

Title and Title Conflicts
in respect of Intermediated Securities
under English Law

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By

Wenwen Liang

**CAMBRIDGE
SCHOLARS**

P U B L I S H I N G

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by Wenwen Liang

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To my parents.

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PREFACE

This book examines property issues in respect of intermediated securities under English law, namely title and title conflicts between a true owner and a purchaser. Intangible book entry securities held with an intermediary, often commingled with the holding of other clients of the intermediary, often give rise to uncertainty in property rights in the securities of an investor under most legal systems, for example, whether property rights can be established and how title conflicts are dealt with.

The general property law implications of intermediated securities and responses of national laws and international uniform law are examined. English property law and trusts law are investigated to identify their mechanisms of recognising property rights. Title conflicts in respect of chattels, certificated bearer securities, and certificated registered securities, are examined to identify the underlying policies and mechanisms. Priority rules across legal and equitable property rights are reviewed to explore their application to title conflicts in respect of intermediated securities as legal and equitable title. Solutions to title conflicts of national laws and international uniform law are exposed as a basis for seeking a better solution for English law.

This book identifies the flexible framework of English property law for establishing property rights over commingled intangibles, in particular through trusts; establishes the policy of priority rules as of comparing the merits of rights and preferring a vested right of a true owner over a subsequent purchaser, in particular a vested right under fiduciary relations. The conclusion is that given the general principle of English property law for vested rights and averse to preventive regulation or remedial mandatory insurance schemes, title conflicts may be tilted towards purchasers in a mild rather than a radical way, by introducing a good faith purchaser rule to intermediated securities or leaving it to judicial discretion where estoppel might work in favour of a purchaser.

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INTRODUCTION

Background

Intermediated securities, also known as securities held with an intermediary, indirectly held securities, or book entry securities, have challenged many areas of law developed for the direct holding of certificated securities.

To many, securities, basically a bundle of intangible rights against the issuer, are synonymous with certificates incorporating or merely proving the intangible rights. They are not. With the paper crunch in major securities markets certificated securities are either immobilised or eliminated to facilitate trading based on computer technologies. This is often an electronic securities holding system composed of a pyramid of intermediaries between an issuer and a final investor. At the top a central securities depository or securities registrar maintains securities accounts for direct counterparties, often custodian banks or major securities brokers, and records their holding of securities on their securities accounts which are electronic entries; custodians and major securities intermediaries maintain securities accounts for clients and record their holding on their securities accounts in the same way; this may be repeated for tiers until a final account holder who does not maintain securities accounts for others and holds securities for himself. A final investor may have securities accounts with all tiers of intermediaries and his holding is recorded on all these securities accounts, i.e., a transparent system, or an investor may solely have securities accounts with his immediate intermediary and his holding is solely recorded on these accounts, i.e., a non-transparent system. Securities of the same issue are often fungible. In a non-transparent system, an intermediary commingles the holding of all investors of the same issue of securities with his upper-tier intermediary. Thus in a non-transparent system an investor has securities held with his intermediary, recorded on his securities account with his intermediary, but not identifiable at the level of any upper-tier intermediary or the issuer.¹

The change is not simply a technical one from certificated securities to immobilised, dematerialised or uncertificated securities, or from direct

¹ See 1.2, 1.3, 4.1, 4.2, and 4.3 for further analysis.

holding to indirect holding (in respect of the issuer-investor relationship). It has major legal implications for property law, corporate law, and conflict of laws. Traditional law on securities transactions is based on the direct holding of physical certificates. It is essentially a physical model. Securities are treated as tangibles and possession of certificates is crucial for holding the rights to securities. It is not surprising that there would be legal uncertainties to apply the physical model to the indirect holding of intangible securities. Legal uncertainties arise where the law does not provide for a predictable and sound solution, does not govern an issue, does not fit the market reality, or complicates transactions by imposing legal requirements designed for the traditional direct holding of certificated securities on the indirect holding of uncertificated securities.²

As to property law aspects, it is uncertain whether the right of an investor in intangible securities held with his intermediary is proprietary or personal. Most civil law countries do not recognise property rights over a pool of intangible fungibles held with another under the principle of specificity and segregation, although it is possible to establish property rights over intangibles held with another segregated in some way.³ Without property rights a client would only have a personal claim against his intermediary for the return of equivalent securities which could not survive the insolvency of the intermediary. Secured transactions in intermediated securities may be invalidated for failure to fulfill formalities based on possession of tangibles.

The indirect holding cutting-off the issuer-investor relationship may cause uncertainty as to whether an investor is recognised by the issuer as an investor and the way an investor enjoys corporate rights attaching to securities. As regards conflict of laws it is difficult to establish the *situs* of intermediated securities under classical rules for tangibles.⁴ Legal uncertainty in rights in intermediated securities is a major impediment to the development of intermediated securities in the long run.

Legal uncertainty regarding intermediated securities has been identified and effectively dealt with by national and international legal efforts. The US, Canada and Switzerland, Luxembourg and Belgium have codified legal rules on the property aspects of intermediated securities.⁵

² UNIDROIT Secretariat, 'Explanatory Notes to the Preliminary Draft UNIDROIT Convention on Harmonised Substantive Rules regarding Securities Held with an Intermediary' [2005] Rev dr unif 36, 44, 46.

³ RM Goode, 'The Nature and Transfer of Rights in Dematerialised and Immobilised Securities' [1996] JIBFL 167.

⁴ See Chapter One for a detailed analysis.

⁵ US, Uniform Commercial Code Article 8; Canada, Uniform Securities Transfer

Internationally there are the Hague Securities Convention on the choice of law applicable to the proprietary rights in securities held with an intermediary adopted under the auspices of HCCH and the Geneva Securities Convention regarding substantive rules on the property aspects of intermediated securities recently adopted under the auspices of UNIDROIT.⁶ A Securities Law Directive covering property law, corporate law and conflict of laws with regard to intermediated securities is in the drafting process in the EU.⁷ There is much literature by academics, governments, practitioners and professional organisations, on legal implications and suggestions regarding general property law issues in respect of intermediated securities.⁸

Under English law there is a statutory framework for the top tier of the securities settlement system on title, title transfer and title conflicts. Other than legal title at the top tier, intermediated securities are subject to general law. There are government reports, academic monographs and articles on general property law and discrete articles on corporate law issues regarding intermediated securities.⁹

Act; Switzerland, Federal Intermediated Securities Act; Belgium, Royal Decree No 62 of 10 November 1967, a Law of 2 January 1991, a Law of 22 July 1991, a Law of 7 April 1995, a Law of 14 December 2005; Luxembourg, Grand-Ducal Decree of 17 February 1971 (as amended in 1994 and 1996).

⁶ HCCH Convention of 5 July 2006 on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary; UNIDROIT Convention on Substantive Rules for Intermediated Securities.

⁷ K Löber and P Paech, 'Interconnecting Law of Securities Holding and Transfer—A Chance for Seamless International Improvements' [2007] JIBFL 9; P Paech and K Löber, 'Post Trading of Securities: Shaping the European Response to Legal Barriers' [2009] JIBFL 211; Giovannini Group, 'Cross-Border Clearing and Settlement Arrangements in the European Union (November 2001)'; Giovannini Group, 'Second Report on EU Clearing and Settlement (April 2003)'; see also <http://ec.europa.eu/internal_market/financial-markets/securities-law/index_en.htm> accessed 26 January 2013.

⁸ RD Guynn and others, 'Modernizing Securities Ownership, Transfer and Pledging Laws (International Bar Association 1996)'; IOSCO/BIS, 'Recommendations for Securities Settlement Systems (November 2001)'; Group of Thirty, 'Global Clearing and Settlement – A Plan of Action (2003)'; CW Mooney, 'Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries' (1990) 12 Cardozo L Rev 305.

⁹ Financial Markets Law Committee, 'The FMLC Report on Property Interests in Indirectly Held Investment Securities: An Analysis of the Need for and Nature of Legislation in the UK' [2005] Rev dr unif 339; Law Commission, 'Law Commission Project on Intermediated Investment Securities First Seminar – Objectives for a Common Legal Framework (22 March 2006)'; Law Commission,

Other than the direct participants in the CREST system, rights of holders of intermediated securities are subject to general law. It is possible under English law to recognise the rights of these holders of intermediated securities as proprietary under trusts. Traditionally the custody of bearer securities has been governed under the law of bailment where an investor retains legal title to securities. Bailment under English law is only applicable to tangibles. It is however allowed under trusts to hold intangibles through another. Thus intermediated securities held by an investor with his intermediary are analysed under trusts law. An investor retains proprietary interests in intermediated securities which are equitable. The trust can accommodate the issue of retaining property in a pool of intangibles held through another. A preliminary question is whether a trust can be established under the requirement of certainty of subject matter, in favour of an investor holding securities commingled with other clients' holding of the same issue of securities, by his intermediary with the upper-tier intermediary. The answer is either by a co-ownership concept that a trust is over the commingled pool of securities and all clients are co-owners in proportion to their holding, or by the argument that intangibles are incapable of segregation and the certainty of subject matter requirement is inapplicable to intangibles.¹⁰

It is widely acknowledged that an investor other than a direct participant in CREST retains an equitable proprietary interest in intermediated securities. There are still uncertainties. For example, the allocation of

'Law Commission Project on Intermediated Investment Securities Second Seminar: Issues affecting Account holders and Intermediaries (23 June 2006)', Law Commission Project on Intermediated Investment Securities Third Seminar: Issues affecting Transferees of Intermediated Securities (27 July 2006)', 'Interim Advice in relation to The EU Legal Certainty Group Advice and the UNIDROIT Convention on Substantive Rules regarding Intermediated Securities' (October 2006), The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities Updated Advice to HM Treasury (May 2007), The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Further Updated Advice to HM Treasury (May 2008); RM Goode, *The Nature and Transfer of Rights in Dematerialised and Immobilised Securities* [1996] JIBFL 167; J Benjamin, *Interest in Securities: A Proprietary Law Analysis of the International Securities Markets* (Oxford University Press, Oxford 2000); E Micheler, *Property in Securities: A Comparative Study* (Cambridge Studies in Corporate Law, Cambridge University Press, Cambridge 2007); M Yates and G Montagu, *The Law of Global Custody* (3rd rev edn, Tottel Publishing, London 2009); L Gullier and J Payne (eds), *Intermediated Securities: Legal Problems and Practical Issues* (Hart Publishing, Oxford 2010).

¹⁰ See 2.4.2.1 for a detailed analysis.

shortfalls in a commingled account for clients held by an intermediary with his upper tier intermediary is not clearly addressed; perfection and priority of security interests need to be clarified; the adverse impact of exceptions to the no-look-through and upper-tier attachment rule; and the resolution of title conflicts between a prior owner and a good faith purchaser, i.e., the protection of good faith purchasers is unclear.¹¹

Regarding title conflicts, i.e., the protection of good faith purchasers against adverse claims of prior owners, purchasers of bearer securities have been protected under negotiability; purchasers of certificated registered securities have been protected under quasi-negotiability through estoppel. The operation of both negotiability and quasi-negotiability rely on the certificates. Intermediated securities are uncertificated which gives rise to uncertainties whether negotiability and quasi-negotiability are available to purchasers of intermediated securities. An analysis of the policies of negotiability and quasi-negotiability is necessary to see the compatibility of the policies with intermediated securities and the implementation of these policies through detailed legal rules.¹²

Meanwhile the trust analysis introduces equitable title to intermediated securities. The issue of the good faith purchaser can be seen in the perspective of priority rules of general property law. The principal priority rule is the first in time rule subject to statutory exceptions and other modifying factors. There is no general good faith acquisition rule. A good faith purchaser of legal title cannot defeat a prior legal title, although a good faith purchaser of legal title can defeat a prior equitable title. It is a complex system of rules given the diversity of rights under English law, i.e., legal right, equitable right and mere equities. Scenarios of good faith purchasers of intermediated securities can be classified as follows: a purchaser of a legal title to intermediated securities against a prior legal title or a prior equitable title; a purchaser of an equitable title of intermediated securities against a prior legal title, or against a prior equitable title via the CREST system, or against a prior equitable title not via the CREST system. It is possible for the legal title of a direct participant in the CREST system acquired in good faith to defeat any prior title, legal or equitable, under the Uncertificated Securities Regulations 2001 SI 2001/3755. Other than a purchaser of legal title, the position of a purchaser of an equitable title to intermediated securities is subject to general law. The treatment of the good faith purchaser of intermediated

¹¹ Financial Markets Law Committee, 'The FMLC Report on Property Interests in Indirectly Held Investment Securities: An Analysis of the Need for and Nature of Legislation in the UK' [2005] Rev dr unif 339.

¹² See Chapter Three.

securities is not uniform, depending on what title a purchaser gets and whether the transaction is via the CREST system. There is much support for the view that reform of rules on title conflicts under English law is necessary.¹³

The protection of good faith purchasers is one aspect of the issue of title conflicts. The other side is the protection of prior owners. A balance has to be struck between the protection of good faith purchasers and prior owners. Internationally one approach goes so far in favour of purchasers that it generally limits prior owners' claims to their intermediaries and protects good faith purchasers with a procedural bar, and if exceptionally an action can be commenced against purchasers it protects good faith purchasers against prior owners with a substantive defense. Another approach continues the good faith acquisition model of civil law. The first approach is very preferential to purchasers and leaves prior owners largely at the mercy of their intermediaries. Thus prevention of intermediary insolvency and insurance against intermediary insolvency are necessary to guarantee the rights of prior owners and maintain the reliability of the indirect holding system.

The tendency is to separate the rights of a purchaser from prior owners and treat the rights of a purchaser as a claim against his intermediary. As it is widely believed that an investor's rights in intermediated securities is a personal claim against his intermediary but meanwhile valid against third parties. It is a kind of mixed right. Property rights in intermediated securities highlight once again the issue of the rights *in rem*-rights *in personam* dichotomy. The key lies in treating the boundary between personal and property rights. The difference between personal and property rights is crucial in the insolvency of the obligor. Treating personal rights as property assumes the rarity of failure of obligors. When obligors do fall insolvent the result may be disastrous. Prevention of the failure of obligors is necessary through financial regulation. Compensation schemes are also necessary in case of obligor failure. Otherwise it is doubtful whether it would be proper to treat claims as property.¹⁴

Research Topic and Methods

Despite much literature on the general legal implications of intermediated securities, research into specific topics is yet to be undertaken. This book examines the property law implications of intermediated securities with a

¹³ See Chapter Four and Chapter Five.

¹⁴ See Chapter Six.

focus on title conflicts in respect of intermediated securities under English law with reference to codified national laws and international uniform law. It aims to examine, under English property law, whether proprietary interests can be established in intermediated securities, and if so, how title conflicts between a prior holder and a purchaser of intermediated securities, both innocent, caused by the intervention of a third party, are resolved.

The major research methods are the black-letter approach, policy analysis and the comparative law approach. Relevant general principles in statutes and case law in force will be examined to see the applicability and potential results of their application to intermediated securities. The underlying policies of the black-letter law will be sought in order to explore their potential extension to intermediated securities. Comparative law is a useful tool to dig into the rationale and justification of legal rules in response to social reality. This is particularly true in the case of intermediated securities which have bewildered many legal conceptions and legal systems. Reference will be made to codified national laws and international uniform law as a benchmark and inspiration to review current rules and make suggestions under English law.

Structures

Chapter One introduces the practices of intermediated securities and legal uncertainty in property law, i. e., the difficulty in establishing property, or rights *in rem*, in intangible book entry securities held with an intermediary, because of intermediation, the practice of commingling and fungibility, under most legal systems. National and international law responses will be exposed.

Chapter Two explores property law, proprietary rights under trusts law, and the securities holding system in England and on this basis, title to intermediated securities under English law. Firstly, characteristics of English law will be examined, including the relation of property rights to contractual claims, the role of equity, the subject matter of property rights, the recognition of property over intangibles, and the idea of relative title, and property rights as remedies, as well as the impact of general property law principles on title conflicts. Secondly, the contractual and proprietary nature of a beneficiary's right under a trust will be examined to demystify the mixed nature of trusts and its implications for title conflicts. Thirdly, intermediated securities in England will be introduced, the statutory legal framework on legal title to intermediated securities at the top tier, and other than that, how title to intermediated securities is analysed under

general property law and trusts law.

Chapter Three explores how title and title conflicts in respect of certificated securities are dealt with as background for exploring title conflicts in respect of uncertificated intermediated securities. Firstly the *nemo dat* principle and its exceptions under common law estoppel and statutes will be introduced. Secondly title and transfer of title to certificated securities of bearer securities and registered securities will be examined. Thirdly title conflicts under negotiability in respect of bearer securities will be analysed, from the perspective of its rationale, evolution and policy, and then the possibility of extension to intermediated securities will be considered. Fourthly title conflicts in respect of registered securities will be analysed, from the perspective of issuer-true owner relationships, issuer-transferee relationships, and true owner-transferee relationships respectively; the central theme is use of common law estoppel to allocate loss between innocent parties caused by strangers; the potential of such estoppel in the context of title conflicts in respect of intermediated securities will be investigated.

Chapter Four introduces the statutory legal framework regarding legal title at the top tier of intermediated holding. The statutory framework on title, transfer of title, and conflicts of legal title to intermediated securities will be introduced. Emphasis will be laid on the statutory estoppel against a prior holder of legal title to claim title against an innocent purchaser, with analysis of its function, its common law origin, its link with negotiability and estoppel in respect of certificated registered securities, and the special statutory compensation and system infrastructure as a way to balance the protection of a true owner and a purchaser.

Chapter Five explores title conflicts in respect of intermediated securities under the priority rules across legal and equitable title under general property law. As a preliminary issue the disposition of intermediated securities will be examined as disposition of equitable interests. Given the resemblance of securities holding systems to payment systems, the nature of credit transfer will be examined. Then the priority system will be analysed: the general rule of first in time and the merits of rights, the priority between legal title and equitable title, and between equitable title and mere equities; the better equity rule and postponement between equitable title; the *Dearle v Hall* rule of notice, will be presented with their policies and the results of their extension to intermediated securities; then a summary analysis will be made of the policies of priority rules and their consistency with intermediated securities.

Chapter Six explores better solutions to title conflicts with regard to intermediated securities. Firstly the factors to be considered and balanced

in dealing with title conflicts are examined as well as mainstream arguments. Secondly a comparative law briefing of approaches under national laws and international uniform law will be given. Thirdly the issue under English law will be reviewed, whether the current situation is satisfactory, whether it is necessary to reshuffle the issue of title conflicts, and possible approaches and results thereof will be presented and analysed.

LIST OF ABBREVIATIONS

FISA	Federal Intermediated Securities Act
USR	Uncertificated Securities Regulations

CHAPTER ONE

INTERMEDIATED SECURITIES AND PROPERTY LAW IMPLICATIONS

1.1 Securities

Generally speaking securities are transferable financial assets, or more exactly transferable contractual claims or rights against the issuer in the final analysis.¹ Contractual claims or rights were personal and non-transferable under classical legal doctrines. On the other hand, it is highly desirable that contractual claims are made transferable as a kind of wealth and value alongside land and chattels. A monetary claim is a personal right against an obligor which can only be enforced through a personal or *in personam* action.² It is however at the same time an asset with economic value which makes it the object of an ownership right if sufficiently specific. It can then be defended against the whole world. The validity of being enforceable against the whole world of personal claims makes personal claims proprietary. Once proprietary, personal claims can be owned, defended, transferred, or given as security.³ Before statutory establishment of securities as a special statutory chose in action and the introduction of certificate as the title to securities, assignment and novation were available to achieve the transfer of securities as intangible rights. Assignment and novation achieved qualified facilitation of the transfer of securities due to their strict requirements of formalities.⁴ To resolve the difficulty securities certificates were introduced to represent the contractual claims to make them tangible and capable of transfer as

¹ M Smith, *The Law of Assignment: The Creation and Transfer of Choses in Action* (Oxford University Press, Oxford 2007) 59-66.

² J Dalhuisen, *Dalhuisen on Transnational Comparative, Commercial, Financial and Trade Law Volume 2: Contract and Movable Property law* (4th edn, Hart Publishing, Oxford 2010) 268.

³ *ibid.*

⁴ J Benjamin, *Interest in Securities: A Proprietary Law Analysis of the International Securities Markets* (Oxford University Press, Oxford 2000) 64-68.

tangibles. For bearer securities, certificates represent title to securities and the transfer of securities certificates represents transfer of ownership to securities. For registered securities, the issuer register represents title to securities and a change in the issuer register represents the change of title. Securities certificates are introduced to facilitate the transfer of title to securities but certificates are not sufficient to constitute transfer of ownership of securities. Securities certificates entitle a holder to be registered with the issuer.⁵ In both cases securities certificates play an important role, which is so important indeed that securities are often considered as tangibles, which may be accurate with bearer securities, but less so with registered securities. Securities certificates facilitate the proof and transfer of ownership to securities by giving a tangible form to intangible rights. And rules on tangibles are ready to apply to certificated securities without the need for devising new rules to intangibles. It is one example of the genius of legal fiction. Indeed it has been so successful that it has brought about the collapse of the system of securities certificates.

1.2 Intermediated Securities

Securities markets based on paper certificates developed to huge scales and centralised stock exchanges were established which in turn precipitated the development of securities trading. In the middle 20th century, developed securities markets were unable to execute certificated transfers in a timely way, i.e., the so-called paper crunch. Delayed delivery of securities certificates after payment was a serious source of risk if securities certificates as proof of ownership or proof of right to claim ownership to securities could not be delivered to buyers in time. In response two approaches were introduced: viz., immobilisation and dematerialisation.⁶ Immobilisation operates in this way: all securities certificates or a global note representing the whole issue are deposited in a central securities depository which maintains securities accounts for direct participants and records their holding on their securities accounts, direct participants then maintain securities accounts for its clients and record their holding, from tier to tier, up to a final investor who holds securities for himself. Ownership or title to securities or interests in securities is the book entry record on the securities accounts with an intermediary. The

⁵ See M Yates and G Montagu, *The Law of Global Custody* (3rd rev edn, Tottel Publishing, London 2009) 8.

⁶ *ibid* 14-15.