Market Needs as Paradigm:

Breaking Up the Thinking on EU Securities Law

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Abstract: Modern patterns for holding investment securities face three basic legal challenges: first, negotiability and the possibility of good faith acquisition must be ensured as they are the basis of today's anonymous trading and settlement of securities. In the past, securities have been incorporated in paper certificates to achieve this result, allowing for the application of principles of property law to what in substance is a set of mutual rights and obligations. Second, account holders need to be protected against intermediary risk. Traditionally, concepts like safekeeping or trust were applied to achieve this result. Since there is a need to adjust to modern, basically electronic holding of securities, these concepts are now stretched to a considerable extent. Third, 40% of holdings entail cross-jurisdictional questions. Therefore, the issues of both negotiability/good faith acquisition and protection against intermediary risk need to be addressed from an international perspective. Modern conflict-of-laws concepts, in particular PRIMA, lead to the application of different laws to the 'same' securities, with potentially differing legal analyses in respect of these securities. The EU legislator was so far unable to address these problems. The Geneva Securities Convention and the Hague Securities Convention provide for answers but face criticism and are not yet implemented.

Keywords: Investment securities, financial law, property, conflict of laws, EU law, Geneva Securities Convention, Hague Securities Convention

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1. INTRODUCTION

More than a decade ago, the international community realised that there was a need to harmonise parts of their securities laws, notably those rules regulating the holding and disposition of securities.\(^1\) Reports on the legal framework governing the holding and disposition\(^2\) of securities found that what had become highly internationalised markets were underpinned by purely national legal frameworks and that this situation created legal risk, notably as acquisition of securities and security interests therein might prove unexpectedly ineffective in cross-jurisdictional situations.\(^3\)

As a consequence, the EU adopted the Settlement Finality Directive in 1998 and the Financial Collateral Directive in 2002.\(^4\) However, both were restricted in their scope and both left legal-conceptual issues largely untouched.\(^5\) Subsequently,

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1 ‘Securities law’ is generally too broad a term, referring to the various legal aspects of securities, depending on its use in the relevant jurisdictions. However, in this paper I use the term to refer to those legal rules governing the owning, holding and disposition of securities and related aspects. Depending on the relevant jurisdiction, the relevant provisions are typically part of property law, commercial law, the law governing security interests such as pledges and charges, insolvency law, corporate law, and, in some countries, dedicated laws governing the holding of securities. Likewise, rules belonging to the sphere of ‘regulation’ can belong to ‘securities law’, as long as they have legal effects dealing with the question of ‘who owns what’, cf. the recent judgment of the UK Supreme Court Re Lehman Brothers International (Europe) (In Administration) [2012] UKSC 6, addressing the question whether the client money rules set up by the UK Financial Service Authority, which require separate holding of client monies (‘segregation’), impact on the insolvency analysis if the segregation requirement is not complied with.

2 ‘Holding’ is a neutral, non-legal term that leaves open whether the holder is the owner/proprietor or only the custodian/book-keeper; ‘Disposition’ is a term that covers both outright transfer and creation of a collateral or security interest over securities.


5 The Settlement Finality Directive is confined to system operators and system participants. It prescribes that (national) insolvency rules cannot reverse transfer orders once entered into the settlement system. The Financial Collateral Directive prescribes that formalities in respect of securities collateral are to be abolished and is (by and large) confined to wholesale market participants. Neither of the Directives attempts to harmonise the content of the securities holder’s right, the rules on how such rights are to
further harmonisation efforts, both in international fora and the EU, rapidly slowed to a trickle: the 2002 Hague Securities Convention⁶ and the 2009 Geneva Securities Convention,⁷ though unanimously adopted after years of expert discussions, faced considerable opposition from inside the EU and to date have not been implemented⁸ by a sufficient number of countries. The European Commission worked on its own proposal for a comprehensive harmonisation of securities law aimed at mitigating legal uncertainty in this area.⁹ Its proposal,¹⁰ based on a blueprint submitted by an expert group and very similar to that put forward by the Geneva Securities Convention, contains rules harmonising:

- the core substance of the right vested in the holder of securities;
- the methods allowing for effective acquisition of securities and collateral interests therein;
- the regimes regarding good faith acquisition and priorities; and
- the regimes addressing the question of who answers for a possible shortfall in securities in the event of insolvency of an intermediary.

This proposal has now been mouldering in the Commission’s drawers for two years. The fate of both the Hague Convention and the Geneva Convention, as well as that of the European legislation show a common pattern: the instruments (or the project in case of the EU) became bogged down as they passed from the stage of expert discussions into the political sphere. The proposed solutions were rejected, and even the case for harmonisation was re-opened and questioned. In all three cases, the furore centred mainly on concerns that account holders’ securities would be less protected if existing legal concepts governing securities holding, notably the concept of property, were undermined.¹¹

This controversy exposed conflicts and tensions of different kinds. Some commentators were genuinely convinced that rights in securities can best be expressed in the form of proprietary positions for conceptual reasons, notably in

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⁸ The Geneva Securities Convention has been signed by Bangladesh only. The Hague Securities Convention has been ratified by Switzerland and Mauritius, and signed by the United States of America.
¹⁰ Cf. n. 16.
¹¹ Here, I employ ‘property’ as a global term, referring to the idea of full legal title, but without paying attention to differences of detail that a comparison of the various jurisdictions’ concepts of property or ownership would reveal.
view of the general approach which classifies securities as tangibles. Others feared that harmonisation of the legal approaches in respect of securities law would inevitably lead to a proliferation of the ‘Anglo-American’ approach which purportedly leads to less protection of client securities in the event of a bank’s or broker’s insolvency. Small wonder that this argument proved very effective in political terms in the wake of the financial crisis. A third type of criticism skinned the surface of the legal debate—centring in particular on property concepts—but in substance aimed at preserving current business models in the securities markets against legal reform, as legal or regulatory changes regularly cause costs and might, in this particular case, open up certain business domains to international competitors.

It was impossible to sort the partisans into clear factions. Governments, regulators, issuers, brokers, merchant banks, service providers and private and institutional investors across national boundaries could be found on both sides of the discussion. There were even divides within organisations acting globally, where the merchant bank arm argued in favour of market-focussed harmonisation while the securities service arm held out for conceptual purity. Justice ministries and central banks in one and the same country might likewise be at odds over that question – and even different divisions within the ECB did not agree as to which concept was the correct basis for harmonisation.

This paper, first, addresses the standoff between an approach centring on the needs of the market, taking them as a paradigm for law reform and harmonisation, on the one hand, and the idea that a legal concept (like in particular ‘property’) should guide the international harmonisation of securities law, on the other hand. I will argue that the former approach offers better guidance and that the needs of the market for legal predictability are the natural and traditional driver and determining factor. However, this approach is not necessarily particularly favourable to the specific interests of banks, brokers and other financial intermediaries, since ‘the market’ also encompasses the interests of institutional

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13 Eg., Cremers, “Reflections on ‘intermediated securities’ in the Geneva Securities Convention”, European Banking and Financial Law Journal (Euredia), 1 (2010-1), pp. 93 et seq.; Scherer and Gallei, “UNIDROIT draft Convention and German securities law: friend or foe?”, Journal of International Banking Law and Regulation, 24(9) (2009), pp. 473 et seq.; Voß, “Die Securities Law Directive und das deutsche Depotrecht”, Europäisches Wirtschafts- und Steuerrecht (EWS), 21(6) (2010), pp. 209 et seq. However, I submit that the distinction between an ‘Anglo-American’ approach to securities holding and disposition on the one hand, and a ‘Continental’ or ‘Civilist’ approach on the other hand, should not be made. Rather, the rift is between jurisdictions in which securities are identified per investor and jurisdictions where securities are held on a commingled basis in omnibus accounts, cf. infra, section 4.3.
15 This phenomenon can be explained by the fact that the aim of a merchant bank is to secure more and easier cross-border business, whereas the securities service arm of the same banking group will consider the protection of the status quo, i.e., market fragmentation, which is more advantageous for its business model.
and private investors, as well as of securities issuers and, ultimately, of society as a whole.

Further, this paper sheds light on the legal choices which the EU will have to consider when shaping harmonised legal underpinnings for holding and disposition of intermediated securities. These include the advantages and drawbacks, in the context of securities law reform, of the two alternative legislative instruments at hand in the EU, i.e., directives or regulations. Following several years of European legislative effort, a directive emerged as the instrument of choice, i.e., an instrument that allows Member States flexibility in implementing the rules. The term ‘Securities Law Directive – SLD’ became a household name even before the instrument was officially proposed. Over the past three years, however, there has been a growing tendency within the European institutions to embark—as far as its financial services are concerned—on legislative projects in the form of regulations, i.e., directly applicable law, rather than directives. Hence—and given that the Commission still seems to be looking at the fundamentals of the future securities law—it is now probably safer to refer to ‘securities legislation’ so as to leave the ultimate form of the future instrument open, whether it turn out to be a directive or a regulation.


17 The Commission itself mentions a ‘securities law directive’ on the website mentioned above.

I will analyse, in turn:

− the misunderstanding that national legal concepts of securities law are a suitable starting point for securities law harmonisation; rather, the international character of the market imposes an international perspective to which national legal concepts can only submit: cf. section 2;
− whether there is a mandate for EU and international harmonisation, the presence of legal uncertainty in securities law as such not being sufficient justification; rather, the need to act must be expressed in cost incurred by the market in good times, as well as the cost of the market and society in times of market turmoil, when an ill-constructed legal framework may cause additional risk or even have systemic implications: cf. section 3;
− the different legal choices at hand regarding the fundamentals of reform, including the alternative forms of the future EU instrument: cf. section 4;

before concluding that there is an ever clearer need to increase legal certainty in this area and that the advantages and drawbacks of both functional and conceptual harmonisation need to be considered very carefully.

2. MIND THE GAP – BETWEEN DOMESTIC THINKING AND LEGAL REALITY

The European System of Central Banks (ESCB) and the European Committee of Securities Regulators (CESR) describe the importance of a sound and reliable legal framework for securities holding and dispositions as follows19:

‘The reliable and predictable operation of a securities settlement system depends on two factors: (1) the laws, rules and procedures that support the holding, transfer, pledging and lending of securities and related payments; and (2) how these laws, rules and procedures work in practice – that is, whether system operators, participants and their customers can enforce their rights. If the legal framework is inadequate or its application uncertain, it can give rise to credit or liquidity risks for system participants and their customers or to systemic risks for financial markets as a whole.’

19 Explanatory Memorandum on Recommendation 1, ESCB-CESR, Recommendations for securities settlement systems and recommendations for central counterparties in the European Union, May 2009 (Ref. CESR/09-446) www.esma.europa.eu/system/files/09_446.pdf (CESR has since been transformed into ESMA, the European Securities and Markets Authority). Similar statements have been formulated by other intergovernmental organisations or public consultative bodies, and also much earlier, cf. note 3.
It is obviously the role of national laws, in particular the law of personal property, commercial law and insolvency law, to provide such a legally sound framework. In a first phase, national laws have laboured for many years to digest an important change in market practice in respect of transactions involving securities. Paper certificates were transformed into ‘intangible’ book-entry securities which are now acquired and disposed of through credits and debits in accounts held by intermediaries20 (cf. section 2.1). That fundamental change triggered adjustments in the underlying domestic legal regimes in all the relevant markets, including the EU Member States. However, these adjustments were made, more or less consistently, on the basis of highly diverse concepts (cf. section 2.2). Since these domestic concepts are now in place, there is little appetite for the notion that the market has again changed over the past twenty years, growing increasingly international (cf. section 2.3). The conflict-of-laws analysis, however, reveals that legal certainty in the area of securities law cannot be achieved without harmonisation of substantive law (cf. 2.4).

2.1. SOME NOTES ON MARKET PRACTICE

For reasons of efficiency – i.e., to avoid having to move physical security certificates whenever a change in ownership of the various banks’ clients occurred –, the first central securities depositories (‘CSD’) for security certificates were founded in Vienna in 1878 and in Berlin in 1882 (both probably modelled on the 18th century London Clearing House21 for cheques and bank notes). Centralised custody of security certificates, combined with centrally organised services to keep account balances for the participating banks and settle securities transfers between these accounts, was gradually adopted in all developed financial markets. The institution of a CSD and ‘clearing and settlement’ of securities services is therefore nothing new. However, while the modern securities holding structures and their legal underpinnings have been described often and at length,22 certain aspects are rarely highlighted, although they are important for our purpose.

First, the actual length of a ‘holding chain’, i.e., the number of intermediaries intervening between the investor and the issuer, depends on concrete circumstances. In some jurisdictions, there is no other intermediary besides the CSD, and investors hold their securities directly with the CSD (‘transparent systems’, cf. infra). In other jurisdictions, the number of intermediaries may be limited to one. In yet other jurisdictions, the number is not limited in any way.

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20 In the following, I generally use the term ‘intermediary’ in order to describe an institution that maintains securities accounts for an account holder. This could be a bank, a broker, a central securities depository, a settlement system, central counterparty or other type of infrastructure. An account is either maintained for another intermediary or for the ‘ultimate account holder’.

21 For the historical aspects: Huang, *The law and regulation of central counterparties* (Hart, 2010), pp. 44 et seq.

However, as soon as securities are held across national borders, i.e., as soon as the underlying securities are located in a foreign CSD, holding chains quasi naturally involve several intermediaries.\(^{23}\) Regulation imposing a certain holding pattern (e.g., one or two-tier holding) is only effective within its home jurisdiction. As soon as the ultimate part of an otherwise domestic holding chain is foreign, domestic regulation no longer has any control over whether this—supposedly—ultimate part is itself an intermediary for others or an investor holding for its own account.\(^{24}\)

Second, the terms ‘account holder’, ‘account provider’ and ‘intermediary’ are often ill-employed. The investor (or rather, the ‘ultimate account holder’)\(^{25}\) is, in functional terms, one of several account holders in respect of the same assets. This is because its direct intermediary maintains a securities account for it and thereby acts as its account provider. However, at the same time, this first intermediary does not itself keep the securities but holds them through its own account maintained for it by a second intermediary which might or might not be the CSD. The first intermediary is, therefore, an account provider and, at the same time, an account holder, depending on the perspective. The same principle applies throughout the entire holding chain.\(^{26}\) Only the CSD is not an account holder, since it keeps the securities itself.\(^{27}\)

Third, intermediaries have to separate (‘segregate’) client securities from any securities they may hold for their own account.\(^{28}\) In practice, own securities and client securities are often booked to distinct accounts with the intermediary’s own

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\(^{25}\) ‘Ultimate account holder’, ‘shareholder’ and ‘investor’ are often used as synonyms. It is important, however, to make a clear distinction: (i) ‘ultimate account holder’ refers to a person’s functional position within a holding structure; that person does not maintain a securities account for another person. (ii) ‘Shareholder’ or ‘bondholder’ are terms belonging to the sphere of corporate law, referring to those persons recognised under company law as being called upon to exercise corporate rights (dividends, vote, etc.). (iii) ‘Investor’ is probably not a legal term, referring rather to the person bearing the economic risk of a share or bond investment. This can be a person ‘standing behind’ the legal shareholder and/or the ultimate account holder.

\(^{26}\) EU Clearing and Settlement Legal Certainty Group, _Solutions to Legal Barriers_ (n.16) p. 30.

\(^{27}\) CSDs have a relationship with the securities issuer. This relationship is not characterised as a securities account. CSDs often have a double role: first, they provide services to issuers; second, they provide services to those who hold securities. The details of the first role vary considerably, as a CSD, under the applicable law, may be part of the process of issuing securities. In that, they often have a legal role determined by the company law. For example, in the UK the CSD in legal terms maintains part of the company register, cf. infra, p. 9. In their second role, CSDs organise the clearing and settlement process by operating the ‘settlement platform’ (meaning: IT infrastructure) to which the accounts of all participating banks are connected.

account provider. However, in most jurisdictions, client assets are not separated per client at the upper tier. Rather, they are pooled in an ‘omnibus account’ and cannot be distinguished per client as they are fungible, i.e., not individually identifiable.

2.2. INSULAR SUBSTANTIVE LAW – AN IDEAL WORLD

Jurisdictions have adapted their laws in order to meet the realities of intermediated securities holding, but they have done so in an insular manner. The task of these substantive legal concepts is to define the legal position of account holders (including the ultimate account holder) and account providers in respect of the securities. Additionally, the substantive law governs the way in which the securities are disposed of, i.e., transferred (for the purpose of sale) or encumbered (by way of collateral/security or ‘quasi security’, including transfer to the collateral taker) and related aspects such as priorities and good faith acquisition.

There are no two legal approaches wholly identical to one another. However, common lines of conceptual thinking allow us to identify five different schools of thought:

– The first method is built on the creation of a trust. This method is in place in particular in England and Wales. The method of holding securities in pooled accounts has become frequent in England only relatively recently, with a significant increase in indirect holdings occurring only after uncertificated securities had been introduced in 1996. Under the trust model, the issuer entrusts its securities to the CSD. The CSD (‘CREST’) assumes the role of the company shareholder register under corporate law and has no legal interest whatsoever in the securities. The participants in CREST are considered the legal owners of the securities which they hold, whether for their own or their customers’ accounts. English securities are transferred by way of amending the shareholder register. As regards securities which the CREST participants credit to the accounts of their account holders, the former act as trustee, i.e., the CREST participant’s account holder becomes trustor (beneficiary) and acquires equitable ownership in the securities. This is not quite the same as legal ownership.

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29 In ‘transparent systems’, client securities are always kept in individual accounts, cf. section 2.2 (fifth indent).
31 Uncertificated Securities Regulations 1995, as replaced by the Uncertificated Securities Regulations 2001, as amended.
but encompasses similar elements and is notably protected in the event of the trustee’s insolvency. To the extent that there is another level, or ‘tier’, in the holding chain, this trustor/holder of an equitable interest in turn acts as trustee for its own customer (the ultimate account holder in our example). The latter, again, acquires equitable ownership in what the trustee holds for it. Thus, in a holding structure involving the CSD and two intermediaries, the ultimate account holder acquires, in legal terms, equitable ownership in an equitable ownership in the securities. In practice, however, the investor is treated as though the securities were its own.

– Second, in the USA and Canada the legal concept underlying intermediated securities is the ‘security entitlement’. To some extent, this resembles the trust model, but there are differences. The legal owner of the securities under this model is a special legal entity, Cede&Co, which is a 100 percent subsidiary company of the NYSE. Under US law, every account holder acquires a security entitlement against its account provider, i.e., every intermediary, acting as account holder, has a security entitlement against its own account provider. In their role as account providers, intermediaries are the addressee of their account holders’ security entitlements. The legal nature of a security entitlement is not exactly the same as legal ownership but is somewhat similar to an equitable interest under English law. In particular, security entitlements are separated from the intermediary’s estate in the event of the latter’s insolvency, hence they are not mere claims. The difference is that security entitlements do not ‘overlap’ as is the case with equitable interests under English law. Every security entitlement against an account provider is distinct from the security entitlements that the account provider itself holds. Consequently, there are legally disconnected security entitlement holders at each level of the holding chain, as opposed to beneficiaries under English law. As under English law, each account holder can only turn to its immediate account provider, not to one at a higher level.

– The third model operates on the basis of granting a full, undivided property interest to the investor. This applies in France. The legal

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34 Financial markets Law Committee, Property interests in investment securities (n.30), p. 9. It is of particular interest that English law struggled to overcome the requirement of certainty of subject matter when fungible assets are kept in bulk: cf. Micheler, “The legal nature of securities: inspirations from comparative law”, p. 132, referring to the decision Hunter v Moss [1994] 1 WLR 452 (CA) which cleared the question for English law. The issue was recently reopened and cleared by the Supreme Court decision [2012] UKSC 6 (cf. n.66).

35 Davies, “Using intermediated securities as collateral: equitable interests with inequitable results”, p. 72.

36 Uniform Commercial Code (“UCC”) §8-102(a)(17); Cf. for relevant aspects, Mooney, Law and systems for intermediated securities, pp. 11-13.

37 UCC § 8-503(a).

framework recognises only ‘dematerialised’ securities, i.e., physical, paper certificates have been abolished though the law still refers to ‘bearer securities’. The CSD is supposed to act as a mere register. Neither the CSD nor any of the intermediaries have any legal interest or right in the securities. The investor has an undivided property interest in the securities which are deemed to be located directly in its account, i.e., the account maintained by its account provider. The investor can only access its securities through its account provider, not through any other intermediary at a higher level.

– Germany and Austria serve as examples for the fourth school of thought, and a similar model is in place in Japan. The model of pooled holding was introduced in Germany on a large scale in 1925, when hyperinflation forced banks to find more cost-efficient ways of securities holding. Under this approach, the investor acquires a property interest in a pool of domestic securities located at CSD level. It is a sui generis type of shared property which only exists in this precise context. The intermediaries are supposed to have no interest or legal ownership; however, they can de facto dispose of the securities (in other words, this position is in some ways comparable to ‘possession’ or ‘control’, which describes a factual relationship, with factual control over the securities). Acquisition and disposition, both outright and by way of creating security, strictly follow the rules of property law in relation to chattels. The investor can access its securities only through its own account provider and other account providers up in the chain are unable to identify the securities since the client’s securities holdings are part of a pool.

42 In relation to foreign securities: cf. p.32, infra.
43 Micheler, “The legal nature of securities: inspirations from comparative law”, pp. 136-143, argues that securities were originally regarded intangibles under German and Austrian law and that the conceptual change to property law was made solely to accommodate the need of the market for bona fide acquisition and protection against adverse claims.
45 Geier, “Comparison of the electronic securities settlement systems for the secondary securities markets in Germany and England”, p. 102.
Fifth, the Nordic countries, as well as Greece follow the so-called transparent approach. Spain has a slightly different model. Outside Europe, China and Brazil have systems in place that resemble this approach. The framework for purely national holdings is as follows: in a transparent system, there are no intermediaries involved, except the CSD. Every investor has its account directly in the CSD. The banks intervening in the securities business do not maintain an account for the investor but only operate the account maintained by the CSD under a special legal and operational framework. In this context, therefore, they are also called ‘account operators’, or something similar. The investor has a direct and unshared property interest in the securities. However, for cross-jurisdictional holdings, the transparent system does not work. This is because the foreign intermediaries involved are unable to ‘operate’ the accounts in the CSD directly since they are not part of that highly integrated national system. In other words, the framework for cross-jurisdictional situations in a transparent system resembles the pooled property model.

These national legal concepts applied to intermediated securities are intimately entangled with other areas of national law, such as, in particular, insolvency law, corporate law, and tax law. Additionally, the operations of national CSDs and their participants are perfectly aligned with the national legal framework, and standard account agreements with customers usually mirror the particularities of each system. It comes as no surprise therefore that thinking on intermediated securities remains caught within the web of national concepts.

As a consequence, any discussion on an international framework for intermediated securities tends rapidly to deteriorate into a dialogue of the deaf. Actors and authors think inside their respective boxes of local law and local operations. However, they forget that such an approach neglects part of the source of the problem: the international character of the securities market is significant (cf. the following section) and represents a challenge to legal certainty which is even greater than that stemming from the simple fact that securities are intermediated (cf. section 2.4).

50 Afréll and Wallin-Norman, “Direct or indirect holdings – a Nordic perspective”, p. 279.
2.3. **THE FINANCIAL MARKET IS NOT AN ISLAND unto ITSELF**

As mentioned before, it makes little sense these days exclusively to test domestic legal frameworks against the criteria of legal soundness. Securities are held, transferred, lent and pledged across borders to a significant extent, and this market cannot be conceptually divided into a domestic and an international one. The EU market is supposed to be an ‘internal’ market, and there is important activity across the Atlantic as well as with Switzerland, Japan and other international financial centres.

Data shows that between 5 percent and 95 percent of investments in the different European financial centres are allocated to cross-border securities; typically, in large financial centres like London, Frankfurt and Paris, between 30 percent and 70 percent are allocated to cross-border holdings. \(^{51}\) The share of cross-border holdings is mirrored by a correspondent percentage of cross-border trading activity. \(^{52}\) No data is available indicating the percentage of securities collateral provided across borders but, going by the aforementioned figures, a significant percentage may be assumed. It is probably justified, therefore, for ease of reference, to collapse these three elements into one catchy, yet still conservatively estimated, figure: on average, about 40 percent of all holding, trading and collateral operations by EU market participants in one way or another imply a cross-jurisdictional element. \(^{53}\)

For these 40 percent of cases, a purely domestic legal analysis cannot yield a comprehensive result. Yet private international law is only part of the answer, as the following section will show.

2.4. **THE PROBLEM DRIVEN BEYOND PIL**

Understandably, the immediate reaction to cross-jurisdictional cases is to seek a solution provided by private international law which will point a given case to one or the other applicable national law. However, the case of intermediated securities is special in that more than one law applies to the same asset \(^{54}\). This leads to incompatibilities which cannot be overcome by private international law rules alone \(^{55}\).

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\(^{51}\) Data extracted from Oxera, “Monitoring prices, cost and volumes of trading and post-trading services”, Report prepared for the European Commission, London and Brussels (2011), p. 73. Though the data itself relates to equity investments, the authors note, *ibid.*, that they have found a positive correlation between equity and debt securities in respect of cross-border holdings.

\(^{52}\) Oxera, “Monitoring prices cost and volumes of trading and post-trading services”, p. 73.

\(^{53}\) The value of cross-border securities holdings in absolute terms is equally staggering (though irrelevant for this analysis). It can be exemplified by the value of cross-border holdings of EU banks and money market funds at the end of 2011, which amounted to 2069.3 billion EUR (data extracted and compiled from European Central Bank, Cross-border positions of Euro-area MFIs, February 2012, ecb.int/stats/money/aggregates/cross/html/index.en.html). This amount relates to short and long-term debt, money market fund shares and equity. Holdings of other financial market participants (investment funds, insurance companies, other investors) are not included in this figure, i.e., the actual absolute value of cross-border holdings of the economy as a whole is significantly higher.
2.4.1. PRIMA AND TIERED HOLDING STRUCTURES

As in any other matter of commercial law, when analysing a cross-jurisdictional situation involving intermediated securities, private international law has to be looked at first. Private international law rules will point to one or another applicable law. Private international law in relation to securities holding and disposition can use a variety of very different criteria capable of connecting a case to the most suitable jurisdiction.\(^{54}\) Today, it is that the ‘connecting factor’ in relation to intermediated securities is the law of the securities account to which the relevant securities are credited.\(^{55}\) This approach has been termed PRIMA, which stands for ‘place of the relevant intermediary approach’. However, the term is somewhat misleading, first, because it is not connected to the ‘intermediary’ but to the account and, second, because it subsumes two different sub-species:

- In relation to what might be termed the \textit{factual} PRIMA, the law of the account is the law of the place where the account is actually maintained. This PRIMA subcategory is, roughly, the approach taken by the relevant EU legislation.\(^{56}\)
- In relation to what might be termed the \textit{contractual} PRIMA, the law of the account is the law agreed upon by the parties, generally supplemented by a requirement that the intermediary has a qualifying establishment in the country the law of which has been chosen. This is the approach underlying the Hague Securities Convention.\(^{57}\)

The difference between both approaches is usually marginal, but it might matter in cases where the law agreed upon by the parties is not the law of the country where the account is ‘maintained’, as will be discussed \textit{infra}, section 4.4. However, I will disregard this difference for the moment. Both sub-approaches follow the same

\(^{54}\) Formerly, a variety of additional approaches existed, which led to huge legal uncertainty. In particular: the law under which the securities are issued; the law of incorporation of the issuer; the law of the place where the paper securities are located; or the law of the place where the initial electronic record is made. \textit{Cf.} overview in Bernasconi, “The law applicable to dispositions of securities held through indirect holding systems”, pp. 27 \textit{et seqq.}; discussion in Ooi, “The Choice of a Choice of Law Rule”, in Gullifer and Payne (eds.), \textit{Intermediated Securities – legal problems and practical issues} (Hart Publishing, 2010), pp. 219-244.


\(^{57}\) Articles 2(1) and 4(1) Convention on the law applicable to certain rights in respect of securities held with an account provider, of 5 July 2006 (adopted in December 2002, the Convention however officially indicates the date of the first signature).
basic idea, that of determining the law applicable to securities on the basis of a
two-party relationship, i.e., the account holder and account provider being bound
together by an account.

As a consequence, each account holder (including intermediaries in their role
as account holders, cf. supra section 2.1) acquires the legal position attributed to it
under the relevant legal treatment in the relevant account provider’s home
jurisdiction. As securities are generally pooled in omnibus accounts, the relevant
law applies on each tier to the entire pool of securities credited to the relevant
account, regardless of the fact that different laws may apply to ultimate account
holders’ accounts, as these accounts may be subject to different jurisdictions.

If, for example, a Frankfurt Fund holds shares of an English Issuer through
Frankfurt Bank which holds them with Paris Bank, which in turn holds them with
London Bank which ultimately is a member of the CREST system, German,
French and English law will apply to these shares on the various tiers. Each
account holder acquires the legal position as determined by the applicable law:58
the topmost account holder, London Bank, is the legal owner under English law;
Paris Bank would be the holder of an equitable interest in the shares under
English law; French law cannot control the holding chain outside its territory and
attributes a full property interest to Frankfurt Bank, despite the fact that Frankfurt
Bank acts as intermediary; the account maintained by Frankfurt Bank for
Frankfurt Fund is governed by German law which would generally, i.e., in a purely
domestic holding chain, attribute a shared sui generis property interest in a pool of
securities to the ultimate account holder.

The obvious difficulty is that different laws apply to what are, at least
economically, the ‘same’ securities. Depending on the conceptual approach
towards intermediation, domestic laws and those who apply them have more or
less difficulty in accepting this fact. Where intermediated securities are strongly
assimilated to tangibles, such as under French and German law, the fact that
various laws apply to the proprietary aspects of the same asset are difficult to
explain. Additionally, in any jurisdiction, the nemo dat principle would prevent any
intermediary from providing its account holder with a legal position better than
that it itself has. In other words, where an intermediary receives securities as
beneficiary under a trust, the question arises of whether it can pass on that
economic position to its own account holder as legal ownership or property. The
fact that such inconsistency arises exclusively because different laws apply does
not make the result more acceptable.

Fortunately, in this concrete example, German rules would reflect the dilemma
that it would be unreasonable to provide the investor with a ‘shared property
interest in a pool of securities’ in a cross-border situation. Instead, the investor
acquires, contrary to the general approach, a fiduciary interest in the securities.59

58 Cf. the basis of domestic legal concepts in England, France and Germany in Section 2.2.
59 Mülbert, “Vom Ende allen sachrechtlchen Denkens”, p. 446. The law is not, however, explicit on
this point. Article 22 Safe-custody Act (Depotgesetz) assumes that ultimate account holders would not
acquire property when purchasing securities located in another jurisdiction. Further, the German
The features of this interest very much resemble the position of equitable ownership under English law. It is probably appropriate to regard this institutionalised ‘legislative emergency exit’ as anecdotal evidence that property concepts as such are difficult to extend across jurisdictional borders when it comes to securities holdings.

2.4.2. INCOMPATIBILITY AND DOMESTIC FLAWS

In light of the principles underlying cross-border holding of securities as described above, the legal position of ultimate and intermediary account holders in cross-jurisdictional holding chains may be unclear in respect of the relevant securities. The fact that more than one law affects their position raises a number of questions:

− What type of right does each account holder in the chain acquire? Nothing, a limited right, or a full right? Is the legal position acquired through the chain compatible with the legal concept attributed by the applicable domestic law?
− Can the right attributed to the investor be violated by any wrongdoing in other parts of the holding chain, for example, by an unauthorised pledge to an intermediary’s creditor (in breach of the intermediary’s duties)?
− Who can exercise voting rights and receive dividends when there is more than one ‘legal owner’ (or ‘proprietor’, respectively) in the chain? After all, only the investor (i.e., the account holder who bears the risk of the investment) should be entitled to voting rights and dividends.

Concentrating on the first and second of these issues (the third belongs rather to the sphere of corporate law), it would appear that doubts as to the nature or quality of the account holders’ legal position become palpable in particular in the event of insolvency of one of the intermediaries involved or of a collateral taker. These questions typically centre on:

− the validity and enforceability of earlier outright transfers of securities;

standard securities account agreement stipulates in Art. 12 that, instead, ultimate account holders acquire a right to delivery of securities which is insolvency-proof as intermediaries act as trustees in respect of these rights.

60 This list reflects the thinking behind the sequence of Articles 9, 11-28 of the Geneva Securities Convention and in Recommendations 4-11 of the EU Clearing and Settlement Legal Certainty Group, Solutions to legal barriers (n. 16). This article does not discuss inconsistencies occurring in the sphere of corporate law as a consequence of intermediation: cross-border holding chains tend to sever the link between investor and issuer, entailing questions as to whether investors can effectively exercise the participatory and other rights flowing from securities; cf. Articles 10, 29-30 of the Geneva Securities Convention and Recommendations 12-14 of the EU Clearing and Settlement Legal Certainty Group.
— the validity and enforceability of security or collateral provided;\textsuperscript{61}
— the validity of an earlier good faith acquisition;\textsuperscript{62}
— the possibility to unwind or reverse dispositions;
— the rank and priority of interests relating to the same asset;
— the protection of client assets and the effectiveness of the acquired position against general creditors of the insolvent intermediary.

The above addresses situations in which the interaction of two or more laws in relation to the same securities leads to legal uncertainty because these laws may be incompatible. So far, I have assumed that each of the laws involved is internally sound. However, that might not always be the case. Within the EU, for some time now the official line has been that the domestic soundness of the law underlying securities holding and dispositions was not an issue,\textsuperscript{63} since cross-border incompatibility was a sufficient argument for harmonisation as it is capable of affecting the functioning of the internal market.

\textit{Unidroit} pointed to potential problems with 'internal soundness' back in 2003.\textsuperscript{64} \textit{De facto}, it is unlikely that all 27 EU Member States have a perfectly coherent legal framework in an area as complicated and new as this one, and there have been studies and papers\textsuperscript{65} as well as cases\textsuperscript{66} questioning the soundness of the


\textsuperscript{62} \textit{Cf.} the example provided in EU Clearing and Settlement Legal Certainty Group, \textit{Solutions to legal barriers} (n. 16) p. 60.

\textsuperscript{63} The Commission’s preparatory work (\textit{cf.} n.16) did not address that aspect and concentrated on cross-jurisdictional issues.

\textsuperscript{64} Unidroit Study Group, “Position paper on harmonised substantive rules regarding indirectly held securities” (2003), p. 13.

\textsuperscript{65} \textit{Cf.} in respect of English Law: Financial Markets Law Committee, \textit{Property interests in intermediated securities} (2004), fmlic.org/Documents/fmlc1_3_july04.pdf, pp. 10-14, setting out inconsistencies regarding (i) the nature of the investor’s right, (ii) the treatment of a shortfall at intermediary level, (iii) the intermediaries liability for complying with fraudulent instructions from 3\textsuperscript{rd} parties, (iv) insufficient perfection requirements, (v) the prevention of account holders trying to trace their securities beyond the level of their direct intermediary, (vi) the risk of creditors to attach account holders securities at a level above the direct intermediary, (vii) uncertainties regarding the priority of competing claims to the same securities, (viii) the absence of a clear \textit{bona fide} rule under English law, (ix) uncertainty regarding whether assignment is the method of transferring book-entry securities, (x) uncertainty regarding whether a valid trust is created at all lack of segregation of securities in omnibus accounts. \textit{Cf.} also Davies, “Using intermediated securities as collateral – equitable interests with inequitable results”, pp. 5-6: (i) it is uncertain whether intermediated securities are within the scope of application of the UK Collateral Regulations, (ii) uncertainty regarding the possibility of \textit{bona fide} acquisition. \textit{Cf.} in respect of German Law: Müllert, “Vom Ende allen sachenrechtlichen Denkens”, pp. 447-448, summarising the ongoing debate within German academia on the possibility of good faith acquisition of intermediated securities and the question of whether the requirement of possession can be fulfilled in the absence of any express legal rule or relevant court decisions.

\textsuperscript{66} \textit{Cf.} in the UK, two recent Supreme Court decisions in connection with the insolvency of LBIE: [2012] UKSC 6 concerned the question as to whether client monies were held on trust despite the fact that LBIE did not comply with the relevant regulatory requirements, ‘CASS7’, to segregate them; [2012] UKSC 6 concerned the question as to whether trusts arise validly over securities in which the trustee was allowed to deal freely (under a repo scheme named \textit{Rascals}); earlier, in \textit{Hunter vs Muis}, the Court had
domestic legal framework. Furthermore, the borderlines between lack of clarity of 
the law and its unsoundness are fluent—a fact that is particularly relevant where 
foreign courts are called upon to apply domestic law. If the law is unclear, there is 
a tangible risk of the court’s interpreting the relevant rules in a manner 
incompatible with the general assumption as to the effect of these rules. 
Consequently, cross-jurisdictional incompatibility and lack of internal soundness 
are not necessarily two separate phenomena. There is a risk that any lack of 
internal soundness or clarity of the domestic legal framework will be perpetuated 
and amplified in a cross-border context.

The private international law analysis is unable to remedy these problems. As 
the fate of the same asset might be analysed under different laws at different tiers 
of the holding chain (in accordance with PRIMA), a loss of rights on the upper 
tier (i.e., the tier that is closer to the CSD) cannot be made up under a different law 
on a lower tier. The securities might simply be ‘gone’, regardless of the legal nature 
that the lower-tier law attributes to the right. As we accept the idea of PRIMA 
(disregarding the conceptual differences between factual and contractual 
approach), then logically the governing substantive laws on each tier of a holding 
chain must be realigned.

3. RISK, COST AND THE LEGISLATIVE MANDATE

Having established that there is legal uncertainty caused by a gap between the legal 
framework and market reality, the question is whether legislators—national and 
EU—should act to close it. In that discussion, individual scenarios of uncertainty 
are irrelevant. Rather, a market-wide perspective needs to be taken and policy 
needs to be determined by goals such as increased competitiveness, economic 
growth and, very prominently indeed of late, prevention of systemic 
consequences. Therefore, the micro-view on legal risk has to be broadened into a 
macro-view on the consequences for the market as a whole. The consequences are 
measured by analysing the cost of uncertainty for the market and for society as a 
whole. Logically, heightened cost systemically incurred by individual market 
participants translates into a decline in competitiveness throughout the market.

Most of the mechanisms by which legal risk translates into cost in the area of 
securities law are no different from those in other areas of commercial law. In 

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to decide more generally whether a trust was validly created over un-segregated client assets: [1993] 1 
WLR 934, and the appeal case [1994] 1 WLR 425. In France, the recent Appellate Court of Paris 
judgment 2008/22085 of 8 April 2009 – RBC DEXIA Investor Services Bank France (and two parallel 
cases) concerned hedge fund assets which the depositor (Dexia) had sub-deposited with Lehman 
Brothers International. After the securities were dragged into Lehman’s insolvency, there was 
uncertainty as to whether the depositor (Dexia) had to make up for the loss and ‘return’ the securities 
to the hedge fund at its own cost. The Appellate Court upheld an earlier decision by the regulatory 
authority in that sense.
particular, the cost of uncertainty is directly reflected in the preparatory and monitoring work\(^{67}\) of the parties, notably that of their legal departments and mandated law firms. Additionally, the degree of legal risk—in particular in respect of collateral—is reflected in the conditions for obtaining credit and in risk-weighting for purposes of establishing capital requirements for financial institutions.\(^{68}\) In some cases, legal risk can result in the parties abstaining from the envisaged transaction altogether (‘opportunity cost’)\(^{69}\). Ultimately, parties might suffer a loss because of erratic legal planning that might materialise in the event of the other party’s insolvency.

Any further discussion of the need to harmonise securities law requires quantifying risk-related cost, preferably in absolute figures, or at least in relative terms.

### 3.1. DIFFICULTIES IN QUANTIFYING RISK AND COST

Data in absolute figures is extremely scarce and it appears difficult to quantify the absolute cost of legal risk inherent in the holding and disposition of securities, as described before,\(^{70}\) for three reasons.

First, risk-prone situations are too varied, and the degree of risk differs. The relevant circle of market participants is highly diverse and risk and cost occur both at the level of all parties that hold securities or use them in any way, and at the level of intermediaries and market infrastructures such as settlement systems. At the same time, the circumstances that produce legal risk differ just as, for instance, holding arrangements differ, including the length of the holding chain and the involvement of foreign law.

Second, regulatory, operational and legal frameworks are heavily intertwined and cannot be disentangled. In fact, it is fair to speak of a comprehensive legal-regulatory-operational framework governing the holding and use of securities in each jurisdiction. As a result, there would appear to be no way of extrapolating the excess cost due exclusively to legal uncertainty.\(^{71}\)

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\(^{67}\) “[A] few years ago I was unable to complete a transaction for a short term secured loan by a Canadian bank to a Canadian life insurance company after a week of trying to piece together the legal advice necessary to do the deal. The security for the loan was to be bonds of a foreign issuer that had been deposited into [Clearstream] in Luxembourg. The physical certificates were actually being held in safekeeping in the Cayman Islands, for tax reasons, and could not be moved. The bonds were owned not by the Canadian life company directly, but by its French subsidiary, which had its chief executive offices in Paris. Five law firms struggled for a week to figure out how to put together the chain of opinions that would be necessary to ensure the lender that the loan was fully secured by the bonds, and could not do it. Because we were unable to advise the client as to the nature and extent of the risks involved, it could not price the transaction appropriately or get internal approval to proceed”, Bradley Crawford, “The ‘Prima Convention’: Choice of law to govern recognition of dispositions of book-based securities in cross border transactions”, p. 163.


\(^{69}\) Cf. n. 67.

\(^{70}\) Cf. section 2.4.2.

\(^{71}\) The data available in the Oxera, “Monitoring prices, cost and volumes of trading and post-trading services”, present excess cost on an aggregate basis. The respondents to the Commission’s consultation
Lastly, legal risk which is initially concentrated on the parties alone can develop systemic importance due to a number of transmission mechanisms. Other market participants may be affected, leading to a chain reaction leaving the market dysfunctional and thereby affecting the economy as a whole. The cost involved is difficult to predict.

It may be possible to put a figure on the concrete risk-related excess cost involved in single transactions. However, such evidence must remain anecdotal. Due to the heterogeneity of the market and the variety of potential cases, as described above, we can only describe the global cost of legal uncertainty on the basis of a model.

3.2. MODEL FOR SPLITTING EXCESS-COST

A 2001 paper estimated that cross-border clearing and settlement within the EU cost up to 10 times as much as domestic clearing and settlement. In 2009, a price monitoring study commissioned by the European Commission found that it was still between two and seven times as expensive. An updated version of that study published in 2011 provides sufficient data to develop a clearer picture of the excess cost caused by legal uncertainty, on the basis of a model.

The cost of cross-border clearing and settlement incurred by fund managers is twice the cost of domestic clearing and settlement. For custodians, this factor is 3.4, for CSDs, 3.8 and for brokers as much as 4.1. These stark differences between domestic and cross-border situations can be attributed to a variety of factors, notably (i) cross-border legal and technical discrepancies, (ii) economies of scale, and (iii) variations in the cost across financial centres, including variations in the types of service provided.

It should be noted that the 2011 study does not identify the relative contribution of the various drivers (including legal discrepancies) to the higher cross-border cost in any precise manner. The only indication it gives is that

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72 There are two basic cases, legal spill-over and economic spill-over. In the former, widely-held assumptions regarding the legal soundness of a given legal arrangement are disappointed; e.g. a court rules clauses in a standard contract invalid; this can lead to an entire market instantly pulling out of this specific type of financial transaction. In the second case, the solvency or liquidity problems of one financial institution which are due to a loss taken as a consequence of legal uncertainty in turn affect that institution’s counterparties’ solvency or liquidity.
73 First Giovannini Report, pp. 36-43.
74 Oxera, “Monitoring prices, cost and volumes of trading and post-trading services”, pp. 85-87.
75 Data extracted from Oxera, “Monitoring prices, cost and volumes of trading and post-trading services”, p. 9 Figure 3 and pp. 108 et seqg., Tables 6.4 and 6.12.
76 Technical and legal discrepancies are called ‘barriers’ in the jargon of the Giovannini reports.
77 The last element addresses the situation in which the service buyer is located in a ‘cheap’ financial centre and trades in an ‘expensive’ financial centre. This will per se result in a transaction cost for the cross-border transaction which is higher than the domestic cost, without any other factors intervening, cf. Oxera, “Monitoring prices, cost and volumes of trading and post-trading services”, p. x.
78 Cf. Oxera, “Monitoring prices, cost and volumes of trading and post-trading services”, p. ix.
operational and legal discrepancies can only explain some of the price differences\(^79\) and that at least some of them are due to lower cross-border volume (\(i.e.,\) lower scale effects) rather than being a specific feature of the cross-border nature of the relevant services.\(^80\) Further, the variation in the cost across financial centres plays a role.\(^81\)

Assuming that:

- cross-border transactions in the EU are 200 percent (average of the indicated scale, above) more expensive than domestic ones, all across the post-trading sector; and that
- economies of scale and variations in the cost of financial centres each account for one third of the excess cost; and that
- operational, regulatory and legal discrepancies each produce one ninth of the extra cost,

legal discrepancies alone would drive the prices of cross-border transactions up by 22.2 percent as compared to purely domestic cost. As securities custody settlement is regarded as a business with very low margins, this share in the overall cost is significant.

However, this figure cannot be taken at face value. On the one hand, there is a general or residual legal risk inherent in commercial transactions that cannot be eliminated. On the other hand, harmonising the legal framework would also allow further streamlining of operational aspects, potentially increasing scale effects. In the ideal case, domestic and cross-border settlement would happen on integrated platforms,\(^82\) considerably dismantling the excess cost of cross-border settlement as compared to domestic settlement. However, that can only happen provided the legal environment allows for such integration.

Lastly, it needs to be stressed that these figures relate exclusively to direct transactional excess cost. It appears impossible to predict any indirect cost caused by an unsound legal framework, such as, in particular, because of repercussions on the financial sector and the economy as a whole. First, the amplitude of such repercussions is pure speculation. Second, an unsound legal framework will never be the sole cause of crisis situations that have a wider significance.\(^83\)

\(^79\) Cf. ibid., p. ix.
\(^80\) Ibid., p. x and p. 109.
\(^81\) Ibid., p. x.
\(^82\) Cf. the ECB’s initiative to set up a pan-European settlement platform to bring down the cost of cross-border settlement (‘Target-2-Securities’).
\(^83\) Cf. the ‘Dexia’ example in n. 66: Legal uncertainty regarding the duty to return client securities which had been lost by a sub-custodian was not the original threat to the relevant hedge funds. Rather, Lehman’s insolvency and the loss of securities that resulted at depositor level was the cause. However, the unclear legal situation left the relevant hedge funds and all investors in comparable situations in the dark as to the safety of their investments, causing considerable liquidity squeezes.
4. FUNCTIONALITY VS CONCEPTUALITY – OR THE RISK OF PERPETUATING THE PROBLEM

Whereas the preceding two sections addressed the sources and consequences of legal uncertainty flowing from intermediated securities, the following paragraphs will discuss some of the elements involved in solving the problem. The Geneva Securities Convention already offers a comprehensive functional framework for intermediated securities. The preparatory work undertaken by the European Commission\(^{84}\) likewise provides insight into how legal uncertainty could be dismantled. The approach taken in both texts has been criticised, first, for seemingly turning investors’ property rights into lesser rights;\(^ {85}\) second, for missing an opportunity, as some commentators sensed, to harmonise securities law while embracing property concepts as its centrepiece.\(^ {86}\)

However, it is conceptually unsound to centre the debate on legal concepts such as, in particular, property, as the better and safer solution, and it often becomes a battle of words.

First, applying property concepts to securities is a relatively new development which occurred in response to market needs in the 19\(^{th}\) and 20\(^{th}\) century, so why now argue that this approach must be preserved in the teeth of contemporary market developments that demand new adjustments (\textit{cf.} section 4.1)?

Second, attributing a property right without being able to control its content raises expectations that cannot be fulfilled (\textit{cf.} section 4.2).

Third, the divide between direct and indirect holding, which is often referred to as a benchmark for safety, is unsuitable (\textit{cf.} section 4.3).

Fourth, in that context and against common assumptions, the debate on the factual or the contractual PRIMA approach is irrelevant (\textit{cf.} section 4.4).

Lastly, harmonisation has been promoted on the basis of a functional approach. However, conceptual harmonisation is equally conceivable—are it on the basis of property or any other concept. The latter approach would require the creation of a new legal and operational framework that is both new and separate from pre-existing domestic securities law. As a consequence, Europe would need to set up a ‘28\(^{th}\) regime’\(^ {87}\) should it opt for conceptual harmonisation (\textit{cf.} section 4.5).

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\(^{84}\) EU Clearing and Settlement Legal Certainty Group, Solutions to Legal Barriers related to Post-Trading within the EU, (n. 16), Part I (recommendations 1-11).


\(^{87}\) At the time of writing, there were 27 member jurisdictions, with Croatia expected to join on 1 July 2013. Therefore, in the future, this should read ‘29\(^{th}\) Regime’.
4.1. MARKET NEEDS HAVE TRADITIONALLY DRIVEN THE LEGAL CONCEPT OF SECURITIES

The concept of proprietary rights in respect of (non-intermediated) securities is itself relatively recent and was introduced in response to market needs. Both shares and bonds consist, in substance, of a relationship between the issuer and the investor. This relationship largely consists of payment obligations. The shareholder commits itself to pay the capital contribution to the issuer. The issuer commits itself to pay a dividend to the shareholder and to grant certain participatory rights. The bondholder commits itself to lend money (the 'principal') to the bond issuer. The bond issuer commits itself to pay regular interest and to repay the principal upon maturity.

All rights in these bundles are, by their very nature, obligations and they were originally regarded as such. However, issuers conceived of the idea to create secondary markets for these obligations, in which pricing was easy and transparent, thereby increasing liquidity. The idea of incorporating securities in certificates stems from that objective. Apart from the fact that the paper legitimates its bearer to receive payments or exercise participatory rights, the mechanism of delivery of the certificate allows for *bona fide* acquisition, protecting the disposer from adverse claims.

Although traditionally, good faith acquisition of claims was not widely accepted, the market’s need for certainty as regards acquisitions of securities in good faith was paramount and in 1853, *Savigny* wrote that “[...], the desire was felt to create new concepts which allowed to apply the aforementioned advantages in respect of disposing of property to obligations as well.”

Other alternatives existed, notably to provide for the possibility of good faith acquisition of this particular type of claims immediately. However, legislators chose to take the property route, thereby coating the original set of obligations with a property hull to allow for good faith acquisition in particular.

Today, the market stands at a crossroads again. It still needs the possibility of good faith acquisition of securities—it is probably even fair to say that the modern securities markets operate on the assumption that account holders will have securities credited to their account without any need to verify whether the disposer holds good title. However, there is now a second main concern which did not exist when *Savigny* promoted the assimilation of securities to tangibles, and this is connected to the phenomenon of intermediation: securities need to be protected in the event of insolvency of a participant in the holding chain.

Today, intermediation has become standard. As a result, while the legal concept of property over securities still caters for one of the main market needs

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90 For instance, the General German Commercial Code (1871) protected the purchaser of securities against adverse claims without classifying securities as tangibles: Micheler, “The legal nature of securities: inspirations from comparative law”, p. 142.
(good faith), it must also cater for protection against the risks of intermediation as the second requirement. Given that the concept of coating obligations by a property hull was market-driven from the outset, there should be nothing to stand in the way of adjusting the legal approach once again now that IT and globalisation have changed the market so radically.

4.2. PROPERTY, INTERMEDIATION AND STRETCHED EXPECTATIONS

Strikingly, pure property law concepts have never been capable of solving the intermediation problem, precisely because their application was conceived to allow for good faith acquisition. These two goals are mutually exclusive. Even in a traditional setting, as soon as a security was delivered into custody, the owner could only trust its custodian that it (i) would comply with segregation requirements to keep the property identifiable, and (ii) that it would abstain from unauthorised dealings in the asset in its own name. As soon as the custodian breached its contractual or legal obligations in this respect, the possibility of loss of the property was always a real one.

Additionally, the ability of a (domestic) property interest as such to provide effective protection against loss is even more limited where the holding chain is international. As set out above (section 2.4.2), the fact that the conflict-of-laws analysis is built on a tiered approach following PRIMA leads to a situation in which the same underlying asset is governed by different laws on different tiers of the holding structure. The legal analysis on one tier of the holding chain is therefore disconnected from the analysis on the other tiers. Assuming that the right deteriorates at an upper tier—for instance by being dragged into the insolvency of one of the intermediaries involved or by being disposed of to a third person—, the legal position on the lower tier, property or other, cannot make up for a loss.

The only solution is to disconnect the fate of the ultimate account holder’s right from the rights of other account holders up the chain and to protect it separately. In other words, protection against insolvency on the upper tier requires that the right at account holder level should always be available regardless of what happens to the pooled rights held in different account layers up the chain. However, if we accept this approach, we can no longer hold up the pretence that the rights are property rights in relation to the same asset.

91 In most, if not all, jurisdictions, the law prescribes that client securities would in principle never be part of the insolvent estate and are not accessible by the intermediary’s general creditors. Further, there are usually rules limiting the power of intermediaries to dispose of the securities exclusively in the interest of the relevant client. However, in case of an intermediary breaching these obligations or going beyond the power attributed to it by the law, rules on specificity or on bona fide acquisition might result in the client losing its securities to the insolvent estate or to a third person. Cf. [2012] UKSC 6 – Rascals (n. 66).
European law, somewhat ill-conceived, takes that route in the Alternative Investment Fund Managers Directive, establishing a ‘strict liability’ of the account provider in the event that securities become lost on the upper tier of the holding chain. However, the account holder’s duty to replace lost assets, even if unconditional, is at odds with the concept of a property interest which always relates to a specific item. Being obliged to replace something implies that it has been lost in the first place.

The fact that the security certificate has lost its function over the last 30 years is only a symptom of this logic. The law has already admitted that the market cannot live with the concept of a security that is located in a specific place. Instead, the market accepts that technically, IT systems document their rights, and that the same securities are documented in different pools of securities in different accounts.

Consequently, to call a legal position ‘property’ does not as such provide an adequate level of protection against the insolvency of an upper-tier intermediary. Rather, the use of the term in the context of cross-jurisdictional securities holding creates unfounded expectations of certainty and safety, as the domestic legal concept cannot provide the account holder with an appropriately robust legal position. The only relevant question is whether the legal framework actually achieves the two main goals—good faith acquisition and protection of account holders’ interests in the event of insolvency—also in a cross-border context. If it does, it does not matter how one labels the right.

4.3. SENSE AND NON-SENSE OF THE DIRECT/INDIRECT DIVIDE

In the early discussions on this subject, the various models as set out above (cf. supra, section 2.2) were not clearly identified. Reference was often made to ‘direct’ and ‘indirect’ holding models. The general feeling was that the trust model (UK) and the security entitlement model (USA) were ‘indirect’, whereas the ‘property-based’ models (France, Germany, Nordic countries, etc.) were ‘direct’.

However, it was never clear what exactly this meant. Did ‘direct’ mean that the investor enjoyed a ‘property’ right in respect of the securities? Or did it mean

93 There are now plans to promote dematerialisation in all European jurisdictions, cf. Article 3(1) and Recital (11) Proposal for a Regulation of the European Parliament and of the Council on improving securities settlement in the European Union and on central securities depositories (CSDs), COM 2012 73 final.
that there was literally no intermediation, i.e., that the investor had immediate control over the securities?

In my view, the watershed is located at the German and French approaches to securities holding. In both systems, the ultimate investors’ rights are termed ‘property’ in one form or another. However, the source of the title, i.e., the securities certificate in Germany or the root entry in the French CSD, respectively, is relatively remote from the investor. In particular, intermediaries maintain accounts for their customers (investors) and pool customer securities in a separate account to be held with an upper-tier entity (CSD or other). In other words, the credit to the account maintained by the CSD is not in favour of the investor but in favour of an intermediary. As a consequence, the intermediary has the de facto power, in legal terms, to dispose of the securities even though it is generally not allowed to do so under regulatory requirements.

The close link of ‘property’ can be established—in jurisdictions such as France and Germany—only by way of definition. In France, the law specifies that the ultimate account holder is the sole proprietor of ‘bearer securities’. In Germany, there are neither legal rules nor court guidance on the subject. Doctrine and academic analysis explain the existence of the property concept.

Therefore, the distinction between ‘direct’ and ‘indirect’ as it was used in the past now seems too vague. The so-called transparent systems are probably the only representatives of the world of direct securities holding. The US security entitlement is unambiguously ‘indirect’. All other models, including that of England, are somehow in between. Yet, tested against the criterion of account structures, they must probably be classified as indirect systems as well.

In the conceptual debate, the notions of ‘direct’ and ‘indirect’ should be dropped as being too vague. Rather, a more nuanced approach should be taken, along the lines suggested above. In any case, it was always questionable whether such rough categorisation was helpful at all, as the next section will explain.

4.4. PRIMA AND PROPERTY

The question of whether the phenomenon of intermediated securities can sensibly be addressed by resorting to property law concepts seems to reverberate on the discussion regarding the private international law aspect.

95 It is important to distinguish between the power to dispose of securities in a legally valid manner (in particular on the basis of bona fide rules) and regulatory requirements not to do so and safeguard client assets, as for example Articles 16(1) Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.

96 García Martín Alferez, “The UNIDROIT project on intermediated securities: direct and indirect holding systems”, p. 3, pointing to the fact that the difference between direct and indirect did not relate to the fact that the investor did or did not physically possess the securities (in that sense all holding systems were indirect) but to the way in which the legal system prevented custody risk and facilitated the exercise of corporate rights by investors.

97 Cf. supra, section 2.2
The factual PRIMA (cf. supra, p. 13 et seqq.) is strongly associated with thinking rooted in the world of property. According to that approach, the law of the place where the account is maintained (a location) is the law that applies. However, the criterion of de facto maintenance of the account may seem to be an easy approach on the surface but in fact extremely difficult to apply when it comes to detail. First, there is a whole array of practical questions (where is the computer located? is it relevant whether the client steps into the branch in country A or country B? what if branches in several countries are involved in dealings in relation to the relevant account?). Second, nobody has so far been able to define what an account actually means in an international context, as it is mostly the national regulatory authority which determines what an account is and who maintains it. Is an account something physical, i.e., comparable to the books traditionally kept by merchants (and this would point us to the location of the computer and the outsourcing issue)? Or is an account a relationship, which raises the question of whether such a relationship can actually have a location or whether the ‘location’ is subject to contractual agreement? Totally opaque though these issues may be, this factual PRIMA subcategory is the approach taken by Article 9 of the EU Financial Collateral Directive and Article 9(2) of the EU Settlement Finality Directive.

As to what might be termed the contractual PRIMA, the law of the account is the law agreed upon by the parties. This approach ultimately leads to a situation where the law governing ‘proprietary’ aspects over securities can be chosen by the parties, an approach perceived as alien to civil law traditions even though it usually requires the intermediary to have a qualifying establishment in the country the law of which has been chosen. This is the law in Switzerland and is also the approach underlying the Hague Securities Convention.

In concrete terms, the difference between both approaches matters in cases where the law agreed upon by the parties is not the same as the law of the country where the account is ‘maintained’. This might occur, in particular, where two financial institutions acting globally have securities accounts with each other. In today’s computerised financial world, the account could literally be in Singapore, New York, Paris, London or Frankfurt. Therefore, most global players prefer to fix the ‘location’ of the account contractually in order to be sure which law applies.

The arguments for either approach are legion. It needs to be stressed, however, that the tiered approach as such and the application of different laws to the same asset that comes with it are the novelties that produce repercussions in point of substantive law. Whether the conflict-of-laws rule settles on either the

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factual or the contractual PRIMA is an additional complication, but it is not the core of the problem.

Accordingly, future deliberations on the connecting factor should attempt to settle on the most practicable solution that offers the highest degree of predictability and certainty and then concentrate on solving the problems surrounding substantive law.

4.5. STRIPPING SHEEP’S CLOTHING AND THE 28TH REGIME

Both the preparatory work undertaken by the EU and the Geneva Securities Convention on intermediated securities follow a functional approach. This means that the changes that must be made to the legal framework are defined by way of describing the factual effect which the domestic law should produce. Two issues arise in this context. First, the functional approach has been criticised—in relation to both initiatives—by some authors as disguising the wolf in sheep’s clothing, as its purported functionality in reality produces a steep conceptual impact on national law. Second, there is room to re-think whether further integration of the EU internal market for capital and financial services would require a greater leap beyond the functional approach in the form of a directly applicable and fully developed new concept for the entire EU securities market. Developing such a concept in the form of a separate, additional and closed legal regime (“28th regime”) may prove to be the more consistent solution and might still be compatible with the Geneva Securities Convention.

4.5.1. THE REMIT OF THE FUNCTIONAL APPROACH

The functional approach was introduced into the universe of securities law by a 2003 UNIDROIT discussion paper and was described as ‘an approach using language that is as neutral as possible and which formulates rules by reference to their results’.

However, there is disagreement as to whether the Convention’s rules transcend the sphere of functionality by de facto venturing deeply into national legal concepts underlying securities holding.

In getting to the bottom of these issues, it is worth recalling the core of legal inconsistencies in relation to intermediated securities: the incompatibility, in principle, of negotiability/bona fide on the one hand, with absolute protection of

99 Cf. supra, n. 87.
holders of intermediated securities, on the other hand.\textsuperscript{102} Most jurisdictions provide for a viable route under domestic law to deal with this dichotomy.

However, these domestic solutions differ as to their concepts and results. Some apply the ideas of the classical property/insolvency law doctrine\textsuperscript{103}, others go down different, \textit{sui generis}, paths.\textsuperscript{104} Some domestic legal frameworks place more emphasis on negotiability, while others are stronger as regards mechanisms to protect account holders.\textsuperscript{105} The obvious consequence of this divergence is incompatibility and legal uncertainty in cross-jurisdictional situations flowing from the different answers to that dichotomy.\textsuperscript{106} As long as this discrepancy is not eliminated, securities laws will mismatch in terms of the question of ‘who owns what’ in a cross-jurisdictional context.

Considering this situation from the solutions angle, it is evident that the key to overcoming this mismatch is to design a \textit{uniform} international solution to the core problem itself.\textsuperscript{107} In other words, there is no getting around changing and aligning national laws in respect of issues such as irreversibility of account holder rights, \textit{bona fide} acquisition and priorities. Such a uniform framework may well require changes to the existing domestic solutions.

The prospect of being compelled to change parts of the core of the domestic legal framework as regards acquisition and disposition of securities is what fuels complaints about lack of functionality and disguising as functional what is in substance conceptual harmonisation. However, this criticism is beside the point. Jurisdictions will continue to be able to organise securities holding, acquisition or

\begin{itemize}
\item \textsuperscript{102} \textit{Cf. supra}, section 4.1.
\item \textsuperscript{103} Notably France, Germany and Austria: property of account holders does not, \textit{a priori}, form part of the insolvent estate. The result of the English trust model—assets held on trust are not accessible to the intermediary’s general creditors—is identical. \textit{Cf. section 2.2.}
\item \textsuperscript{104} Notably the USA (§8-503(a) UCC: securities held by an intermediary are \textit{a priori} client securities and not accessible to its creditors) and Switzerland (Article 17 Federal Intermediated Securities Act: client securities shall be excluded from the insolvent estate. Non-segregated securities are deemed client securities).
\item \textsuperscript{105} The US system is probably the paradigm of a legal framework ensuring negotiability. The fact that security entitlements are entitlements (only) against the direct intermediary (\textit{cf. section 2.2}) disconnects the acquisition leg from the disposal leg in both operational and legal terms. In many other jurisdictions, the \textit{de facto} disconnection cannot be denied—where an intermediary ‘draws on the pool’, acquisition by \textit{bona fide} customers can often not be avoided—whereas \textit{de lege} that disconnection and the entailed increase of the aggregate number of securities credited in the system is impossible. It is important to note, however, that the US system employs regulatory safeguards to avoid inflation of securities. The result is that in many countries, inflation of securities is conceptually ‘impossible’ but happens \textit{de facto}, whereas in the US, inflation is conceptually ‘possible’ and happens \textit{de facto} but is forbidden by law. The actual difference in terms of certainty for account holders is probably marginal.
\item \textsuperscript{106} For example, in a cross-jurisdictional situation of defective acquisition of securities, both jurisdictions involved might in principle protect good faith acquisition. However, if the law applicable to the acquirer’s account requires a good faith acquisition to be mirrored by an equivalent loss of another account holder, whereas the law applicable to the purported disposer’s account protects the disposer against the loss because the transaction was defective, the acquirer will \textit{de lege} acquire the securities, whereas the purported disposer will \textit{de lege} keep its securities. The two regimes on negotiability/\textit{bona fide} are not compatible. \textit{Cf. the example in EU Clearing and Settlement Legal Certainty Group, Solutions to Legal Barriers, 60.}
\item \textsuperscript{107} \textit{Cf.} the relevant provisions of the Geneva Securities Convention: Article 18 (acquisition by an innocent person); Article 24(3) (buy-in in case of uncovered holdings); Article 26 (loss sharing in case of insolvency of the intermediary).}
\end{itemize}
disposition on the basis of their concept, be it trust, entitlement, full or shared property, transparent holding, etc., as long as the relevant aims are achieved. The current legal frameworks underpinning intermediated securities are generally relatively recent and were developed to accommodate intermediation. They are creative to the point where the result might be called a legal fiction. Consequently, that conceptual flexibility should be used again when adapting the existing frameworks in light of a new, additional and inevitable imperative, i.e., the internationalisation of the market and the widespread cross-jurisdictional holding of securities.

In summary, the rules proposed by the Geneva Securities Convention and the EU Commission are functional as to their nature, though demanding as regards their content since they require substantial legislative changes. The idea of functionality delivers what it is intended to deliver. Therefore, it is not a wolf in sheep clothing – rather, it is still a sheep in sheep’s clothing, though a pretty big one.

4.5.2. FUNCTIONALITY, UNIFORM LAW AND THE 28TH REGIME

Drafting directly applicable EU law in the areas of substantive private and commercial law is a delicate task. Therefore, directives—i.e., legal acts addressed to Member States which require autonomous implementation into their laws—have in most cases been the instrument of choice. As directives are probably the paradigm of a functional legal instrument, they allow Member States to adapt the EU rules to the wider architecture of their legal bodies and to honour domestic legal concepts in the process of implementation. The form of directive has generally been chosen to harmonise aspects of private and commercial law underlying financial market and securities transactions, in particular. The relevant examples are the Financial Collateral and the Settlement Finality Directives as well as the Directive on the Winding-up of Credit Institutions.

EU legislators will have to consider whether the law governing the holding and disposition of intermediated securities would be better cast into a directive or a regulation. As mentioned in the introduction, a Securities Law Directive has been in the making so far. However, both the functional, more flexible instrument of

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108 Cf. the different ‘schools of thought’, supra, section 2.2.
109 Cf. supra, sections 4.1 and 2.2.
110 One prominent legal fiction is that, under German law, an account holder is supposed to have ‘possession’ over the securities, cf. the criticism by Einsele, Wertpapierrecht als Schuldrecht, pp. 64-88. A second example is that French law still applies rules originally applicable to ‘bearer securities’ despite the fact that all French securities have been dematerialised and only exist in electronic form; cf. Drummond, ‘Intermediated securities: reflections on a new concept’, p. 435.
111 Cf. Article 288 Treaty on the functioning of the European Union: ‘A directive shall be binding, as to the result to be achieved, upon each member State to which it is addressed, but shall leave to the national authorities the choice of form and methods.’
112 Cf. n. 4 and n. 56.
113 Cf. supra, section 1, especially n.17.
directives and the conceptual, more stringent instrument of regulation have specific advantages and drawbacks when applied to the area of intermediated securities.

These advantages and drawbacks can probably be best understood by analysing a similar case. The Financial Collateral Directive governs legal matters closely related to the holding and disposition of intermediated securities. To a certain extent, therefore, the process of implementing the Financial Collateral Directive is comparable to that of harmonising Member States laws on intermediated securities. Also, this instrument takes a functional approach, i.e., its provisions are capable of being incorporated into different types of legal concepts underlying securities collateral transactions. However, the process of implementing the Financial Collateral Directive into all domestic laws produced a patchwork of quite diverse national regimes governing collateral: First, the directive gave some levy to national legislators as regards the personal and material scope of the rules. This levy was the result of political compromise and created an EU-wide regime comprising maximalist frameworks in some member States and minimalist frameworks in others. Second, the (functional) drafting of the Financial Collateral Directive left room for different interpretations as to the substance of the rules, which produced mismatches between existing domestic law and harmonised EU law, ultimately creating legal uncertainty in respect of certain issues instead of removing it. Third, member States went on dragging their feet

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114 My argument focuses on the Financial Collateral Directive since the second relevant instrument the Settlement Finality Directive, is very limited in its personal and material scope and as such scarcely qualifies as a wide-ranging reform of securities law. Further, the practical need for the core rule of the Directive—preventing a settlement freeze in a settlement system after its commencement—was uncontested, whereas the need for harmonisation of securities law is still queried.

115 The Financial Collateral Directive relates to the provision of collateral in the form of financial instruments, cash or credit claims provided under an arrangement either involving transfer of title or by way of security to a collateral taker (i.e., pledge, charge, lien, etc.). The material aspects are the following: Formalities regarding the creation of a collateral interest are abolished (Article 3) and procedures and formalities for the enforcement of collateral in a default situation simplified (Article 4). Furthermore, the directive enables the parties to agree on a right of use over securities provided as collateral (Article 5). Lastly, it institutionalises certain market practices, i.e., close-out netting (Article 7), top-up collateral and substitution of collateral securities (Article 8). The material scope of the Financial Collateral Directive may be regarded as a clipping from the wider project of securities law reform. However, it relates exclusively to the creation of collateral interests and to the recognition of the aforementioned market practices. The basic question of how acquisitions and dispositions, including the creation of security, are rendered legally effective is dealt with only as regards formal requirements.

116 Cf., for instance, the functional definition for security financial collateral of paragraphs 1(c) and 2 of Article 2 of the Financial Collateral Directive: "security financial collateral arrangement" means an arrangement under which a collateral provider provides financial collateral by way of security to or in favour of a collateral taker, and where the full or qualified ownership of, or full entitlement to, the financial collateral remains with the collateral provider when the security right is established; … References in this Directive to financial collateral being 'provided', or to the 'provision' of financial collateral, are to the financial collateral being delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker or of a person acting on the collateral taker's behalf.


118 Cf. ibid., pp. 208 et seqq.

119 E.g., as to the UK, the application of the rules of the Financial Collateral Directive to floating charges, the most important means of providing security under English law, is in doubt. Under the Directive,
in respect of implementation for some considerable time; as a consequence, EU-wide implementation was delayed by two years. This was because of the existence of conceptual hurdles that needed to be overcome in order to be able to adapt certain areas of contractual, commercial and material insolvency law to the new standard.

Against this background of patchy and unsatisfactory implementation of the Financial Collateral Directive, difficulties are probably also in store when incorporating the harmonised rules on the holding and disposition of intermediated securities into domestic law. Indeed, the difficulties may prove significantly greater since the material scope of the law governing intermediated securities holding and disposition is much wider and delves more deeply into the substance of material law than does the Financial Collateral Directive. Therefore, it is probably fair to predict that the securities law harmonisation as currently envisaged by the EU will resemble an exponentiated Financial Collateral Directive. With this in mind, I expect the problems encountered in implementing that instrument to be a multiple of what was experienced with the Directive. As a consequence, there seems to be little chance that a directive on wider securities law harmonisation could be meaningfully implemented.

A directly applicable EU regulation would avoid the aforementioned drawbacks. There are generally two approaches to building such a self-contained legal regime in the EU. The first model entails comprehensive replacement of domestic law. Under this approach, the entire sphere of securities holding and disposition would be governed by directly applicable EU law and national laws in this area would cease to have effect. It would also entail the introduction a universal European definition of ‘security’. This ‘all in’ approach would have the advantage that no doubts can arise as to whether a given transaction is covered by the regime or not. However, there are market segments on the fringes of the universe of intermediated securities where harmonisation is of no interest and where the application of rules designed for intermediated securities would not make sense. Therefore, a ‘rump’ domestic securities law would necessarily need to remain in place.

This dilemma would be avoided by drawing on the second model, i.e., that of co-existence under which a new, supplementary legal framework for a clearly defined part of the securities market is introduced while a residual part of the

the relevant collateral assets need to be ‘in possession or under control’ of the collateral taker. This requirement might conflict with the general freedom of a provider of a fix charge to continue dealing in the relevant assets. As the need to register the charge depends on whether the charge is inside or outside the scope of the Directive, uncertainty regarding this aspect has immediate repercussions on legal certainty, cf. Fawcett, “The Financial Collateral Directive: an examination of some practical problems following its implementation in the UK”, Journal of International Banking Law and Regulation 20(6) (2005), p. 212.

Cf. n. 115.

In certain cases there seems to be no or little need for harmonisation: (a) securities which are directly held by the ultimate investor on the issuer’s books; (b) non-fungible securities, like parts in private limited companies; and, (c) non-publicly traded securities.
market continues to be governed by national law. National law would not be displaced. Rather, the relevant transactions would be imported into an independent, separate EU regime. Here, a clear distinction would have to be made between those securities subject to the EU regime and those that continue to be governed by domestic laws. It would be paramount to introduce clear-cut criteria such as (a) the type of the relevant assets, (b) the fact of being traded on regulated markets or other recognised types of market, (c) whether the securities are booked to securities accounts or settled through designated settlement systems, or, (d) whether the securities have an ISIN\textsuperscript{122}. Also, an opt-in could be created by (e) allowing issuers to issue their securities into the new regime, even though these securities would otherwise not be covered. By contrast, the involvement of an international element in the relevant situation would be too unclear a criterion.

The major drawback of creating a uniform, directly applicable regime for all EU jurisdictions resides in the need to create a fully-fledged legal, regulatory and operational set-up. The functional approach naturally relies on domestic rules and structures and would only require changes to those aspects of the law that needed to be harmonised. By contrast, any directly applicable conceptual and uniform regime would need to be comprehensive since there would be no general provisions of national commercial law available to provide that general legal foundation of securities law. Also, the relevant market infrastructure, such as, in particular, securities settlement systems, would need to adapt to the new legal framework. Such a project would naturally require considerable effort and resources and probably meet with scepticism from academia and national policy makers. However, it might be clearer in terms of legal certainty.

In essence, the European legislator will have to choose between a directive built on a functional approach and a regulation built on defined legal concepts. Though a regulation appears to be more intrusive, it should be borne in mind that the effect of functional harmonisation will be substantial, too.\textsuperscript{123} Therefore, there might not be too big a difference between both alternatives in terms of ‘legislative fallout’. As regards compatibility with international standards, in particular the Geneva Securities Convention, both approaches are capable of producing an instrument that will ultimately create European law which is compatible with that international benchmark.

5. CONCLUSION

After about a decade of discussing the law of intermediated securities in Europe, the time has now come to recognise that modern securities law is bound to centre around three fundamental legal challenges.

\textsuperscript{122} The International Securities Identification Number (ISIN) identifies exchange traded shares, bonds, funds, options and futures.

\textsuperscript{123} Cf. the preceding section.
First, negotiability has been a guiding principle of securities law since Savigny’s times: acquirers and security takers need to be sure that they receive good title without being obliged to verify the origin of the relevant securities or to investigate the transferor’s power to dispose of them. This principle has, in many jurisdictions, resulted in the application of property law concepts to rights which are obligations in substance. The incorporation of securities in negotiable paper certificates was the most obvious characteristic of this development. In modern securities settlement systems, where transferor and transferee remain anonymous and interconnect remotely through intermediaries, the principle of negotiability of securities is ever more essential.

Second, securities laws have also been guided by the purpose of protecting account holders against intermediary risk. Originally, that risk could be addressed by applying traditional concepts such as safe-custody of property or trust. Five different general concepts are still in use, all more or less employing elements of traditional property law. However, the development of modern multi-tier holding, which in many jurisdictions entails the pooling of securities in omnibus accounts, meant that these concepts needed to be modified to ensure that the ultimate account holder’s remoteness from its assets would not impinge on the robustness of its legal position. However, traditional legal concepts appear to be stretched to their limits and may be unable effectively to protect against intermediary risk. This is all the more true since the aim of protecting investors against intermediary risk on the one hand, and the achievement of negotiability on the other hand, are two conflicting aims. Domestic laws do not always manage to reconcile these aims in a manner capable of withstanding severe pressure.

Third, cross-jurisdictional compatibility is needed in respect of the above because securities holding and securities dispositions now stretch across national borders, amounting to at least 40% of the overall volume within the EU. Cross-jurisdictional holding and disposition are equally built on the principles of negotiability and protection against intermediary risk. In this respect, they require the same degree of legal certainty as purely domestic scenarios. In cross-jurisdictional scenarios, ‘PRIMA’ governs the conflict-of-laws question. Though the PRIMA-based conflict-of-laws analysis features some uncertainties of its own, the novelty consists mainly in the way it disconnects the different tiers of a holding chain from one another. This leads to the application of different laws to what is, at least economically, the same asset. As the applied laws differ in substance, notably as regards the mechanisms balancing negotiability and protection against intermediary risk, there is considerable risk of mismatch and resulting legal uncertainty. This arises from incompatible legal solutions to that dichotomy being forced to interconnect. As a typical result, a loss sustained on a tier closer to the source of the title cannot be made up for on the lower tier, even if the lower-tier law provides for the securities to be the account holder’s property. The rules of private international law cannot remedy that situation.
With legal uncertainty rife, legislators must ponder the prospective gains of improving and harmonising the law. However, anecdotal evidence alone does not provide a sufficient case for action. The potential advantages of harmonisation should be measured in that part of the cost of legal uncertainty that can be removed. Its absolute cost in the area of intermediated holdings cannot be measured. The relative cost of legal uncertainty and a lack of clarity can be determined on the basis of a model: it increases cost by about 22.2 percent in cross-jurisdictional transactions, as compared to purely domestic situations. The potential cost to the market and society, should market turmoil produce legal uncertainty on a wider scale is impossible to predict with any certainty.

As to the approach to be taken, settling on property concepts as understood in some continental jurisdictions cannot provide a satisfactory solution. The word ‘property’ alone is unable to guarantee the possibility of good faith acquisition while at the same time protecting the investor against intermediary insolvency on one of the upper tiers of the holding chain. Accordingly, harmonisation is bound to happen either on a result-based and functional approach, or on the basis of a newly created, supranational, directly applicable and ‘closed’ legal framework.

Functional harmonisation, on the one hand, ties in more smoothly with existing domestic securities law and with existing market infrastructure. However, its harmonising effect will be smaller. A supranational legal framework, on the other hand, in particular one built by way of EU Regulation, requires the creation of a fully-fledged legal and infrastructure system that does not have recourse to national laws and national operational specificities. The definition of clear criteria determining which securities are ‘inside’ that framework and which are ‘outside’ would be of utmost importance. The legislative effort for such a project would be considerable, but the gain in legal certainty would also be more significant.