PART I

The Geneva Securities Convention and the future EU legislation in comparison

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The Geneva Securities Convention: objectives, history, and guiding principles

LUC THÉVENOZ

1.1 Money, securities and the intermediary holding system

Capital markets form the essentially virtual and increasingly global marketplace where money flows from investors to governments, companies and some international financial institutions that use these funds for their operation and growth. However, investors do not part with their money for free. They are offered future cash flows, such as interest and repayment of capital (for bonds) or dividends (for shares). The issuers of these bonds, shares, and any variation thereof sell promises of future cash flows to investors. Indeed, they issue rights to investors in exchange for their cash. Such rights are enforceable against the relevant issuer. They typically consist of monetary claims, fixed or contingent; voting and other rights to participate in certain decisions in respect of the issuer; or any combination thereof.

Investors are willing to pay good money against rights entitling them to future cash flows and some degree of decision-making power. But that is not enough. Such rights would have less value if investors did not have the ability to re-sell their rights to other investors. Absent this feature, they would be stuck with their bonds until redemption (note, however, that some bonds are perpetual), and with their shares until the issuer goes bankrupt or is otherwise liquidated, which is not usually what investors hope for.

In the capital markets, the rights issued to investors must therefore be negotiable, i.e., capable of being transferred by way of sale, or being used as collateral in a credit or other financial transaction. The problem with such rights is that they are intangible. Transferring intangible rights is fraught with risks. How can the seller or collateral provider prove that she is the legal owner of such rights? How can she prove their actual contents and extent? How will the buyer or the collateral provider be able to exercise them and, if need be, to sell or pledge them further on? Entitlement to and transfer of intangible rights raise significant evidential and legal problems. That creates a variety of risks, ranging from legal uncertainty to operational mistakes and fraud.

By contrast, physical property is much easier to trade, because the thing that is being sold or pledged has physical substance and can be delivered to the buyer or to the secured party. There are also risks in transaction over tangible property, such as legal title, authenticity and other qualities of that thing. Legal rules have evolved so as to protect against such risks to various degrees, from the protection of an innocent acquirer (*acquéreur de bonne foi*) to remedies against the seller for defective goods.

The law can never fully protect the acquirer of either tangible or intangible property, but there is no doubt that tangible, movable property is usually easier to transfer, and allows the acquirer to more easily assess its risks and protect against their occurrence.

It was therefore a great innovation of mercantile law and of the infant capital markets to start treating intangible rights against issuers *as if* they were tangible movable property. Issuing physical securities representing fungible fractions of the rights created by an issuer to a large degree allowed such rights to be treated *as if* they were movable property. The securities were not only evidence of the rights issued ('certificates'), they were also the movable vehicles whose transfer according to the law governing chattels also operated the transfer of the intangible rights 'attached to' or 'incorporated in' them. Investment securities, *valeurs mobilières*, *Wertpapiere* were a major innovation of the financial markets. In their purest form as bearer certificates, securities might actually be subject to the very rules applying to chattels and incur the same types of risk (e.g., lack of authenticity, defective title). Registered securities have retained mixed features because registration of the transfer was and still is required to effect transfer of title or to procure or allow the exercise of all or some of the rights.

Why use the past tense for most of the last paragraph? Because transferring securities as pieces of movable property has become quite exceptional. It is even impossible or prohibited in certain jurisdictions which have legally abolished the issuance of certificated securities, at least in so far as listed securities are concerned. Over the last sixty years, the great innovation of turning intangible rights into tangible, movable property has been rendered impractical, costly, and undesirable. At the risk of oversimplifying the story, issuers find it costly to issue and redeem certificates and coupons, to handle registration of investors, and to deal with lost or stolen certificates. For investors, keeping certificated securities may be quite inconvenient. For example, storing them in a safe deposit box is somewhat risky and/or costly; handling the certificates every time one wants to sell, pledge or redeem the certificates securities or simple to cash in the coupons is inconvenient. Banks, securities dealers and other financial intermediaries are willing to earn a fee for keeping those certificates in safe custody, but they would rather avoid detaching coupons and dealing with the physical delivery of certificates for every transaction. Notwithstanding economies of scale, processing costs and operational risks increase exponentially with the number of issues and with transaction speeds. Governments have taxation and anti-money laundering issues of their own, with certificated securities moving from hand to hand.

In the same way as private cars and highways allowed mass tourism and the development of sprawling suburbs, certificated securities were the vehicles that allowed the expansion of the capital markets. However, ever-more cars, moving at ever-increasing speed, created increasing traffic jams. Investors, issuers, and the intermediaries for the capital markets set about creating huge and safe parking lots where securities would be immobilised most of the time, if not for ever. Thus appeared central securities depositories (CSDs), to which banks and other financial institutions would deliver their own securities and the securities of their clients for safekeeping. At an ever-increasing scale starting from the 1960s, the physical delivery of securities was replaced by credits and debits in securities accounts maintained by CSDs for their participating financial institutions, and by financial institutions for their clients or for other financial institutions. By doing so, participants in the capital markets actually ceased to treat securities as movable property and resumed dealing with the rights attached to the securities, though not by way of assignment in the legal sense, but in a sort of a book-keeping way.

In other words, while one of the great innovations of capital markets was to load intangible rights into physical vehicles, to facilitate their circulation in the markets and among investors, the costs and risks of exponentially crowded highways connecting markets and investors resulted in the parking of the vehicles. The vehicles themselves became largely irrelevant, and sales and other transactions in respect of the rights stored in the vehicles were henceforth recorded in special accounts called 'securities accounts'.

It is interesting to note that whether vehicles of the same brand and type, or securities of the same issue, are considered as fungible bulk and their transfer recorded by a debit and a credit of a given number, or whether they are individually registered and a record is kept of every particular vehicle or security transferred in any given transaction, is a matter of national preference.[1] The huge data-handling capacities of modern information technologies accommodate either approach.

If the market can work by keeping a record of vehicles immobilised all year long, why continue manufacturing individual cars in large numbers? Might issuers instead consider creating a small truck containing all the rights comprised in a single issue? Or might they abstain from making cars completely, and use the same securities accounts for rights which could be registered somewhere, rather than manufactured in the form of cars? Both approaches would save time and cost and might help minimise risks, assuming of course that investors would accept forgoing the right to take their car out for a drive.

This is actually what happened. Once the immobilisation of securities with CSDs became generally accepted, issuers tested the market acceptance of jumbo certificates – each representing a whole issue, and fully dematerialised securities – and discovered that this was often acceptable. In most countries where full dematerialisation of listed securities has not yet been statutorily imposed, dematerialised securities and jumbo certificates are driving out certificated securities. National differences remain in this area, which are deeply linked to market usage, operational arrangements, investment costs, legal doctrines and investor preferences.

1.2 New risks, new legal issues

When bonds and shares were traded as certificated securities, risks did exist, which the laws allocated among participants to a transaction: defective title and protection of bona fide purchasers, forged certificates, effectiveness of defences and of restrictions not documented in the certificate, implied representations and warranties by the transferor, etc. But once

1 A very good example of the latter is Spain, and described by Francisco Garcimartín in Chapter 12 of this book. Whether securities are fungible or not remains controversial in English law: see Goode, 'Are Intangible Assets Fungible?', [2003] *Lloyd's Maritime and Commercial Law Quarterly*, 379, and is a core issue in the English 'Rascals' case which arose from the insolvency of Lehman Brothers; see *Pearsons & Ors as the Joint Administrators of Lehman Brothers International (Europe) (In Administration)* v. *Lehman Brothers Finance SA* [2011] EWCA Civ. 1544, and its discussion by Dilnot and Harris, 'Ownership of a Fund', 272.

such securities circulated without physical delivery, most of these rules became de facto obsolete. The acquirer could no longer rely on possession of the certificate as prima facie evidence of the transferor's title, nor could he read the fine print on the certificate.

New risks emerge when the delivery of securities is replaced by book-entries in securities accounts. The financial intermediary keeping the books may make mistakes. It may act upon instructions that were forged or not otherwise authorised by the account holder. More rights may happen to be credited to the securities accounts of clients than the intermediary itself has in custody or which are credited to its own account with the CSD or other intermediaries. In the intermediated world, mistakes and fraud do not generally affect certificates; they relate to instructions received and entries made by the intermediary.

Indeed, the immobilisation and dematerialisation of securities create huge efficiencies, at the cost of relying almost exclusively on the operational safety and financial soundness of CSDs, banks and other financial intermediaries maintaining securities accounts for their clients. In most jurisdictions, all these intermediaries are regulated and supervised, which should improve their reliability and financial soundness. But this is not a foolproof guarantee of no risk, no loss. The financial crisis that started in 2007 provides ample evidence to the contrary.

Besides the regulation and supervision of intermediaries maintaining securities account, it is clear that the commercial law principles that dealt with certificated securities needed to be supplemented, if not replaced, by new rules dealing with immobilised or dematerialised securities, or rather with securities held through the intermediary holding system. In some jurisdictions, such as Belgium,[2] Luxembourg,[3] France[4] and the United States,[5] the legislature quickly stepped in. In some others, such as

2 *Arrêté royal n° 62 du 10 novembre 1967 favourisant la circulation des instruments financiers fongibles*; see also Chapter 9 of this book by Michel Tison and Lientje Van den Steen.

3 *Règlement grand ducal du 17 février 1971 concernant la circulation de valeurs mobilières*, replaced by the *Loi du 1[er] août 2001 concernant la circulation de titres et d'autres instruments fongibles*. This is soon to be supplemented, according to a Bill (*Projet de loi relative aux titres dematerialises*, n°6327) of 12 September 2011 now pending before the Luxembourg Parliament.

4 *Décret n° 83–359 du 2 mai 1983 . . . relatif au régime des valeurs mobilières*. The relevant provisions are now codified in the *Code Monétaire et Financier* at Arts. L211–1 et seq.

5 An initial revision of 1977 was replaced in 1994 by the current version of Art. 8 ('Investment Securities'), which has been enacted in all fifty-one states and adopted by the Federal Reserve Board to regulate the clearing and settlement system for the federal government's bonds.

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Switzerland,[6] new statutory provisions were implemented only recently, or are presently being considered.

These new provisions deal with all or some of the following issues:

- What is the legal meaning of a credit of securities to a securities account? Is it merely evidential? Or does it represent or somehow contain rights against the relevant issuer, as did certificated securities before?
- Who should enjoy the rights attached to the securities? Any account holder to whose account such securities are credited? Or only the ultimate account holder down the pyramid, i.e. one who does not act as an intermediary for a further account holder?
- What steps are required for a credit to a securities account to be effective against the bank maintaining the account? Are additional steps required for the rights to become effective against the issuer and against third parties? Are such rights also effective in case of insolvency of the bank?
- Is a credit to a securities account the only way to acquire securities held through the intermediary holding system (let us call them intermediated securities, for convenience)? Is a debit the only way to dispose of intermediated securities? Can they be pledged to the intermediary or to a third party in some other way than by having them credited to a securities account in the name of the collateral taker? Which steps are necessary for such dispositions to become effective against third parties and against the insolvency administrators of the collateral provider?
- What happens if a debit to a securities account was not authorised by the account holder? Is the acquirer in that transaction protected? Is knowledge or lack thereof (bona fide) relevant? Must one party lose whenever the other wins, or are there circumstances in which both are protected and it is for the intermediary to make up for the missing securities?
- Until what point can an instruction to transfer intermediated securities be revoked by the transferor? What if the transferor is pronounced insolvent before the transfer has been completed? For systemic reasons, can the rules of a securities settlement system modify the legal rule on that issue?
- Can transfer orders and their respective credits and debits be netted, so as to be settled on a net basis?

6 Federal Intermediated Securities Act of 3 October 2008; see Chapter 13 of this book by Hans Kuhn.

- Can credits be made conditionally, so that they can be reversed if the relevant condition is not fulfilled? Does this apply to credits made before the settlement date if the transfers are not settled?
- Can an investor's securities be attached with any intermediary other than the one maintaining that investor's securities account? What are the effects of an attachment notified to a CSD instead?

It would not be very difficult to expand that list over the next three pages, but that is not the purpose of this chapter.

Our point here is to note that these numerous issues connected with the intermediary holding system are likely to be regulated in one way or another in most jurisdictions, but unlikely to be regulated in the same way. If Canadian investors only held securities issued in Canada, and Greek securities were only in the hands of Greek residents and institutions, this would bother nobody except perhaps for a few highly specialised scholars of comparative law. But such is not the case. Bonds issued by the Greek government are held by many investors outside of Greece, and Canadian investors hold, personally or via investment funds or pension funds, significant stocks of non-Canadian securities. In short, the globalisation of the financial markets has resulted in very significant cross-border holdings. A good example is offered by Swiss banks, which traditionally hold internationally highly diversified portfolios of securities for resident and non-resident clients.[7]

In short, besides the legal (and operational) risks associated with investors holding domestic securities through domestic intermediaries, cross-border situations give rise to additional legal (and operational) risks.

1.3 The governing law issue

The first obvious risk relates to the determination of the applicable law in cross-border holdings. When a Canadian investor sells Greek bonds to a Caiman Island vulture fund, which law governs the questions listed above and some others? The same question also applies when that same Canadian investor uses US Treasury bills as security for a loan extended by a Japanese bank.

7 At the end of April 2012, securities held by all clients with Swiss banks were valued at CHF 4,281 billion, of which 58.6% were issued by foreign issuers. Non-resident (individual and institutional) clients held a higher proportion of 70.8% of foreign-issued securities. Source: Swiss National Bank, *Monthly Statistical Bulletin*, June 2012, Table D52a.

The need for a clear rule of conflict was identified and discussed abundantly in the 1990s.[8] As early as 1998, the European Community adopted the 'place of the relevant intermediary approach' (PRIMA). For example, Article 9(1) of the Financial Collateral Directive refers to 'the law of the country in which the relevant account is maintained'.[9] Similar rules are mentioned in two other directives.[10] These directives achieved a fair degree of European Union-wide harmonisation, even though their respective scopes remain partial and the national provisions implementing those directives are not identical, and may thus provide diverging answers in some cases.

But cross-border holdings are not confined to the European Union. Considering the significant legal risk created by the diversity and sometimes uncertainty of the relevant rules of conflict, the Hague Conference on Private International Law took up that very issue in an expedited project.[11] Initiated in 1999, the project resulted in a diplomatic conference held in October 2002 which adopted the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary.[12] This 'Hague Securities Convention' is dated 5 July 2006, being the day when the US and Switzerland formally signed the Convention.[13]

While the initial work of the Conference essentially followed the same lines as the then recent European directives, the approach was changed. Careful analysis showed that a purely objective test yields uncertain results when the relevant intermediary maintains securities accounts using a global platform or extensive outsourcing. In such situations, where is a

8 Guynn et al., *Modernizing Securities Ownership, Transfer and Pledging Laws*; Potok et al., *Cross Border Collateral: Legal Risk and the Conflict of Laws*.
9 Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (FCD). See also below pp. 38 et seq. and 51 et seq.
10 Art. 24 of the Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions (WUD); Art. 9(2) of the Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems (SFD), as amended by Directive 2009/44/EC of the European Parliament and of the Council of 6 May 2009.
11 Bernasconi, *The Law Applicable to Dispositions of Securities Held Through Indirect Holding Systems*, Preliminary Document No 1 of November 2000, especially at 30 et seq.
12 Hague Conference on Private International Law, Proceedings of the Nineteenth Session (2002), tome II: Securities, 2006.
13 The Hague Securities Convention is not yet in force because it has been signed by three states (Mauritius, Switzerland and US) but ratified only by the first two. It nonetheless became part of Swiss statutory law on 1 January 2010.