisions that should govern intermediated securities. Instead, it leaves the choice of law principles to the Hague Securities Convention.¹⁴³ The Convention was approved in 2002 to harmonize the international choice of law rules in all cases involving intermediated securities.¹⁴⁴ If the parties expressly agree as to which jurisdiction's laws will apply in the event of a dispute, that law will apply so long as at the time of the agreement the intermediary had an "office regularly engaged in securities account maintenance activities" in that jurisdiction.¹⁴⁵ If there is no agreement between the parties or the agreed upon jurisdiction is not valid, the laws of the jurisdiction where the intermediary is incorporated or organized will apply.¹⁴⁶ These conflict of law provisions are aligned with the conflict of law provisions of U.C.C. Article 8.¹⁴⁷

The problem that arises in this area is that parties to the UNIDROIT treaty are not required to adopt the Hague Securities Convention, and thus far none of the parties to the convention have ratified it.¹⁴⁸ To fulfill the expectations of the parties to a transaction and to provide the most legal certainty, it is crucial to know which laws will govern the transaction. To provide this certainty, the drafters of the UNIDROIT treaty should include a conflict of law provision stating that the determination of which jurisdiction's laws will apply is governed by the Hague Securities Convention regardless of whether the nation has ratified the convention. This way, by ratifying the UNIDROIT treaty, parties agree to also be bound by the prin-

141. See U.C.C. § 8-511 cmt. 2 (2003).

142. See BJERRE & ROCKS, *supra* note 5, at 58-60.

143. See UNIDROIT *Final Report*, *supra* note 11, at 1.

144. Sandra M. Rocks & Kate A. Sawyer, *Survey of International Commercial Law Developments During 2003*, 59 BUS. LAW. 1663, 1671-72 (2004).

145. *Id.* at 1672.

146. *Id.*

147. See U.C.C. § 8-110 (2003).

148. See Hague Conference on Private International Law, *Status Table*, Convention of 5 July 2006 on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary, http://www.hcch.net/index_en.php?act=conventions.status&cid=72#mem.

principles of the Hague Securities Convention, eliminating the problem of some countries failing to ratify the convention.

C. Harmonization Versus Minimum Standards

As discussed in Part III, one of the greatest benefits of an international system governing the rights and obligations of the intermediated securities system is the reduction of systematic risk. The more uniform the standards applied by the UNIDROIT treaty, the more certainty it will provide, thereby reducing systematic risk to the greatest extent. Contrary to this aim, the treaty has often deferred to the laws of the individual countries.¹⁴⁹

The U.S. especially should push for higher minimum standards and greater harmonization of laws. The drafters of the treaty have often imposed provisions similar to those of U.C.C. Article 8. The more such provisions are contained within the treaty, the better it is for American investors because they will be guaranteed the same rights with their international investments that they currently enjoy in the domestic market. It may not be feasible to attain an extensive amount of harmonization because other countries are likely to want to protect or establish their own system, but the U.S. should push for harmonization on major issues such as the priority of account holders in the event of intermediary insolvency, as discussed above.

VI. CONCLUSION

The UNIDROIT treaty is a significant step towards harmonizing international laws in the area of intermediated securities and reducing systematic risk in international investment. While the treaty has some important differences from U.C.C. Article 8, it is based on the same principles and produces similar results in many of the areas it addresses. While the treaty is not as extensive as Article 8, it serves a different purpose. Article 8 was intended to be a comprehensive set of rules governing the holding of securities, whereas the treaty was intended to provide only a base level of protection that would be expanded on by the laws of the participating countries. While there are still many issues to be resolved with the treaty, the drafters have provided a framework that will establish minimum protections for investors and serve the international financial community well.

Valerie Combs

149. See *supra* Part IV.