The London School of Economics and Political Science

Proprietary rights in indirectly held securities: legal risks and future challenges

Elena Christine Zaccaria

A thesis submitted to the Department of Law of the London School of Economics and Political Science for the degree of Doctor of Philosophy, London, April 2015.

Declaration

I certify that the thesis I have presented for examination for the MPhil/PhD degree of the London School of Economics and Political Science is solely my own work other than where I have clearly indicated that it is the work of others (in which case the extent of any work carried out jointly by me and any other person is clearly identified in it).

I warrant that this authorisation does not, to the best of my belief, infringe the rights of any third party.

I declare that my thesis consists of 69,572 words.

Statement of use of third party for editorial help

I confirm that my thesis was copy edited for conventions of language, spelling and punctuation by Babette Pragnell and Rachel Murray.

Abstract

Over the centuries, English law has developed a 'flexible' and 'malleable' idea of property - in particular through the rules of equity - which has proved capable of adapting to the continuing changes in market practice. The question now to be addressed is whether this 'flexible' idea of property can also adequately represent interests in indirectly held securities or whether (as suggested by the Financial Market Law Committee) the new financial practice requires statutory clarification.

Unlike most civil law systems, English law has been able to accommodate many new issues arising from the practice of intermediated securities within the existing framework. For example, the complex indirect holding structure is built on the well-developed institution of trust and sub-trust which allows investors to obtain equitable proprietary rights in the assets held for them by the intermediary.

The proprietary characterisation of these types of rights has recently been challenged by McFarlane and Stevens, on the grounds that they seem to establish the same level of protection against third parties, by classifying the investors' rights as 'persistent rights' or 'rights against rights'. The main advantage of using the concept of a persistent right (rather than a proprietary right) is that it provides a better understanding of the legal structure of intermediation, as well as showing that no statutory clarification is necessary within the United Kingdom.

The thesis tests the theoretical foundation of McFarlane and Stevens' argument, using the current Lehman insolvencies as a platform for evaluation. The primary objective is to consider whether the idea of 'persistent rights' or 'rights against rights' is better able to explain the precise functions of this new practice and overcome the legal uncertainties typically associated with the indirect holding system.

Acknowledgments

The writing of this thesis would have been a far more arduous and less satisfying experience had it not been for my supervisors Michael Bridge and Eva Micheler. My profound gratitude goes to them for their guidance, encouragement and precious advice offered to me throughout my time as a Ph.D. student.

I would also like to thank Emma Chell, Roy Goode, Gabriel Moens, Gabriel Moss, Habib Motani, Philipp Paech, Giorgio Resta, James Rogers and Giuseppe Tucci for having taken the time to share their valuable experience and give their answers to all my many questions.

A special acknowledgement and my sincere gratitude goes to Joanna Benjamin who gave generously of her time and helped me to understand the more diverse complexities of this area of law.

I am also grateful to the LSE Law Department and the Olive Stone Memorial Fund, whose financial support made the writing of the whole thesis possible.

I take this opportunity to thank my parents for their constant attention and the great personal sacrifice made to support me over the years. Last but not least, I would like to thank my husband Roberto, for his patience and encouragement through this venture as well as my daughter Francesca Leah who was born in the final stages of the drafting of this thesis and has been so understanding as to allow me to sleep unawakened through many a night.

All responsibility for the contents of this thesis, and any errors it may contain, is solely my own.

Table of Contents

1. Introduction

At the end of the eighteenth century, the common law concept of property was described by Sir William Blackstone (1723 - 1786) in his *Commentaries on the Laws of England*[1] as ‘that sole and despotic dominion which one man claims and exercises over the external things of the world, in total exclusion of the right of any other individual in the universe.’[2] This definition of property, based on an absolute dominion over material things, is no longer accepted in the common law tradition.[3] The question then to be posed is: what is property today?

Since Blackstone, considerable effort has been devoted by academics to clarifying the concept of property, in the attempt to identify its exact meaning, define its boundaries and establish how it relates to other areas of the law. Despite these efforts, the concept of property has no single or widely accepted definition. The reason for this is that key features of property, which may be applicable in all circumstances, are somewhat difficult to identify in rigorous terms.

One could start investigating the compound meaning of property by stating that it ‘deals with the relationship between an individual and a “thing” and the effect of that relationship on the world at large.’[4] In this regard, it is common practice to assert that the hallmark of property is its universality. This means that proprietary rights can be asserted *erga omnes*, i.e. against the whole world and not only against a given individual, such as a contracting partner. However, these universal rights are not invincible, as the level of protection that a rightful owner enjoys *vis à vis* third parties may vary significantly in terms of length of time and number or categories of persons against whom proprietary rights may be asserted[5].

[1] Blackstone, (1765 - 1769, book 2, chapter 1 - Of Property, in General).
[2] *Id.* Blackstone’s idea of property essentially contained two elements: '(i) the physicalist conception of property that required some “external thing” to serve as the object of property rights, and (2) the absolutist conception which gave the owner “sole and despotic dominion” over the thing', Vandevelde (1981, p. 331).
[3] Lawson and Rudden (1982, pp. 1 – 8); Swayze (1915, p. 9) and Vandevelde (1981, p. 357). For a comparative analysis see also Mattei (2000, p. 18).
[4] Bridge (2002, p.12). See also Lawson and Rudden (1982, pp. 1 – 8).
[5] See nn. 154 - 155 in ch. 2 and accompanying text.

Legal theorists typically regard the concept of property as a "bundle of rights" that may be exercised by the rightful owner or possessor with respect to a thing. The interests that are associated with property are the three traditional rights of enjoyment, management and possession as understood in their broadest, most abstract form.[6] By enjoyment, one means the right to enjoy the benefits of property and receive an income from it. The right to management is the right to decide how and by whom the thing owned or possessed shall be used or transferred.[7] Lastly, the right of possession consists of two elements: 'first, the exercise of factual control over the [thing]; and secondly, the concomitant intention to exclude others from the exercise of control'.[8] The same "bundle of rights" does not necessarily attach to all forms of property, as there may be a need to detach some rights from others and to vest them in different persons. For instance, in the case of a bailment, there may be circumstances in which possession is distinguished from the enjoyment of the thing, as the factual control by one person (e.g. the hirer of a television set) may provide an income for someone else. Furthermore, under a trust the person who is to enjoy the benefits of property (i.e. the *cestui que trust* or beneficiary) is different from the person who has the actual management (i.e. the trustee). Hence, the "bundle of rights" is composed of 'legal building bricks, which can be used and put together in different ways'[9], depending on the intention of the parties.

This complex scenario clearly demonstrates the shift away from the Blackstonian conception of property as an absolute dominion over material things. The idea that it is possible to create multiple interests over the same asset (which can have different levels of exigibility against third parties) blurs the perception of property as a close and exclusive relationship between an individual and a thing[10].

In support of this argument, it should be borne in mind that during these last decades the concept of property has faced new challenges due to a significant change in economic needs and conditions. Nowadays, a large proportion of people's wealth

---

[6] Certain legal theorists commonly divide property into a large number of constituent rights, such as the right to the income, the right to possess, the right to use, the right to manage and the right to security. For instance, Honoré and Becker identified 11 and 13 different elements, respectively, which constitute property. See Honoré (1961, p. 116) and Becker (1980, p. 190).
[7] Honoré, (1961, p. 116).
[8] Bridge (2002, p. 17).
[9] Bell (1989, p. 5).
[10] Schroeder (1996, p. 1286); *Id.* (1994, pp. 277-305) and Grey (1980, p. 69).

consists of intangible (or incorporeal) property.[11] In other words, the assets which are today considered to be of relevant value to parties are no longer related solely to land, goods and other tangible assets but may be extended to a variety of incorporeal movables, such as debts[12], goodwill, shares in a company and various forms of intellectual property. In addition to the increased use of diverse types of intangible property, another factor has significantly developed over the last decades, i.e. the heavily intermediated nature of modern markets. Indeed, a large part of financial and commercial practice is now built on the creation of indirect relationships between holders of a proprietary right and the underlying asset to which such a right relates. This practice is based on the existence of multiple fiduciary relationships where parties act in relation to the property or affairs of others.[13] Indirect holding systems may be used for a variety of purposes, such as tax planning, pension and charity fund management as well as investment or banking services[14].

In this context, one could question whether the concept of property can also easily accommodate rights over intangible assets too, especially where such rights are asserted through a number of intermediaries. For the most part, these concerns are perceived in the financial sector, particularly when dealing with the legal framework governing the practice of indirectly held securities (also known as intermediated securities). Today, most investors hold their assets (i.e. equity and debt securities) indirectly, through one or more intermediaries (such as financial institutions, brokers, depositories and other professional investors). The central point of this practice is that investors may be

---

[11] For centuries, land had been regarded as the most valuable asset. In the 19th century and the early 20th century, as a result of the industrial revolution, the focus shifted from land to manufactured goods. More recently, the traditional concept of property, in terms of material wealth, has undergone yet other significant changes. In particular, over the past fifty years, the importance of intangible property as a source of wealth has grown significantly. See on this point Harris and Mooney (2006, p. 358) and Bridge (2002, p. 4).

[12] These 'assets' are classic examples of 'pure intangibles'. They are defined as 'those legal rights *in personam* to pay a certain sum of money or deliver specified property, which the right holder can transfer to someone else by assigning them', Penner (1997, p. 109). Indeed, such rights represent 'an item of value because they can be transferred to a third party by way of sale or security for a loan', Bridge (2002, p. 6).

[13] The fiduciary relationship between the parties may take various forms, depending on the specific terms of the contract governing such relationship. For example, in common law jurisdictions fiduciary relationships are typically created through a trust. The main characteristic of the law of trust is that it allows the beneficiary and the trustee to own the property simultaneously in different ways (i.e. through legal and equitable ownership, respectively).

[14] For example, William Amos of the Financial Conduct Authority ('FCA') has recently emphasised that with regards to financial markets '[i]n 2013 UK-managed assets stood at £5.2tn and generated £13bn in management fees', Amos (2014). In addition, '[t]he UK ranked first in Europe and second worldwide, after the US, measured by assets under management (AUM). 8% of global financial assets and 36% of European financial assets under management were managed in the UK', *Id.*

separated from the issuer of the underlying securities by multiple layers of intermediaries (often spanning a number of jurisdictions). Recent research has aimed to evaluate whether this new practice "requires special treatment or whether it can be dealt with on ordinary legal principles"[15].

Unlike most civil law systems, English law has managed to adapt many new issues arising from the practice of intermediated securities within the existing framework. For example, the complex indirect holding structure is built on the well-developed institution of trust and sub-trust which allows investors to obtain equitable proprietary rights in the assets held for them by the intermediary.

Interestingly, the proprietary characterisation of these types of rights has recently been challenged by McFarlane and Stevens, on the grounds that they seem to be able to establish the same level of protection against third parties, by classifying the investors' rights as 'persistent rights' or 'rights against rights'[16]. Their main argument is that in an indirect holding system the investor's right does not attach to the underlying securities, being simply a (*sui generis*) right against the right held by the intermediary. The advantage of using the concept of a persistent right (rather than a proprietary right) is that it provides a better understanding of the legal structure of intermediation, as well as showing that no statutory intervention is necessary within the United Kingdom.

This thesis tests the theoretical foundation of McFarlane and Stevens' argument, attempting to demonstrate that the investor's right is to be classified as proprietary rather than *sui generis*. In this regard, the author evaluates two alternative solutions to the theory of a right against a right (both conferring proprietary status to the investor's title). The first solution is based on the idea of an indirect right *in rem* which means considering the investor as holding a right that attaches *indirectly* [emphasis added] to the underlying securities. The second approach is that of an interest in a sub-property and is meant to identify the investor's item of property with "something" that is separate and distinct from the underlying securities, corresponding to the right of the intermediary. More specifically, in the latter case the investor holds a proprietary right in the intermediary's proprietary right in the underlying securities.

15 Gullifer (2010, p. 8). Among others see also Benjamin (2000, paras. 1.105 - 109) and Yates and Montagu (2013, paras. 3.10 – 3.55).
16 McFarlane and Stevens (2010 a, p. 37).

The primary objective is to highlight the idea that while an indirect right *in rem* may create certain difficulties when explaining the practice of indirectly held securities, the theory of an interest in a sub-property can easily be accommodated to the complexities of intermediation. Indeed, there are many similarities between the idea of an interest in a sub-property and the theory of a right against a right; yet the author believes that the former should be preferred to the latter due to its closer consistency with the historical development of English property law.

The thesis also intends to critically evaluate the idea suggested by McFarlane and Stevens that the introduction of changes to the existing legal framework is not warranted. In particular, it will show that neither the theory of a right against a right nor that of an interest in a sub-property can really help us overcome all the legal uncertainties typically associated with the indirect holding system and that there are consequently still definite areas where the case for a statutory intervention may prove beneficial.

The thesis is developed over six chapters. The first chapter introduces the issue of indirectly held securities and provides a general background to the latest legal developments in relation to securities holding practices. The second chapter demonstrates that there is no need to apply the theory of a right against a right to the practice of intermediated securities, as English property law seems capable of explaining the nature of the investors' rights. The last four chapters identify certain examples of legal uncertainty which afflict today's modern markets and thus seek to determine whether the theory of a right against a right or that of an interest in a sub-property can provide clear answers to these practical problems.

Chapter 1: Intermediated interests in intangible assets

1. A general background

Over the past decades, the practice of holding and transferring securities in financial markets has changed substantially, with a definite shift away from direct holdings of paper-based securities to indirect (book-entry) holdings. Nowadays, investors hold their financial assets through one or more intermediaries and securities are issued and transferred by means of intangible electronic records rather than paper certificates.

Prior to the widespread use of information technology, securities had always been issued and transferred in paper-based form. However, by the early 1970s in the United States and the 1980s in the United Kingdom, this practice involving the actual physical movement of paper instruments or certificates became subject to ever more severe strain. The administrative burdens and the risk of loss created by the vast amounts of paper that had to be moved around the system made paper-based transfer procedures labour-intensive and insecure, as well as posing strong limits to the number of transfers that could actually be processed. As a result of this, the physical delivery of paper documents has since been largely replaced by electronic settlement, which involves a technique called 'book-entry transfer'. The new practice entails the use of an electronic system, whereby the interest of the investor is represented by a credit entry to his/her securities account and transfers are made in the same way as bank funds transfer (i.e. by debit and credit entries to such accounts)[17]. Consistently with this practice, the credit of securities to the account of an intermediary confers on the investor the right both to dispose of the securities and to receive the corporate and economic benefits attached to the financial assets[18].

[17] Gullifer (2010, p. 16) and English Law Commission (May 2008, para. 2.25).

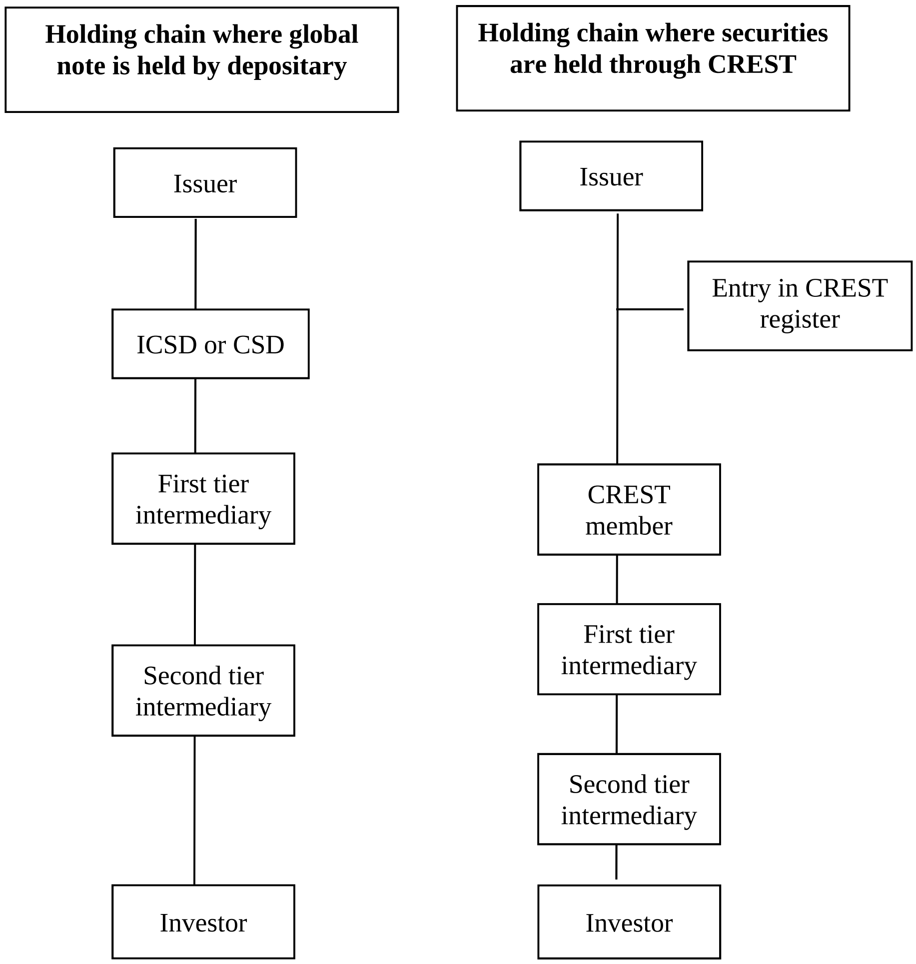
[18] In the case of debt securities, these benefits include the right to the repayment of the principal sum (usually claimed at a specified maturity date) and the right to regular interest payments. In the case of equity securities (also known as shares), the investor generally enjoys the right to receive dividends as well as the right to vote as a shareholder. However, the duty of the intermediary to exercise voting rights on behalf of the investor is often excluded in the account agreement. For an analysis of the rights enjoyed by the investor see Article 9 (1) of the UNIDROIT Convention (Kanda et al. 2012, paras. 9-4 - 9-33), Principle 3 (1) set out by the European Commission (2010, paras 3.1 - 3.2) and English Law Commission (May 2008, paras. 4.38 and 4.42).

There are two different models of electronic settlement, namely immobilisation and dematerialisation. The latter is the path that has been largely adopted by the United Kingdom and consists of the 'elimination of physical certificates or documents of title, which represent ownership of securities, so that securities exist only as computer records'[19]. More specifically, dematerialised securities, when issued, are recorded in the UK electronic settlement system called CREST, now Euroclear UK & Ireland Ltd (to which only certain financial institutions have access) and transfers are recorded in that register. CREST maintains securities accounts in the name of its members, who have a direct relationship with the issuer. Members of CREST may hold securities on their own behalf or, more frequently, as intermediaries on behalf of other intermediaries, who in turn hold for investors. In practice, there are often a number of intermediaries who hold securities for investors[20]. This means that in a very simplified scenario, a member of CREST holds for a first-tier intermediary, the first-tier intermediary holds for a second-tier intermediary and so on down the chain to the investor (figure 2). However, chains are frequently more complex, since 'each intermediary may acquire its holdings of the same issue from a variety of sources rather than a single one'.[21] Hence the tiering of relationships creates 'a pyramid structure in which the issuer can deal with a relatively small number of large players who in turn will hold accounts for a greater number of smaller participants, and so on down through the pyramid to the ultimate investor'[22].

An alternative method to dematerialisation, used in many countries including the United States, is immobilisation. In this case, unlike dematerialisation, paper documents and certificates continue to exist. However, in order to avoid physical movement, such instruments or certificates are retained (i.e. immobilised) by a depositary, that is linked to a settlement system[23]. Accordingly, property rights in securities move between market participants in the settlement system by book-entry transfer. In a typical scenario involving immobilisation, large pools of securities of different issuers are retained with a central security depository (CSD) and investors hold securities indirectly through a tier of intermediaries that are ultimately connected to the central securities depository (figure 1)[24]. This means that, consistently with dematerialisation, even in

[19] The Group of 30 (1989).
[20] Benjamin (2007, para. 19.04)
[21] FMLC (July 2004).
[22] Gullifer and Goode (2013, para. 6-07).
[23] *Id.*
[24] In the United Kingdom, UK securities are not immobilised in a CSD. CREST (now called Euroclear UK & Ireland Ltd) is a settlement system through which dematerialised UK securities are held. This

cases like this a number of intermediaries may stand between the investor and the issuer. In practical terms, the difference between immobilisation and dematerialisation does not affect the holding structure as a whole but only the relationship between the issuer and the depositary or CREST member.



Figures 1 and 2
Source: Gullifer and Payne (2010), p. 3.

The effect of these changes in the financial market infrastructure is to (i) reduce the movement of paper involved in the issue and transfer of securities; (ii) facilitate rapid dealings; (iii) increase the volume of business in financial markets; and (iv) facilitate stock lending as well as sale and repurchase agreements ('repos')[25].

means that CREST 'does not hold securities, since its members hold direct from the issuer', Gullifer and Goode (2013), para. 6-07 (n. 33).

[25] These types of secured financing transactions are an efficient source of money-market-funding and are typically used by broker-dealers and leveraged investors (such as hedge funds seeking funding). In very general terms, a repo consists of a transfer of title in the securities coupled with an agreement to buy back the same type of securities at a specified price and at a future date. A secured loan is economically very similar to a repo. Hence, the two transactions are often used as substitutes for each other. For an analysis of repos see (among others) E. Lomnicka (2012 a, paras. 7.58 - 7.71) and *Id.* (2012 b, paras. 5.56 - 5.69).

In 2004 it was estimated that on a worldwide basis, investment bonds, shares and other investment securities worth approximately €50 trillion were held indirectly[26].

However, it has recently been argued that while the practice of securities markets has changed considerably, its legal framework has lagged behind and is now outdated[27]. In 2004, the Financial Markets Law Committee (the 'FMLC') proposed legislative intervention in the United Kingdom, having found that the existing framework still relied on traditional legal concepts based on the assumption that tangible assets held in physical form were involved.[28]

The need to introduce changes to the existing legal framework is also felt at a European and international level, in the context of cross-border transactions, which play a significant role in securities markets. This concern was raised by (i) the Legal Certainty Group (the 'LCG'), in its 2008 Advice to the European Commission on the need for new legislation on intermediated securities[29] ('LCG Advice') and (ii) UNIDROIT, in the Convention on substantive legal rules regarding securities held through securities accounts, which was adopted in 2009 (the 'UNIDROIT Convention').[30]

2. The legal structure of intermediation and its implications on the investor's rights

---

[26] UNIDROIT (December 2004, para. 1.2.3).

[27] In England, the practice of indirectly held securities has been studied for over a decade. Among others see Benjamin (2000); *Id.* (2003 pp. 249 – 304); Gullifer and Payne (2010); Austen-Peters (2000); Yates and Montagu (2013); Gullifer and Goode (2013, paras. 6–01 – 6-45) and Micheler (2007).

[28] FMLC (July 2004). Following publication of the FMLC Report in 2004, this matter was referred to the English Law Commission. See on this point English Law Commission (May 2008). According to Benjamin, this 'legal anachronism' may become a source of legal risk in investment securities, M. Yates and G. Montagu (2013, para. 1. 15) and Benjamin (2000, paras. 14. 35 – 14.43).

[29] LCG (August 2008).

[30] UNIDROIT *Securities Convention on Substantive Rules for Intermediated Securities* (Geneva, October 2009). The scope of the UNIDROIT Convention is broader than that of the work of the LCG as it aims to create a legal framework for intermediated securities that can be applied at worldwide level. It is not yet clear whether the European Commission and the EU Member States will decide to ratify the UNIDROIT Convention. The EU Commission is currently preparing a draft legislation on legal certainty of securities law (Securities Law Legislation – 'SLL') on the basis of the recommendation proposed by the LCG. Accordingly, a decision by the EU Commission and the Member States on whether to adopt the UNIDROIT Convention is not expected to be taken before the final content of the future SLD has been clarified (email correspondence with Klaus Löeber, European Central Bank, and Marcel-Eric Terret, European Commission, DG Internal Market Financial Markets Infrastructure, Monday 5/10/2010). However, setting such a decision aside, it is expected that the 'European Commission will strive to obtain a close convergence between the future [SLL] and the UNIDROIT Convention' (email correspondence with Klaus Löeber, European Central Bank, Monday 5/10/2010).

One of the issues that has captured significant attention among practitioners and academics concerns the need to devise a legal structure of intermediation. Thus, we may begin by asking, is it possible to apply existing legal concepts or is it necessary to create a new set of rules, which may be applied specifically to this practice?

English law applies the existing principles to describe the indirect holding system. In particular, it primarily adopts the concept of trust[31]. Hence, the investor is left as the beneficiary under the trust, to retain an equitable interest in the assets held for it by the intermediary. However, since financial practice usually involves a chain of intermediaries, a more complex analysis tends to apply, using the concept of a sub-trust. This means that the first-tier intermediary holds the assets on trust for the second-tier intermediary, who holds them on sub-trust for the third-tier intermediary and so on down the chain to the last investor. Pursuant to the rules of trust, only the first-tier intermediary has legal title to the assets[32]; all the other account holders simply enjoy equitable rights.

The main advantage in using the concepts of trust and sub-trust in the practice of indirectly held securities is that the investor's securities are not considered part of the intermediary's own estate but are treated as a separate fund[33]. As a result, the investor's assets are protected from the intermediary's credit risk[34].

---

[31] There is also another concept which may apply to securities, i.e. the concept of bailment. In this case, the intermediary (who acts as bailee) acquires possession of the securities, while legal ownership remains with the investor (who acts as bailor). However, in order for the bailee to obtain possession the securities must be bearer securities. This means that in the case of intangible assets (namely securities that are registered in the register of the issuer or are evidenced by a credit to the account of an intermediary) trust is considered the only alternative under English law which enables the investor to be protected against the intermediary's credit risk. See on this point also Austen-Peters (2000, pp. 26 – 27); Benjamin (2000, para. 2. 36); *Id.* (2007, paras. 19.08 - 19.11); Yates and Montagu (2013, paras. 3.12 – 3.13); FMLC (July 2004, para. 6.1) and English Law Commission (May 2008, paras. 2.59 and 2.62).

[32] Pursuant to Regulation 24 (6) of the *Uncertificated Securities Regulations* 2001, SI 2001 No. 3755 (USR), the entry in the CREST register confers to its members the legal title to the financial assets and determines the person or entity who is considered as the shareholder for company law purposes.

[33] Pursuant to Section 283 (3) (a) of the Insolvency Act 1986, the assets held on trust by an individual who is bankrupt cannot be considered part of his/her estate. Similarly, when the insolvent trustee is a company, the assets of the beneficiary are not available to the trustee's creditors. On this point see, for example, *Habana Ltd v Kaupthing Singer & Friedlander (Isle of Man) Ltd* [2011] W.T.L.R. 275; (2009-10) 12 I.T.E.L.R. 736; HC (IoM); *Barclays Bank Ltd v Quistclose Investments Ltd* [1970] A.C. 567, [1968] 3 W.L.R. 1097, [1968] 3 All E.R. 651 and *Kayford Ltd (in Liquidation), Re* [1975] 1 W.L.R. 279.

[34] *Commentary on Principles For Investment Securities Statute*, Principle 3, in FMLC (July 2004, para. 9); English Law Commission (May 2008, para. 2.61); Benjamin (2000, para. 2. 35) and Yates and Montagu (2013, para. 3.10 – 3-13/ 3-17).

This principle of 'insolvency immunity' or 'insolvency ring-fencing' is considered 'fundamental to the viability of an intermediated holding system.'[35] The reason for this is that an investor would be unwilling to rely on an indirect holding system if such a system may not preserve the allocation of risk[36]. In market practice, when purchasing securities the investor takes on the risk of the transaction as well as being entitled to the potential returns that may be generated by the investment whereas the intermediary only acts on behalf of the investor and shares neither the investment risk nor its returns. As a result, if the investor's assets were available to the intermediary's creditors, the allocation of investment risk would be significantly distorted[37].

Another benefit related to the concepts of trust and sub-trust is that they can facilitate the application of the so-called no-look-through principle which is considered essential to the practice of indirectly held securities[38]. In particular, such a principle requires the investor to hold rights only against the intermediary in whose account such rights are recorded (i.e. the relevant intermediary). This means that the investor is prevented from making claims against other intermediaries standing further up the chain (i.e. higher-tier intermediaries)[39].

The reason that lies behind this principle is that in market practice it is difficult, if not impossible, to trace the chain of title from the last investor up to the highest-tier intermediary. One of the explanations for this impediment is that each intermediary only has details of his/her own account holder and therefore has no direct access to information about those parties standing either further up or further down the chain[40].

---

[35] English Law Commission (June 2006, para. 1.31). On the importance of safeguarding the account holder's assets from the credit risk of his/her intermediary see also Gullifer (2010, p. 18); Benjamin (2000, paras. 2. 35 and 2.39) and *Commentary on Principles For Investment Securities Statute*, Principle 3 in FMLC (July 2004, para. 9).

[36] English Law Commission (May 2008, paras. 3.2 - 3.4).

[37] English Law Commission (June 2006, para. 1.32 - 1.33) and *Id.* (March 2006, paras. 1.57 and 1.60). In the 2006 paper on intermediated securities, the English Law Commission emphasised that an 'investor ultimately entitled to securities must have confidence that this protection against creditors applies to account holders at every level in the custody chain and regardless of the jurisdiction in which the securities account is located', *Id.* (June 2006, para. 1.31). However, pursuant to the no-look-through principle the investor is not necessarily in a position to directly enforce his/her claims against the insolvent intermediary (who is standing for example, at the top of the chain). See text to nn. 189 and 207 in ch. 2.

[38] English Law Commission (June 2006, para. 1.234) and Gullifer (2010, p. 14).

[39] This principle applies in both common law and civil law systems as well as being stated under Article 9 (2) (b) and (c) of the UNIDROIT Convention. On this point see also European Commission (2010, para. 12.2); English Law Commission (March 2006, para. 1.46) and *Id.* (June 2006, paras. 1.237 and 1.247).

[40] However, see the case of certain jurisdictions which apply the so-called 'transparent' system, English Law Commission (May 2008, paras 2.43 - 2.45).

For example, the highest-tier intermediary is unlikely to have any record of the lowest-tier account holder. As a result of this lack of information it would be difficult for the highest-tier intermediary to evaluate the validity of a claim made by the lowest-tier account holder without facing considerable expense and excessive delay.[41] In order to avoid these consequences, the no-look-through principle states that the intermediary is only liable to parties that have a direct relationship with the said intermediary, rather than to 'an indefinite number of unidentified'[42] parties standing along the chain[43].

In certain jurisdictions (including the one in the UK), the level of enforcement of the investor's rights is more restricted, in order to prevent the investor from making claims not only against higher-tier intermediaries but also directly against the issuer[44]. This means that the investor receives the benefits attached to the securities only from the relevant intermediary, who is then required to pass the investor's claims up the chain to the issuer.[45]

These restrictions on the level of enforcement of the investor's rights are consistent with the law of trust which generally prevents the investor, as the beneficiary under a sub-trust, from 'looking-through' the relevant intermediary (who acts as the sub-

41 Gullifer (2010, pp. 14 – 15) and FMLC (July, 2004, para. 6.5).

42 English Law Commission (June 2006, para. 1.234).

43 The difficulty in tracing the chain of title through multiple layers of intermediaries is further exacerbated by the practice of using netting arrangements. While netting has the advantage of facilitating transfers and settlements, it can also create a number of difficulties in the tracing of securities (or their proceeds) from one account to another, as well as in finding the corresponding debit for a particular credit entry. See on this point, Gullifer (2010, p. 14); FMLC (July 2004, para. 6.5) and English Law Commission (August 2008, para. 2.46). As emphasised by most practitioners, the no-look-through principle 'allows an intermediary to quantify and manage its risk by reducing most of its system risks to bilateral risk assessments', English Law Commission (June 2006, para. 1.234).

44 These are the so-called 'indirect holding' systems. They apply to common law jurisdictions as well as to some civil law jurisdictions (such as those in Belgium and Luxembourg). The alternative is a direct holding system, (which applies, for example, in Germany, Austria, France, the Netherlands and Spain) where investors can enforce their rights directly against the issuer. Pursuant to Article 9 (2) (b) of the UNIDROIT Convention, the Contracting States have the choice of determining whether an investor may enforce the rights 'attached' to the securities directly against the issuer. See on this point also Principle 1 (2) of the European Commission (2010, para. 1.2) which states that '[t]he legislation should not harmonise the legal framework governing the question of whom an issuer has to recognise as the legal holder of its securities.'

45 However, such restrictions may threaten the effective exercise of voting rights or other discretionary rights by shareholders (due primarily to the technical difficulties and the excessive costs incurred by intermediaries when passing voting instructions and other relevant information along the chain, European Commission (2010, paras 17.1 - 17.2). See on this point also the Kanda et al. (2012, paras. 28.12 and 28.13; Mooney (2008, pp. 50 – 51); Mooney and Kanda (2010, pp. 89 – 91) and European Commission (2011), para. 3.17.1.3 and LCG (August 2008, para. 14.3.3). For a detailed analysis of the difficulties incurred by intermediaries in exercising voting rights on behalf of their account holders see Payne (2010, paras. 187 – 218) and Kahan and Rock (2009, paras. 259 – 261).

trustee)[46]. More specifically, these rules allow the investor to enforce his/her equitable rights only against the lowest-tier intermediary who passes the equitable claim up the chain to the highest-tier intermediary[47]. As the legal owner of the securities, only the intermediary standing at the top of the chain is entitled to bring a claim directly against the issuer; all the other account holders are restricted to enforcing their equitable rights against the relevant intermediary.

Therefore, the co-existence of these equitable interests linked one to another in a series of sub-trusts and, more importantly, the limitations posed on the investor in enforcing his/her rights along the holding chain of the intermediaries, raises doubts as to the exact nature of such rights. In other words, what is it that is held by the investor on the account?[48] Is it a right to a 'thing' (right *in rem* or proprietary right), a right against a person (right *in personam* or contractual right) or rather a *sui generis* right?[49]

The difficulty in providing clear answers to these questions re-opens an 'old' academic debate regarding the nature of equitable rights under a trust. Thus, the next chapter analyses the different theoretical approaches to the nature of equitable rights and seeks to ascertain which approach is best suited to laying down a solid legal foundation for the practice of indirectly held securities and, in particular, to establishing the precise nature of the investor's right.

Such an analysis is truly essential, as it would help us comprehend the complexity of the custody chain as well as testing the ability of the exiting principles of trust to *fully* [emphasis added] explain this new practice.

---

46 See text to nn. 189 and 207 in ch. 2.

47 *Commentary on Principles for Investment Securities Statute*, Principle 2 (d), in FMLC (July 2004, paras. 6.5 and 9); English Law Commission (June 2006, paras. 1.232 - 1.242) and Gullifer (2010, pp. 14 – 15).

48 Gullifer and Goode (2013), para. 6–18.

49 Gullifer (2010, p. 19).

Chapter 2: Re-conceptualising securities ownership

1. The nature of the beneficiary's rights under a trust: proprietary rights or purely personal rights?

The nature of equitable rights in property has long been the focus of academic debate. Particularly, in the case of trusts some scholars view the equitable right of a beneficiary (also known as the *cestui que trust)* simply as a right *in personam* (i.e. a personal right) against the trustee and not as a right *in rem* (i.e. a proprietary right) exercisable against the trust fund[50].

This debate started sometime between the end of the 19th century and the beginning of the 20th century, when the historian and legal theorist Frederic Maitland challenged the proprietary nature of equitable rights under a trust. During one of his celebrated lectures on equity, Maitland argued that equitable rights cannot be classified as proprietary rights as they are not enforceable against certain types of third parties, namely *bona fide* purchasers for value who have obtained a legal right in the assets without notice of the trust[51].

According to Maitland, this view seems to be consistent with the historical evolution of the equitable rights under a trust[52]. In this regard, it should be mentioned that as far back as medieval law the *cestui que trust* was considered as having merely a personal right against the trustee (i.e. a right to the proper performance of the trustee's obligations) and such a beneficiary was not entitled to prevent third parties from interfering with his/her rights[53]. It was only later, in the mid-17th century, that the developing rules of equity gradually changed this approach by extending the protection of the beneficiary's rights against an increasing number of diverse classes of persons[54]. In particular,

---

50 Maitland (1936, p. 107); Langdell (1908, pp. 5 – 6); Ames (1913, p. 262); Holland (1882, pp. 140 – 261) and Stone, (1917, p. 467).
51 Maitland (1936, p. 120).
52 For an analysis of the historical evolution of the equitable rights under a trust see Worthington (2006 b, pp. 3 – 67); Gardner (2011, pp. 217 - 225); Penner (2012, p. 30) and Waters (1967, p. 219).
53 This point was emphasised by Sir Edward Coke at the end of the sixteenth century, Coke (1639 p. 272 b).
54 The nature of the beneficiary's rights started to change significantly during Lord Nottingham's Chancery tenure (1673 – 1682). Lord Nottingham re-conceptualised the beneficiary's right as being analogous to legal estates, i.e. portions or slices of ownership over the same assets, Yale (1961, pp. 88 – 101). See also on this point also Gardner (2011, pp. 217 - 218).

pursuant to the rules of equity the *cestui que trust* was granted protection against (i) purchasers for value who had actual or constructive notice of the trust (i.e. knew or had reasons to know that the assets had derived from a breach of trust); (ii) parties who had received the trust assets without consideration; (iii) parties who had inherited the trust property from the trustee as well as (iv) creditors of the trustee in cases where the latter had been declared bankrupt. This process took over two centuries but by the 19^{th} it was evident that the beneficiary could enforce his/her rights against all parties other than *bona fide* purchasers for value without notice of the trust.

While admitting that the equitable rights under a trust had become *almost* [emphasis added] equivalent to proprietary rights, Maitland infers that they had not yet reached that status[55]. The reason for this is that equitable interests were not considered by Maitland as 'rights against the world at large but [only as] rights against certain persons'[56]. In other words, the fact that such interests are always vulnerable to a *bona fide* purchaser for value without notice of the legal estate means that they cannot be asserted *erga omnes*[57] (i.e. they are not universal). These considerations led Maitland to perceive equitable interests essentially as rights of a personal nature that have a misleading resemblance to rights *in rem*.[58]

This interpretation proposed by Maitland is somewhat controversial. In particular, his approach to equitable rights attracts criticism from those scholars who consider such rights as property rather than mere obligation[59]. The rationale behind this argument is that the ability of the beneficiary to recover the assets from third parties (other than *bona fide* purchasers for value) is incompatible with the beneficiary having no more than a right *in personam* against the trustee. According to Austin Scott, 'a right *in rem* is usually defined to be a right available against the world at large, corresponding to a duty imposed upon the world at large; and by the world at large is meant indeterminate

---

55 Maitland (1936, p. 112).
56 *Id.*
57 However, from a comparative prospective, this argument does not seem convincing. In this regard, many civil law systems 'classify ownership as a right *in rem* despite the fact that their codes contain rules whose result is that these rights are not enforceable against a *bona fide* buyer for value in a large class of circumstances', Micheler (2007, p. 36). See on this point, for example, ss. 135, 136, 883, German Civil Code (BGB); s. 365 Austrian Civil Code (ABGB); see also arts. 9, 900, 931, 937, Swiss Civil Code, art. 1153 Italian Civil Code and art. 2279 French Civil Code.
58 Maitland describes an equitable right as 'a right primarily good against *certa persona*, *viz.* the trustee, but so treated as to be almost equivalent to a right good against all [except innocent purchasers for value]', Maitland (1936, pp. 23 and 106 – 116). See on this point also Langdell (1908, p. 6).
59 Scott (1917, p. 269); Huston (1915, pp. 87 - 90 and Amos (1936/1937, p. 1264).

persons, an indefinite number of persons, not necessarily everyone in the world; and it is to be distinguished from a right *in personam,* or obligation, which is a right available against determinate persons, corresponding to a duty imposed upon determinate persons.'[60]

This approach is confirmed by Simon Gardner who emphasises that the rights of the beneficiary are considered proprietary since 'they do not simply rest on the trustee personally, but are […] attached to the trust assets'[61]. Once again, the principal manifestations of the proprietary quality of these rights (i.e. the attachment to the trust assets) can be identified by the following applications: firstly, the ability to prevent the trustee's creditors from claiming their share of the trust property and secondly, to give the beneficiary the possibility to trace the trust assets into the hands of any person other than *bona fide* purchasers for value without notice of the trust. Indeed, with regard to the latter there may be circumstances in which the beneficiary is entitled to make a claim against third parties only through the trustee. However, as will be broached in the next section of this chapter, in those cases in which the trustee is unwilling to enforce the trust, the beneficiary may bring proceedings directly against third parties under the so-called Vandepitte procedure. Thus, following this analysis it is possible to argue that the beneficiary enjoys a bundle of interests, which includes not only personal rights against the trustee but also proprietary rights in the trust assets.

2. The proprietary nature of the beneficiary's rights and the role of equity in English law

The proprietary characterisation of the equitable rights under a trust has greater acceptance among English scholars than Maitland's view, which assigns mere personal rights to the *cestui que trust*[62]. In particular, it is argued that 'where it appears that the right is enforceable against third parties the expression 'an equity' has come to be used in the sense of a proprietary interest ranking at the bottom of a hierarchy of proprietary

[60] Scott (1917, pp. 273 – 274).
[61] Gardner (2011, p. 210). In particular, Gardner considers to be 'attached' to the trust property certain fundamental obligations that trustees owe to the beneficiaries, i.e. 'their duties to respect the fact that the property is not beneficially their own', *Ibid.*, p. 13. These obligations on the part of trustees are matched by the corresponding rights of the beneficiaries, which, like the trustees' obligations, are also 'attached' to the trust property, *Ibid.*, pp. 210 – 215.
[62] Gardner (2011, pp. 210 – 225); Virgo (2012, pp. 54 – 57); Martin (2012, para. 1-019); Moffat et al. (2009, pp. 249 - 252); Worthington (2006 b, pp. 63 – 67); Gray and Gray (2009, paras. 7.1.1. and 7.1.3) and Webb and Akkouh (2013, pp. 29- 30) and Rudden (1987, pp. 239 – 241- 243).

interests'[63]. This approach is also supported by the English courts[64] and by statute law[65] which both recognise the beneficiary as having a proprietary right in the trust assets. However, these equitable proprietary rights are generally considered to be of a special nature since they do not operate in the same way as legal proprietary rights. According to Martin '[t]o argue that a beneficiary's rights are proprietary is not to say that legal rights are the same as equitable or that equitable ownership is the same as legal'[66]. On the contrary, '[…] it is to accept the basic peculiarity of ownership under the English law of trusts'[67]: '[t]he trustee is the owner at law and the beneficiary is the owner in equity'[68].

As mentioned earlier, one of the main differences is that unlike legal proprietary rights the equitable interests of a beneficiary under a trust are at all times vulnerable to the *bona fide* purchaser for value. The rationale behind this principle is that in the case of a trust the beneficial interest is 'hidden' in as much as it is the legal owner (acting as the trustee) who usually has possession of the property. Hence, under these circumstances there is a greater risk that third parties (who acquire such property) will be unaware of the existence of a trust[69]. This may explain why, according to equity rules, *bona fide* purchasers (to whom trust property is transferred) are protected from the risks created by trusts[70].

---

63 Neave and Weinberg (1978-1980 pp. 24 and 38). For a different view, see Nolan, who defines the beneficiary's proprietary rights as negative or 'exclusionary' (i.e. negative 'rights to exclude non-beneficiaries from the enjoyment of the trust assets' as opposed to positive rights to impose trustee duties on such assets, Nolan (2006 a, p. 233) and *Id.* (2006 b, 19).

64 *Tinsley v. Milligan* [1994] I AC 340, p. 371 (Lord Browne-Wilkinson); *Westdeutsche Landesbank Girozentrale v. Islington London Borough Council* [1996] AC 669, 705 (Lord Browne-Wilkinson) and *Foskett v. McKeown* [2001] I AC 102, 108, 127 (Lord Millett). See, more recently *Lehman Brothers International (Europe) v CRC Credit Fund Ltd and others,* [2012] UKSC 6; *Re Lehman Brothers International (Europe)* (No. 2) [2009] EWCA Civ 1161; *Pearson v. Lehman Brothers Finance SA* [2011] EWCA Civ 1544 which describe the interests of a beneficiary under a trust as property rights rather than mere personal rights. The European Court of Justice, however, reached the opposite conclusion in *Webb v. Webb* Case C 294/92 [1994] QB 696 (not followed in *Re Hayward (deceased)* [1996] 3 WLR 674 but applied in *Ashurst v. Pollard* [2001] 2 All ER 75 and *Prazic v. Prazic* [2006] EWCA Civ. 497).

65 See, for example, Section 22 (1) of the Trusts of Land and Appointment of Trustees Act 1996 which expressly defines the interests of a beneficiary under a trust as 'interests in property'.

66 Martin (2012, para. 1-019). See on this point also Virgo (2012, p. 51).

67 *Id.*

68 *Id.*

69 Trusts are apt to mislead third parties: 'the trustee, by virtue of his possession of the property, will appear to the outside world to be beneficially entitled to it, whereas in fact the beneficial interest lies elsewhere', Webb and Akkouh (2013, p. 35). See also Hargreaves (2011, p. 174). This may explain why, according to equity rules, *bona fide* purchasers (to whom trust property is transferred) are protected from the risks created by trusts.

70 This reasoning is consistent with Section 25 of the Sale of Goods Act 1979 (SGA) which deals with circumstances where a *bona fide* purchaser can defeat the legal title of an owner. However, doubts were raised about this argument, Webb and Akkouh (2013, pp. 35 - 36).

Furthermore, the beneficiary cannot bring a direct claim against third parties who steal[71] or carelessly damage the trust property[72]. In these cases, the general rule is that the claim for tort of conversion or tort of negligence lies only with the trustee[73], who holds the legal ownership and has either possession or the right to immediate possession[74]. Should the trustee refuse to make a claim against the third parties, the beneficiary may commence an action to compel the trustee to do so. Alternatively, under the *Vandepitte* procedure the beneficiary may be entitled to sue the tortfeasor but only to the extent that the trustee is made a party to the proceedings.

The procedure is known as Vandepitte, after the case *Vandepitte v. Preferred Accident Insurance Corp. of New York*[75]. In *Barbados Trust Co Ltd (formerly known as CI Trustees (Asia Pacific) Ltd) v Bank of Zambia & Anor* the court argues that this procedure 'simply provides a short cut to prevent litigation under which the trustee could be forced to sue followed by an action under which the trustees sues'[76]. Indeed, there have to be 'special circumstances' entitling a beneficiary to take part in the proceeding against the tortfeasor (e.g. cases where the conduct of the trustee is subject to criticism or where the trustee is unable to sue)[77].

Once again, these rules seem to confirm that (as a general principle) the beneficiary can only enforce his/her equitable interest indirectly *through* [emphasis added] the trustee[78].

---

71 See among others, *MCC Proceeds Inc v Lehman Brothers International (Europe)* [1998] 4 All E.R. 675 CA. According to Palmer, however, a very limited number of cases may lead to suggestions that the beneficiary is entitled to claim in conversion, Palmer, (1986, p. 228).

72 The beneficiary is also prevented from suing for tort of negligence those parties who have damaged or caused economic loss to the trust assets. See on this point, *Leigh & Sillivan v. Aliakmon Shipping Co. Ltd (The Aliakmon)* [1986] AC 785, 809 (Lord Brandon).

73 For a discussion on 'how the courts are currently approaching the issue of direct common law claims by the beneficiary against third parties', see Hargreaves (2011, p. 169). See also Smith (2008 p. 521); Virgo (2012, p. 52); Low (2010, p. 507); Hawes (2011, p. 336); Tettenborn, (1996, p. 39) and Barker (1998, p. 153). However, this principle (which prevents the beneficiary from directly suing third parties) does not apply if the trustee participated in the interference with the trust asset, since in such circumstances no wrong would be committed by the third party.

74 The beneficiary is entitled to bring an action directly against the tortfeasor only in the exceptional circumstances where he/she has acquired possession of the property. However, in such cases the beneficiary has to rely on his/her possessory title rather than his/her equitable interest, *Healey v. Healey* [1915] 1 KB 938; *International Factors v. Rodriguez* [1979] Q.B. 351, 359-360; *Stroud Architectural Services Ltd v John Laing Construction Ltd* [1994] 2 BCLC 276; *MCC Proceeds Inc v. Lehman Brothers International (Europe)* [1998] 4 All E.R. 675, 691; *London Borough of Hounslow v. Jerkins* [2004] EWHC 315 (QB) and *Leigh & Sillivan v. Aliakmon Shipping Co. Ltd (The Aliakmon)* [1986] AC 785, 809, 812.

75 [1933] A.C. 70 P.C.

76 [2007] 1 CLC, 434, 452.

77 *Hayim v. Citibank NA* [1987] A.C. 730 PC, 747

78 In *Roberts v Gill & Co and another* [2010] UKSC 22, [2011] 1 A.C. 240, 262, Lord Collins of Mapesbury JSC stated that 'joinder […] has a substantive basis, since the beneficiary has no personal right to sue, and is suing on behalf of the estate, or more accurately, the trustee'. See also *Parker-Tweedale v. Dunbar Bank*

The reason why both the tort of conversion and the tort of negligence are restricted to cases involving legal proprietary interests or possessory interests lies in the common law nature of these actions, since common law does not recognise the equitable title of the beneficiary under a trust[79].

These differences seem to suggest that equitable ownership is weaker than legal ownership in so far as (i) it does not bind *bona fide* purchasers for value and (ii) it allows the beneficiary to bring a tort action against third parties only through the trustee.

The special nature of equitable ownership is deeply rooted in the historical development of the concept of trust and, more importantly, in the role that was played by equity in creating new forms of property.

The core idea is that over the centuries the rights of a beneficiary under a trust gradually changed from purely personal rights into property[80]. This was made possible through the rules of equity, which have provided the beneficiary's rights with specific advantages typically related to ownership and other proprietary rights.

The creation of this new form of property is part of a broader process that characterised the development of certain equitable rights and resulted in a significant expansion of the

---

Pic. (C.A.) [1991] (Ch) 12, 19. See, however, *Shell UK Ltd v. Total UK Ltd* [2010] EWCA Civ. 180, [2011] QB 86, where the Court of Appeal considers (i) the beneficiary 'the real owner' of the trust assets, 'the legal owner being little more than a bare trustee' (*Ibid.,* p. 99) and (ii) consequently, recognises the right of the beneficiary (in his/her capacity as the equitable owner of the assets) to bring a direct claim against the third parties (provided that the trustee is made a party to the proceedings) (*Ibid.*, pp. 98 - 103). In particular, the Court of Appeal held that the beneficiary could recover all consequential losses, including those that were suffered merely by the beneficiary and not by the trustee (namely, economic losses caused by the destruction of the trust property). This decision was criticized by most legal scholars. For example, according to Hargreaves 'the suggestion that Shell is the "real owner" fundamentally misunderstands the orthodox view of the beneficiary's interest', Hargreaves (2011, p. 166). Indeed, continues Hargreaves, 'it is the trustee who holds the legal title and therefore it is always the trustee who is the "real owner"', *Id.* The Court of Appeal based its decision primarily on the argument that the question at stake was not the recovery for the physical damage of the goods but merely for consequential losses (which were not suffered by the trustee). However, Hargreaves considers this argument poorly convincing since 'if the beneficial owner was unable to recover for damage to the property itself, it would be an odd result if he/she can recover for consequential economic losses suffered as a result of the same damage', *Id.* Furthermore, to provide a direct claim to the beneficiary would come at the cost of unacceptably undermining the structure of a trust (in as much as the main purpose of a trust is to centralise in the hands of the trustee the 'management and enforcement functions', *Ibid.* p. 174). For a similar view on this decision, see also Turner (2010, pp. 445 – 447); Edelman (2013, p. 66) and Low (2010, p. 507).

[79] Rushworth and Scott (2010, p. 537); Penner (2009, p. 255) and Hargreaves (2011, p. 164). In *MCC Proceeds Inc v Lehman Brothers International (Europe)* [1998] 4 All E.R. 675, 691, Mummery LJ stated that 'an equitable owner under a trust had no title to sue in conversion at common law' and that the fusion of law and equity by the Judicature Acts of 1873 and 1875 had not changed this common law rule.

[80] Worthington (2006-2007, p. 930) and McKendrick and Goode (2009, p. 42).

notion of property[81]. Equity carried out this process by correcting the common law and treating certain personal rights as proprietary.

The development of these equitable interests was achieved by adopting two different mechanisms. Firstly, equity recognised new categories of interests in property under the notion of trust and of equitable charges. It did this by allocating to different parties the bundle of rights that are typically associated to ownership[82]. For example, with regard to a trust, the management of the trust property (including the right of alienation and the right of possession) is allocated to the trustee, while the beneficiary retains the substantial enjoyment of the thing. The main characteristic of the law of trust is that it allows both the trustee and the beneficiary to own the property simultaneously in different ways (i.e. through legal and equitable ownership, respectively). However, as mentioned earlier, this form of 'dual ownership' was not a feature of the initial structure of trusts. The right of the beneficiary was originally classified as a purely personal right against the trustee and developed into a proprietary right only later. This change in nature was achieved essentially by granting proprietary protection to the beneficiary (namely, the power to exclude others from interfering with his/her right). A similar process to the one governing the structure of trusts can be found in relation to the creation of equitable charges, since both 'devices began as contractual arrangements ("personal obligations"), and slowly evolved until they were unequivocally recognised as delivering new (divided) property interest in the underlying […] asset'[83].

Secondly, equity transformed into property certain interests in intangible assets (e.g. debts and shares in a company) which were typically characterised by common law as 'personal rights against specific parties'[84]. Once again, this change was made possible by providing some form of proprietary protection to the holders of such rights, as well as permitting their assignment to third parties[85].

[81] Worthington, (2009, pp. 7 – 9).
[82] This 'fragmentation of ownership' was already known in common law due to the co-existence of different estates (i.e. freehold or lease) or interests (i.e. easement or charge) in land, Lawson and Rudden (1982, pp. 76 -97).
[83] Worthington (2006-2007, p. 921).
[84] *Ibid.* p. 920.
[85] By doing so, these interests were transformed 'from purely personal rights, which could simply be enjoyed, to proprietary rights, which could also be traded' (Worthington, 2006-2007, p. 35) and asserted against third parties.

The main difference between these two mechanisms is that in the second case (concerning interests in intangible assets) equity simply transformed existing rights from personal into proprietary, while in the first case it created new devices or 'novel divisions of bundle of rights'. These involved interests that were initially classified as personal and were later transformed into property (namely, the interest of the beneficiary under a trust and the interest of the chargee).

This new idea of property (based on the coexistence of legal and equitable rights) seems to support the argument that the interests of a beneficiary under a trust should be classified as proprietary rather than merely personal rights. However, the intervention of equity in commercial transactions and its implications on English property law make it rather difficult to use the classical Roman law dichotomy of rights *in personam* and rights *in rem* for these types of rights. Roman law defines property in terms of a sole and absolute dominion over things but this interpretation is not accepted in English law[86]. Hence, it would be rather misleading to define the proprietary nature of the equitable interests under a trust using Roman law terminology (i.e. referring to them as rights *in rem* as opposed to rights *in personam*) [87].

3. The theory proposed by McFarlane and Stevens: not proprietary rights but 'rights against rights'

An alternative approach would be to classify the equitable rights under a trust as *sui generis* rights. This approach is supported by Pettit, who considers the equitable rights of a *cestui que trust* 'not quite [proprietary] rights because of the doctrine of the *bona fide* purchaser' and not quite '[personal] rights because of the doctrine of following trust

[86] It could be argued that this holistic approach to property (based on a 'sole and despotic dominium' over things, Blackstone (1765 - 1769, book 2, chapter 1 - Of Property, in General) was never recognised in English law. Indeed, the practice of reducing ownership into a bundle of rights and allocating each of these rights to different parties was already accepted in early common law, Lawson and Rudden (1982, p. 76). Hence, the idea of creating multiple proprietary rights over the same asset was simply enhanced by equity.

[87] On the reluctance to use this *in rem-in personam* terminology, see, among others Waters (1967, p. 230); Turner, (1931, p. 138 ff. and Nolan (2006 a, p. 232). In *Livingstone v. Commissioner of Stamp Duties (Queensland)* (1960) 107 C.L.R. 411, p. 448 the *in rem-in personam* classification was deliberately avoided as 'more hindrance than help was likely to come from' [using this terminology]. Indeed, 'the courts have nearly always been content to examine the rights of the trust beneficiary in a pragmatic manner, very often with an eye on the issue between the parties and an intention that the merits of the case shall not be lost in theoretical speculation on the effects of the distinction between legal and equitable estate', Waters (1967, p. 230).

funds'[88]. As a result of this peculiar status, Pettit prefers to define the equitable interests under a trust as a 'hybrid' creation[89] or *sui generis* rights[90] rather than 'trying to force them into a classification which is really inadequate'[91]. The main problem is that Pettit does not further investigate into the nature of the beneficiary's right, as he fails to explain what exactly is meant by a 'hybrid' creation or *sui generis* right.

A step forward in this analysis is offered by Ben McFarlane and Robert Stevens who define an equitable right not as a 'right to a thing' (i.e. a proprietary right), or a 'right against a person' (i.e. a personal right) but as a 'right to, or against, a right' (i.e. a 'persistent right').[92] This new category of rights was coined to emphasise that equitable rights (e.g. under a trust) can be classified as *sui generis* rights since they do not attach to a 'thing' but rather attach or flow from the rights of another.[93] The advantage for equity, in recognising the concept of a right to a right is that 'it permits B to enjoy the benefit of a right without holding that right directly, whilst also recognising that B has more than a mere personal right against A, the holder of the right.'[94]

The starting point of this analysis is to qualify proprietary rights merely as rights that '(i) relate to the use of [material] things[95] and (ii) impose a *prima facie* duty on the rest of the world'[96]. This definition strictly confines the concept of property to a very short and closed list of rights that does not include what is conventionally described as an equitable proprietary interest[97]. In particular, it rejects the idea that a proprietary right

---

[88] Pettit (2012, pp. 81 and 83) and Hanbury (1935, p. 62).
[89] This expression was originally coined by Hanbury when he argues that: 'equitable interests must be regarded as hybrids, midway between *iura in rem* and *ira in personam*' (Hanbury 1935, p. 62).
[90] See on this point also Nathan and Marshall (1967, p. 9) and, in particular, Smith (2008, p. 379) who describes the beneficiary's equitable interest under a trust not as a proprietary right but rather as a separate patrimony.
[91] Pettit (2012, p. 83).
[92] McFarlane and Stevens (2010 a, p. 37). The term 'persistent right' 'is used to refer to any right usually called an "equitable proprietary right"', McFarlane (2008, pp. 23 - 27). More specifically, with regard to a trust the fact that in certain circumstances equity binds third parties to the trustee's personal obligations towards the beneficiary has prompted McFarlane and Stevens to define the beneficiary's right as 'persistent', McFarlane and Stevens (2010 b, pp. 1 – 2).
[93] *Id.*
[94] McFarlane and Stevens (2010 a, p. 38).
[95] Proprietary rights can only relate to the use of 'an object that can be physically located' (namely, land and goods), McFarlane (2008, p. 132). Hence, this does not include rights over intangible assets that are classified by McFarlane either as 'persistent rights' (e.g. debts, goodwill or shares in a company) or 'background rights' (e.g. intellectual property rights), *Ibid.*, p. 133.
[96] *Ibid.*, p. 22.
[97] McFarlane and Stevens argue that 'while there is a closed list, or *numerus clausus* list, of rights against things, there is no such limit to the content of rights against rights', McFarlane and Stevens (2010 b, p. 2) and McFarlane (2008, pp. 32 and 135 – 140).

may (i) relate to intangibles and (ii) more importantly, may be recognised in the case of an indirect relationship with the asset (whether tangible or intangible) through an intermediary (e.g., a trustee)[98].

With regard to the equitable right of a beneficiary under a trust, McFarlane and Stevens criticise the 'very common view' that over the centuries equity has extended the notion of property by creating 'a weaker, more vulnerable version of the proprietary rights recognised at common law'. This 'orthodox […] view', continue McFarlane and Stevens, 'overlooks the genius of equity'[99], which does not recognise two competing concepts of ownership (namely, equitable as opposed to legal ownership) but includes the equitable right of a beneficiary into a new category of rights (i.e. 'persistent rights')[100].

Unlike personal interests, this type of rights shares with property a very important feature, i.e. the power to bind third parties and not only a specific person such as a contracting partner. This means, for example, that if the trustee is insolvent the beneficiary's right is protected against the trustee's creditors. However, it can be ascertained that there are certainly differences between a persistent right and a proprietary right since the former (unlike the latter) does not relate directly to a thing but rather to the right of another person. In other words, the equitable right of a beneficiary is a right against the proprietary right held by the trustee[101]. This means that in order to enforce his/her persistent right against a third party, a beneficiary does not 'need to find a particular thing' (such as a trust asset) but 'needs to show that [the third party] has acquired a right that depends on the [proprietary] right held by [the trustee].'[102]

These conceptual differences between a proprietary right and a persistent right explain why the beneficiary under a trust is prevented from making a claim directly against a person who steals or carelessly damages the trust assets[103]. According to McFarlane and

98 McFarlane and Stevens (2010 b, p. 4). For a different view see Penner (2009, p. 254).
99 McFarlane and Stevens (2010 b, p. 2).
100 *Id.*
101 McFarlane (2008, pp. 23 – 24).
102 *Id.*
103 If the beneficiary ('B') is regarded as having a right against the ownership of the trustee ('A'), 'B has a *prima facie* power to impose a duty on anyone who acquires A's ownership of the [trust assets]' (e.g. A's creditors in cases of bankruptcy or parties who have inherited the assets from A). Hence, when B decides

Stevens, the reason for this limitation is not simply that common law does not recognise the equitable title under a trust but rather that the beneficiary has no rights to the trust property and, consequently, 'no claim, either at law or in equity, against the parties who steal or damage such property.'[104] Indeed, the third parties do not derive any title to the trust property from the trustee since they have just committed a wrong against the latter and, consequently, violated his/her proprietary right. In accordance with this reasoning, the trustee is the only person entitled to make a claim for conversion or negligence directly against the tortfeasor[105]. As mentioned above, if the trustee is unwilling to make such a claim, 'the beneficiary can apply to the court to force the trustee to do so'[106].

However, in this case the claim of the beneficiary is 'an action against the *trustee,* not against a *third party* in connection with the trust property'[107]. Similarly, the *cestui que trust* may exceptionally decide under the so-called Vandepitte procedure to join the legal owner in the action against the third parties. Once again, this procedure confirms that the beneficiary has no direct claim against the tortfeasor as the latter has not infringed a right against the beneficiary but rather against the trustee[108].

The limitations imposed on the beneficiary seem to support the argument that an equitable right under a trust cannot be considered a competing ownership to the legal ownership but should be classified as a persistent right[109]. In other words, in order to explain these limitations it is more appropriate to rely on the conceptual rather than the historical distinctiveness of an equitable interest under a trust[110]. The main point is that 'equity does not simply provide a different answer to the same question' but offers a 'conceptually distinct new right' (i.e. a persistent right)[111]. Hence, the 'anomalies' related

---

to exercise such a power, the third party is under a duty to B not to use the assets for any purpose other than B's interest, *Ibid.*, p. 30.

104 McFarlane and Stevens (2010 b, p. 4).

105 Since B has no right to the trust property, the third party who steals or damages such property ('X') does not commit a wrong against B but only against A. Hence 'B has no power to impose a duty on X, as X has not acquired a right from B', McFarlane (2008, p. 29).

106 'It is worth noting that, as A holds his ownership of [the assets] on trust for B, A is under a duty to use that right, and its products, for B's benefit. So if, for example, (i) A refuses to bring a claim against X, then, (ii) B can apply to court to force A to make such a claim', *Id.*

107 Smith (2008, p. 521).

108 McFarlane (2008, p. 30).

109 McFarlane and Stevens (2010 b, p. 4).

110 McFarlane and Stevens reject the idea of equity as a distinct set of rules that are peculiar to English law and were developed by the Court of Chancery in parallel with common law. This perception 'is unfortunate in a jurisdiction where the administration of law and equity has long since been fused', *Ibid.*, p. 28.

111 *Ibid.*, p. 9.

to an equitable proprietary right 'depend not on the localized tradition of equity but rather upon the exportable concept of rights against rights.'[112] Indeed, one of the main benefits they propound for identifying this new concept is that it 'allows for the export of equitable property rights to jurisdictions with no tradition of equity: any legal system can recognise the concept of a right against a right.'[113]

4. Criticism of McFarlane and Stevens' approach to equitable rights

McFarlane and Stevens offer a theory that is meant to describe the existing principles of trust (and more in general of equity) from an innovative perspective. This means that their intention is not to propose normative changes but simply to show that (in contrast with the traditional approach to the law of trust) the concept of a right against a right provides a better understanding of the existing legal framework[114].

The argument, however, is difficult to accept given that firstly, the traditional approach to the law of trust does not effectively create any form of friction or inconsistency with general principles of property and secondly, the application of a right against a right is likely to undergo criticism for both theoretical and practical reasons.

4.1 The proprietary theory is adequately capable of explaining English trust law

The aim of this chapter is to defend the approach that views the equitable interest of a beneficiary as a proprietary right, rather than a right against the trustee's ownership (i.e. a persistent right). One way to support the proprietary nature of the beneficiary's right is to accept the view suggested by Penner to define such an interest as an 'indirect' right in the trust assets[115]. Indeed, the main feature of a trust is that the beneficiary is generally entitled to assert his/her rights against third parties *through* [emphasis added] the trustee[116]. This means that the proprietary nature of the equitable rights under a trust is based on an indirect relationship between the beneficiary and the trust assets.

---

112 McFarlane and Stevens (2010 a, p. 28).
113 'Practically, the concept of a right against a right has a powerful explanatory force. It can be used to show how other jurisdictions either already have the same concept or could readily adopt it', *Ibid.*, pp. 2-3. See also McFarlane and Stevens (2010 a, p. 58).
114 McFarlane and Stevens (2010 b, p. 2).
115 Penner (2009, p. 254) and *Id.* (2014, pp. 477 and 480).
116 In other words, 'any claim in relation to the trust property is […] vested in the trustees who, as part of their duty to protect the trust property, have a duty to sue third parties who interfere with the trust', Hargreaves (2011, p. 165). Hence, 'the trustee is the proper claimant', while 'the beneficiary can only enforce their beneficial interest indirectly through the trustee', *Id.*

Such a relationship is created by the rules of equity that allow the beneficiary, through the trustee, to trace the trust assets into the hands of third parties[117]. McFarlane and Stevens respond to this argument by stating that if the right of the beneficiary ('B') is indirect, it cannot be '*in rem*' but only a right against the right of the trustee ('T')[118]. Penner disagrees on this point and states that 'nothing is provided to ground [this] assumption.'[119] In particular, he argues that 'if B has a right against T's ownership, then B has a right against whatever makes it the right it is, including its *in rem* aspects'[120]. In other words, 'the point about the *in rem* quality of B's right against T's ownership is that B's rights turn on *what happens to the property, not on what happens to T* [emphasis added].'[121] For example, in cases regarding the claim for tort of conversion and tort of negligence, 'B acquires a right to sue T to sue C' (i.e. the tortfeasor) because 'C interfered with the *property* [emphasis added], not because he interfered with T's *property right* [emphasis added]'[122]. Hence, B's right is 'linked to what happens to the property, and is perfectly logically seen as a right *in rem*'[123].

One must reject McFarlane and Stevens' assumption that equitable ownership is *competitive* [emphasis added] to legal ownership[124]. Indeed, nowadays it is rather difficult to contend that English law 'recognises two competing interests in the same asset, the

117 *Id.* See also Gardner (2011, p. 247).
118 McFarlane and Stevens (2010 b, pp. 2 – 4).
119 Penner (2009, p. 254).
120 *Id.*
121 *Id.*
122 *Id.* For an in depth analysis of Penner's argument see Penner (2014, p. 476 ff.).
123 *Id.* In support of the orthodox approach Virgo mentions the decision of the Court of Appeal in *Shell UK Ltd. v. Total UK Ltd* 2010] EWCA Civ. 180, [2011] QB 86. In this case an explosion seriously damaged pipelines and tanks in which the claimant, Shell UK Ltd., stored its oil. The explosion was the result of the negligent overfilling of a fuel storage tank (which was caused by the defendant, Total UK Ltd.). As required by statute, the pipelines and tanks were held on trust for the claimant by two companies, United Kingdom Oil Pipelines Ltd ('UKOP Ltd') and West London Pipeline and Storage Ltd ('WLPS Ltd'). The question for the Court of Appeal was whether the beneficiary was entitled to sue the defendant. The Court decided in favour of a beneficiary's claim against the tortfeasor (provided that the trustee was made a party to the proceeding). As already mentioned in this chapter, the issue at stake was not the compensation for physical damage to the goods but for consequential economic losses that were suffered only by the beneficiary and not by the trustee (namely, losses caused as a result of the beneficiary's inability to supply fuel to his/her customers). In this case, following the 'right-against-rights thesis' the third party would have committed a wrong not against the beneficiary but only against the trustee. Hence, the beneficiary would have a right to the compensation for damages 'that would be obtained by the trustee suing the tortfeasor for the interference with the trustee's legal proprietary right', Virgo (2012, p. 56). Virgo considers McFarlane and Stevens' approach too 'artificial'. In his view, in this case the trustee has 'no right to obtain damages', since he/she has not suffered any loss. On the contrary, 'the loss was suffered by the beneficiary and the rights arising from this loss need to be attached to the trustee's right to sue for interference with the proprietary right,' *Ibid.*, 57. Virgo's argument may attract criticism. Indeed, although the trustee did not suffer *stricto sensu* any losses, he/she does acquire a 'right to damages' in as much as management and enforcement functions are concentrated in the trustee's hands. For an analysis on this point, see above n. 105 in this chapter.
124 Penner (2009, p. 254).

common law recognising the trustee as owner, equity recognising the beneficiary as owner'[125]: '[i]f the trustee does not have the rights he has, then the beneficiary cannot have the right he has, and no court of equity has ever expressed a view to the contrary[126].' In this regard, it has been recently argued by certain legal scholars that equitable ownership is 'derivative of' rather than 'competitive with' legal ownership[127]. According to Penner and Matthews, this statement is not inconsistent with the idea that the interest of a beneficiary is *linked* [emphasis added] to the property[128].

Furthermore, the fact that the claim for tort of conversion and tort of negligence lies only with the trustee does not prevent the equitable rights under a trust from being classified as proprietary rights. On the contrary, these limits on the level of enforceability of the beneficiary's rights seem to be consistent with the purpose of a trust. The main argument is that equity created the structure of trust by allocating to different parties the bundle of rights that are related to ownership. As mentioned by Lawson and Rudden, the 'habit of splitting ownership into its component parts'[129] and conferring them to different parties is a practice which was already in use in early common law[130]. This means that equity just confirmed and strengthened the idea of 'fragmented' ownership[131]. Particularly, with respect to trusts it allows the benefits of ownership to be 'split from the responsibilities of management'[132]. The 'separation' between management functions and enjoyment of the trust property explains why the beneficiary cannot bring a direct claim against third parties who steal or carelessly damage the trust assets. Indeed, the management responsibilities of a trustee, 'by their very nature, encompass protecting the trust property from third parties[133].' Hence, if the beneficiary were allowed to sue the tortfeasor directly, this 'would be tantamount to overriding the discretion of the trustee, which would unacceptably undermine the structure of a trust[134].' Accordingly, the beneficiary is entitled to enforce his/her rights directly against third parties only in those circumstances where the trustee (i) breaches

125 *Id.*, (2014, p. 475).
126 *Id.*
127 Penner (2009, p. 254). See also on this point Matthews (2002, p. 206).
128 *Id.*
129 Lawson and Rudden (1982, p. 76).
130 See above n. 85 in this chapter.
131 Lawson and Rudden (1982, 76).
132 Worthington (2006 b, p. 75).
133 Hargreaves (2011, p. 174).
134 *Id.* In those circumstances where the trustee unreasonably refuses to sue the third party, the beneficiary is entitled to demand that the trustee be replaced by another person who would instead bring action, *Ibid.* 179.

his/her fiduciary obligations (e.g. in cases of fraudulent transfers) or, alternatively, (ii) is unable to carry out the terms of the trust (i.e. in cases of bankruptcy or death of the trustee).

There are also practical concerns that prevent the beneficiary from directly suing third parties[135]. For example, 'in a complex trust, the trustee may be balancing the interests of multiple different beneficiaries so it makes sense that the trustee is responsible for any third party actions[136].' In these cases, the 'recovery by the trustee will ensure the property is properly distributed to the correct beneficiaries at the correct point in time[137].'

These considerations on the special nature of the trustee-beneficiary relationship show that the concept of an equitable ownership can certainly provide convincing arguments to explain the limits to the beneficiary's rights. Hence, it is not quite clear why the concept of a right against the trustee's legal ownership should be considered necessarily more persuasive than the better known theory of a proprietary right created by the fragmentation of ownership (although classified as a peculiar form of property relating only indirectly to the trust assets).

An argument addressed in favour of the theory of a 'right against a right' is that it avoids the 'inconsistencies' that are typically related to the orthodox approach. In particular, McFarlane and Stevens reject the theory of an extensive notion of property (based on the coexistence of legal and equitable interests in both tangibles and intangibles) and criticise the practice of asserting that (unlike other interests) proprietary rights are transferable and exercisable against third parties.

The reason for this criticism is that the orthodox approach does not provide 'a *stable* [emphasis added] meaning to the term property right'[138], which is consistently applicable in all circumstances. In this regard, 'it is not true to say that all rights' that are

---

135 Low (2010, p. 512).
136 Hargreaves (2011, p. 182).
137 *Id.* In addition, a direct common law claim by the beneficiary (additional to the trustee's claim) could lead to a risk of double liability for third parties. According to Hargreaves, where it is a bare trust, 'this can be straightforwardly resolved by requiring joinder of the trustee, as the Court of Appeal did in *Shell v. Total*', Hargreaves (2011, p. 182). This, however, 'is not so simple where the trust is more complex and some beneficiaries choose to bring direct actions whereas others rely only on the trustee's claim', *Id.* See on this point also Low (2010, p. 512).
138 McFarlane and Stevens (2010 a, p. 35).

transferable and exercisable against third parties 'are viewed as proprietary rights'. For example, it is possible for certain types of personal obligations (namely, contractual rights) to be transferred to third parties, while the assignment of proprietary rights may be subject to restrictions. Similarly, proprietary rights are not the only interests that can be asserted *erga omnes* since the right to physical integrity and to reputation also imposes a *prima facie* duty on the rest of the world.

For these reasons, McFarlane and Stevens believe that the orthodox approach 'does not draw a useful distinction between property rights […] and personal rights […]'[139]. By contrast, the idea of confining the concept of property to a restricted list of rights (that does not include equitable proprietary rights) is considered more appropriate in as much as it places property within sharp and definitive boundaries[140].

Once again, these conclusions are open to criticism in so far as the orthodox approach does not create inconsistency within English law. The traditional approach is intended to recognise proprietary rights as 'exercisable' against third parties and generally 'transferable'. This means that the attributes of 'excludability' and 'transferability' are regarded by most English scholars as the characterising features of property. However, this general statement cannot be interpreted in rigorous terms and, moreover, is not used under the orthodox approach to distinguish property rights from *all other interests* [emphasis added]. Particularly, with regard to the attribute of excludability, the general view is that not all rights exercisable against third parties are classified as proprietary rights. As emphasised by the greater part of English scholars, the attribute of excludability is not a unique feature of property but is used primarily to draw a line between proprietary interests on the one hand and personal (mainly, contractual) interests on the other: a proprietary right 'can be asserted against the world at large'[141] while a personal right is exercisable 'against another individual such as a contracting partner'[142]. Setting aside this main distinction, nothing prevents us from recognising that (unlike contractual interests) there may be other types of rights which share with property the feature of 'excludability' (e.g. the right to physical integrity and to reputation). The reason for this is simply that certain interests receive greater protection than others as a result of the importance in a community of setting socio-political and

139 *Ibid.* p. 36.
140 *Id.*
141 Bridge (2002, p. 12).
142 *Id.*

economic priorities (e.g. the need to protect private property as well as the right to *corpus*[143], *fama*[144] and *dignitas*[145]). This principle seems to be consistent with the classification (typically applied in civil law systems) of 'absolute' *versus* 'relative' rights 'depending on whether they involve a legal remedy *erga omnes*' (i.e. against the whole world) or only *inter partes* (i.e. against a given individual). Following this classification, personal obligations are considered 'relative' since they are only effective against a specific person (such as a contracting party). On the other hand, the category of 'absolute' rights comprises both proprietary rights (i.e. real rights or rights *in rem*) and the so-called 'personality rights' (e.g. rights to physical integrity, to reputation and to privacy) which can be enforced against every person who interferes with such rights. As a result of this analysis, nothing prevents us from stating that unlike personal obligations, proprietary rights are exercisable against third parties.

With respect to the attribute of transferability, 'it is no longer possible to suggest that "property" is assignable, but […] contract rights, are not'[146]: 'the modern rule is that both are assignable'[147]. This argument (supported by McFarlane and Stevens) is certainly true and brings us to partially reconsider the traditional view according to which 'the truly essential features of property rights are that the right-holders can *transfer* [emphasis added] […] and can exclude third parties from interfering with their rights'[148]. The reason for this is that such a statement is now only partially indicative of property. For a number of centuries the twin attributes of 'excludability' and 'transferability' were strictly used to separate proprietary rights from contractual rights. It was only between the latter part of the 19th and the early 20th century that the attribute of 'transferability' was gradually conferred to an increasing number of rights (that were typically classified by common law as purely personal). This process was made possible through the rules of equity which then started treating certain types of personal rights as 'transferable, usable wealth'[149] (e.g. the right to receive payment from a customer). Furthermore, in certain circumstances the assignment of proprietary rights may be subject to specific

143 'Bodily integrity'.
144 'Reputation'.
145 'Dignity'.
146 Worthington (2006 - 2007, p. 927).
147 *Id.*
148 *Ibid.*, p. 920.
149 *Id.*

restrictions either on public policy grounds[150] or as a result of the parties agreeing to such limitations (namely, by inserting a no-assignment clause in the contract)[151]. The result of this practice was to gradually confine the main distinction between property and obligation to the concept of excludability. Hence, today the general perception is that proprietary rights differ from contractual rights since they are better protected than the latter. In other words, the *distinctive* [emphasis added] feature of property is its universality[152].

This demonstrates that there is no uncertainty arising from the orthodox approach in so far as it is still possible, through the attribute of 'excludability', to draw a distinction between proprietary rights on the one hand and contractual rights on the other. Nevertheless, although proprietary rights are exercisable against third parties, this statement cannot be interpreted in too rigorous a fashion, since there are exceptions to the general rule. As emphasized by Sarah Worthington, 'there are no assets that entitle their holder to *absolute* [emphasis added] rights to enjoy, to transfer, and to exclude others'[153]. This means that with respect to the attribute of excludability, 'common law property rights may in certain instances be overridden[154], and equitable rights, for example the interest of a trust beneficiary in the trust assets, are always vulnerable to the *bona fide* purchaser for value without notice of the legal estate'[155]. In other words, there are different degrees of exigibility of proprietary rights that can either be imposed by law or contractually created by the parties. These exceptions to the general rule apply regardless of whether the notion of property relates merely to 'physical things' (as

150 'Consider the restrictions on assignment of certain categories of land, or certain categories of goods (such as national art treasures, or petrol in periods of national shortage)', Worthington (2006 - 2007, p. 928). 'Put another way', continues Worthington, 'public policy determines whether a particular bundle of rights is assignable'.

151 Bridge, 'Unassignable Rights' in Bridge et al. (2013, para. 29-028). See, for example, on this point *Swift v Dairywise Farms Ltd* [2001] EWCA Civ 145; [2003] 1 WLR 1606 note; *Re Celtic Extraction Ltd* [2001] Ch 475, CA; *Money Markets International Stockbrokers Ltd v London Stock Exchange* [2001] 1 WLR 1150; *Don King Productions Inc v Warren* [2000] Ch 291.

152 Bridge (2002, p. 12).

153 Worthington (2006 – 2007, p. 923).

154 Common law proprietary rights may be overridden by legislation for reasons of public interest (e.g. environmental restrictions on the use of land) or for the protection of certain groups of people (e.g. compulsory licensing and government use of a patent). Furthermore, in relation to land a person's ownership of property may be limited by the competing existence of different estates (i.e. freehold or lease) or interests (i.e. easement or charge) in land. See on this point Lawson and Rudden (1982, pp. 76 - 97) and McFarlane (2008, pp. 6 – 12).

155 Bridge (2002, p. 12). Moreover, the exigibility of an equitable proprietary right may be subject to statutory limitations or other conditions, which are based on the type of interest involved. For example, with regard to competing charges over the same assets, if the debtor becomes insolvent a floating charge holder has lower priority than the fixed charge holders as well as various statutory creditors.

suggested by McFarlane and Stevens) or is extended to intangibles (as supported by the orthodox approach).

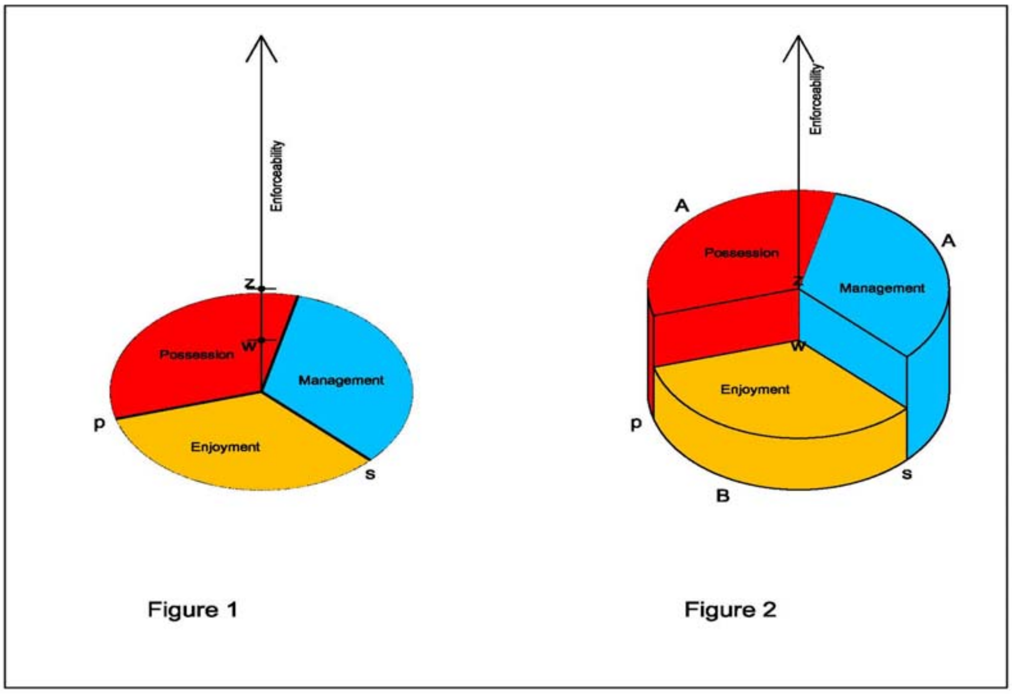
According to this reasoning, it is difficult (if not almost impossible) to confine the notion of property within sharp and definitive boundaries. English law has developed a 'flexible' and 'malleable' idea of property, particularly through the rules of equity, which has proven capable of adapting to the continuing changes of market practice[156]. As a result of this process, the concept of property cannot be analysed by strictly using a 'tick box' approach[157], with the aim of identifying in rigorous terms its features (as if they were applicable consistently in all circumstances). In contrast with a *stable* [emphasis added] definition of property (based on a rigorous dominion over material 'things'), 'property rights are more or less expansive, more or less limited, and some property rights are not freely transferable at all'[158]. This means that the orthodox approach can operate regardless of the absence of clear boundaries between proprietary rights and contractual rights.

4.2 The concept of property entails a dynamic (and not static) relationship between an individual and a thing

The development of a flexible idea of property is best described by a diagram (figure 1), graphically representing proprietary rights, consisting of a horizontal plane with a vertical axis intersecting the plane at the origin.

156 The terms 'flexible' and 'malleable' are used by James Penner in relation to the concept of property. On this point see Penner (1996, p. 723).
157 Worthington (2006 – 2007, p. 923).
158 This aspect was emphasised by Michael Bridge during a joint meeting (of senior Chancery, Queen's Bench judges and senior academics) at London Law Club on April 2010. See on this point also Bridge, 'Unassignable Rights' in Bridge et al. (2013, para. 29-033). These changes have led Worthington to challenge the existence of a boundary between property and obligation. In particular, she states that '[e]quity […] has effectively eliminated the divide between property and obligation, or between property rights and personal rights', Worthington (2006 – 2007, pp. 917 – 918). This approach seems on the one hand to be quite valuable in support of the idea that English property law cannot be analysed in rigorous terms but on the other, probably too audacious since it is still possible to consider the attribute of excludability as the sole essential feature of property, *Id.*

Proprietary rights as they are applied to a trust



The vertical axis indicates the different degrees of exigibility of a proprietary right: the higher the proprietary right is positioned along the vertical axis, the greater the level of protection a rightful owner or possessor enjoys *vis-à-vis* third parties generally.

On the horizontal plane the three sectors of a circle represent the power to use and enjoy proprietary rights in whichever way one should choose, subject to any specific limitation under the applicable law. In other words, it comprises the 'bundle of rights' which are typically associated to property, i.e. the rights of enjoyment, management and possession.

By joining the coordinates positioned along the vertical axis and the horizontal plane, proprietary rights may take on various forms and acquire different levels of intensity in terms of power of the rightful owner or possessor to exclude all others from the use or enjoyment of the 'thing'.

In figure 2 the different proprietary rights are shown as they apply, for example to trusts. The interest of the beneficiary in a trust fund ('B') is represented in yellow by the coordinates *wps*, as plotted on *w* along the vertical axis and on *ps* along the horizontal plane. Similarly, the interest of the trustee ('A') is represented in blue and red by the coordinates *zps*, as plotted on *z* along the vertical axis and on *ps* along the horizontal plane. It can be seen from this diagram that the proprietary right of a beneficiary is rather limited, both in terms of its enforceability against third parties and of its power to dispose of the trust fund. On the other hand, the trustee has a right to manage and use the trust fund, but only in the interest of the beneficiary. Accordingly, if the trustee (in breach of trust) uses the assets for his/her own benefit, the beneficiary is entitled to trace such assets to any person other than a *bona fide* purchaser for value[159].

The example of a trust shows that the relationship between an individual and a 'thing' (on which the meaning of property is based) is a dynamic relationship, as its content is liable to change depending on the intention of the parties.[160] This means that many different kinds of proprietary rights can be created in relation to the same asset. Property may be sliced into multiple interests, which may vary significantly in terms of extent and duration.[161] The main objective of a coexistence of multiple layers of proprietary interests is to maximise the economic value of the asset.

Furthermore, the diagram reveals that this flexible idea of property is now based almost exclusively on a non-rigorous definition of excludability. In this regard, it might be argued that certain rights are now 'regarded as "property" rather than "obligation" since commercial practice demanded that these rights be recognized as enforceable against third parties'[162]. This has certainly been the key factor that resulted in the adaptation of the beneficiary's rights under a trust from personal to proprietary. Indeed, over the centuries equity extended the protection of the beneficiary's rights by permitting its enforcement not only against the trustee but also against third parties. These changes

---

159 This means that if the trust assets are acquired by a *bona fide* purchaser for value without notice, there is no proprietary claim available to the beneficiary but only a contractual right, which can be enforced against the trustee for breach of trust.

160 Gray and Gray (2009, pp. 8 - 14).

161 Figures 5 and 6 in Appendix to Chapter 2, offer another scenario in which diverse proprietary interests may be attached to the same asset. This example shows that in addition to the interest of the beneficiary C (which is represented by the coordinates *wps*) and the interest of trustee A, (which is represented by the coordinates *hpt*), it is possible to identify also the interest of bailee B, which is represented by the coordinates *zts*). In accordance with a bailment at will, possession is transferred for a limited period of time from the bailor (who in this case acts also as the trustee) to the bailee (coordinates *ts*). It can be seen from the diagram that the legal interest of the bailee is limited in terms of its enforceability against third parties (coordinate *z*). The reason for this is that such a title can be enforced only for a limited period of time, which the bailor determines at his/her discretion.

162 Worthington (2001, p. 260). This statement refers specifically to shares, but it can be extended to other proprietary rights, such as the right of the beneficiary under a trust.

were gradually introduced by the courts of equity in response to persistent commercial pressure. The trend toward affording greater protection through the recognition of proprietary rights has developed over time and continues to be present today in so far as courts have recently emphasised that the proprietary nature of an interest depends on the intention of the parties: if the purpose was to create a right that is 'sufficiently strong'[163] to be asserted *erga omnes*, then such a right can be classified as proprietary[164].

4.3 Difficulties in accepting the concept of a right against a right

In support of the proprietary nature of equitable rights under a trust, it could also be claimed that the idea of a right against a right is likely to encounter certain reservations from both the theoretical and practical points of view.

Firstly, the concept of a 'right against a right' is alien to English law, which classifies the equitable interest of a beneficiary under a trust as 'proprietary' rather than 'persistent' rights. In this regard, courts and statute law are generally more inclined to address commercial needs by accommodating existing principles rather than creating an entirely new class of rights. This practice has been established over the centuries not only by creating the idea of an equitable ownership under a trust or by granting new forms of charges to secured creditors[165], but also by extending the category of proprietary rights to include interests over an increasing number of intangibles. This trend was recently confirmed when statute law introduced a rather 'singular' idea of possession, which applies to all types of assets (whether tangibles or intangibles). In particular, the 2010 Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations ('FMIR') overrides the common law requirements (which have traditionally confined the concept of possession to the idea of *physical and exclusive control* [emphasis added]) by allowing a secured creditor to take possession over investment securities (regardless of the nature)[166]. Although this

[163] *Pearson and others v. Lehman Brothers Finance SA* [2010] EWHC 2914 (Ch), para. 253.
[164] *Ibid.*, para. 225.
[165] See, however, McFarlane and Stevens, who on the one hand classify the interest in a fixed charge as a persistent right and on the other, regard the interest in a floating charge as a power to acquire a persistent right. With regard to mortgages, if the mortgagor holds a persistent right (e.g. a right under a trust), the mortgagee acquires that same type of persistent right. See on this point, McFarlane and Stevens (2010 b, p. 26 and McFarlane (2008, pp. 583 – 633).
[166] See on this point text to n. 572 – 592 in ch. 6.

innovative provision has attracted some criticism[167], it does confirm a general trend in favour of adapting (wherever possible) existing legal concepts to commercial needs rather than creating *ex novo* different categories of rights.

McFarlane and Stevens disregard this general trend and elaborate an abstract theory which seems to be detached from English case law and statute law. Although the intention was to draw up a set of interests whose boundaries are clear and well defined, this has been achieved at the expense of not taking into account the historical development of English property law. The question remains, can a particular concept within a legal system be described without tracing its historical roots? Certain comparative lawyers believe that from a methodological point of view this cannot be considered a correct approach to legal analysis[168], as it may lead to a distorted or misleading idea of the true, characteristic features of a particular legal system[169].

Secondly, one must reject the argument that the theory of a 'right against a right' 'allows for the export of such [a concept] to jurisdictions with no tradition of equity'[170] (particularly, civil law jurisdictions). Indeed, there is no evidence to support this argument. Although it is true that non common law systems do not recognise the notion of equitable ownership, it is difficult to believe that they would find it easier to accept the theory of a persistent right. The reason for this is that 'rights are abstract relations'[171] and the idea of a right against someone's proprietary right is alien not only to common law traditions but also to civil law traditions.

---

[167] *Id.* Part of the purpose of this recent provision was to overcome the uncertainties concealed in the wording of the FCD, particularly of Art. 2(2) which deals with the methods of perfection of a security interest over investment property (namely, bearer securities in certificated form and securities in dematerialised form). According to the EC Directive, a security agreement is effective against third parties when the secured creditor acquires 'possession' or 'control' of the assets. Unlike possession, the notion of control is unknown to English law. Hence, rather than introducing a new method of perfection which applies specifically to securities in dematerialised form, the FMIR opted for an extension of the idea of possession. The UK provision may be subject to criticism since it does not appear to be consistent with the wording of the FCD.

[168] See among others, Gorla (1981, p. 730) and *Id.*, (1964, p. 930).

[169] In this case for example, McFarlane and Stevens embrace the idea (common to civil law jurisdictions) that definitions and classifications of legal concepts descend from the formulation of absolute theories rather than being constantly accommodated to practical needs. However, as highlighted by Lawson, this approach does not seem to reflect English legal culture and style (in terms of the manner typically used by English Courts to deal with legal problems), Lawson (1975, p. 24).

[170] McFarlane and Stevens (2010 b, p. 28).

[171] Penner (2009, p. 254).

One last aspect that deserves careful consideration is the idea of a 'right against a right' being part of a broader theory (proposed by McFarlane and Stevens) which confines the notion of property to a restricted list of rights that does not include interests in intangible assets[172]. This approach could raise doubts from a practical point of view as it is in contrast with the general trend toward granting increasing importance to intangibles rather than tangibles.[173] As emphasised by the Organisation for Economic Co-operation and Development ('OECD'), 'in most countries the investment in intangibles is growing rapidly' and in certain cases it also 'matches or exceeds investment in traditional capital such as machinery, equipment and buildings'.[174] Hence, by accepting McFarlane and Stevens' approach to intangible assets, the importance of proprietary rights would be significantly reduced while persistent rights and background rights[175] would start to be associated to a large and increasing portion of people's wealth. To a certain extent, it could be stated that this restrictive approach to proprietary rights would not be easily accepted either in common law or civil law jurisdictions. While there are considerable differences among legal systems, the general trend in most countries is to classify at least certain types of interests in intangibles as proprietary (e.g. intellectual proprietary rights). As a result of these practical reservations, the approach suggested by McFarlane and Stevens is likely to be confined to the academic debate and unlikely to be accepted in practice.

5. The proprietary character of a right against a right

At this point, the author suggests that a third possible measure could be to confer proprietary *status* to a right against a right. In this regard, one could argue that for the purpose of a trust the beneficiary holds a proprietary right in the trustee's right in the

---

172 See above n. 95 in this chapter. McFarlane and Stevens's approach can be challenged also for a theoretical prospective. Foe example, Harris highlights that 'nostalgia for a true property limited to physical objects is a false lead', Harris (2002, p. 62). More specifically, 'if there is a libertarian case for exclusive and autonomous use of land and chattels, there is surely also one for autonomous transacting with one's money, bank accounts, intellectual property-holdings and company shares', *Id.* 'To deny this', continues Harris, 'is to insist on too literal an application of the domain conception of rights', *Id.* "'Tt s true that the [idea that property entailing exclusive and autonomous use] can be most directly drawn around our physical property-holdings, but there is nothing to prevent the extension of the idea to portions of wealth', *Id.* For a different opinion see Pretto-Sakmann (2002, p. 79) who believes that 'the physical or at least locatable idea of property preserves the taxonomical value of the category 'of proprietary rights*, Id.*

173 See on this point Rahmatian, who criticises the authors' view that proprietary rights can only attach to tangible 'things', Rahmatian (2009, pp. 878 – 879).

174 OECD (September 2011).

175 See above n. 95 in this chapter.

main property. For example, if A holds a bicycle on trust for B, B acquires a (proprietary) right in A's (proprietary) right in the bicycle (rather than a *sui generis* right or an indirect right in the bicycle).

The general idea lying behind this argument is that the beneficiary's right does not attach to the original property, which led to the creation of the trust (i.e. the bicycle) but attaches to a separate asset which is strictly linked to such a property. In other words, what the beneficiary really acquires is an interest in a sub-property that derives from the property immediate above it.

The key issue is to try to establish what precisely is meant by 'sub-property'. In the example mentioned above, the sub-property can be identified with the trustee's (management) right in the bicycle which allows B to enforce a series of rights against A that are typically related to proprietary rights (such as a right to enjoy the benefits of the bicycle, to pass the bicycle on to his/her heirs and to be protected against A's creditors in cases where A is declared bankrupt).

This description of B's right in a sub-property shows that there are many similarities between such a solution and the theory of a right against a right given that in both cases B acquires a package of rights against A. The only difference is simply the proprietary or *sui generis* characterisation of B's right. More specifically, while the theory suggested by McFarlane and Stevens considers a right against a right as a *sui generis* title, the alternative option (proposed by the author and based on the concept of an interest in a 'sub-property' or in a 'derivative asset') identifies A's right in the bicycle as the item of property held or owned by B[176]. This means that the debate should not really be about the nature of B's right but rather about the subject matter of B's *proprietary* [emphasis added] right under a trust.

McFarlane and Stevens would most likely disagree with this analysis, stating that proprietary rights only attach to tangibles and not to abstract concepts such as rights. This argument, however, can be rebutted since (as emphasised in the previous sections of this chapter[177]) English law has frequently shown that even a simple right (such as a

[176] The principle assumes an even clearer perspective if one considers that A's proprietary right is solely a right to manage the bicycle *in the interest of B* [emphasis added].
[177] See *supra* text to nn. 83 – 85 in this chapter.

debt) can be recognised as an item of property. Hence, there is no reason to reject the idea of conceiving the management functions of the trustee as an asset.

A further objection to the proprietary characterisation of a right against a right is that it can clash with the idea of fragmented ownership. Once again this criticism does not seem very convincing. A closer look at the concept of an interest in a sub-property shows that although it does not comply *stricto sensu* with the conventional trust law, it does reach the same conclusions as those of a general model of fragmented ownership. In particular, such a concept confirms the tendency in English law to allocate to different parties a bundle of rights which are somehow (whether directly or through a sub-property) related to the same asset. The objective in this case is clearly to maximise the economic value of that asset by allowing the *cestui que trust* to enjoy the benefits of property through the right of the trustee.

For these reasons the concept of an interest in a sub-property is likely to be preferred to that of a right against a right, as it seems to be more in line with English case law (which has often highlighted the proprietary nature of the beneficiary's right) and it does not depart from English legal taxonomy.

6. The nature of the investor's rights in the practice of indirectly held securities: the application of the proprietary theory.

After having examined the different theoretical approaches to the nature of equitable rights under a trust, it is now necessary to establish which of these approaches is best suited to describe the nature of the investor's rights in the practice of indirectly held securities. As mentioned earlier, English law uses the concepts of trust and sub-trusts to explain the legal structure of intermediation. This means that, for example, the first-tier intermediary ('A') holds the securities on trust for the second-tier intermediary ('B'), who holds them on sub-trust for the benefit of the last investor ('C'). Hence, the question at stake is to understand how to classify B's and C's respective rights. In other words, are they purely contractual rights? *sui generis* rights (i.e. 'rights against rights')? or proprietary rights (described either as indirect rights *in rem* or, alternatively, as rights in a sub-property)?

6.1 The concept of an interest in securities

Most scholars and practitioners stress the importance of defining the account holder's rights as proprietary, rather than merely contractual rights[178]. The rationale behind this analysis is to ensure that the investor's rights in the securities are protected against third parties, particularly fraudulent transferees[179] and the intermediary's general creditors in the event of its insolvency[180].

These considerations lead Benjamin to define B's and C's rights as 'interests in securities'[181]. In this regard, C enjoys a bundle of interests, which include personal rights against B and proprietary rights in relation to the assets held for C by B[182]. Although such interests are linked with the original rights embodied by the underlying securities, they are 'legally distinct'[183] from them, being considered separate 'assets' from the underlying securities[184].

As a result of this analysis, assuming for example that (unlike A) B and C do not hold a proprietary right in the underlying securities, the question remains: what is it exactly that they own? Benjamin does not address this issue. However, an answer to this question is suggested by the concept of an interest in a sub-property which in the author's view can provide a plausible theoretical foundation to Benjamin's description of an interest in securities. More specifically, it could be argued that B and C own the (management) right of the relevant intermediary. The combination of these interests represents the different items of property (ultimately linked to the underlying securities) that are held

178 Benjamin (2000, paras. 13.02 – 13.63) and Gullifer (2010, p. 228). However, this argument is not uncontroversial, especially for civil lawyers, who are traditionally bound to the idea of ownership based on the exclusive dominion over 'things'. In this respect, particular concern was raised about the possibility of property rights subsisting in relation to intangible assets, especially where such rights are held by intermediaries and in the absence of allocation. See among others Pretto-Sakmann (2005, pp. 23 – 35) and Gardella (2007, pp. 87 – 126).

179 The right of recovery is, however, subject to any defence the transferee might have against the original owner (such as the defence of a good faith purchaser).

180 As mentioned above, 'the enduring usefulness of proprietary rights […] lies in the ability to bind third parties', Benjamin (2000, para 13.29). Benjamin considers this ability as the 'practical reason' for treating the investor's right as a proprietary right. For a critique see Pretto-Sakmann (2005, pp. 197 – 212) who argues that the nature of a right is not determined by the nature of the judgment or the level of protection that may be asserted against third parties. See on this point also Stone (2017, p. 468) and Cook (1915, 232).

181 Benjamin (2000, para. 1.05).

182 *Ibid.*, paras. 1.108-1.109.

183 *Id.*

184 FMLC (July 2004, para. 9) and English Law Commission (May 2008, paras. 2.25/ 2.28).

by B and C, respectively. This proprietary position allows B and C to enforce a package of rights against the relevant intermediary, including rights to receive dividends or other distributions from the issuer, rights to pass on voting instructions and rights to be protected from the intermediary's creditors in cases of insolvency.

Looking at this description from a trust law perspective, the layering of intermediaries produces a hierarchy of trusts where the beneficiary acquires a proprietary right in the sub-trustee's right that in turn derives from the main trustee's right in the property. This structure of intermediation can be compared to the image of a train composed of a locomotive and two carriages, where the locomotive represents A's right in the underlying securities while the two carriages correspond to B's and C's rights. In particular, each carriage represents a separate asset where the last carriage is directly linked to the first, which in turn is connected to the locomotive[185].

To a certain extent, the idea of an interest in securities is probably the closest one can get to the solution offered in the United States under the 1994 revision to Article 8 UCC that introduces the concept of 'security entitlement'. In Comment 17 to § 8-102 UCC, the Drafting Committee for the revision to Article 8 emphasises that 'a security entitlement is both a package of personal rights against the securities intermediary and an interest in the property held by the securities intermediary'[186]. This means that once again C does not hold an interest in the underlying securities but in 'something' rather different. In particular, any reference in Article 8 UCC to 'property' or 'financial assets' held by B for C should be regarded as a conventional term referring to whatever it is that the intermediary holds for the account holder at a certain point in time (i.e. a bundle of rights that can be enforced directly only against the relevant intermediary)[187].

The main difference between Benjamin's approach and Article 8 UCC is that in the latter case the concept of security entitlement does not rely on a trust law analysis but is based on statutory provisions that were specifically designed to explain the structure of

[185] Another image could be the one used by Benjamin, who compares the structure of intermediation to 'a series of Russian dolls, one inside the other, with the smallest doll containing a jewel. Each doll is different from every other doll, although the value of all the dolls derives alike from the jewel. The jewel equates by analogy to the underlying securities, and each doll to a different interest in securities', Benjamin (2000, paras. 1.108-1.109).
[186] Official Comment, § 8-102 UCC para. 17.
[187] These considerations were elaborated following a telephone conversation in May 2014 with James S. Rogers, Reporter NCCUSL (National Conference of Commissioners on Uniform State Laws) Drafting Committee to Revise UCC Article 8.

intermediation. As highlighted in the Official Comment to Article 8 UCC, '[t]he technique used in [this provision] is to acknowledge explicitly that the relationship between a securities intermediary and its entitlement holders is *sui generis*, and to state the applicable commercial law rules directly, rather than by interference from a categorization of the relationship based on legal concepts of a different era'[188]. In the absence of *ad hoc* legislation on intermediated securities under English law, the idea of an interest in securities attempts to reach similar conclusions to the ones adopted under Article 8 UCC by looking at the existing principles of trust and sub-trust from a novel perspective (where A, B and C seem to hold assets which are legally distinct from one another).

The reasoning underlying the decision to elaborate a theory whereby the 'interest in securities' or 'security entitlement' attaches to separate assets[189] (rather than to the underlying securities) is based on the (necessary) application of the no-look-through principle. The main argument is that if the investor is considered to hold rights only against the relevant intermediary (being prevented from making claims against the issuer or against higher-tier intermediaries), it would be difficult to establish whether his/her proprietary right attaches directly to the underlying securities.

Another advantage related to the concept of 'interest in securities' or 'security entitlement' is that it can facilitate the choice of law in cross-border transactions. More specifically, when the resolution of proprietary issues is involved, a key factor that is traditionally used to determine the applicable law is the place where the assets are located (i.e. the *lex rei sitae* rule or simply *situs* rule). According to this principle, if one were to accept Benjamin's theory or the US approach the applicable law 'should be determined solely by reference to factors involving the relationship between the investor and the relevant intermediary'[190]. In the European Union, such a solution is in

188 Prefatory Note, Official Comment Article 8 UCC, p. 719.

189 In the context of an indirect holding system, a US lawyer would most likely avoid the use of expressions such as 'interests attaching to separate assets' (given that such a wording is typically associated to existing principles of property law). Nevertheless, assuming in this case that the asset is not regarded as a 'specific identifiable thing' but simply as a 'package of rights against the intermediary', one would not be jeopardising the purpose and meaning of a security entitlement by using this type of expression.

190 Rogers (2006, p. 287). A completely different outcome would be obtained, if the rights of B and C were considered property interests in the underlying securities. In this case, the *lex situs* would be identified with the law where the underlying securities are located, which is not considered by most practitioners to be an appropriate solution for conflict of laws issues, given that it can produce 'absurd results in the indirect [holding] system, especially with respect to secured lending transactions,' Vaaler

accordance with the provisions of Article 9(2) of the Settlement Finality Directive (98/26/EC) 'SFD' and Article 9 (1) of the Directive on financial collateral arrangements (2002/44/EC) 'FCD' that apply the so-called 'Place of the Relevant Intermediary Approach' ('PRIMA')[191].

6.2 The theory of an indirect right in the underlying securities

An alternative (proprietary) solution to the one suggested by Benjamin or Article 8 UCC could be to fit Penner's theory on the nature of an equitable right under a trust to the practice of intermediated securities and, therefore, to consider the proprietary right of both C and B as an *indirect* [emphasis added] right in the underlying securities.

According to this reasoning, only A would have immediate access to the underlying securities (being considered the 'legal' and 'direct' owner of those assets) while all the other account holders standing further down the chain would have a *sui generis* (equitable) proprietary right which attaches indirectly to the underlying securities. In the latter case, the peculiar nature of the entitlement (i.e. its 'indirectness') would explain why, for example, B and C are prevented from enforcing their claims directly against the issuer (who would not recognise them as the 'owners' of the underlying securities). The reason for this limitation could be that B's and C's proprietary rights are concealed behind A's interest in the underlying securities. In other words, only A is registered on the books of the issuer as the 'holder' of those securities, while B and C derive their

(1996, p. 275). See also Rogers (1996, pp. 1457 – 1460); Benjamin (2000, paras. 1.109 / 7.13 – 7.52); Ooi (2003, p. 126 ff.); Bernasconi et al. (2002, pp. 27 – 30) and Goode et al. (1998, p. 9).

191 For similar measures see also Article 14 of the Regulation on Insolvency Proceedings (2000/1346/EC) and Articles 24 and 31 of the Directive on the reorganisation and winding up of credit institutions (2001/24/EC). In contrast with the European Union, the United States has chosen to adopt a variant of the basic PRIMA approach in order to give effect to party autonomy. In particular, § 8-110 (b) (e) and § 9- 305(a) (3) UCC identify the law governing transactions in intermediated securities with the law selected by the intermediary and his/her customer (i.e. 'consensual PRIMA' as opposed to 'factual PRIMA'). The US approach was also adopted in the 2002 Hague Convention on the law applicable to certain rights in respect of securities held with an intermediary (which however, was not signed by any member state). The advantages and drawbacks of the different options related to PRIMA (i.e. consensual and factual PRIMA) were discussed by Paech during the conference 'Investing in Securities' held at Harris Manchester College, University of Oxford on May 16th 2014. See also Paech (November 2012, p. 14); Goode et al. assisted by Bernasconi (2005) and Rogers (2006, p. 287 ff.).

proprietary titles from the account managed by the relevant intermediary[192]. Hence, the issuer is not in a position to verify B's and C's indirect ownership[193].

The longer the custody chain the higher the risk that those investors (standing at the bottom of the chain) will encounter technical difficulties in enforcing their proprietary rights effectively [194]. For example, operational errors and delays can frequently occur when processing voting instructions through the holding chain of intermediaries. These difficulties could be considered a consequence of the indirect nature of these types of proprietary rights and more importantly of the complexity of the custody chains[195].

The main benefit of using an approach based on the concept of an 'indirect' right in the underlying securities is that it can easily be adapted to the conventional way of interpreting the law of trust and the idea of fragmented ownership[196].

One could argue that in an indirect holding system, property is split into a number of separate rights that are distributed among all the account holders (standing in the holding chain of intermediaries). Pursuant to the rules of trust and sub-trust, in this case the benefits of ownership are granted to C while the management functions are divided between A and B.

The coexistence of multiple (proprietary) interests over the same assets (i.e. the underlying securities) should not create any friction between the parties, given that each of these rights is subject to specific conditions and limitations which have been designed to avoid any potential conflict between the parties. This shows why, for example, B is entitled to manage the securities for the benefit of his/her customer (i.e. C) but is prevented from enforcing his/her (management) rights directly against the issuer. Indeed, if B were entitled to make claims against the issuer, the (management) rights of

---

192 This may lead to considering 'the account as the root of title', Gullifer and Goode (2013, para. 6–21).

193 The indirect nature of B's and C's interests in the underlying securities would also explain certain restrictions imposed on equitable owners under Section 126 of the Company Act 2006. In particular, this provision states that 'no notice of any trust […] shall be entered on the register of members'.

194 Payne (2010, pp. 187 – 218) and Micheler (2014, pp. 3 – 7). For these reasons the investor's voting rights are sometimes subject to certain contractual restrictions. Cfr. n. 45 in ch. 1.

195 An additional risk related to the *indirect* nature of these proprietary rights occurs in cases of fraudulent behaviour by the relevant intermediary. For example, if C's assets are transferred by B to a third party in breach of trust, it would be almost impossible for C to trace those assets in an indirect holding system (see on this point text to nn. 426 – 429 in ch. 4.

196 As mentioned earlier, it is usually suggested that under English trust law the beneficiary enjoys a proprietary right in the underlying asset.

A would be significantly compromised (creating some form of friction between the existing interests). Similarly, C is entitled to enjoy the benefits of property but is prevented from managing the securities, given that such a conduct would compromise the management functions of both A and B. The need to avoid any form of conflict between the parties is also the fundamental reason for preventing A from bypassing B so as to gain immediate access to C's account.

These considerations could show that English law has managed to establish a definite balance between the different proprietary interests over the underlying securities. Such an outcome broadly reflects what financial practitioners would define as the application of the 'no-look-through' principle[197]. Hence, at first glance it could be argued that there is no inconsistency in using the idea of an 'indirect right *in rem*' to explain the practice of intermediated securities.

In line with this argument, the diagrams below (figures 3 and 4) show the different proprietary rights as they apply within a very simplified scenario of an indirect holding system[198]. Once again, the graphs reveal that property may be divided into multiple and separate 'slices', each of them representing a *direct* or *indirect* interest in the underlying securities.

---

[197] In most English cases, third parties who may have acted to the detriment of the trust assets do not owe a duty of care to the beneficiary. The reason that lies behind this principle is that '[t]he rights of a beneficiary have already been recognised and protected under the existing equitable principles dealing with the trust and the rights of the beneficiary against the trustee', *Parker-Tweedale v Dunbar Bank p.l.c. (No. 1)* [1990] 2 All ER 577, 586-587. See also *Roberts v Gill & Co* [2010] UKSC 22; [2011] 1 A.C. 240. This principle also applies to the beneficiary under a sub-trust who attempts to enforce his/her equitable rights directly against the head trustee (e.g., decision of the Privy Council - Hong Kong *Hayim v Citibank NA* [1987] A.C. 730). There are, however, exceptions to this general rule. See for example, *Nelson v Greening & Sykes (Builders) Ltd* [2007] EWCA Civ 1358 and the leading case *Saunders v Vautier* [1841] 41 E.R. 482 (which under certain conditions allows the beneficiaries to obtain legal ownership and thereby terminate the trust). In order to avoid these exceptions, in market practice custody agreements usually include clauses which strictly prevent the investor from making direct claims against the issuer or higher-tier intermediaries, Micheler (2014, p. 6) and English Law Commission (June 2006, para. 1.237). Both the FMLC and the English Law Commission believe that a statutory clarification on this point is probably necessary, given that 'the practicalities of fast moving settlement systems and the need for market efficiency require a clear prohibition against looking through to higher tier intermediaries […]', English Law Commission (May 2008, paras. 2.71 – 2.72). See however, Section 150 (now Section 138 D) of the Financial Services and Markets Act 2000 ('FSMA') which allows an investor to make a claim against a higher-tier intermediary as long as such intermediary is (i) an authorised person for the purposes of the FSMA and (ii) in breach of certain regulatory rules (including the rules regarding the holding of client assets and client money, i.e. 'client assets' rules or 'CASS' rules), English Law Commission (June 2006, para. 1.237).

[198] It is worth mentioning that in practice the indirect holding structure is frequently more complex, indeed so complex that it is almost impossible to offer a comprehensive graphic representation showing all proprietary rights related to indirectly held securities.

Proprietary rights as they are applied within a very simplified scenario in an indirect holding system

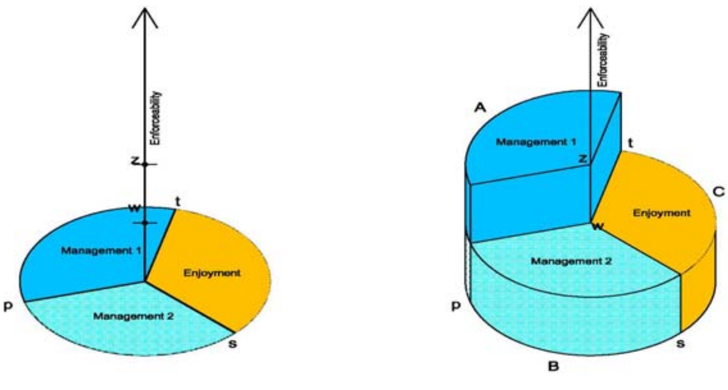


Figure 3 Figure 4

On the vertical axis of the first diagram (figure 3), the coordinates z and w show the different levels of enforceability of the right of each account holder. The first-tier intermediary (i.e. A) holds a legal interest and all the other account holders (i.e. B and C) have an equitable interest over the assets. On the horizontal plane there are three sectors within the circle that represent the management functions of A, the management functions of B and the benefits of property enjoyed by C, respectively[199]. The second diagram (figure 4) represents the different 'slices' of interests in the underlying securities. In particular, it shows that A has the ability to enforce his/her rights against the issuer, while B can only bring a claim against the issuer through A. The diagram also reveals that A has no direct access to C's account as such an action would compromise the management functions of B. In other words, '[C] should be considered to have a relationship exclusively with [B]'[200].

Notwithstanding these considerations, a further analysis of the theory of an indirect right *in rem* shows that certain concerns can still be raised over its consistency with the practice of intermediated securities.

---

[199] The right of possession is not included in the diagram given that traditionally such a right has never been applied to intangibles. See, however, on this point text to nn. 576 – 581 in ch. 6.
[200] Gullifer and Goode (2013, para. 6–19).

One principal objection to this theory is that difficulties can arise when selecting the applicable law in cross-border transactions. More specifically, in these cases the well-established *lex situs* rule would correspond to the law of the country where the underlying securities are located, which is not considered an appropriate solution for the indirect holding system, as well as being in contrast with PRIMA, that is applied in both Article 9 (2) SFD and Article 9 (1) FCD. These reservations certainly raise an interesting point. Nevertheless, the problem can be partly overcome by stating that PRIMA is not simply a development of the traditional *lex situs* rule but rather a new concept that applies in cases where securities are held through a chain of intermediaries[201]. At present, PRIMA is only included in SFD and FCD which relate specifically to collateral arrangements. Hence, it would be necessary to introduce a statutory provision that extends PRIMA to all dealings in intermediated securities[202].

7. A diverse explanation of the indirect holding system: the investor's right as a right against the intermediary's right

McFarlane and Stevens criticise the proprietary characterisation of these interests in securities, in so far as they seem to establish the same level of protection against third parties by classifying B's and C's rights as 'persistent rights' or 'rights against rights'. According to McFarlane and Stevens, this new theory is helpful in explaining the nature of an account holder's rights in a multi-tiered structure as: 'whether positioned at the end of the chain, or in the middle of a chain, an investor acquires (i) personal rights against the party with whom he deals, and (ii) a right to the right held by that party'[203]. The crucial feature of a persistent right is that although it cannot be treated as a

[201] One could argue that the *lex situs* rule was 'not designed with this kind of holding mechanism in mind', Collins et al. (2012, para. 24-071) and that its application in the context of intermediated securities would be not only impractical but also meaningless. The rationale behind this well-established principle is that 'the country of the *situs*' is usually the place where the (intangible) assets 'are properly recoverable or can be enforced', Collins et al. (2012, para. 22-025). In an indirect holding system, however, the *situs* of the assets (i.e. the underlying securities) does not seem to coincide with the place where the investor's interests are enforceable, given that for example, (i) C can only enforce his/her proprietary right through B and (ii) title is evidenced solely by book entry in the account of the relevant intermediary. For these reasons the whole purpose of applying the *lex situs* rule is void, while PRIMA seems to be the most appropriate solution in this context.

[202] Such a solution would be welcomed by the market since 'a fragmented approach depending on the purpose of the transfer is conceptually and practically unsatisfactory', Yates and Montagu (2013, para. 5.60) and Goode et al. (1998, p. 26). An attempt to extend the PRIMA approach to all transactions related to intermediated securities can be found in Principle 14(1) European Commission (2010, para. 14.1). See on this point also the 2002 *Hague Convention on the law applicable to certain rights in respect of securities held with an intermediary*.

[203] FMLC (July 2004, para. 9).

proprietary right it gives 'the investor more than […] mere personal right[s] against his/her contractual partner'[204]. This means that 'the investor's position […] does not depend on the solvency of his/her contractual partner or on that of any intermediaries higher up the chain'[205].

Another point to their argument is that by using the theory of a persistent right an explanation can also be given to the application of the no-look-through principle in the practice of intermediated securities. Indeed, in this case it would 'make no conceptual sense to say that [B] can declare a sub-trust [in favour of C] and then drop out of the picture: the sub-trust depends both for its creation and its continued existence on [B] continuing to hold a right against A: that right of [B] forms the subject matter of the sub-trust in favour of [C]'[206]. Hence, on the basis of these considerations it seems clear that C cannot make a claim directly against A since C's right is strictly linked to B's right which in turn derives from A's right.

Another benefit claimed by McFarlane and Stevens is that the theory of a persistent right can facilitate the application of PRIMA in cross border transactions. The idea lying behind this theory is that C has no right in the underlying securities but simply a right in B's right in A's right in the underlying securities. This means that the applicable law should not be identified with the *lex rei sitae* but rather with the law governing the relationship between B and C.

Considerable doubts on this approach have been raised by practitioners. For example, Moss argues that the idea of a right against a right 'does not entirely meet, as a matter of gut feeling, [the investor's] expectations'[207] in as much as the latter feels more secure when regarded as the owner of the intermediated securities rather than the holder of 'a right to somebody else's right to someone else's right and so on'[208].

---

[204] McFarlane and Stevens (2010, p. 38).
[205] *Id.* According to McFarlane and Stevens, by accepting the theory of a 'right against a right' it is easier to explain why the securities should be traced through the chain of intermediaries.
[206] McFarlane and Stevens (2010, p. 47).
[207] Moss (2010, p. 65).
[208] *Id.* This statement is certainly persuasive, although it fails to emphasise that the investor does not have immediate access to the underlying securities. Hence, what the investor really holds is either an indirect (proprietary) right in the underlying securities or (most likely) a right in a sub-property, which is ultimately linked to the underlying securities. In the latter case, it is possible to use the term 'intermediated securities' to describe the sub-property as a distinct item from the underlying securities. Indeed, it would be less confusing for the investor to be regarded as the owner of 'the intermediated securities' rather than

In support of this argument, the proprietary characterisation of the investor's rights was recently confirmed in *Pearson and others v. Lehman Brothers Finance SA*[209] (which concerned the nature of the interests in intermediated securities acquired by *Lehman Brothers International (Europe)* (LBIE) for its affiliates). In his judgement, Briggs J finds that 'the question whether [the affiliate company] has a *proprietary interest* [emphasis added] in the [asset] acquired by [LBIE] depends upon the mutual intention [of the parties], to be ascertained by an objective assessment of the terms of the agreement or relationship between [LBIE] and the [affiliate company] with reference to that [asset]'[210]. The purpose of this analysis, continues Briggs J, is to determine whether the parties intended to create rights that are 'sufficiently strong'[211] to be enforceable against third parties, particularly the intermediary's general creditors in cases of bankruptcy. This shows once again that the central feature of a proprietary right lies almost exclusively in its ability to bind third parties (regardless of whether such a right refers to tangibles or intangibles, to a direct or indirect relationship with the underlying securities)[212].

Nevertheless, the main point is to understand whether the theory suggested by McFarlane and Stevens can offer a significant contribution to the practice of intermediated securities and therefore, overcome issues of legal uncertainty which may arise when using the two approaches based on the proprietary nature of the investor's rights (namely the concepts of an indirect right *in rem* and an interest in securities).

Indeed, McFarlane and Stevens sustain the theory that a right against a right is to be preferred to a proprietary concept given that the former (unlike the latter) can provide a better understanding of the legal structure of intermediation and 'adequately meet the practical problems of intermediated securities'[213].

---

the owner of the 'intermediary's right in the underlying securities'. Hence, by using the expression 'intermediated securities' one is simply choosing a more convenient way to describe the concept of sub-property.

209 [2010] EWHC 2914 (Ch).

210 [2010] EWHC 2914 (Ch), para. 225.

211 *Ibid.*, para. 253

212 The judge's decision was confirmed in almost all its aspects by the Court of Appeal, (2011 EWCA Civ. p. 1544). For a critical analysis of the proprietary nature of these types of rights see Pretto-Sakmann (2005, p. 202).

213 McFarlane and Stevens (2010, p. 33).

In this regard, McFarlane and Stevens' main argument is that (unlike the proprietary concept) the idea of a right against a right demonstrates that no statutory intervention is necessary within the United Kingdom as the existing legal framework can effectively respond to the needs of market practice and ultimately protect the investors' rights[214]. This position is open to criticism, as already in 2004 the FMLC proposed the introduction of legislative changes in the United Kingdom[215]. This proposal derived from concerns to render the legal framework more effective and cost-efficient.

It is true that English law, particularly through the rules of equity, has developed on a 'pragmatic' and 'common-sense basis'[216] and that, unlike most civil law systems, it offers a flexible idea of property capable of adapting more easily to market practice. Benjamin emphasises 'the enormous *technical* contribution that trusts have made to financial law, by permitting a range of innovative proprietary structures that could not otherwise have arisen'[217]. However, she also argues that 'while the traditional principles of English law operate well in the electronic environment, there are (unsurprisingly) […] also areas where the case for law reform is clear'[218].

8. A choice between a right against a right, an indirect right *in rem* or an interest in securities

The next four chapters evaluate the validity of the three theories in cases where fraudulent behaviour or insolvency of an intermediary arise[219]. In particular, the study identifies certain examples of legal sensitivities affecting the current legal framework, namely (i) the problem of certainty of the subject matter in the trust; (ii) the need to increase clarity over the allocation of shortfalls in an *omnibus* account; and (iii) the importance of identifying a clear definition of control and possession over intangibles.

The overall objective is

---

214 *Id.*
215 FMLC (July 2004, para. 1.2). See text to nn. 27 – 28 in ch. 1.
216 Benjamin (2000, 14.28 – 14.43).
217 *Ibid.*, para. 14.29.
218 *Ibid.*, para. 14.38.
219 Various Lehman entities were involved in the indirect holding system of securities.

- firstly, to show which of the three approaches described above provides a better understanding of the practice of intermediated securities: a right against a right, an indirect right in *rem* or an interest in securities;

- secondly, to establish whether and to what extent there is a need for statutory clarification, notwithstanding McFarlane and Stevens' suggestions that the existing legal framework can effectively ensure 'client asset protection'.

Chapter 3: The uncertainties surrounding *omnibus* accounts

1. The need to ensure an efficient functioning of indirect holding practices: individual segregated accounts or *omnibus* accounts?

In market practice, there can be said to be two ways of holding and transferring securities through intermediaries.

During the greater part of the 20th century, it was customary for the intermediary (who would hold securities for more than one investor) to create separate accounts for each client rather than commingling all securities of a particular issue in a single account[220]. To do so, the intermediary would open several client accounts with the issuer or with the higher-tier intermediary and would register each account in the name of one of his/her clients.

Since the 1990s, there has been a definitive shift from individual segregated securities accounts to pooled securities accounts[221], so much so that in most countries (including the United Kingdom)[222] intermediaries nowadays usually hold all securities of the same type in a global or *omnibus* account, maintained with the issuer or with the higher-tier intermediary, rather than segregated accounts for each client. This means that the second-tier intermediary (standing at the bottom of the chain) will open an *omnibus* account in his/her name with the first-tier intermediary, for example, and will then usually register the clients' interest in the pooled account in his/her own books[223]. As a result of this practice, with *omnibus* accounts 'the only reference to a clients' specific

220 Micheler (2010, p. 132) and Benjamin (1996, para. 2.74).

221 Although in most countries pooled accounts were introduced relatively recently (i.e. in the 1990s) in Germany and Austria they became 'standard practice' directly after the First World War, Micheler (2010, p. 132). Cfr. n. 228 of this chapter.

222 The possibility of opening and operating *omnibus accounts* is recognised, for example, in Australia, Austria, Belgium, Germany, Hong Kong, Japan, Luxemburg, Poland (only very recently), Singapore, the United Kingdom and the United States. In each of these jurisdictions, this practice may be subject to different conditions and restrictions (e.g. access to pooled accounts limited only for certain categories of investors). There are certain jurisdictions (such as those of France, Greece, Italy and the Scandinavian countries) where clients' securities are not allowed to be placed in *omnibus* accounts and, therefore, need to be segregated in individual accounts. See on this point also IOSCO (February 2013); AFME (March 2012) and English Law Commission (May, 2008, paras. 2. 51 – 2.53). 925

223 The practice of using *omnibus* accounts does not affect the requirement to segregate clients' assets from the intermediary's assets. Hence, in this example two separate accounts would typically be opened with the first-tier intermediary (i.e. an *omnibus* account for the clients' assets and a 'house' account for the second-tier intermediary's assets).

allocation is made in the [second-tier] intermediary's account and not in the account of [the first-tier] intermediary or in the register of the issuer'[224].

Omnibus accounts are used primarily to simplify the intermediaries' management of clients' investments and more broadly to provide a greater efficiency in the practice of indirectly held securities. This new method allows the intermediary to transfer securities from one customer to another (e.g. 10,000 shares from customer M to customer N) simply by recording such a transfer on his/her own books (i.e. by debiting M's account and crediting N's account with the 10,000 shares). Conversely, with individual segregated client accounts, an intermediary is required to enter this transaction not only in his/her own books but also in the books of higher-tier intermediaries or in the register of the issuer. This very simplified scenario[225] (which is represented in figure 1[226]) shows that unlike the individual segregation system, *omnibus* accounts have the advantage of drastically reducing the operational steps that an intermediary needs to undertake on a daily basis in order to manage his/her clients' investments[227]. Other benefits (related to *omnibus* account structures) may also include the reduction of administrative costs[228] and operational risks[229]. Moreover, when only one account is needed for many investors (i) fees associated with maintaining the account are significantly lower[230] and (ii) the likelihood of any technical failure is more limited[231].

---

224 English Law Commission (May 2008, para. 2. 17). See also Benjamin (2000, paras. 2.73 – 2.74) and FMLC (July 2004, para. 2.3) and Johansson (2009, para. 3.2.4).

225 In market practice the holding chain between the investor and the issuer is frequently more complex, especially in the case of cross-border transactions. In this regard, securities of the same issue can be held through multiple (e.g. three or four) tiers of intermediaries, each of which may (i) be located in different countries; (ii) act on behalf of a large number of clients (hundreds, if not thousands) and (iii) engage regularly in a variety of transactions for each of these clients (e.g. buying, selling and lending).

226 Figure 1 shows how transfers are made when all client securities are commingled in a single account. In this case, if M wishes to sell 10,000 shares to N, the transfer is only recorded in the account of the second-tier intermediary.

227 AFME (March 2012); Chan et al. (August 2007, p. 6).

228 This may explain why in certain countries *omnibus* account structures became standard practice at times of economic distress. This point was clearly highlighted by Micheler who states that interestingly in Germany and Austria, 'pooled accounts were introduced on a large scale in 1925 when years of hyperinflation forced banks to find a more *cost efficient* [emphasis added] mechanism of holding securities', Micheler (2010, p. 132).

229 Johansson (2009, para. 3.2.4) and Guynn (1996, pp. 24 – 25).

230 The practice of using *omnibus* accounts has the advantage of also reducing the costs related to 'transfers where credit and debit entries offset and the settlement processing technique permits internalised (or net) settlement', Turing (August 2005, p. 2). On this point, see also AFME, (April 2013, 4).

231 This aspect is highlighted by the AFME, *Post Trade*, cit. 8 – 9: 'There are two fundamental principles driving the use of *omnibus* accounts higher up the chain of intermediaries, rather than the use of more segregated account structures. The first is the principle of simplicity, rather than complexity; the second is the principle of data uniqueness (i.e. the principle that data should be stored and maintained in one place only, and not stored in multiple locations, so that –if the data were to change – there would not be the requirement that the update be effected in multiple locations, with the associated risk that not all updates

The combination of all these advantages (i.e. a greater simplicity, cost savings and lower operational risks) can facilitate the flow of capital and provide quicker access to liquidity[232].

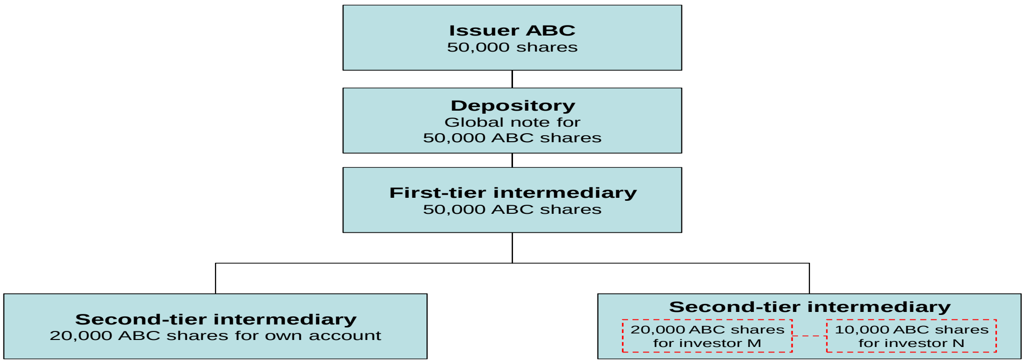


Figure 1

Source: Gullifer and Payne (2010), p. 13.

Setting aside the advantage gained by ensuring the efficient functioning of the market, *omnibus* or pooled accounts also have a downside and can create difficulties in protecting the investors' rights. One of the main characteristics of using a single client account is that all the assets are held by intermediaries on a 'fungible' and 'unallocated' basis. This means that the securities (i) are 'interchangeable with each other (typically as a result of having the same terms and conditions [as well as referring] to the same series of issue)'[233] and (ii) cannot be identified as belonging to a specific investor (since they are part of a large bulk of assets held in custody for all clients). As emphasised by Benjamin, 'while it is possible at any time to determine how many of the individual securities comprised in the client holding are attributable to a particular [investor], it is not possible to determine [specifically] which ones'[234]. A corollary of this peculiar form of custody is that 'the redelivery obligation owned by the intermediary to each client is not an obligation to return the assets originally delivered *in specie*, but merely an obligation to return assets equivalent to those originally delivered'[235].

are effected in the same manner, or at the same time). [...] These two principles suggest that the operation of *omnibus* accounts over segregated accounts is preferable both for reasons of cost (as simplicity is cheaper to manage than complexity) and for reasons of risk (as the maintenance of data in multiple locations creates the risk of inconsistencies between the data locations)'. On this point see also Turing (August 2005, p. 2) and Chan et al. (August 2007, p. 6).

232 The author is grateful to Joanna Benjamin for highlighting this point.

233 English Law Commission (May 2008, para. 2.17).

234 Yates and Montagu (2013, para. 3.25).

235 *Id.*

This practice of holding securities on a 'fungible' and 'unallocated' basis challenges the proprietary nature of the investors' rights in so far as such 'rights do not attach to particular assets'[236]. The core idea is that 'a property right creates a relationship between the owner and an asset and for a property interest to arise we need to be able to determine the asset to which the interest relates'[237]. Under English law this main principle applies to both legal and equitable ownership. In particular, with regard to equity, the 'identification of the asset' is also necessary for a successful creation of a trust.

These concerns lead us to seek answers to the following questions: (i) can 'a trust [be created] in favour of a client whose interests in securities are […] commingled together with those of other clients […]'?[238] (ii) which of the three theories proposed in the second chapter (i.e. a right against a right, an indirect right *in rem* or an interest in securities) can better reflect the commercial reality of how securities are commonly held by intermediaries? and (iii) does this point warrant the introduction of a statutory clarification? In the following sections of this chapter an attempt will be made to reply these questions.

2. The lack of sufficient certainty in *omnibus* accounts: is there a valid trust?

Pursuant to general principles of English trust law, three requirements must be satisfied in order for a valid trust to arise. These requirements are better known as the 'three certainties' and they include (i) 'certainty of intention' (i.e. parties should be willing to create a trust[239]) (ii) 'certainty of beneficiary' (i.e. the beneficiary should be known or ascertainable[240]) and (iii) 'certainty of subject matter (i.e. it is necessary to establish which assets are held on trust[241]). The first two 'certainties' can easily be met in the securities

[236] Benjamin (2000, para. 2.72). Hence, the ownership of a share in a fungible pool may be recharacterised as a mere contractual right.
[237] Micheler (2007, p. 122). See also Gullifer (2010, p. 22).
[238] Benjamin (2000, para. 2.80).
[239] In order to evaluate the mutual intention of the parties, English courts will not consider merely the wording used in the contractual agreement (e.g. technical legal language of trust law) but the substance of what the parties intended to achieve. On this point see *In re Kayford Ltd (in liquidation)* [1975] 1 WLR 279 and *Tito v. Waddell* (No 2) [1977] (Ch) 354.
[240] *Re Gulbenkian's Settlements* [1970] AC 508 and *McPhail v. Dalton* [1971] AC 424.
[241] This point is clearly highlighted by Webb and Akkouh, who state that '[a]s trusts involve the imposition of obligations in respect of the holding of property, we need to know to which property the trust relates',

markets, subject to the condition that the contractual agreement is sufficiently clear as regards the objective of the parties as well as the identity of the beneficiary[242]. On the contrary, the requirement for certainty of subject matter can create difficulties in practice, as it does not seem to be fulfilled in those cases where all securities are commingled in a single client account (as opposed to being segregated in multiple accounts).

The debate on this issue was triggered off by the case *Re London Wine Company (Shippers) Ltd*[243] in which the Court decided that a trust in a pool of fungible units cannot be considered valid if the parties are not able to clearly ascertain the items of property that are held for the beneficiaries. The case concerned a company that had sold wine to customers while retaining the possession of the wine in various warehouses. Following the insolvency of the company, the purchasers tried to assert a proprietary interest in the wine but their claim was rejected since it was not possible to specify which particular cases of wine included in the bulk were attributable to a specific contract of purchase[244].

Consistent with this reasoning, for most of the 20th century the general view was that a trust could not be created over a commingled pool of goods in the absence of a clear identification and segregation of such goods in favour of the beneficiaries[245]. However, if this principle were applied to *omnibus* accounts there would be serious implications for the financial market. Particularly, in cases of insolvency of the intermediary the

---

Webb and Akkouh (2013, p. 46). 'Moreover', Webb and Akkouh continue, 'if there is more than one beneficiary we need to know their respective entitlements in relation to the property; in other words, what part of the total fund each beneficiary gets', *Id.*

242 The intermediary usually registers the names of the account holders in his/her own books.

243 *Re London Wine Company (Shippers) Ltd* [1986] PCC 121.

244 In other words, in *Re London Wine Company (Shippers) Ltd* it was not really the mixing in itself that was fatal, but the non-attribution or earmarking of specific goods (comprised in the bulk) in favour of the beneficiaries, *Ibid.*, 137. Similar conclusions can be found in *Re Wait* [1927] 1 (Ch) 606 which concerned a contract for the sale of goods (and not a trust). In this particular case, the Court of Appeal held that the owner of a large bulk of goods (i.e. 1000 tons of wheat) could not transfer to another person an unallocated amount of that bulk (i.e. 500 tons of wheat). The main argument was that a proprietary right arises only in those circumstances where the goods can be 'earmarked, identified or appropriated as the [goods] to be delivered […] under the contract', *Id.* 629 (Atkin LJ). See, however, the dissenting opinion of Sargant LJ in *Ibid.* 645. For an analysis of this case see Bridge (2014, para. 3.31). In relation to the sales of tangible assets, the principle that no proprietary right can be transferred to the buyer prior to ascertainment was modified by the *Sale of Goods (Amendment) Act* 1995 ('SGAA 1995').

245 Another case (which supports this idea of a lack of sufficient certainty of the subject matter under a trust) is *Re Goldcorp Exchange Ltd* [1995] 1 AC 74 (PC), 90. In this case a gold dealer (Goldcorp Exchange) agreed with certain customers to hold gold on their behalf on an unallocated basis. Following the company's insolvency, the customers tried to assert the proprietary nature of their right. However, the Privy Council rejected their claim in so far as the assets had not been allocated to any specific customer (i.e. there was no 'customer name tag' on the gold bullion). For a detailed analysis of the case see Micheler (2007, p. 124).

investors would be prevented from claiming a proprietary right in the custody assets (being recognised as having merely a contractual right against the custodian)[246].

Luckily for the custody industry in the early 1990s this lack of sufficient certainty in *omnibus* accounts was overcome thanks to the decision in *Hunter v. Moss*[247]. Robert Joseph Moss was the registered holder of 950 shares in *Moss Electrical Company Ltd.* ('M.E.L.'). In 1986 he made a declaration of trust over 50 of those shares in favour of David Morris Hunter. Once again, there had been no specific designation of which assets (forming part of the bulk) were to be allocated to the beneficiary[248]. The court at the first instance held that when a trust is created over intangibles (such as shares), the requirement for certainty of subject matter does not apply. Indeed, in this case Moss 'did not identify any particular 50 shares for Hunter because to do so was unnecessary and irrelevant'[249]. All 950 shares which were held by Moss 'carried identical rights'[250] and therefore were perfectly interchangeable. Hence, according to Rimer QC 'any suggested uncertainty as to subject matter appears [in this case] theoretical and conceptual rather than real and practical'[251]. The Court of Appeal affirmed the decision of first instance by stating that a trust was validly created in favour of Hunter[252]. In this regard, Dillon LJ argued that '[j]ust as a person can give, by will, a specified number of his shares of a certain class in a certain company, so equally, in [his] judgment, he can declare himself trustee of 50 of his ordinary shares in M.E.L. […] and that is effective to give a beneficial proprietary interest to the beneficiary under the trust'[253].

Hunter v. Moss was followed by Neuberger J. in *Re Harvard Securities Ltd*[254]. Although with some reservation[255], the latter case confirms that the requirement for specific allocation of trust assets is not applicable to shares (as opposed to chattels)[256].

---

246 Yates and Montagu (2013, para. 3.29).
247 *Hunter v. Moss* [1993] 1 WRL 934, [1994] 1 WRL 452.
248 In other words, which 50 of Moss's 950 shares were to go to Hunter? The impact of this uncertainty is clearly addressed by Hayton: 'If Moss subsequently sells 50 shares how do the revenue know whether he is selling his own shares, so that he is chargeable to capital gains tax, or if he is selling Hunter's shares so that Hunter is so chargeable? If the proceeds of sale are profitably or detrimentally reinvested does the new investment belong in equity to Hunter or Moss?', Hayton (1994, p. 336).
249 *Hunter v. Moss* [1993] 1 WRL 946.
250 *Id.*
251 *Id.* With regard to the difficulty in establishing which of the trustee's subsequent dealings are related to the trust property, Rimer QC argues that 'if any uncertainty were to arise, that would not be because the trust fund was uncertain as to subject matter, but rather because the trustee failed to keep proper account showing how he had subsequently dealt with it', *Id.*
252 *Hunter v. Moss* [1994] 1 WRL 452.
253 *Ibid.*, 459.
254 *Re Harvard Securities Ltd* [1997] 2 BCLC 369

The decision in *Hunter v. Moss* was, however, subject to some criticism. According to certain scholars[257], there is no basis in law for asserting that trusts over intangibles should be treated differently from those over tangibles[258]. Moreover, it must be remembered that in English law the requirement for certainty of subject matter is considered essential also for trusts over money held in bank accounts[259]. Hence, it is somewhat difficult to understand why segregation should be required for certain types of intangibles (such as cash) but not for other types (e.g. shares).

Contributing to this debate, Goode offers a theory that attempts to reconcile the decision in *Hunter v. Moss* with the views expressed by those scholars who have criticised this judgment. In particular, Goode confirms the decision in *Hunter v. Moss* regarding the part on the validity of a trust over a pool of shares but provides different grounds on which such a conclusion can be reached. The starting point of Goode's analysis is to qualify interests in shares or in other securities (e.g. bonds) as co-ownership rights of a 'single, legally indivisible asset'[260] rather than interests in individual units. The rationale behind this definition is that shares and debt securities are considered no more than fractions or portions of an identified bulk, namely the share capital of the issuing company and the aggregate principal amount (and interests thereon) issued under a particular debt instrument[261]. Such a bulk is indivisible in the sense that transfers of any

---

255 Neuberger J takes into consideration the arguments that were addressed by certain scholars against the decision in *Hunter v. Moss*. Nevertheless, he comes to the conclusion that although he can see 'the force of these points', he still considers such a decision to be a binding precedent for the court, *Re Harvard Securities Ltd* [1997] 2 BCLC 369, 575 - 579. The reason for this is that *Hunter v. Moss* was not decided *per incuriam* and, therefore, it cannot be overruled, *Id*. *Hunter v. Moss* was applied (less reluctantly) in the Hong Kong case of *Re CA Pacific Finance Ltd.* [2000] 1 BCLC 494.

256 '[…] it seems […] that the correct way for me, at first instance, to explain the difference between the result in *Hunter* , and that in *Wait* , *London Wine* and *Goldcorp* , is on the ground that *Hunter* was concerned with shares, as opposed to chattels', *Ibid.* 578.

257 Hayton (1994, pp. 337 – 338); Hudson (2009, p. 104) and *Id.* (2013, p. 41). See also the Australian case of *White v. Shortall* [2006] NSW SC 1379.

258 It should be noted that 'on the particular facts of the case, it was clearly in the interests of justice that a valid trust should be found in the absence of a contractual entitlement', Yates and Montagu (2013, para. 3.40). Indeed, 'the judgment, which was pragmatic, focused more on the merits of the dispute before the court than the wider principles of equity', *Id.* For a favourable opinion regarding the decision in *Hunter v. Moss* see Worthington (1999, p. 6).

259 See, for example, *Mac-Jordan Construction Ltd v. Brookmount Erostin Ltd* [1992] BCLC 350; *Re Jartray Development Ltd.* [1982] 22 BLR 134; *Rayack Construction v. Lampeter Meat Co. Ltd.* [1979] 12 BLR 30; *Neste Oy v. Lloyds Bank plc* [1983] 2 Lloyd's Rep 658 and *Concorde Constructions Co Ltd v. Cogan Ltd.* [1984] 29 BLR 120. As pointed out, however, by certain scholars 'these cases may be distinguishable on the basis that they relate to generic and not *ex* bulk assets', Yates and Montagu (2013, para. 3.40 n. 2).

260 Goode (2003, p. 384).

261 This theory applies to shares and bonds regardless of the circumstances or whether a specific number or code has been allocated to each one of these securities. According to Goode, 'numbering is merely a form of accounting allocation and does not give a share [or a bond] an existence distinct from the […]

part of it (e.g. of a certain number of shares) are simply transfers of a portion of the bulk and, therefore, can only give rise to co-ownership of what constitutes a single asset[262]. This means that securities 'are not like bottles of wine, gold bars or potatoes'[263] in so far as they cannot be physically divided 'into separate units [which are] capable in law of being separately owned'[264].

The main difference between the decision in *Hunter v. Moss* and the theory of co-ownership is that the latter, unlike the former, does not accept the idea that a proprietary right can arise under a trust without attaching to a specific asset. According to Goode when a trust is created over a pool of intangible assets (such as shares) the requirement for certainty of subject matter continues to apply, albeit in a different manner from tangibles. In these cases 'there is no uncertainty of subject matter, because the trust property comprises the entire [bulk of assets]'[265]. In particular, the interest of each beneficiary attaches to a fraction or a portion of a single, indivisible pool of intangibles.

For example, with respect to intermediated securities, if the intermediary holds shares of a particular class for a certain number of investors, these customers will be considered as co-owners of the common pool of securities (rather than holders of an interest in separate assets)[266]. These considerations suggest that 'the true basis of the [decision in

---

issue of which it forms part', *Id.* Similarly, bearer securities are not treated differently from registered securities. Once again 'it is true that bearer certificates are susceptible to individual ownership as pieces of paper, but the paper has no independent value, it merely embodies an entitlement to a co-ownership interest in the securities issue itself', *Id.*

262 According to Micheler, Goode's theory is not in line with current company law principles in so far as 'shareholders do not own the share capital', Micheler (2007, p. 130). The reason for this inconsistency is that 'the share capital does not exist as an asset, it is rather a figure on the company's balance sheet reflecting the contributions made or owed by the shareholders to the company and serving as a tool to determine distributions of dividends and of other benefits', *Id.*

263 Goode (2003, p. 384).

264 *Ibid.*, 383.

265 Benjamin (2000, para. 2.82).

266 This idea of co-ownership applies regardless of whether securities are held in an *omnibus* account or in individual segregated accounts. Indeed, Goode rejects the view that with individual segregated accounts the customer retains ownership of particular securities (which do not belong to the common pool), Goode (2003, p. 387). In particular, he argues that the practice of using individual segregated accounts 'does not render the securities … any more divisible than they were before' the creation of such an account, *Id.* Hence, 'the customer's interest remains an indirectly held co-ownership interest with other investors in securities of the same class', *Id.* The difference between these two types of accounts is highlighted primarily in a situation of shortfall, since only clients using the *omnibus* account model are exposed to sharing potential losses caused by the intermediary in the pooled account. See on this point Gullifer and Goode (2013, para. 6.14).

Hunter v. Moss] was not the intangible nature of shares, but rather their indivisible nature'[267].

In agreement with Goode's theory, Benjamin argues that in custody arrangements the requirement for certainty of subject matter is automatically satisfied by an implied co-ownership arrangement among the custodian's clients[268]. Indeed, in these cases 'the custodian holds the client holding under a single trust for all clients to whose accounts it has credited the relevant security, as equitable tenants in common'[269].

This argument (based on the idea of an implied 'co-ownership' arrangement between the investors) assumes that the intermediary holds clients' assets separately from 'house assets'. The general rule, under financial service regulations[270] and general principles of trust law, is that an intermediary needs to segregate clients' assets from his/her own deposits[271]. The main objective of this principle is to ensure that customers' assets are safeguarded in the event of the financial failure of the intermediary[272]. Benjamin argues that when the intermediary complies with such a requirement, co-ownership rights in an *omnibus* account arise automatically[273]. The reason for this argument is that all the circumstances at stake seem to imply that it is the customers' common intention to (i) commingle all their assets in a single client account and (ii) acquire such assets as tenants in common.[274] English case law is not, however, clear on this point[275]. For this reason,

---

267 Benjamin (2000, paras. 2.87 - 2.88) (particularly n. 158).
268 *Id.*
269 Yates and Montagu (2013, para. 3.42) and Benjamin (2003, p. 263).
270 See, for example, Rules 6.2.1 and 6.2.2 of Client Asset Sourcebook (CASS). The rules contained in CASS are designed to implement certain requirements under Articles 13 (7) and 13 (8) of the Markets in Financial Instruments Directive (EC) 2004/39 ('MiFID') and Article 16 (1) (d) of the Commission Directive (EC) 2006/73, whose aim is to ensure that regulated firms make adequate arrangements to safeguard clients' ownership rights. See also Article 16 (8) and paragraph 51 in the preamble of the EC Directive 2014/65 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU ('MiFID II') which is intended to comprehensively revise MiFID and is expected to take effect from January 2017.
271 This means that separate accounts will be opened by the intermediary, depending on whether they relate to its own securities or to its clients' securities (see figure 1). Cfr. n. 223 in this chapter.
272 European Commission (2010, para. 13.2). Indeed, this segregation ensures the speedy recovery of clients' assets following the insolvency of the intermediary. In other words, it reduces the market impact of the insolvency of an investment firm.
273 Benjamin (2000, para. 2.83).
274 This analysis is consistent with *Re Stapylton Fletcher Ltd., Re Ellis, Son & Vidler Ltd* [1994] 1 WRL 1181, [1995] 1 All ER 192 where the Court held that the customers of a wine company were 'jointly interested, as tenants in common, in the bulk' (1198 and 210). The facts of this case are very similar to those in *Re London Wine Company (Shippers) Ltd* [1986] PCC 121. There are, however, certain differences that explain the contrasting outcome of the two cases. In *Re Stapylton Fletcher Ltd* the bottles or cases of wine intended for the customers had been carefully recorded and segregated from the company's trading stock, before being commingled in the warehouse stock ([1994] 1 WRL 1181, 1194). On the contrary, in *Re London Wine Company (Shippers) Ltd*) the customers' goods had never been identified and physically segregated

in market practice intermediaries are expressly advised to provide a co-ownership status in their clients' documentation[276].

The precise nature of the investors' rights in an *omnibus* account was specifically addressed by the FMLC in its Commentary on Principles for Investment Securities Statute in 2004. The FMLC recommends the introduction of specific rules which state that, unless otherwise agreed, the intermediary's clients have co-proprietary rights in the pooled account. Such 'rights are proportioned to the entitlement of each customer' and, therefore, do not attach to specific securities but to a fraction of the co-owned pool[277]. The wording of the proposed rules is in line with the Sale of Goods Act 1979 ('SGA 1979') which introduces the concept of an implied co-ownership. In particular, Section 20 A states that title to a share in the identified bulk passes to the buyer once the purchase price has been paid. In this case, the buyer acquires an 'undivided share in the bulk'[278] and 'becomes an owner in common of the bulk'[279]. The purpose of this provision is clearly to extend the existing concept of tenancy in common to 'a contract for the sale of a specified quantity of unascertained goods'[280]. Hence, Section 20 A is not intended to apply to intangibles (such as intermediated securities) but only to cases involving sales of goods.

Notwithstanding the FMLC's proposal, a statute on intermediated securities (comprising similar rules to those stated in Section 20 A SGA 1979) has not yet been introduced in the United Kingdom. Hence, scholars and practitioners have been eager for a solution on *omnibus* accounts (based on the idea of co-ownership) to be developed at least

---

from the assets of the company. The difference in circumstances between the two cases led the Court in *Re Stapylton Fletcher Ltd* to assert the existence of a tenancy in common in the bulk between the customers.

275 As emphasised by Benjamin '*Re Stapylton Fletcher Ltd* related only to legal interests arising in the sale of goods' Benjamin (2000, para. 2.88, n. 144). Conversely, '*Re London Wine Company (Shippers) Ltd*) considered the position both at law and in equity, and indicated […] that very clear wording would be required in order for an equity in common to arise'. This shows that *Re Stapylton Fletcher Ltd* can hardly be used as authority in relation to trusts over intangible property.

276 Benjamin (2000, para. 2.88).

277 *Commentary on Principles For Investment Securities Statute*, Principle 2 in FMLC (July 2004). See, on this point, Article 25 (4) of the Geneva Convention (Kanda et al. (2012, para. 25.15) that leaves to Member States the possibility of choosing which technique to allow in market practice (i.e. individual segregation, *omnibus* accounts or both options).

278 Section 20 A (2)(a) SGA 1979

279 Section 20 A (2)(b) SGA 1979.

280 Section 20 A (1) SGA 1979. More specifically, the SGA temporarily re-characterises the contract for the sale of goods as a contract for the sale of a share in goods. Only when the goods are subsequently separated from the bulk does the contract go back to being simply characterised as a sale of goods.

through case law[281]. Such an opportunity to deal with this matter arose in *Pearson and others v. Lehman Brothers Finance SA* (better known as the Rascal case)[282].

The case concerned the beneficial ownership of securities (worth in excess of US$ 1.5 bn) which were acquired by Lehman Brothers International – Europe ('LBIE') on behalf of its affiliates before the collapse of Lehman Brothers Group. The relationship between LBIE and its affiliates had been structured in a rather unusual manner in so far as LBIE (who acted as the trustee) was entitled to (i) hold all securities acquired both for itself and its affiliates in un-segregated accounts and (ii) use such securities 'as part of its own business assets'[283]. These circumstances were inconsistent with a typical trustee-beneficiary relationship and led LBIE to challenge the beneficial title to the securities upon the affiliates. The parties had elaborated a very complex mechanism to overcome certain regulatory restrictions while at the same time preserving the Lehman Group's global settlement practice. In this regard, it was customary for LBIE to settle all the securities which were acquired for the affiliates into its own account rather than into a separate account. These securities were usually used by LBIE either to raise finance for the Lehman Group by lending the assets to third parties or, alternatively, to cover short positions (which may arise inadvertently due to settlement failures). This practice 'was perceived to be very beneficial to the [Lehman] Group in terms of efficiency and economy, but it was also perceived to create, at least potentially, [certain] problems for [LBIE]'[284]: primarily (i) the need to comply with the regulatory requirements regarding the segregation of securities acquired by LBIE for his/her clients (including the affiliates) and (ii) the fact that 'the use of securities for the raising of finance […] required [LBIE] to be able to transfer absolute and unencumbered title to [third parties]'[285]. In order to address these problems, the Lehman Group introduced the so called 'RASCALS' scheme which involved the use of repo contracts and stock loan agreements so that each affiliate could sell LBIE its beneficial proprietary interest in the underlying securities 'in exchange for monetary consideration, […] leaving the affiliate with a contractual right against LBIE to recover its proprietary interest in equivalent

[281] Benjamin (2000, para. 2.85) and Birks (1998, p. 230).
[282] [2010] EWHC 2914 (Ch) and (2011 EWCA Civ. 1544). For an analysis of this case see Dilnot and Harris (2012, p. 272); Toube (2011, p. 74); Sherman & Sterling LLP (2012, p. 77); Cooke (2011, 136); Lyons et al. (2012, p. 195); Goodman (2012, p. 57).
[283] [2010] EWHC 2914 (Ch), para. 72.
[284] *Ibid.* para. 8.
[285] *Id.*

securities, again for monetary consideration, at a future date'[286]. This mechanism enabled LBIE to maintain a 'non trustee-like conduct' for as long as it held beneficial title to the asset, pursuant to repo contracts and stock loan agreements. Taking into consideration all these circumstances, LBIE claimed in Court that no beneficial title was ever acquired by the affiliates (due to uncertainty of subject matter or uncertainty of terms in the trust).

Briggs J. rejected LBIE's argument by stating that 'the law should not confine the recognition and operation of a trust to circumstances which resemble traditional family trust, where the fulfillment of the parties' commercial objective calls for the recognition of a proprietary interest in [the affiliates]'[287]. More specifically, Briggs J confirms the idea that a trust which is created over a large pool of securities for the benefit of different parties is not void for the lack of certainty of subject matter[288]. In support of this judgment, Briggs relies on Goode's theory when stating that in this case a 'trust works by creating a *beneficial co-ownership share in the identified fund* [emphasis added], rather than in the conceptually much more difficult notion of seeking to identify a particular part of that fund which the beneficiary owns outright'[289].

One should mention, however, that Briggs J does not look into the nature of the underlying securities to reach these conclusions and therefore he does not seem to comply *in toto* with Goode's analysis. Indeed, there is no reference in the judge's decision as to whether the underlying securities should be classified as 'a single, indivisible asset' as opposed to separate units. Unlike Goode, Briggs J bases his judgment simply on the idea that under the circumstances of the case it was the parties' common intention to create a single trust over all the securities held in the pooled

---

[286] 2010] EWHC 2914 (Ch), para. 11.

[287] *Ibid.*, para. 225. The reason for this decision is that 'at the heart of any repo or stock loan [agreement, lies] a mutual assumption that, prior to its taking effect, the […] seller or stock lender [should have] some form of proprietary interests in the underlying securities' (para. 297). Indeed, in line with the RASCALS scheme, the parties' commercial objective was divided into three main phases: firstly, to confer an equitable proprietary interest upon the affiliates by way of creating a trust; secondly, to transfer such an interest to the trustee (i.e. LBIE) so as to preserve the Groups' global settlement practice and thirdly, to re-transfer the beneficial ownership back to the affiliates. This 'three-phase process' was repeated by the parties on a daily basis until the securities were finally sold on the market.

[288] [2010] EWHC 2914 (Ch), para. 225 (principle iii): 'a trust of part of a fungible mass without the appropriation of any specific part of it for the beneficiary does not fail for uncertainty of subject matter, provided that the mass itself is sufficiently identified and provided also that the beneficiary's proportionate share of it is not itself uncertain'.

[289] *Ibid.*, para. 232. Briggs J applies the concept of co-ownership also in *LBIE v. RAB Market Cycles* [2009] EWHC 2545 (Ch), para. 56. On this point see the Australian case *White v. Shortall* [2006] NSW SC 1379, paras. 153 – 192 and 212. See also Hayton et al. eds. (2010, paras. 814 – 8.22) and Morton (2003, p. 298).

account[290]. Accordingly, there was no uncertainty of subject matter because the trust property comprised the entire account holding rather than just unidentified parts of it[291]. This means that when clients' securities are held by an intermediary in an *omnibus* account, each investor is entitled to a proportionate share in the trust property. Such a principle is considered as 'the basis upon which securities are intermediated in the modern world, and therefore a principle to which the law should lend the broadest possible support'[292].

The decision in the Rascal case goes even further when it emphasises that a trust is valid even in those cases where the property is 'a constantly changing fund beneficially co-owned by a constantly changing class of the clients of the trustee'[293]. Furthermore, a trust does not fail for want of sufficient certainty 'merely because the trustee has, at the date of the creation of the trust, yet to acquire property answering the relevant description'[294].

In December 2011, Briggs J's judgement was for the most part upheld on appeal, confirming that the investors (whose assets are held in the pooled account) are considered co-owners of the trust property[295].

---

[290] See on this point also *LBIE v. RAB Market Cycles* [2009] EWHC 2545 (Ch), para. 56; *Lehman Brothers International (Europe) (in administration) v CRC Credit Fund Ltd and others* [2010] EWCA Civ. 917, para. 171 and *Eckerle v Wickeder Westfalenstahl GmbH* [2013] EWHC 68 (Ch), para. 14 (g). As emphasised by Gullifer, the idea that shares or debt securities are fractions of an indivisible bulk (and that, consequently, they cannot be identified as single units) 'has not been the subject of much discussion in the literature or the cases', Gullifer and Goode (2013, para. 6.14). However, certain reservations have been raised by Morton who believes that such an approach can create some form of inconsistency in practice. 'Take [for example] the question of voting rights', Morton (2003, p. 298). 'According to [Goode's] analysis', continues Morton, 'the voting rights of shareholder A and shareholder B form part of a single asset which they hold in common with each other and the other shareholders': '[i]s it not odd that they can exercise these common rights in opposite ways?', *Id.* Furthermore, with regard to intermediated securities, Micheler emphasises that shares or bonds can be segregated from other units of the same issue by entering separate entries for each investor in the shareholders' register. Although these entries cannot be considered as physically separate, they are still techniques which allow the allocation of specific units to certain investors, Micheler (2007, p. 130). For a different opinion see, Benjamin (2003, p. 263) and Ooi (2003, para. 3.14).

[291] [2010] EWHC 2914 (Ch), para. 233. See on this point *Re CA Pacific Finance Ltd.* [2000] 1 BCLC 494. Furthermore, a trust does not fail for want of sufficient certainty 'merely because the trustee has, at the date of the creation of the trust, yet to acquire property answering the relevant description', *Pearson and others v. Lehman Brothers Finance SA,* [2010] EWHC 2914 (Ch), paras. 225 (principle iv) and 235. See also *Tailby v. Official Receiver* (1888) 13 App Cas 523.

[292] [2010] EWHC 2914 (Ch), para. 227.

[293] *Ibid.*, para. 233. See on this point also *Re CA Pacific Finance Ltd.* [2000] 1 BCLC 494.

[294] *Pearson and others v. Lehman Brothers Finance SA,* [2010] EWHC 2914 (Ch), paras. 225 (principle iv) and 235. See also *Tailby v. Official Receiver* [1888] 13 App Cas 523.

[295] [2011] EWCA Civ 1544 (paras. 71 – 73). The Court of Appeal confirmed Justice Briggs' decision in the part where it stated that a valid trust was created between the parties and that consequently the beneficial title had passed from LBIE to the affiliates. The next issue was to understand whether the

The approach taken in the Rascal case seems to be in line with Section 20 A SGA 1979 which applies the concept of co-ownership to a bulk of goods in cases involving contracts of sales. Of course, with trusts as with sales the idea of co-ownership can be applied only in those circumstances where (i) the bulk is sufficiently identified; (ii) the parties' proportionate share in the fund is not itself uncertain and (iii) the bulk is comprised with fungible assets. Provided that these conditions are met, it is possible to argue that it was the parties' common intention to acquire a proportionate share in the identified bulk.

A similar idea of co-ownership in *omnibus* accounts was introduced in the United States under §8-503 (b) UCC. This provision confirms that when clients' securities are commingled in a single account, each investor is entitled to a '*pro-rata* proprietary interest in the fungible pool of underlying securities held by the intermediary'[296].

3. The application of the idea of co-ownership to the theories of a right against a right, an interest in securities and an indirect right *in rem*

McFarlane and Stevens believe that the problem of uncertainty of the subject matter in *omnibus* accounts may be overcome by using the concept of a right against a right (as opposed to that of a proprietary right).

The main point of this argument is that the theory of co-ownership proposed by Goode can be applied without difficulty to the concept of a right against a right. In particular, McFarlane and Stevens confirm the idea that for a trust to be valid, 'there is no need for the intermediary to segregate any specific [securities] before declaring a trust in favour

---

beneficial title to the securities had been reacquired by LBIE as a result of the RASCALS scheme. At first instance, Justice Briggs held that 'LBIE [had] paid the price on the on-leg of the first repo by offset against [the affiliates]'s debt for the acquisition price', [2011] EWCA Civ. 1544, para. 123 and [2010] EWHC 2914 (Ch), para. 20). Hence, the beneficial title had passed to and had remained with LBIE until the securities were sold back to the street. The Court of Appeal agreed with these conclusions, although it based its decision on a different reasoning. In particular, (in contrast with Briggs' decision) the Court of Appeal stated that no effective payment had been made on the on-leg of the first repo by way of offset of the debt owed to LBIE by the affiliates. Nevertheless, pursuant to the terms and conditions of the RASCALS arrangements the affiliates were estopped by convention from denying that the beneficial title had passed to LBIE.

[296] Rogers (1995, p. 692). As emphasised by Vaaler, 'although the term "fungible bulk" used in the 1978 version is not used in Revised Article 8 (based, perhaps, on lack of euphony) the concept is the same, i.e. the account holder acquires a property interest in the fungible pool of securities held by the intermediary', Vaaler (1996, p. 282, n. 119).

of an investor'[297]. The reason for this is that 'a requirement of segregation may be justified in relation to [tangibles] but is irrelevant when considering [securities]'[298]. For example, 'a notion of an individual share, unlike the notion of an individual sheep, makes no sense'[299]. Shares cannot be divided into separate units in so far as they are simply 'proportionate right[s] against the company and other shareholders'[300]. This means that the holder of 100 shares out of an issue of 1,000 shares has a tenth share in the company. Similarly, with regard to a trust, if a company issues 200 shares of which A holds (as a trustee) 100 for B, there is no inconsistency in stating that B has not only a personal right against A but also a right against A's half share in the company (i.e. a right against A's right to the 100 shares).

This analysis has shown that there is scope for Goode's theory to be applied to the concept of a right against a right[301]. Nevertheless, two further considerations can also be raised regarding this analysis. Firstly, McFarlane and Stevens do not offer a new solution to the problem of uncertainty of the subject matter in a trust but simply rely on the existing theory of co-ownership elaborated by Goode. Secondly and more importantly, they do not necessarily demonstrate that the theory of co-ownership is less effective when using the idea of an interest in securities. In this regard, it should be mentioned that Goode never challenged the proprietary nature of the investor's right in an *omnibus* account but simply stated that what the investor really acquires is a beneficial *co-ownership* [emphasis added] in a single, indivisible asset, rather than in separate units. Hence, following the example mentioned above, there can be no difficulty in arguing that B acquires both a personal right against A as well as an interest in 50% of the share capital of the company. More specifically, the proprietary right of the beneficiary *attaches* [emphasis added] to a sub-property, which is ultimately connected to a portion of the share capital of the company)[302]. The difference between the idea of a right against a right and that of an interest in securities is more a question of labels rather than of substance, given that in the first case B acquires a right in A's right in the share capital

297 McFarlane and Stevens (2010, p. 40).
298 *Id.*
299 *Id.*
300 *Id.*
301 Unlike Goode, however, McFarlane believes that in this case a shareholder would not acquire a portion of the share capital but simply a percentage of a set of personal rights against the issuer (e.g. a right to dividend and a right to vote at meetings), McFarlane (2008, p. 136).
302 See, however, n. 262 of this chapter.

of the company whilst in the second B acquires a proprietary right (i.e. a right in a sub-property).

The same argument could be used with regard to the approach of co-ownership, given by Briggs J in the Rascals case. This means that such an approach can be applied to a trust over a pool of securities, regardless of whether the interest of the beneficiary is classified as a *sui generis* right or as a proprietary right[303]. Once again, the only difference between these two classifications would be that in the first case, the trust fund comprises simply a bulk of multiple rights against the intermediary, whilst in the second it consist of a bulk of separate assets[304].

It is possible to argue that also the concept of an indirect right in the underlying securities can be applied to the two approaches of co-ownership. This means that if A holds 100 shares for B, nothing should prevent us from stating that B can have an indirect right either in the share capital of the company or in the individual securities comprised in the client account.

Doubts, however, could be raised regarding the possibility of accepting the idea of an indirect right *in rem* when investigating certain consequences related to the practice of *omnibus* accounts, mainly the lack of transparency in the indirect holding system. As mentioned at the beginning of this chapter, with *omnibus* accounts the investor's interest in the securities is only shown in his/her intermediary's books and cannot be traced higher up the custody chain. This means that the investor is not in a position to know where and with whom his/her securities are held. For example, if A holds the securities on trust for B, who holds them on sub-trust for C, it is difficult for C (without B's intervention) to monitor his/her securities, as no reference is made in A's account to C's proprietary right in the underlying securities[305]. Although these circumstances significantly weaken C's interest in the underlying securities, such reasoning could be

303 For a different approach see Micheler (2010, pp.144 – 149) who argues that shares have a special purpose that makes them different from property and obligation. In particular, 'securities are fungible instruments that are issued by companies […] with a view to raising money for their business […]', *Ibid.*, 144. Micheler emphasises that the law is designed to facilitate this purpose and to make the circulation of securities cost efficient. These special characteristics explain why the ordinary rules of identification do not apply to securities but only to tangibles.
304 Of course, if one were to accept the concept of an interest in securities, the item of property held by each account holder would correspond to the package of rights against the intermediary. Cfr. text to nn. 184 – 185 in chapter 2.
305 Similarly, the issuer would only recognised A as the owner of the securities, as there is no reference in his/her books to either B or C.

based on the peculiar nature of C's proprietary entitlement, i.e. its indirectness. In other words, one could say that A is not aware of C's ownership *status*, since C's interest is strictly related to B's interest in the underlying securities[306]. This argument is not very convincing, however, since it is difficult to view C's proprietary right as 'attached' to the underlying securities if there is no clear tracing thread between the investor standing at the bottom of the chain and the securities issued by the company.

On the basis of this analysis, it would seem clear that the practice of using *omnibus* accounts could easily be explained by the theories of a right against a right and an interest in securities, but that it could conflict with the theory of an indirect right in *rem*.

4. Identifying legal sensitivities in the current legal framework

The final question that remains unanswered is whether recent developments in case law have removed the uncertainties surrounding *omnibus* accounts.

In contrast with the FMLC's recommendations, McFarlane and Stevens argue that no statutory intervention is necessary to overcome the lack of sufficient certainty in *omnibus* accounts.

Indeed, the problem raised by most practitioners with regard to pooling seems to be resolved by the court's current understanding of the conceptual rules. In particular, Briggs J confirms the idea that a trust is valid despite the fact that clients' securities are held on an unallocated basis by the intermediary. This statement has even greater value if one considers that in the Rascals case the parties do not really challenge the principle of co-ownership itself but only its application to the specific circumstances of the case ('where the intermediary [was] free to deal with the securities as it pleases and to mix them with others held for other affiliates and for its own benefit'[307]).

[306] Of course, C's reliance on B is primarily due to the legal structure of intermediation as well as the application of the no-look-through principle (regardless of whether the securities are held in an *omnibus* account or in an individual segregated account). Yet, the lack of transparency typically associated to *omnibus* accounts significantly exacerbates such reliance on B, making it impossible for C to track his/her securities along the holding chain.

[307] [2011] EWCA Civ 1544, para. 72.

A lack of legislation, however, raises the question of how an *omnibus* account can operate in practice[308]. In particular, if the intermediary's clients are to be considered as co-owners of the pool of securities, it is necessary to establish whether each of these clients should obtain the consent of the other co-owners in order to dispose of his/her assets. In relation to goods forming part of a bulk, a solution to this problem was expressly provided by the SGA 1979 which introduces the concept of an implied consent among the co-owners. In particular, Section 20 B states that each co-owner can deal with his/her share in the bulk without having to obtain the express consent of the others. Conversely, in the case of intermediated securities there are no specific rules confirming the existence of an implied consent among the parties. For these reasons, intermediaries are advised to expressly provide for a similar principle in the account agreement[309]. Hence, a statutory clarification on this point would certainly be useful[310].

5. The future of *omnibus* accounts in the aftermath of the Lehman Brothers' collapse

Notwithstanding the problem related to the allocation of specific securities, the practice of opening *omnibus* accounts also entails other sensitive implications for financial market infrastructures. In particular, earlier in this chapter it was emphasised that *omnibus* accounts reduce the level of transparency in the indirect holding system, in so far as the investor's proprietary interest is only recorded in his/her intermediary's account[311]. This means that neither the issuer nor the higher-tier intermediaries have any relevant information regarding the amount, location, value and ownership *status* (including the

---

308 *Ibid.*, para. 2.85

309 The trend towards an implied consent between the parties streamlines and expedites the process relating to the transfer of securities.

310 While admitting that the theory of co-ownership has now been accepted by the courts, Moss infers that 'uncertainty has [not] been [completely] "squeezed" out of […] the problem' regarding *omnibus* accounts, Moss (2010, p. 66). A satisfactory solution would be to regard the trustee as holding a pool of shares on trust, not only for the clients but also for his/her own benefit. According to Moss 'there is nothing conceptually difficult about all the shares being held on trust in this way and the terms of the trust decide who gets which of the shares', *Id.* 'The awkwardness here', continues Moss, 'is that intermediaries don't normally regard shares that they own themselves as shares held on trust for themselves and documentation is unlikely to be drafted on this basis', *Id.* The idea that the property can be beneficially shared with the trustee is consistent with general principles of trust law (which allow a party to act both as the trustee and the beneficiary of a trust fund). With regard to intermediated securities, this general principle has been recently confirmed in the Rascals case where Briggs J argues that a trust is valid even if the property is beneficially shared by the intermediary with his/her clients, 2010] EWHC 2914 (Ch), para. 233. In other words, nothing prevents a party from being both the trustee and the beneficiary of a trust fund. In this case, the trustee/beneficiary may also decide to share the beneficial ownership of the fund with other parties.

311 See *supra* text to nn. 221 - 224 of this chapter.

existence of liens or encumbrances) of the investor's assets. In view of the concentration of all these data in only one place (i.e. the relevant intermediary's account), the application of appropriate rules is warranted to safeguard the client's assets and minimise the risk of loss or misuse in cases of insolvency or fraudulent behaviour by the intermediary.

The European Commission has recently raised certain reservations on the practice of using *omnibus* accounts. In particular, it argues that one of the main obstacles to 'promoting the book-entry in an account […] as the definitive proof of rights is […] the pooling of securities in *omnibus* accounts' which has the effect that 'the holding chain is *complex and opaque* [emphasis added] and rights of the accounts holders are *unclear* [emphasis added] and may even be exercised more than once over the same security.'[312] The core idea is that *omnibus* accounts may have contributed to the problems encountered in the failure of Lehman Brothers in so far as these types of accounts make it 'difficult to identify who owns what, where risk is concentrated and who is exposed to whom.'[313]

This argument was subject to severe criticisms by most practitioners who believed that 'such a reasoning is, at best, misconceived'[314]. There is no clear evidence that in the Lehman Brothers case the lack of protection of the investors' rights was caused essentially by the practice of using *omnibus* accounts[315]. On the contrary, it seems that this problem was related to the existence of substantial inadequacies in the firm's existing policies and procedures for holding clients' money and assets[316]. One of the main difficulties faced during the insolvency procedure was the considerable lack of certainty surrounding the clients' entitlement over money and assets. This problem was caused by several factors, which included (i) insufficient and inaccurate record-keeping[317], (ii) lack of communication within the Lehman group[318], (iii) inadequate trust

---

312 European Commission (October 2012). For an analysis of this paper see Yates and Montagu (2013, paras 7.191).
313 European Commission (May 2013).
314 Yates and Montagu (2013, para.7.191).
315 The author is deeply grateful to Joanna Benjamin for these considerations. An extensive analysis of the main problems arising in the Lehman Brothers case has been evaluated by Joanna Benjamin in a forthcoming research paper which was very kindly discussed with me in *ante prima*.
316 Benjamin (2014, p. 334). More broadly, as emphasised by Joanna Gray and Peter Metzing '[d]uring the collapse of Lehman Brothers regulators, competitors and even the Lehman's management could not identify their exact financial exposures to one another on a timely basis, which contributed to the systemic effects of its demise', Gray and Metzing (2013, p. 237)
317 FSA (September 2012, para. 4.14) and *Id.*, (January 2010, para. 1.4).

letters for client money[319], (iv) failure to strictly comply with segregation requirements between house accounts and clients' accounts[320] as well as (v) the use of complex secured financing arrangements which jeopardised the protection of clients' assets[321].

Of course as mentioned earlier, with pooling clients are more exposed to the risk of inadequate behaviour by the intermediary. However, this could be overcome by introducing more effective rules that promote the safeguarding of clients' assets and enhance the supervision of the intermediaries by the regulatory authorities[322]. In this regard, the Financial Conduct Authority ('FCA') has recently undertaken a fundamental review of the client money and custody assets regime[323]. The objectives include, for example, to improve 'systems and controls for maintaining accurate and up-to-date records of client assets holdings'[324] as well as enhancing 'the information provided to consumers (both retail and wholesale) about how their money and assets are held by a firm'[325].

Other regulatory initiatives (undertaken both nationally and internationally) that may indeed enhance client asset protection, include proposals or recommendations to (i) enhance the existing duties to cooperate and share information in an insolvency proceeding[326]; (ii) increase the transparency of a firm's intra-group relations[327]; (iii)

---

318 This point was highlighted by Joanna Benjamin in a forthcoming research paper.

319 'Some firms could not locate trust acknowledgements for each of the firms' client money accounts or produce evidence that the trust status extended to the deposit or money market facilities they used' FSA (January 2010, p. 5). According to the FSA 'having this documentation in place is an important requirement' as '[l]etters confirming the trust status of the account acknowledge that a statutory client money trust has been established for the proper segregation of client money', *Ibid.* 2.1.8. See, on this point, also CASS 7.8.1.

320 'Appropriate segregation and accurate record-keeping of client money is essential for the effective operation of the trust that is created to protect client money', *Ibid.*, 2.2.23. As emphasised *In the matter of Lehman Brothers International Europe (in administration)* [2012] UKSC6, the lack of strictly complying with this requirement as well as the ambiguities revealed in the regulatory framework (CASS 7.4.11) were factors that caused significant delay in the return of clients' money. A similar situation arose in connection with the segregation of clients' securities. In the Rascals case, although the parties did not *stricto sensu* breach the segregation requirement (CASS 6.2.1) they had devised a scheme for the sole purpose of circumventing the regulatory restriction. This scheme was so complex and atypical that it created significant uncertainty as to 'who owns what' and, consequently, delays in returning the assets.

321 For example, in *RAB Capital Plc v Lehman Brothers International (Europe)* [2008] EWHC 2335 (Ch) LBIE's prime brokerage clients faced considerable difficulties in retrieving their assets.

322 The author is deeply grateful to Joanna Benjamin for her thoughts on this point.

323 FCA (June 2014, paras. 2.1 and 2.2) and *Id.* (July 2013, para. 1.11).

324 IOSCO (February 2013, Recommendations 1 and 3) and *Id.* (January 2014, Recommendations 2, 5 and 6). See also FCA (June 2014, paras. 1.9 - 1.15/5.28 – 5.97/6.10/7.153 – 7.157) and *Id.* (2013, para. 1.24).

325 FCA (July 2013, para. 1.6) and *Id.* (June 2014, paras. 1.6 and 9.1 – 9.33).

326 Bloxham (January 2014, Recommendations 21-27). See also Regulation 13 of the Special Administration Regulations 2011.

327 Bloxham (April 2013, para. 5.38). See also FCA (June 2014, paras. 5.23 – 5.26).

introduce a clear distinction in a firm's records between securities held on a purely custody basis and those which are subject to more complex contractual arrangements (mainly, the use of custody portfolio as collateral for financing)[328]; (iv) increase the transparency of securities financing transactions[329]; (v) strengthen fiduciary duties of investment intermediaries[330] and (vi) introduce limits to the practice of rehypothecation (along the lines of US law)[331].

Although these regulatory initiatives may be warranted for all types of client accounts (whether segregated or pooled), they are certainly considered essential when using *omnibus* accounts[332].

In support of this argument, Benjamin recognizes that 'the use of individually segregated client asset accounts is an option that certain particularly risk averse clients prefer'[333]. However, she also points out that, unlike pooling, this method 'is operationally costly, as it is incompatible with the aggregation and netting of inputs at each stage of post-trade processing and at each level of the global custody network'[334]. This means that 'any significant shift from *omnibus* to individually segregated accounts would introduce significant costs and delays in post trade processing, and therefore market liquidity'[335].

In the latest report on the proposal for a Security Law Legislation ('SLL'), the European Commission partly confirms its reservations on pooling. The idea is to enhance

---

328 Bloxham (January 2014, paras. 8.94-8.97). See also FCA (June 2014 paras. 1.15 and 5.23/5.26).

329 Proposal for EU regulation on reporting and transparency in securities financing transactions, 29 January 2014. See also FSB (April 2012).

330 Law Commission (October 2013).

331 Under US Federal Reserve Board's Regulation T and SEC (i.e. Securities Exchange Act) Rule 15c3-3 a prime broker may rehypothecate assets to the value of 140% of the client's liability to the prime broker. In other countries (including the UK), there are no statutory limitations on the amount of client's assets that can be rehypothecated. Hence, unless parties do not decide to negotiate a limit on rehypothecation a prime broker is free to rehypothecate 100% of the value of assets deposited by clients.

332 An interesting proposal suggested by Benjamin would be to introduce two separate regulatory regimes for two different types of custody service, i.e. 'traditional custody' (typically involving long-term institutional investors) and 'client securities finance' (concerning, for example, hedge funds whose assets are normally used as collateral for financing). The introduction of two separate regimes would allow regulators to better target investors' needs without jeopardising market efficiency, Benjamin (2014, pp. 327 – 328).

333 These considerations are quotes from forthcoming research by Joanna Benjamin, not yet published but very kindly discussed with me in *ante prima*.

334 *Id.*

335 *Id.*

transparency[336] firstly by offering the customer the option of choosing between individual segregated accounts and *omnibus* accounts[337] and secondly by trying to introduce some form of restriction on pooling[338].

Nevertheless, certain conditions on pooling have already been introduced into other EU 'post-crisis measures'[339] whereby the intermediary is required, for example, to (i) offer customers a choice between *omnibus* accounts and individual client segregation[340], (ii) inform them of the costs and level of protection associated with these options[341], (iii) invite clients to confirm their choice in writing[342] and (iv) provide these services on 'reasonable commercial terms'[343]. The European Commission intent is to facilitate the use of individual segregation by attempting to make customers more aware of the potential risks associated with *omnibus* accounts and to offer segregation at a 'commercially reasonable' cost.

These considerations show that although most of the uncertainties related to *omnibus* accounts have now (to a large extent) been removed, there are still certain problems

336 One of the main objectives of the future SLL is to 'ensure that the beneficial owners have appropriate transparency and control over their assets', European Commission (May 2013, para. 20).

337 The existing practice allows the intermediary to decide whether the particular circumstances of the case make it commercially feasible to offer the option of individual segregation to clients. If the European Commission's proposal were accepted, the intermediary would be under a duty to offer such an option to all clients, regardless of the circumstances of the case.

338 The European Commission introduces a restriction on this practice by stating that 'if an investor chooses to hold securities in an *omnibus* account, that account should clearly indicate that the securities are held in the name of the nominee but on behalf of the client', European Commission (May 2013, para. 15). 'This suggested approach', continues the European Commission, 'could make account structures more transparent and strengthen the investor's position in identifying his rights over securities, while choosing the most appropriate level of transparency and control', *Ibid.* para. 16. The wording of this statement is not, however, very clear. There are two possible ways to interpret this restriction on *omnibus* accounts and neither of them seems entirely convincing. If this statement means that a list of the investors' names as well as their respective share in the pool of securities should be registered in the account of the higher-tier intermediary, the whole purpose of omnibus accounts would be jeopardised. Alternatively, if the account should only mention that the securities are held in the name of an intermediary but on behalf of others, this clarification would not enhance transparency (in terms of 'who owns what') as there would be no reference to 'which assets belong to whom'.

339 Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories ('EMIR'); Regulation (EU) No 909/2014 of the European Parliament and of the Council on improving securities settlement in the European Union and on central securities depositories (CSDs) and amending Directives 98/26/EC ('CSDR') and 2014/65/EU and Regulation (EU) No 236/2012. See also and the Alternative Investment Fund Managers Directive 2011/61/EU ('AIFMD').

340 Article 39 (5) EMIR, proposed Article 35 (3) CSDR and paragraph 40 of the Preamble AIFMD. Prior to the introduction of these provisions, in most cases the intermediary would apply the option of using *omnibus* accounts unless the customer were to specifically require segregation.

341 Article 39 (5) EMIR and proposed Article 35 (4) CSDR.

342 Article 39 (5) EMIR.

343 Article 39 (7) EMIR and proposed Article 35 (4) CSDR.

affecting client asset protection that can be overcome only through regulatory intervention.

6. Summary of the analysis

In most cases intermediaries hold securities on behalf of several investors in a single account without allocating specific securities to individual clients (i.e. *omnibus* account or pooled account). This practice may challenge the investors' ownership over the securities, given that it makes it difficult to determine the specific assets to which the right of each investor relates. The main point is to establish firstly, which of the three theories related to the nature of the investor's right can overcome this uncertainty and secondly, if there is a real need for a statutory intervention.

The chapter shows that the theories of a right against a right and of an interest in securities can safeguard the investor's right in an *omnibus* accounts. However, despite this assurance both theories fall short of offering a novel solution to the problem of uncertainty but simply rely on the existing principle of co-ownership (based on the idea that each investor does not own specific securities but simply a portion or a fraction of a single bulk[344]). Thus, following this analysis one could argue, for example, that C has a 50% share in the bulk, without this statement necessarily affecting the nature of C's interest (that can be either a right against B's right or a right in a sub-property).

The same argument can be used when referring to the theory of an indirect right *in rem*, given that such a theory can be easily applied to the idea of co-ownership. In other words, nothing prevents us from stating that C holds (although only indirectly) a 50% share in the bulk of securities.

In the latter case a problem may occur when looking at the practical consequences related to *omnibus* accounts, mainly the lack of transparency in the indirect holding system. Indeed, in a pooled account, if C is prevented from keeping track and monitoring his/her securities along the holding structure, it is difficult to conceive C as the actual owner of the underlying securities standing at the top of the chain. This

[344] There are two ways of interpreting the principle of co-ownership given that the investor can be considered as sharing either a fraction of the share capital of the company or, alternatively, a portion of the pooled account.

difficulty arises regardless of whether C is considered to hold a proportionate share in the entire bulk rather than a specific number of individual units. Hence, unlike the first two theories the concept of an indirect right *in rem* does not seem to offer a clear understanding of the practice of using *omnibus* accounts.

The chapter has also highlighted the issue that the principle of co-ownership has removed the uncertainties surrounding *omnibus* accounts and therefore, the investor's interest in the bulk of securities can now be fully safeguarded. There are, however, certain aspects which may still require some form of clarification. For example, it would be useful to be able to rely on a statutory provision that determines whether the investor can dispose of his/her share in the bulk without having to obtain the consent of all the other co-owners. This would mean introducing the concept of an implied consent between the parties along the lines of Section 20 (b) SGA 1979.

Chapter 4: Allocation of shortfalls: who bears the risk of loss?

1. A conflict of choice between the 'first in, first out' rule and the '*pro-rata* sharing' solution.

As a general rule an intermediary is required to hold a sufficient amount of securities to satisfy the claims of his/her customers[345]. This means that the number of securities held by the intermediary for the benefit of the account holders should be equal to the number of securities credited to the clients' accounts. The objective of this rule is to minimise the customers' financial risks and to ensure the integrity of the intermediated holding of securities[346]. Notwithstanding this fundamental principle, in market practice a potential loss in the clients' accounts (better known as a 'shortfall'[347]) is likely to occur at any time due, for example to an operational error[348] or to fraudulent behaviour of the intermediary[349]. If either of these circumstances do occur, the accepted rule is that the intermediary is then under an obligation to replace the missing securities or alternatively, to pay an equivalent sum of money to his/her customers[350].

A solution to the 'shortfall problem' is, however, more complex, particularly in those circumstances where the intermediary is insolvent[351]. As emphasised by the English Law Commission, if the intermediary is unable to compensate his/her customers 'the potential loss will crystallise into a real loss'[352] which would then give rise to an

345 English Law Commission (June 2006, paras. 1.91 and 1.261). See also UCC § 8-504 (a) and Article 24 of the Geneva Convention.

346 Article 24 (1) of the Geneva Convention (*Official Commentary*, cit., para. 24.1)

347 A definition of shortfall is offered by the FMLC in its Commentary on Principles for Investment Securities Statute: '[a] shortfall arises where the securities actually held through an intermediary fall short of the aggregate of customer entitlements, so that the pool is insufficient to meet such entitlements', *Commentary on Principles For Investment Securities Statute*, Principle 4 in FMLC (July 2004).

348 Operational errors are not uncommon in market practice due to the large number of transactions that are undertaken by intermediaries on a daily basis.

349 In breach of his/her fiduciary duties an intermediary can use part of the clients' securities for his/her own investment purposes and decide to transfer such assets to third parties.

350 There are, however, cases in which a shortfall is not caused by the 'improper' behaviour of the intermediary. For example, potential losses can also arise in those circumstances where 'the account holder has purchased securities but a settlement failure results in them not being delivered into its account', English Law Commission (June 2006, para. 1.90) and FMLC (July 2004, para. 6.2). In these cases the intermediary is not responsible for the shortfall and, therefore, the losses will be borne by the account holders. Cfr. n. 351 in this chapter.

351 In addition to insolvency, similar difficulties can arise even in those circumstances where the intermediary is under no obligation to compensate his/her customers (for example, if the fraudulent transaction was caused by an insolvent intermediary standing further up the holding chain for which the relevant intermediary is not responsible).

352 English Law Commission (June 2006, para. 1.91).

unsecured claim in the insolvency proceedings. In this case, particular concern would be raised when dealing with *omnibus* accounts in so far as it is not quite clear which of all the account holders (whose securities are commingled in a single client account) would bear the risk of loss. Let us imagine, for example, that on day 1 T holds 10,000 shares in favour of M and that on day 2, 20,000 shares are added to the same account in favour of N. If then on day 3, 5,000 shares are mistakenly or fraudulently transferred by T to a third party, the question arises as to whether the loss should be allocated to either M or N or, alternatively whether it should be shared proportionately by both parties.

Traditionally, English law has applied the so-called 'first in, first out' rule to overcome the issue of competing claims to assets which are held in a pooled account. According to this rule, which was initially elaborated in *Devaynes v. Noble* (better known as the 'Clayton's case')[353], the first assets included in the account are considered as the first assets drawn out of the account. This means that in the example mentioned above, the 'first in, first out' rule would allocate the loss of 5,000 shares to M but not N in so far as the latter's assets were added to the initial fund at a later stage.

The disadvantage of this rule is that it can 'produce results of a highly arbitrary nature'[354]. Indeed, the possibility of the account holders actually avoiding the loss and retaining all their assets relies exclusively on the accidental order in which the securities are credited to the *omnibus* account. This approach is considered unfair and unequal since 'it enable[s] a particular group of investors to establish an entitlement to a particular asset […] to the exclusion of other investors just because they invested on one day of the week rather than another'[355]. There is also another important aspect addressed by most practitioners in their criticism of the 'first in, first out' rule. Although this principle appears (at least at first sight) to be convenient and very simple to apply, in practice it can turn out to be quite the opposite. For example, with regard to the practice of indirectly held securities it can be extremely challenging to apply the 'first in, first out' rule, given that the large volumes and rapid transfers of financial assets sometimes make it difficult (if not almost impossible) to identify those account holders whose assets were first credited to the *omnibus* account.

---

353 [1816] 35 E.R. 781, (1816) 1 Mer. 572. For an analysis of this case see, for example, Ellinger et al. (2011, pp. 766 – 770); Martin (2009, pp. 691 – 696) and Smith (1997, pp. 184 – 194).
354 *Barlow Clowes International Ltd v. Vaughan* [1992] 4 All ER 22.
355 *Id.* See on this point also Smith (1997, p. 194).

The presence of these obstacles explains why in market practice the 'first in, first out' rule is not so often applied. In an attempt to overcome these hazards, at least to some degree, the parties are usually advised to insert in their contractual agreements a clause which allows the account holders to share proportionately the risk of shortfalls[356]. The purpose of this clause (better known as the '*pro-rata* sharing' solution or '*pari passu*' rule[357]) is to allocate the losses in proportion to the number of securities held by each account holder in the investment fund. For example, if M is entitled to one third of the shares in the *omnibus* account[358] and N is entitled to the other two thirds[359], M and N will bear respectively one third and two thirds of the losses. However, an open question still needs to be answered: what happens in those circumstances where no clause is inserted by the parties in the custody agreement or where the contract is simply not clear on this issue?

A possible answer to this question is offered by the Court of Appeal in *Barlow Clowes International Ltd v Vaughan*[360]. The case concerns 11,000 investors who had advanced large amounts of money to Barlow Clowes International Limited ('BCI') with the intention of investing these sums in gilt-edged securities. In particular, the investors had agreed to take part in a collective scheme where their money would be 'mixed together and invested through a single pool'[361]. By the time BCI went into liquidation and the receivers were appointed, it became clear that most of the money had been fraudulently dissipated by the company (leaving a substantial shortfall in the amount available for distribution to the investors). The issue addressed to the court was to determine whether the remaining funds should be shared *pari passu* by all the investors or whether they should be distributed in accordance with the 'first in, first out' rule.

The Court of Appeal refused to overrule the decision in the Clayton's case but concluded that the 'first in, first out' principle should not be applied in those circumstances where such an application 'would be impracticable or result in injustice

356 This was highlighted in CASS Rule, 2.3.3 G which stated that 'firms are expected to advise the private client that … in the event of an unreconcilable shortfall after the failure (defined to mean insolvency events) of a custodian, clients may share in that shortfall in proportion to their original shares of the assets in the pool.' The provision is, however, no longer in force.

357 In *Boughner v. Greyhawk Equity Partners Limited Partnership (Millenium)* [2012] CarswellOnt 10466, [2012] ONSC 3185 (Ont. S.C.J. Commercial List), para. 37 this method was also defined as the expression '*pro rata ex post facto*' approach.

358 Following the example mentioned above M holds 10,000 shares out of a total of 30,000 shares.

359 This means that N holds 20,000 shares out of a total of 30,000 shares.

360 [1992] 4 All ER 22.

361 *Id.*

between the investors'[362], or 'would be contrary to either the express […] or presumed intention of the [parties][363]. In other words, although the 'first in, first out' principle is the default rule to be applied where the assets of innocent parties are commingled in a single account, there may be situations where such a rule should not be applied and where 'a preferable method of distribution [is] available'.

These considerations (that also found support in later cases[364]) significantly narrow the scope of application of the 'first in, first out' rule. Indeed, if this judicial interpretation were to be accepted, the rule established in the Clayton's case would now rarely be applied, given that it can create difficulties in practice and 'lead to unfairness in the majority of cases'[365]. The question at stake is therefore, to understand which alternative method should be applied to allocate the remaining funds among the investors. In *Barlow Clowes International Ltd v Vaughan*, the Court of Appeal argued that 'instead [of applying the 'first in, first out' rule] the available assets and moneys should be distributed *pari passu* among all unpaid investors rateably in proportion to the amounts due to them'[366]. As emphasised by Woolf and Leggatt LJJ, the *pro-rata* sharing solution is regarded as being more appropriate in this case since (i) it avoids complex and costly calculations and (ii) it seems to be more consistent with the intention of the parties.

---

362 *Barlow Clowes International Ltd v. Vaughan* [1992] 4 All ER 22 (*per* Lord Justice Woolf). The court argued that the application of the 'first in, first out rule' would be impracticable and produce unfair results among the investors[362]. So far as fairness is concerned, in practice, as mentioned earlier, the use of 'a rule of convenience' (such as the one established in the Clayton's case) can produce arbitrary results. The argument has even greater value if one considers that in this case 'the dates upon which investments were received by BCI often depended upon agents [...] combining the investments of a number of clients and then forwarding a lump sum to BCI'. 'In addition to relying upon the arbitrary results which follow from the "mechanistic" application of the ["first in, first out"] rule', the court bases its decision 'upon the expense and time which will be involved in having to apply [such a] rule'. Indeed, notwithstanding the advent of computer technology the task of applying this method is clearly complex. Likewise, 'the costs involved will [also] result in a depletion of the assets available to the investors', *Id.* 'In determining the appropriateness of the machinery used for resolving the claims of the investors among themselves, surely this should be a relevant consideration', *Id.*

363 In the specific circumstances of the case, the terms of the agreement required all the investors' money to be paid into a common fund which was shared by all the parties in proportion to the amount of their original contributions. This meant that there was no intention to hold and earmark single investments on the account of specific parties. In particular, the nature and the circumstances of the fund showed that the parties could not have intended to allocate the risk of losses to certain investors but not to others. Hence, the 'first in, first out' rule should not be applied given that it would be in contrast with the implied intention of the parties (*per* Lord Justice Woolf).

364 See *Russell-Cooke Trust Co. v. Prentis* [2002] EWHC 2227 (Ch), [2003] 2 All ER 478 and *Commerzbank Aktiengesellschaft v. IMB Morgan Plc* [2004] EWHC 2771 (Ch), [2005] 2 All ER (Comm) 564. For a critical view on the application of Clayton's case see also (for Australia) *Re French Caledonian Travel* [2003] NSWSC 1008, [2004] 22 A.C.L.C. 498 and (for New Zealand) *Registered Securities Ltd* [1991] 1 NZLR 545, 553 and *Re International Investment Unit Trust* [2005] 1 NZLR 270, paras 50 – 54.

365 Webb and Akkouh (2013, p. 326). For a similar point see also Conaglen (2005, pp. 47-48) and Scott (1913-1914, p. 130, n. 15).

366 *Barlow Clowes International Ltd v. Vaughan* [1992] 4 All ER 22.

With regard to the latter point, Woolf LJ accepts the idea that the investors' intention was most likely to distribute the remaining funds in accordance with the *pro-rata* sharing solution rather than the 'first in, first out' rule[367]. 'This', continues Leggatt LJ, 'follows from the fact that because the investors envisaged that their money would be combined together, and therefore mixed in one or more bank accounts, before being invested in gilts, there is no reason to determine either the sequence in which payments into the account may have occurred or priority between investors.'[368] As a result of these considerations, the court held that 'each [investor] ha[d] an equitable charge on the fund in the account for the amount of his investment, and own[ed] an aliquot share of the investment pool.'[369]

Consistent with this reasoning and with regard to the practice of indirectly held securities, the FMLC recommended the introduction of a statutory provision which states that 'shortfalls should be borne proportionately'[370]. The objective of this solution is to exclude 'the application of the complex traditional […] rules whereby a particular shortfall is attributed to a particular person on the basis of timing of accounts entries'[371]. Once again, the benefit of the *pro-rata* sharing solution is to avoid 'the risk of uncertainty, delay and expense in complex litigation'[372].

2. The 'tracing approach' supported by McFarlane and Stevens: a more appropriate way of distributing losses?

McFarlane and Stevens criticise the decision in *Barlow Clowes International Ltd v Vaughan* in that part where the Court of Appeal favours the application of the *pro-rata* sharing solution as opposed to the 'first in, first out' rule. Similarly, they also express

367 'I have no doubt that it is correct to presume that the investors would have intended that what could be salvaged, as a result of the "common misfortune" they had suffered, should be dealt in accordance with the [*pro*-rata sharing] solution and not in accordance with the [first in, first out] rule', *Id.*
368 'In my judgment Mr Walker is correct when he submits that the rule in Clayton's Case applies in this context only where there is a *wrongful* [emphasis added] mixing of different sums of trust money in a single bank account. The rule does not therefore apply where there is a collective investment scheme, whose participators must intend that their money should be mixed together and invested in or through a single pool [...]', *Id.*
369 *Id.*
370 *Commentary on Principles For Investment Securities Statute*, Principle 4 in FMLC (July 2004).
371 *Id.*
372 *Id.*

reservations on the FMLC's recommendation in so far as its arguments in favour of the *pro-rata* sharing rule are essentially 'pragmatic rather than conceptual'[373].

'One weakness in the authoritativeness of *Barlow Clowes International Ltd v Vaughan*', continue McFarlane and Stevens, 'is that the application of the rule in Clayton's case was, on any view, inappropriate'[374]. The reason for this is that *Devaynes v. Noble* dealt with 'the rights of a banker and his customer to the funds in a bank account'[375] and, therefore, did not involve a dispute between trust beneficiaries. In particular, the court addressed the question of allocating any payment by the customer amongst the various debts owed to the bank. This meant that the nature of the claim was entirely different from that identified in *Barlow Clowes International Ltd v. Vaughan*.[376] In the latter case, the dispute 'did not concern the issue as to which debt a particular payment should be presumed to discharge'[377] but it simply aimed to resolve the problem of competing claims between the beneficiaries. Hence, *Devaynes v. Noble* was of no relevance to deciding 'who gets what in cases of shortfall'[378].

According to McFarlane and Stevens, a more appropriate solution would be to apply tracing rules to determine which investor bears the risk of loss[379]. These rules (which have developed both at common law and in equity) attempt to identify 'the account holder whose securities have been misappropriated from the pooled account and to allocate the full amount of the loss to that [particular] person'[380].

Let us consider, for example, that on day 1 T holds 10,000 shares for M and that on day 2 another 10,000 shares are added to the same account in favour of N. On day 3, T wrongfully sells 5,000 shares to third parties and uses the proceeds of the sale for its own purposes. If on day 4, 7,000 shares are added to the clients' account in favour of P, the question arises as to which investor bears the risk of a shortfall. Pursuant to general principles of tracing, the loss of 5,000 shares is allocated *pro- rata* between M and N

373 McFarlane and Stevens (2010, p. 41).
374 *Ibid.*, 42. See on this point also Smith (2000, p. 78).
375 *Barlow Clowes International Ltd v. Vaughan* [1992] 4 All ER 22 (*per* Lord Justice Leggatt)
376 Smith (2000, p. 78). For a similar view see the judicial trend in Canada and the United States *Re Ontario Securities Commission v. Greymac Credit Corporation* [1986] 55 O.R. 2nd 673 and *In re Esteem Settlement* [2002] Jersey L.R. 53.
377 McFarlane and Stevens (2010, p. 42).
378 *Id.*
379 *Id.*
380 English Law Commission (June 2006, para. 1.115).

(who will receive 8,500 shares respectively), while P is not affected by the shortfall and is, therefore, entitled to obtain the entire amount of his/her original contribution (i.e. 7,000 shares). The purpose of this principle is 'to allocate a shortfall only among those persons that were account holders at the time that the improper transaction occurred'[381]. This means that '[s]ubsequent deposits into the account (whether by new or existing account holders) would be unaffected'[382]. In other words, following the analysis suggested by McFarlane and Stevens, P's right against T's right to the 7,000 shares is not jeopardized by the shortfall.

The main difference between the so-called 'tracing approach' and the *pro-rata* sharing solution is that the latter (unlike the former) requires *all* [emphasis added] investors to share *pari passu* the risk of shortfalls, regardless of when the wrongful behaviour by the intermediary occurred[383].

In *Barlow Clowes International Ltd v. Vaughan* the tracing approach was considered as a possible and more equitable alternative to the *pari passu* rule[384]. However, the Court of Appeal decided that in the circumstances of the case it would have been too complex to identify the account holders whose securities had been misappropriated from the pooled account. This is clearly emphasised by Dillon LJ when he argues that 'the complexities of this method would […], in a case where there are as many depositors as in the

381 *Ibid.*, para. 1.125
382 *Id.*
383 The approach suggested by McFarlane and Stevens also differs from the 'first in, first out' rule which simply allocates the entire amount of the losses to the investor who made the earliest deposit in point of time (i.e. M). The core idea is that the 'first in, first out' rule has 'nothing to do with tracing' (Leggatt LJ in *Barlow Clowes International Ltd v. Vaughan*). See also the point highlighted by Smith where he states that the rule in Clayton's case 'was initially thought to govern tracing [see *Hallett's Estate (Re)* [1880] 13 (Ch) D. 696 (C.A.)], but it soon became apparent that the results could be absurd'. 'As between banker and customer', continues Smith 'a rule of "first in, first out" makes perfect sense as a default position, [b]ut as between a breaching trustee and his beneficiary, who has nothing to do with the bank account, it makes no sense.' Hence, 'in the context of that competition, the application of Clayton's case to tracing was overruled long ago', Smith (2000, p. 78).
384 The tracing approach is also defined by courts as the '*pro rata* sharing on the basis of tracing', 'rolling charge' or 'North-American method'. As explained by Dillon LJ in *Barlow Clowes International Ltd v. Vaughan* such a method was 'preferred by the Canadian and US courts to [the first in, first out rule], as more equitable'. There is also another method based on tracing rules which is often used by North American courts, i.e. the 'Lowest Intermediate Balance Rule' or 'LIBR'. Under the LIBR approach, 'a claimant to a mixed fund cannot assert a proprietary interest in the fund in excess of the smallest balance in the fund during the interval between the original contribution and the time when a claim with respect to that contribution is being made against the fund', *Cummings Estate v. Peopledge HR Services Inc.* [2013] CarswellOnt 6685, 2013 ONSC 2781, [2013] W.D.F.L. 2886, para. 25.

present case and even with the benefits of modern computer technology be so great, and the cost would be so high, that no one has sought to urge the court to adopt it'[385].

McFarlane and Stevens criticise this decision and argue that the alleged complexity of the tracing process is overstated[386]. Furthermore, they emphasise that the appropriate choice of whether to apply or not the tracing method or not should not depend on practical concerns but rather on the application of conceptual rules[387]. For example, the case in *Barlow Clowes International Ltd v. Vaughan* concerns a trust over a pool of securities that are beneficially owned by various investors. When part of those securities are wrongfully withdrawn from the account, the typical approach in English law would be to allocate losses only to those investors who effectively contributed to the fund from which the withdrawal was made[388]. This approach (based on standard tracing rules) shows that the rights of the investors in an *omnibus* account do not rank equally or *pari passu*, given that any contribution to the fund (occurring after the withdrawal) is not affected by the shortfall[389].

Notwithstanding this general principle, McFarlane and Stevens believe that in certain circumstances it is still possible to apply the *pari passu* rule, 'provided that [such a rule] is the basis of the trust created by the terms of [the] investment'[390]. In other words, if the parties expressly agree that 'the securities held by the intermediary are to be held in common for the benefit of all the investors from time to time'[391], the *pro-rata* sharing solution may still be applied in cases of shortfalls.

What happens, however, if funds are simply misdirected? Would it be possible for the parties to apply the *pro-rata* sharing solution, if the clients' assets are used by the intermediary to purchase a yacht, for example (as in the case of *Barlow Clowes International Ltd v. Vaughan*)? According to McFarlane and Stevens, in this particular case it would be inappropriate to apply the *pari passu* rule. The reason for this is that 'if trust funds are used to purchase a yacht only those investors with a right at that time should have an

385 *Barlow Clowes International Ltd v. Vaughan* [1992] 4 All ER 22 (*per* Lord Justice Dillon)
386 McFarlane and Stevens (2010, p. 42). For a similar view see also Smith (1997, p. 268) and *Id.*, (2000, pp. 86-87).
387 *Id.*
388 Gardner (2011, p. 318 ff.).
389 McFarlane and Stevens (2010, p. 43).
390 *Ibid.*, 44
391 *Id.*

interest in the yacht'[392]. Indeed, '[w]here the claim brought by the investor is in relation to what traceably survives of what he originally paid to invest, or to what traceably survives of securities which were held for him personally, it is inappropriate to apply any principle of *pro-rata* distribution'[393].

These considerations bring McFarlane and Stevens to the conclusion that the *pari passu* rule can only apply if both (i) 'the dispute does not involve any claim to the proceeds of misdirected funds, but purely concerns shortfalls'[394]; and (ii) each investor agrees to share the fund with other account holders from time to time. In all other circumstances the general rule would be to apply the traditional rules of tracing (which does seem to be more in line with English trust law).

3. A right against a right, an interest in securities or an indirect right *in rem* in allocations of shortfalls?

The starting point of this debate is to establish which theory concerning the nature of the beneficiary's right is better suited to solve the problem concerning the allocation of shortfalls: is it the concept of a right against a right, that of an interest in securities or that of an indirect right *in rem*?

The answer to this question is that none of these three concepts can really help us to identify the most appropriate way of allocating losses in an *omnibus* account. The reason for this is that the conceptual differences between a right against a right, an interest in securities and an indirect right in the underlying securities have no impact on the discussion about the method to be used when distributing losses among account holders. Indeed, at least in principle all three concepts could be applied in cases of shortfalls. Hence, if one were to argue that the tracing approach is the most appropriate solution to the problem of competing claims in a trust fund, the same conclusion could be reached regardless of whether the beneficiary's interest is classified as a *sui generis* right or as a proprietary right. Let us go back to the example where M and N are the only account holders at the time of the shortfall. If later T decides to add 7,000 shares on the same account in favour of P, one could say that P's right against T's right or,

---

392 'Subsequent investors are unable to trace the value of their investments into any rights already held by the intermediary', McFarlane and Stevens (2010, p. 44).
393 *Id.*
394 *Id.*

alternatively, that P's interest in the sub-property or in the underlying securities is not affected by the shortfall[395].

Certain problems, however, may arise when attempting to apply the concept of an indirect right *in rem* to the practice of intermediated securities. For example, securities may be wrongfully or fraudulently transferred to good faith purchasers and (as shown in the Rascals case) they can also be used or re-hypothecated by the intermediary. If at the time of the shortfall no securities are transferred back to the account, the investor is simply left with a right[396] against the intermediary to recover equivalent securities (not being in a position to track the underlying assets that were initially credited on his/her account)[397]. This shows that what the account holder really acquires in an indirect holding system is not a right that attaches to a specific asset but simply a right in whatever is held by the intermediary at a certain point in time (i.e a package of rights against the account provider)[398]. While this description seems to be inconsistent with the idea of an indirect right in *rem*, it can be accommodated in the concepts of a right against a right and of an interest in securities.

Notwithstanding these considerations on the nature of the investor's right, the question remains which of the solutions concerning the allocation of shortfalls is better suited to apply to the practice of intermediated securities? Is it the tracing approach (as suggested by McFarlane and Stevens), the first in, first out rule or the *pro-rata* sharing solution?

4. A response to McFarlane and Stevens' considerations on the tracing approach

---

395 Similarly, it is possible to argue in favour of the 'first in, first out' rule or the *pro rata* sharing solution, without this affecting one's choice on the nature of the beneficiary's right.

396 Pursuant to general principles of trust, the account holder's right is an (equitable) proprietary right. However, the account holder can be left with a mere contractual obligation in those circumstances where, for example, his/her beneficial interest in the securities is transferred to the intermediary under a repo contract or a stock loan agreement.

397 As mentioned in chapter 2, in the event of wrongful or fraudulent conduct on the part of the trustee good faith purchasers are protected from adverse claims enforced by the beneficiaries (see, however, *infra* in conclusions). Similarly, under a repo contract or stock loan agreement the account holder is prevented from enforcing a proprietary right against third parties (having simply a contractual right against the intermediary to obtain equivalent securities at a certain point in time). Notwithstanding these limitations, it would be in any case practically impossible for the investor to trace the securities from one account to another along the holding chain of intermediaries. See, on this point, text to nn. 39 – 43 in ch. 1 and text to nn. 426 – 428 in this chapter.

398 See text to nn. 184 – 185 in ch. 2.

Certain criticisms could be advanced on the merits of McFarlane and Stevens' analysis of the various methods used to distribute losses between beneficiaries.

With regard to the 'first in, first out' rule, McFarlane and Stevens raise an interesting point when stating that the decision in *Devaynes v. Noble* has no relevance in determining the allocation of losses and distribution of trust funds between beneficiaries.

This view is consistent with the position of both the US and Canadian courts, that have often stated that '[t]he rule in [the] Clayton's case should be limited to the relationship between a bank and its customers [and that] it should not be extended to the relationship between […] innocent beneficiaries'[399]. For example, in *Ontario (Securities Commission) v. Greymac Credit Corporation* Morden JA argues (i) that the 'first in, first out' rule is merely a fiction which was originally developed to regulate the appropriation of payments between banker and customer and (ii) that the application of such a rule to a different scenario (which involves a dispute between trust beneficiaries) may lead to 'irrational'[400] and unfair results[401].

Unlike Canada and the United States, England has not yet rejected *in toto* the 'first in, first out' rule as the law applicable to co-mingled trust cases. Nevertheless, the decision in *Barlow Clowes International Ltd v. Vaughan* significantly narrows the scope of application of the rule in Clayton's case (making it almost impossible for such a rule to be applied in practice)[402]. Hence, setting aside conceptual considerations, no substantial difference remains between the positions held by the North American courts, on the one hand and the English courts, on the other.

---

399 *Ontario (Securities Commission) v. Greymac Credit Corporation* [1986] 55 O.R. 2nd 673, para. 1. See for Canada also B*oughner v. Greyhawk Equity Partners Limited Partnership (Millenium)* [2012] CarswellOnt 10466, [2012] ONSC 3185, para. 81; *Paddock v. Paddock* 2008 CarswellOnt 8794, [2009] W.D.F.L. 2783, 78 R.F.L. (6th) 54, para. 37 and *Law Society of Upper Canada v. Toronto Dominion Bank* [1998] 42 O.R. (3d) 257, paras. 9 – 13. For the United States see *Ruddle v. Moore* 411 F.2d 718 (D.C. Cir. 1969) and *Re Walter J Schmidt & Co, ex p. Feuerbach* [1923] 298 F. 314, 316. See also Scott (1913-1914, p. 130) and Smith (2000, pp. 78 – 79).
400 Scott (1913-1914, p. 130).
401 'When the law adopts a fiction it is, or at least it should be, for some purpose of justice. To adopt it here [i.e. to co-mingled trust cases] is to apportion a common misfortune through a test which has no relation whatever to the justice of the case. Such a result […] can only come from a mechanical adherence to a rule which has no intelligible relation to the situation,' *Re Walter J Schmidt & Co, ex p. Feuerbach* [1923] 298 F. 314, 316, *per* Judge Learned Hand.
402 See on this point text to n. 364 in this chapter.

In an attempt to identify the approach that is best suited to solve the issue of competing claims between beneficiaries, McFarlane and Stevens maintain their criticism on the decision in *Barlow Clowes International Ltd. v. Vaughan*. In particular, they consider the tracing approach to be the more appropriate solution given that (i) it produces more equitable results for the parties and (ii) it complies with English trust law.

In terms of justice, there is probably little doubt that the tracing method is to be considered the fairest solution that can be applied in co-mingled trust cases. The reason for this is that such an approach allocates losses only to those investors who were account holders at the time of the shortfall and therefore, does not affect the other beneficiaries who deposited their assets in the trust fund at a later stage[403].

One might argue that it is unfair to 'penalise' certain beneficiaries (rather than others) based on the timing of the shortfall[404]. That argument, however, is not the most convincing one[405]. Indeed, '[i]f this seems unfair, the unfairness is that which is inherent in the specific nature of proprietary rights'[406]. According to Smith, '[i]f my car is parked next to yours, and mine is hit by lightning and consumed by fire while yours is untouched, I might think this is very unfair; [b]ut this is part of what it means for a thing to be mine, and another thing to be yours'[407].

Another point in favour of the tracing approach is that it seems to be consistent with English trust law, which has traditionally used tracing rules to allocate losses among beneficiaries. This statement is indeed widely accepted.

Unlike other methods of risk distribution (such as the *pro-rata* sharing solution and the 'first in, first out' rule), the tracing approach is not based on a 'pure fiction' but attempts

403 This position is confirmed in *Barlow Clowes International Ltd. v. Vaughan* 22 (*per* Woolf and Leggatt LJJ).
404 See, for example, counsel to Waldock in *Boughner v. Greyhawk Equity Partners Limited Partnership (Millenium)* [2012] CarswellOnt 10466, [2012] ONSC 3185, paras. 23 – 24.
405 For a different opinion see English Law Commission (June 2006, para. 1.132) when it states that although the 'rolling charge method could be considered the fairest of the *pro rata* formulae', 'the basic *pro* sharing method best reflects the common risk that account holders undertake'. The reason for this is that '[i]t is not the shortfall itself but the intermediary's inability to remedy the shortfall that account holders must consider when choosing to hold securities through one or more intermediaries', *Id.* 'As this credit risk may change over time it is the account holders that are assuming the credit risk at the moment of the intermediary's insolvency that should bear the loss', *Id.*
406 Smith (2000, p. 81).
407 *Id.* See, on this point, also Smith (1997, pp. 303 – 305).

to reflect 'the reality of what has occurred'[408]. The core idea underlying tracing rules is to introduce a process which (i) attempts to truly safeguard the proprietary rights of each investor and, therefore, (ii) assigns losses only to those beneficiaries whose assets have *actually* [emphasis added] been misappropriated by the trustee.

This process does not apply when using the 'first in, first out' rule and the *pro rata* sharing solution, as both can be considered 'rules of convenience based upon a mere presumption of law'[409]. For instance, in *Barlow Clowes International Ltd. v. Vaughan* the court favoured the application of the *pro rata* sharing solution and decided on the basis of a legal fiction, which assumed that all investors' contributions to the trust fund had been made simultaneously[410] and prior to the occurrence of the shortfall[411]. This presumption was not necessarily in line with the actual circumstances of the case[412] and was adopted by the court mainly for the purposes of convenience[413]. The objective was to require each investor to share losses on a *pro rata* basis, regardless of the time when such an investor's contribution was made to the trust fund.

One of the main consequences of using the *pro rata* sharing solution is to jeopardise the proprietary rights of those beneficiaries who were not account holders at the time of the shortfall. Let us imagine, for example, that on day 1 T holds 20,000 shares in favour of

[408] English Law Commission (June 2006, para. 1.115). See, however, n. 413 in this chapter.

[409] The expression has been used by the courts merely in relation to the 'first in, first out' rule. However, (at least to a certain extent) it can be extended to the *pari passu* rule given that the latter, like the former, (i) is based on a legal fiction and (ii) is adopted primarily for purposes of convenience (being considered much easier to apply than the tracing approach).

[410] See, on this point, Gardner (2011, p. 319 n. 64).

[411] The argument can be considered even more convincing when applied to the 'first in, first out' rule, which is also based on a legal fiction. More specifically, in this particular case it is presumed that the first withdrawals from a bank account are charged against the first deposits. As emphasised by Scott, '[a]s between the depositor and the bank, this rule is fair enough; for it is a question of intent as to what part of the account is paid when the depositor makes a withdrawal, and since it is necessary to have some definite rule, in the absence of any evidence of actual intent, this rule is adopted because it comes as near as any to expressing the probable intent' of the parties, Scott (2013 - 2014, p. 130). The problem occurs when the rule is applied to co-mingled trust cases, given that 'this presumption of law' is considered wholly inappropriate in determining the relationship between the beneficiaries. Indeed, in these circumstances it is difficult to believe that the 'first in, first out' rule is the closest that one could get to expressing the probable intent of the parties. Cfr. text accompanying nn. 449 and 450 to this chapter. When comparing the 'first in, first out' rule to the *pro rata* sharing solution, the latter seems to be more in line with the probable intent of the parties and therefore produces a more appropriate solution for investors. The answer, however, is likely to change if one compares the *pari passu* rule to the tracing approach (rather than to the 'first in first out' rule). In this case it is easier to conclude that the parties' probable intent was to allocate losses only to those investors who were account holders at the time of the shortfall (rather than assuming that all investors' contributions had been made simultaneously).

[412] In *Barlow Clowes International Ltd. v. Vaughan* the investors' contributions to the trust fund were made at different points in time (i.e. both prior to and after the occurrence of the shortfall).

[413] More specifically, the *pari passu* rule was considered the more appropriate choice in this case given that it avoided the complexities and the excessive costs associated with the tracing approach.

M and N and that on day 2, 5000 shares are fraudulently withdrawn from the account by the trustee. If on day 3, 7000 shares are added to the clients' account in favour of P, the tracing approach would prevent P's proprietary rights from being affected by the shortfall. This, however, would not be the case should the parties decide to apply the *pro rata* sharing solution. In this event, P would find him/herself in the awkward position of losing part of the shares at the precise moment when the property had been acquired.

These considerations seem to confirm that the *pro rata* sharing solution (as well as the 'first in, first out' rule) is not a process that adheres to tracing rules but is rather a remedy set to distribute losses in a more simplified manner, thereby avoiding inconvenient delays and considerable costs.

The theory which favours the tracing approach (as opposed to other methods of risk distribution) is confirmed by the US and Canadian courts which have often stated that 'losses to [a trust] fund should be allocated against the interests of the beneficiaries in proportion to their respective traceable interests in the fund at the time the loss occurred'[414]. This means that as a general rule the tracing approach is considered by North American courts to be 'the preferable [mechanism] to resolving competing claims to mingled trust funds'[415].

There are, however, certain exceptions to this general rule. The reason for this is that the tracing approach does not usually apply 'where it is not practically possible to determine what proportion the mixed funds bear to each other, or where the claimants have expressly or by implication agreed among themselves to a distribution based otherwise than on a [tracing approach]'[416]. In other words, there may be circumstances where the application of the tracing approach is considered 'inconvenient' or 'unworkable', especially when dealing with large 'numbers of accounts, investments and transactions, which make calculations too complicated and expensive to undertake'[417].

---

414 *Re Ontario Securities Commission v. Greymac Credit Corporation [*1986] 55 O.R. 2nd 673, para. 15. See on this point also *Boughner v. Greyhawk Equity Partners Limited Partnership (Millenium)* [2013] ONCA 26; *Ruddle v. Moore* 411 F.2d 718 (D.C. Cir. 1969) and *Re Walter J Schmidt & Co, ex p. Feuerbach* [1923] 298 F. 314, 316; Scott (2013 – 2014, pp. 78 – 79) and Lowrie and Todd (1997, p. 46 ff.)

415 B*oughner v. Greyhawk Equity Partners Limited Partnership (Millenium)* 2012 CarswellOnt 10466, 2012 ONSC 3185, para. 81.

416 *Toronto Dominion Bank v. 2026227 Ontario Inc.* [2012] ONSC 2992, para. 37.

417 *Ontario Securities Commission v. Greymac Credit Corporation* [1986] 55 O.R. 2nd 673, para. 45.

The position of the North American courts is clearly highlighted in the Canadian case *Ontario (Securities Commission) v. Greymac Credit Corporation* where Morden JA comments as follows: 'While acknowledging the basic truth of Lord Atkin's observation that "convenience and justice are often not on speaking terms" (*General Medical Council v. Spackman*, [1943] A.C. 627, 638), I accept that convenience, perhaps more accurately workability, can be an important consideration in the determination of legal rules. A rule that is in accord with abstract justice but which for one or more reasons, is not capable of practical application, may not, when larger considerations of judicial administration are taken into account, be a suitable rule to adopt'[418].

For these reasons, the *pro rata* sharing solution is often chosen by the North American courts as a valuable alternative to the tracing approach, given that (i) it has the advantage of relative simplicity and (ii) unlike the 'first in, first out' rule, it also produces reasonable results for the parties[419]. This is confirmed, for example, in certain cases where the Canadian courts have expressly decided in favour of the *pro rata* sharing solution[420] (being considered the most convenient method to distribute losses as well as an approach which better reflects the nature and purpose of a mixed trust account[421]).

---

[418] *Id.*

[419] The main point of this argument is to qualify the tracing approach as the 'general rule' applicable to co-mingled trust cases and to use the *pro rata* sharing solution only in exceptional circumstances. However, there are different views on this matter. For example, in *The Law Society of Upper Canada v. Toronto Dominion Bank* Blair J believes that in co-mingled trust cases the *pro-rata* sharing solution cannot be considered an exceptional remedy, given that it is *usually* [emphasis added] the more appropriate method to distribute losses between the beneficiaries. Indeed, although the tracing approach is likely to produce fairer results for the parties, 'it is manifestly more complicated and more difficult to apply' in practice (para. 32).

[420] See, among others, *Toronto Dominion Bank v. 2026227 Ontario Inc.* [2012] ONSC 2992, para. 54 and *Law Society of Upper Canada v. Toronto Dominion Bank* [1998] 42 O.R. (3d) 257, paras. 30 – 34.

[421] 'A mixed trust fund is a device whereby a trustee […] holds funds in trust for different persons or entities. It is in many ways a mechanism of convenience, i.e., it avoids the necessity, and the cost, and the cumbersome administrative aspects of having to set up individual trust accounts, and the records relating to such accounts, for the transactions relating to every beneficiary. This practical characteristic of mixed trust funds should be recognized in considering the nature of such funds. It provides an economic and organizational benefit to the public. […] What follows from this … is that a mixed fund of this nature should be considered as a whole fund, at any given point in time, and that the particular moment when a particular beneficiary's contribution was made and the particular moment when the defalcation occurred, should make no difference. The happenstance of timing is irrelevant. The fund itself … is an indistinguishable blend of debits and credits reflected in an account held by the trustee in a bank. […] It is a *blended* fund. Once the contribution is made and deposited it is no longer possible to identify the claimant's funds, as the claimant's funds. All that can be identified, in terms of an asset to which recourse may be had, is the trust account itself, and its balance', *Law Society of Upper Canada v. Toronto Dominion Bank* [1998] 42 O.R. (3d) 257, paras. 43 – 44.

The absence of a rule that allows the tracing approach to be applied indistinctively in all circumstances (regardless of their complexity) raises the question of whether such an approach can be considered 'convenient' or 'workable' in the case of intermediated securities.

McFarlane and Stevens believe that the tracing approach can be applied in these circumstances without difficulty[422]. More specifically, they emphasise that 'regardless of the number of claimants and transactions, the application of [the tracing approach] requires no mathematical operation more complicated than long division'[423]. 'Once the relevant data is imputed, a computer programme a few lines long could perform the calculations'[424]. Hence, '[a] fear of numbers cannot be a sufficient justification for excluding this approach'[425].

This position does not seem to be willingly accepted by most practitioners, especially those who have often stressed the importance of introducing a statutory provision that favours the application of the *pari passu* rule[426]. Indeed, for the tracing approach to be applied one must be able to identify the underlying operation that led to the shortfall and 'track the [precise] order in which transactions in and out of the account occurred'[427]. This may be possible only if the following conditions are met: (i) a limited number of trades take place on the *omnibus* account daily; (ii) all transactions are settled in 'real time' and on a 'gross basis' and (iii) the intermediary maintains accurate and up-to-date records of client assets holdings.

The failure of Lehman Brothers showed that the practice of intermediated securities usually entails a far more complex scenario than the one described above. In most cases the intermediary is instructed to manage hundreds or thousands of trades each day. These transactions are often characterised by a high degree of technical complexity and

---

422 McFarlane and Stevens (2010, p. 42).
423 McFarlane and Stevens cite Smith (Smith (1997, p. 268).
424 McFarlane and Stevens (2010, p. 42). See on this point also Austen-Peters (2000, p. 140).
425 *Id.*
426 English Law Commission (June 2006, paras. 1.131); Moss (2010, pp. 66-67) and Yates and Montagu (2013, para. 3.55) and *Commentary on Principles For Investment Securities Statute*, Principle 4 in FMLC (July 2004).
427 English Law Commission (June 2006, para. 1.131).

at times by an atypical use of certain contractual agreements designed, for example, to avoid certain regulatory restrictions (as in the so-called 'Rascals scheme')[428].

More importantly, most transactions are not usually settled in 'real time' and on a 'gross basis' but are subject to a netting arrangement. In particular, settlement takes place at predetermined times in the course of the business day, when all transactions relating to the same class of securities are offset against one another and only net transfers are made between the parties. This process is known as 'net settlement' and has the advantage of drastically reducing the settlement costs (e.g. liquidity and collateral savings) as well as ensuring the efficient functioning of the market. The downside of this system however, is the difficulty of tracking each individual transaction since such a system only shows a single net position for each account holder.

The vast and varied activity in an *omnibus* account, as well as the use of netting in the course of clearing and settlement shows that in most cases it is extremely difficult to trace the precise order in which each transaction occurred. This statement has an even greater value if one considers that in practice the clients' records have also sometimes proven to be inaccurate and unclear[429].

Furthermore, as mentioned by the English Law Commission 'the composition of the account holders as the size of their respective holdings may alter significantly from day to day'[430]. This means that 'the date on which the relative holdings of the account holders are measured is critical to the allocation of shortfalls'[431]. In this respect, 'the *pro rata* sharing solution based on entitlements at the date of insolvency enjoys a considerable practical advantage over the other alternatives'[432]. A method (such as the tracing approach) that allocates losses based on the moment in which the improper or erroneous transaction occurred, could prove unworkable or even impossible, 'if the composition of the account holders has changed dramatically by the time that the intermediary or its liquidator confirms [shortfall]'[433].

---

[428] See text to nn. 281 - 294 in ch. 3.
[429] *Id.*
[430] English Law Commission (June 2006, para. 1.133).
[431] *Id.*
[432] *Id.*
[433] *Id.*

Setting aside these specific problems, even in the event where the application of the tracing approach is considered 'possible' or 'workable', significant time and effort may need to be expended to obtain all relevant information regarding the clients' holdings. The main concern here is that an investigation of this kind can be a key challenge in cases of shortfalls since a lengthy period of time may pass before clients are able to effectively recover their assets. This difficulty in obtaining a quick access to the securities may be the cause of severe losses to certain account holders and potentially lead to their financial failure. Hence, in this case the risks to financial stability would certainly be significantly high.

These considerations explain why Canada and the Unites States decided to introduce a statutory provision that excludes the application of the tracing rule in the practice of intermediated securities. In particular, s. 97 (2) of the Canadian Securities Transfer Act ('STA') and §8-503 (b) of the United States Uniform Commercial Code ('UCC') emphasise that the account holders have a *pro rata* property interest in the *omnibus* account 'without regard to the *time* [emphasis added] the entitlement holder acquired the security entitlement or the *time* [emphasis added] the securities intermediary acquired the interest in that financial asset'[434].

The general idea is that the doctrine of tracing is 'increasingly difficult to apply to the fast moving and intangible rights, typically the subject of modern and sophisticated investment markets'[435].

Consistent with this reasoning, when the intermediary fails and the custody assets are being distributed in an insolvency proceeding, North American law provides that losses

[434] Official Comment, § 8-503 UCC para. 1: 'Subsection (b) makes clear that the property interest described in subsection (a) is an interest held in common by all entitlement holders who have entitlements to a particular security or other financial asset. Temporal factors are irrelevant. An entitlement holder cannot claim that its rights to the assets held by the intermediary are superior to the rights of another entitlement holder by virtue of having acquired those rights before or after, the other entitlement holder. Nor does it matter whether the intermediary had sufficient assets to satisfy all entitlement holders' claims at one point, but no longer does. Rather, all entitlement holders have a *pro rata* interest in whatever positions in that financial asset the intermediary holds'. This provision however, does not determine how losses are distributed in insolvency proceedings, as in these cases the distribution rules are determined by the applicable insolvency law.

[435] Bloxham (January 2014, para. 3.15). Similarly, '[r]evised Article 8 expressly abandons all tracing rules', Facciolo (1999 – 2000, p. 623). See on this point also Schroeder (1994, pp. 332 -334); Khimji (2007, p. 99) and Rogers (1995, p. 692).

are ascertained for each type of securities and borne *pro rata* by all the account holders who share an interest in those securities (i.e. 'the issue-by-issue *pro rata* sharing rule')[436].

When the insolvency involves a stockbroker, United States law goes even further by introducing under the Bankruptcy Code and the Securities Investor Protection Act ('SIPA') a special regime for distributing assets. The objective is to elaborate a very simple procedure which provides that '*all customer property* [emphasis added] is distributed *pro rata* among all customers in proportion to the dollar value of their *total positions* [emphasis added], rather than dividing the property on an issue-by-issue basis'[437]. This means that losses are distributed on a *pro rata* basis to all customers, regardless of the nature of the securities which are involved in the shortfall. As a result of these special rules, 'the fortuity that there may be a shortfall in X securities but not in Y securities does not result in a windfall for Y securities entitlement holders and the X securities account holders do not bear the entire burden of the shortfall'[438]. The intention is clearly to allow each client to have 'a higher likelihood of a lower potential loss' as well as satisfying his/her claim within reasonable time.

The importance of ensuring the prompt recovery of clients' assets was the subject of a heated debate in the UK during the financial crisis. Indeed, the failure of Lehman Brothers in 2008 posed serious challenges to the existing legal framework. In particular, English insolvency law did not provide clear rules aimed at mitigating the impact that the failure of large investment firms may have on the financial market (e.g. by excluding the application of complex tracing rules to determine 'who owns what' and 'who bears the risk of an eventual loss' in the *omnibus* account)[439].

As emphasised by HM Treasury, one of the main problems in the Lehman case was that the insolvency regime required the Administrators 'to achieve a high degree of confidence over the overall value of claims before they c[ould] take key decisions on the management of the estate […]'[440]. This situation prevented the Lehman Administrators

---

436 For an analysis of the US regime applicable in cases regarding the insolvency of a bank see Mooney (2008, p. 16).
437 Official comment, § 8-503 UCC para.1.
438 Mooney (2008, p. 16).
439 One of the main problems addressed by most practitioners is, for example, to provide an alternative to tracing (see on this point Bloxham (January 2014, para. 3.15) and *Id.* (April 2013, para. 5.30).
440 HM Treasury (September 2010, p. 4).

from acting swiftly and entailed a considerable delay in the return of clients' money and assets.

The question at stake was to establish whether in specific circumstances (such as those experienced in the Lehman case) it is necessary to attribute a greater importance to 'speed' rather than to 'accuracy'[441].

A first answer to this question was offered in 2011 ('SAR'), with the introduction of a special administration regime for investment firms[442]. One of the objectives was to provide measures designed to facilitate the prompt return of clients' assets. For example, Regulation 12 (1) and (2) SAR addresses the issue concerning the allocation of losses in an *omnibus* account. In particular, it states that if the administrator 'becomes aware that there is a shortfall in the amount available for distribution' of a particular class of securities, then the shortfall should be shared '*pro rata* by all clients for whom the investment bank holds [those] securities'[443].

In contrast with the McFarlane and Stevens analysis, the wording of this provision clearly suggests that losses should be allocated to the account holders, regardless of the time when the shortfall occurred. The only condition introduced under Regulation 12 is to allow the Administration to establish a 'bar date', i.e. a date by which account holders must prove their claim[444].

The solution set out under Regulation 12 is similar to the one adopted by Lehman Brothers International Europe ('LBIE') in the Claims Resolution Agreement reached in 2009 with some of its clients and counterparties. Hence, the objective of this provision

[441] FSA (September 2012, para. 4.4) and FCA (July 2013, para. 2.3). This particular aspect was also discussed during the conference 'Law After Lehmans' held at the LSE on October 13th 2013.
[442] The Regulations apply to investment banks, which are defined in the Banking Act 2009.
[443] The clients will claim for the shortfall as unsecured creditors (based on the date when the special administration commenced), Regulation 12 (7) SAR.
[444] Regulation 11 SAR.

(which is based on a issue-by-issue *pro rata* sharing rule)[445] is simply to give statutory effect to this type of agreement[446].

Similarly, Article 26 of the Geneva Convention introduces the *pro rata* sharing rule for account holders (on an issue-by-issue basis) that is applicable in the insolvency proceeding of an intermediary. There are however, certain limitations to this general principle, given that it can only apply 'unless otherwise provided by any conflicting rule [used] in that [intermediary's insolvency] proceeding'[447]. This condition would allow Contracting States to use alternative distribution rules (for example, along the lines of SIPA and the US Bankruptcy Code) which can be 'quite different from the issue-by-issue *pro rata* sharing [principle]'[448].

As for the proposal of a SLL, it seems most likely that the EU provision would leave to Member States the choice of identifying the mechanism governing the distribution of shortage[449].

To sum up, the practice of intermediated securities shows that it is rather difficult to accept McFarlane and Stevens' idea that the tracing approach can easily be applied to financial markets. On the contrary, it seems that the application of 'any traditional principles of tracing in the case of investment securities may be […] practically

---

[445] Regulation 12 has not yet been applied, since most of the cases (which were subject to the special administration regime) ended up involving primarily shortfalls in client money accounts (rather than in client securities' accounts), Bloxham (January 2014, para. 2.15.1). This rule, however, does not apply to shortfalls in client money accounts which continue to be allocated in accordance with general principles of trust law and to the client money regime as set out in CASS 7. The FCA is now considering reviewing the client money distribution rules, FCA (July 2013, para. 2.1).

[446] There are, however, certain issues that are still outstanding and warrant consideration: for example, whether to (i) allow clients to obtain priority in cases of shortfall rather than classifying them as ordinary unsecured creditors; (ii) align treatment of client money and custody asset claims and (ii) consider the opportunity of applying special distribution rules (similar to the distribution scheme provided under SIPA and the US Bankruptcy Code) rather than dividing property on an issue-by-issue basis.

[447] The wording used to define this limitation suggests that 'the conflicting rule need not be a part of any insolvency law *per se*', Article 26 (2) of the Geneva Convention, Kanda et al. (2012, para. 26.11). This means that the distribution rules used in an insolvency proceeding can be, for example, also the result of the application of general principles of property law (as in the case of banks under United States law), Mooney (2008, p. 55).

[448] Article 26 (2) of the Geneva Convention, Kanda et al., 2012, para. 26.11).

[449] Principle 10 European Commission (2010, para. 10.1). According to the European Commission, 'a harmonized loss sharing rule at EU level would impinge on rules of national insolvency law addressing the issue and potentially distort prioritization of account holders' and security providers' interests. Therefore, the envisaged principle only proposes that the national law should contain a clear and predictable solution, leaving the details and mechanisms of such solution to national policy', *Ibid.*, para. 10.2. See also European Commission (2011, para. 3.10.1.3).

impossible'[450]. In addition to these practical difficulties, the *pro rata* sharing solution seems to be the closest one can get to expressing the probable intent of the parties, given that investors are generally more willing to share the risk of shortfall with the other account holders, rather than having to accept the formidable risk of bearing the entire burden of a potential loss[451].

Although SAR has significantly improved the legal framework in cases of shortfalls, there are certain issues that are still outstanding and warrant consideration: for example, whether to: (i) align treatment of client money and custody asset claims (which means extending Regulation 12 to client money) and (ii) consider the opportunity of applying the *pro-rata* sharing rule to all customers' assets[452] rather than dividing property on an issue-by-issue basis (along the lines of US law)[453].

5. Summary of the analysis

The chapter tries to ascertain which method may best be used when distributing losses between account holders in *omnibus* accounts. The choice is concentrated primarily between the tracing approach and the *pro-rata* sharing solution. The main difference between these two options is that in the first case losses are shared merely among those investors who were account holders at the time of the shortfall, while in the second they are distributed *pro-rata*, regardless of the precise time when the account holders deposited the securities in the trust fund.

None of the three theories related to the nature of the investor's right helps us determine the most appropriate solution in cases involving intermediated securities. In principle, all three theories are applicable, given that the conceptual differences between a right against a right, an interest in securities and an indirect right in *rem* are irrelevant when choosing between the *pro-rata* sharing solution and the tracing approach. For example, one could say that A and B bear the risk of loss in an *omnibus* account, regardless of the proprietary or *sui generis* character of their respective rights.

---

450 Schroeder (1994, p. 332).
451 This point was raised by Guy Morton during the conference on 'Intermediated Securities and Investor Rights' held at the LSE on March 24th 2014.
452 This solution would be in line with the distribution scheme adopted in the US Securities Investor Protection Act (SIPA).
453 The author is deeply grateful to Joanna Benjamin for this suggestion.

However, the choice as to which of the different options concerning the allocation of shortfalls in an *omnibus* account would be most appropriate for use in the practice of intermediated securities still needs to be made.

McFarlane and Stevens believe that the tracing approach should be regarded as the best solution to apply when distributing losses between account holders. This position, however, is debatable.

More specifically from a theoretical prospective it is indeed true that the tracing approach should be preferred to the *pro-rata* sharing solution given that it attempts to truly safeguard the proprietary right of each investor by reflecting 'the reality of what has occurred'[454]. While the tracing approach allocates the risk of shortfall only to those account holders who have actually suffered economic losses, the *pro-rata* sharing solution extends such a risk to all account holders, assuming (on the basis of a legal fiction or a rule of convenience) that all securities have been registered simultaneously and prior to the occurrence of the shortfall.

However, English and North American courts have shown that the *pro-rata* sharing solution should be applied in those cases where the tracing approach is considered 'inconvenient' or 'unworkable'. One of these cases may certainly include the practice of intermediated securities. In this regard, the English Law Commission and the FMLC have often emphasised the difficulty of applying the tracing approach in an *omnibus* account given that in such circumstances it may be arduous for the parties to (i) establish the exact order in which each transaction occurred and therefore (ii) determine which account holder registered his/her securities prior to the occurrence of the shortfall. Such a difficulty is likely to prevent investors from gaining immediate access to their securities, thereby increasing the risk of financial instability.

The failure of Lehman Brothers and more importantly, its impact on the financial market confirmed these concerns and in the UK led to the introduction of Regulation 12 SAR which states that losses in an *omnibus* account should be shared *pro-rata* 'by all

[454] English Law Commission (June 2006, para. 1.115).

clients for whom the [intermediary] holds [the] securities'[455]. To a certain extent this provision brings English law in line with United States and Canadian law, which had already introduced a rule that favours the *pro-rata* sharing solution in the practice of intermediated securities.

455 Regulation 12 (2) SAR.

Chapter 5: The notion of control and the effects on third parties

1. Perfection of a security interest over indirectly held securities: general considerations

The following two chapters focus on the concept of control as a method of perfection of a security interest over indirectly held securities. In particular, they evaluate the different ways in which control may be applied in practice, identifying its advantages and limitations as well as legal sensitivities in the context of financial markets. Once again the overall objective is (i) to demonstrate which theory concerning the nature of the investor's right can better define the exact meaning of control and (ii) to show whether the existing legal framework can meet the practical problems of intermediated securities.

Before entering into a detailed discussion on the notion of control, an attempt to define what is intended by 'perfection' of a securities interest is warranted.

The word 'perfection' has no defined statutory or judicial meaning under English law, as it was originally coined in Article 9 UCC[456] and then gradually gained acceptance outside the United States. However, the concept that lies behind the US terminology is not new to the English law of security and it refers to the various means by which a secured creditor can make its security interest effective against third parties[457].

In order to fulfil the perfection requirement, 'the law usually[458] requires […] the performance of some act which puts third parties on notice of the security interest'[459]. The rationale behind the need to ensure some form of public notice is that third parties

[456] See § 9-308 to 9-316 UCC.
[457] Perfection is not a condition of validity of the security interest, but it is essentially designed to ensure that third parties are given notice of the existence of encumbrances on assets. As a result, 'perfection' of a security interest is different from 'attachment' (another expression introduced by Article 9 UCC). 'Attachment' indicates the creation of a security interest between debtor and creditor and it ensures that the security interest fastens (i.e. attaches) onto the asset so as to give the creditor rights *in rem* against the debtor himself. This means that attachment refers to the validity of the security interest and its effects are strictly confined to the parties who take part in the security agreement, i.e. debtor and creditor. See Beale et al. (2012, paras. 7.01-7.30); Gullifer and Goode (2013, paras. 2-01 – 2-02 / 2-16 – 2-33) and McKendrick and Goode (2009, pp. 689-719).
[458] There are, however, instances of 'automatic perfection' where mere attachment is sufficient. For an analysis see, among others, Gullifer and Goode (2013, para. 2-19).
[459] McKendrick and Goode (2009, p. 689). 'This requirement of public notice can be called a perfection requirement', Gullifer and Goode (2013, para. 2-16). The term perfection was also used by the English Law Commission in its final report 'to refer to any steps necessary to render a type of security effective in the debtor's insolvency', Law Commission (2005, para. 3.6).

are not necessarily in a position to acquire knowledge of the existence of a security interest, particularly in those situations where the debtor remains in possession of the asset, or where the asset is intangible[460].

The English law of security has traditionally relied on two methods of perfection: the taking of possession and registration. The former is the oldest form of publicity for security interests and consists of granting possession of the collateral (i.e. the asset taken as a security) to the creditor. With this method public notice is simply achieved when the debtors are out of possession, as this circumstance 'puts anyone dealing with [them] on inquiry' [461]. The second method was adopted in England in 1900 and has been applied to a considerable number of charges since then[462]. It is considered a more efficient method of publicity and it is applicable to a broad range of charges where possession is simply impractical (e.g. charges on land, certain types of intangibles, ships and aircraft or floating charges). It is achieved through registration of the security interest in the Company Charges Register (if the interest is created by companies) or under the Bills of Sale Act (if the interest is granted by individuals). The main purpose of registration is to avoid the 'false wealth picture'[463] given in those circumstances, where there is no visible perception of the existence of charges on the debtor's asset.[464] In other words, it fulfils the important function of providing credit information to interested parties.[465] Such information is often used by rating agencies, such as Standard and Poor's, to estimate the credit-worthiness of an individual or a company and hence to evaluate the ability of a potential borrower to repay a debt. In this regard, a poor credit rating may reveal a high risk of defaulting on a loan, and consequently lead to high interest rates, or even to the decision by the potential lender not to extend such a loan.

---

460 McKendrick and Goode (2009, p. 690).
461 *Id.*
462 See Section 14 of the Companies Act 1900. The duty to register individual security bills of sale has a longer history in English law. In relation to charges created by a company, prior to 2013 registration was limited to certain categories of security interests. As from 2013, (with minor exceptions) all charges created by companies are registrable under s. 859A of the Companies Act 2006.
463 Gullifer and Goode (2013, para. 2-20).
464 Therefore, the duty to register can be described as reflecting 'the law's dislike of the secret security interest, which leaves the debtor's property apparently unencumbered,' Goode (2009, para. 11.121). See also Bridge (2008, p.180) and Simpson and Dahan (2005, p. 3).
465 A few years ago the registration system was subject to some criticism in England, being described as unnecessarily complex and restricted only to a limited number of charges. See Bridge (2008, pp. 180 - 181); *Id.* (2006, p. 268); Gullifer and Goode (2013, para. 2-19); Beale (2004, p. 117); McKnight (2006, p. 587). As mentioned earlier, in 2013 a new regime was introduced. One of the major changes was to extend registration to all charges created by companies. See on this point, among others, Gullifer and Goode (2013, para. 2-18).

Under English law, transfer of control was recently recognised, for certain forms of intangible property (including indirectly held securities), as a third method of perfection. In particular, under Regulation 3 of the Financial Collateral Arrangements (No. 2) Regulations (FCAR), transposing Article 2(2) of the FCD[466], a secured creditor who has 'possession or control' over financial collateral is exempted from any registration requirement.[467]

The idea of control as a means of perfection was first introduced in Article 9 UCC (in connection with the 1994 revision to Article 8 UCC regarding investment property) and was subsequently also adopted outside the United States in an attempt to make the existing legal framework more responsive to financial market needs.

The main purpose of the 'control' concept is to reduce costs and prevent delays when transferring investment securities.[468] Practitioners generally show a great reluctance to register charges, as 'the paperwork involves an administrative burden that may be impracticable where collateral is turned over rapidly.'[469]

[466] In June 2009, the EC Directive 2009/44 'amending Directive 98/26/EC on settlement finality in payment and securities settlement systems and Directive 2002/47/EC on financial collateral arrangements as regards linked systems and credit claims' was officially published in the EU Official Journal ('EC Directive 2009/44'). With respect to financial collateral arrangements the objective was to expand the number of financial claims which can be collateralised. The main amendment to the FCD is the inclusion of credit claims eligible for the collateralisation of central bank credit operations, which are defined as 'pecuniary claims arising out of an agreement whereby a credit institution […] grants credit in the form of a loan.' For the purposes of the EC Directive 2009/44, the 2010 Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations 2010 No. 2993 has recently amended the FCAR.

[467] One of the main purposes of the FCD and implementing regulations is to remove the formal requirements (other than the need for 'writing' and the transfer of 'possession or control') in 'the creation, validity, perfection, enforceability or admissibility in evidence of a financial collateral arrangement' (Article 3.1 FCD). In other words, a financial collateral arrangement should not be made 'dependent on the performance of any formal act' (Article 3.1 FCD), which may impede the rapid dealing required by the international financial market. However, the Directive must also 'provide a balance between market efficiency and the safety of the parties to the arrangement and third parties, thereby avoiding *inter alia* the risk of fraud' (Recital 10 FCD). This balance is achieved by requiring that (i) the financial collateral arrangement is evidenced in 'writing or in a legally equivalent manner' (Article 3.2 FCD) and (ii) the financial collateral is 'in the possession or under the control of the collateral taker or of a person acting on the collateral taker's behalf' (Article 2.2 FCD). See on this legal issue also Regulations 3 and 4 of the FCAR.

[468] See Recitals 3, 9 and 10 of the FCD.

[469] Benjamin (2000, p. 107).

One way to think of control is to regard it as the 'intangible's equivalent to possession of tangibles.'[470] The general rule is that a security interest in intangibles cannot be perfected by possession when 'there is no indispensable *res* to be possessed (like a negotiable instrument).'[471] Nevertheless, 'some of these intangibles interests can be put under the control of a secured creditor to the exclusion of others, and this will put third parties on notice.'[472] This means that for certain forms of intangible property the registration requirement (as a substitute to possession) may be deemed unnecessary as control seems to provide sufficient notice of the security interest to third parties[473]. This formulation raises four specific questions: (i) what is the precise meaning of control? (ii) is it consistent with the ideas of a right against a right, of an interest in securities and of an indirect right *in rem*? (iii) does the FCD or the FCAR provide a clear definition of this new concept? (iv) does control cover floating charges and, if so, to what extent?

2. The compound meaning of control

There have been different definitions of the notion of control, which do not always seem to be mutually consistent (or at least not at first glance).

A first attempt to define control was made by the FMLC in its Commentary on Principles for Investment Securities Statute in 2004. According to the FMLC, control may be positive or negative: 'a person has positive control over assets where they are able to dispose of them',[474] alternatively or cumulatively,[475] 'a person has negative control over assets where they are able to block any other person from disposing of them.'[476] In other words, 'positive control' is the ability of the secured party to have the assets sold or transferred without any further involvement of the debtor; while 'negative

---

470 White and Summers (2000, p. 775). See also Bridge (2006, p. 268) who states that control should be 'to certain forms of intangibles property what possession is to tangible property.' But see also Official Comment, § 8-106 UCC para. 7, which clarifies that the UCC concept of control has a special meaning when applied to investment property, that is not equivalent to possession. See text to nn. 589 and 590 in ch. 6.
471 White and Summers (2000, p. 775).
472 *Id.*
473 The general policy behind this rule is clearly stated by the English Law Commission when it argues that 'registration should not be necessary in order to perfect a [security interest] if its existence should be sufficiently evident to third parties', English Law Commission (2004, para. 2.150). See also Gullifer and Goode (2013, para. 2-19).
474 *Commentary on Principles For Investment Securities Statute*, Principle 6(b) in FMLC (July 2004). For a definition of the two types of control, see also English Law Commission (2005, paras 5.46 – 5.50).
475 See English Law Commission (2004, para. 4.24).
476 *Id.*

control' is the ability of the secured party to prevent the debtor from dealing with those assets.

More recently, the FMLC proposed another definition of control that seems to differ from the first[477]. In its Report *Issue 87 – Control – Gray v. G-T-P Group Ltd* which was published in December 2010, the FMLC argues that the concept of control may include two forms: negative and practical (*de facto*) control[478]. Negative control is achieved by way of a contractual agreement between the secured party and the debtor and it prevents the debtor from disposing of the collateral without the consent of the secured party. Practical (*de facto*) control is 'the ability of the [secured party] to prevent any dealing with the collateral by the [debtor], whether or not in doing so it would be in breach of its contractual obligations to the debtor'[479].

A more in-depth and comprehensive analysis of the concept of control is provided by Benjamin and Beale when they argue that it is possible to identify different types of control according to two main sets of distinctions[480]. Firstly, control may be either positive or negative. Consistent with the interpretation provided by the FMLC in July 2004, 'positive control is the ability to remove an asset from the collateral pool and negative control is the ability to prevent an asset from being so removed'[481]. Secondly, 'either positive or negative control may be legal (i.e., the right to remove or prevent removal as the case may be) or operational (i.e., the practical ability to remove or prevent removal, by account entry or otherwise).'[482] This second distinction is only partially detected in the FMLC's reports of 2004[483] and 2010[484]. According to Benjamin

---

[477] However, see also n. 483 of this chapter.
[478] FMLC (December 2010, paras 6.8 – 6.11) and *Id.* (April 2011). See also CLLS - Financial Law Committee (October 2010); Parsons (2011, p. 6) and Parsons and Dening (2011, p. 168).
[479] FMLC (December 2010, para. 6.10).
[480] Benjamin (2007, para. 20.117 - n. 192) and *Id.* (2009, pp. 258 – 259). On this point see also Beale et al. (2012, paras 10.24 – 10-40) and Zacaroli (2010, p. 184.
[481] Benjamin (2007, para. 20.117 - n. 192).
[482] *Id.*
[483] The distinction between operational and legal control is to be found under Principle 6(b) of the FMLC's Investment Securities Statute, while the difference between negative and positive control is explained in the *Commentary on Principles For Investment Securities Statute*, Principle 6(b) in FMLC (July 2004). Despite these two separate distinctions, the report fails to draw a convincingly comprehensive outline as to how the classification operates between these two main sets of distinctions.
[484] FMLC (December 2010, para. 6.10). As mentioned above, in its recent report the FMLC argues that the concept of control may include two forms: negative and practical (*de facto*) control. A careful analysis of this interpretation shows that it includes Benjamin's distinction between legal and operational control, but not the distinction between negative and positive control. In other words, in this report the FMLC only takes into consideration negative (and not positive) control and it argues that negative control can be legal (i.e. the contractual right to prevent the debtor from disposing of the collateral) and/or practical (i.e.

and Beale, legal control is the 'right' of the secured party to dispose (positive control) or to prevent disposal (negative control) of the collateral and is achieved by way of a contractual agreement between the debtor and the secured creditor. Alternatively or cumulatively, operational control is the 'practical ability' of the secured party to 'control' the delivery of the assets. This situation typically occurs when the debtor and the secured creditor agree to transfer the collateral into the account of the secured party (rather than leaving the securities credited in the debtor's account)[485]. By doing so, the secured party is in a practical (*de facto*) position to either dispose of the securities (positive control) or prevent any other person from dealing with those assets (negative control). Operational or practical control may be acquired by the secured party, despite the concomitant existence of a legal control over the collateral. This means that the secured party may have a practical ability to 'remove or prevent removal'[486] of the collateral from the account, 'whether or not in doing so it would be in breach of its contractual obligations to the debtor'[487].

Benjamin and Beale's interpretation of the notion of control shows that in the practice of indirectly held securities it is possible to identify multiple forms of control, whose content is liable to change significantly according to the circumstances. This new idea of control is not in contrast with the two interpretations provided by the FMLC. On

the *de facto* ability of the secured party to prevent any dealing with the collateral by the debtor). The reason for leaving out 'positive control' is that the FMLC's report of December 2010 envisages only the types of control that fall within the protections afforded to security over financial collateral by the FCD. As demonstrated in section 3 of this chapter, the test of control for the purposes of the FCD is only negative control (as positive control is insufficient). These considerations were elaborated by the author following a meeting in October 2011 with Habit Motani (Partner at Clifford Chance and member of the FMLC Working Group for the Report Issue 87 on Control) and Emma Chell (Senior Associate PLS at Clifford Chance).

485 One could argue that in the practice of indirectly held securities, the position of the intermediary is the closest one could get to *de facto* control. Indeed, one of the key features of a system of indirectly held securities is that the party maintaining the account is considered the gatekeeper to the asset in the account: 'not only does it keep track of what comes in and goes out, but it is in the position to *control* such movements for the benefit of other parties interested in the account', Thévenoz (2008, p. 443). However, the focus in this chapter is to evaluate the transfer of control as a method of perfection of a security agreement over indirectly held securities, involving exclusively the relationship between the account holder/debtor and the creditor. In other words, the main function of this study is to consider whether and to what extent the secured creditor is able to exclude the debtor from using and enjoying the collateral (notwithstanding the position of the debtor's account provider in relation to the collateral). For the purpose of this study, the position of the intermediary is relevant only to the extent that the secured creditor is the debtor's intermediary. In this case, the collateral is credited to the intermediary's own account at a different higher level in the holding chain, or alternatively remains credited to the debtor's account. See on this point also FMLC (July 2010, para 6.6) and Zacaroli (2010, p. 184).

486 Benjamin (2007, para. 20.117 - n. 192). See also Beale et al. (2012, paras 10.18 – 10-35) and Gullifer and Goode (2013, paras. 4–22 and 6-32).

487 FMLC (December 2010, para. 6.10). In other words, in this case there is a need to obtain some form of action by the creditor in order to remove the collateral from the account (notwithstanding the debtor's contractual right to dispose of the collateral).

the contrary, it includes them both by classifying the different forms of control according to two main sets of distinctions: control may be positive and/or negative as well as operational and/or legal. This means that (consistent with the concept of property) the notion of control is composed of 'building bricks, which can be used and put together in different ways'[488].

The classification suggested by Benjamin and Beale confirms that there is no absolute or single definition of control because this concept comprises different features that can be combined in a number of ways depending on the intention of the parties. Indeed, a closer look at the practice of indirectly held securities shows that parties may choose from at least seven different combinations[489].

Practical, legal, negative and positive control

The first combination comprises all four types of control, i.e. legal and practical control as well as positive and negative. This particular situation is the 'safest' way of creating a security interest over the collateral and it consist both of (i) transferring the securities into an account 'controlled' by the secured creditor[490] as well as (ii) conferring to such party the contractual right to dispose, and to prevent any other person from disposing, of the collateral.

Practical, negative and positive control

The second combination is acquired when the collateral is transferred into the creditor's account but the debtor maintains the right to remove the collateral at any time prior to enforcement[491]. In this case, the creditor is in a '*de facto*' (but not legal) position to both sell or transfer the collateral and prevent the debtor from exercising his/her contractual rights over the collateral.

488 The expression was originally coined with regard to the traditional proprietary rights of enjoyment, alienation and possession. In other words, it referred to the 'bundle of rights' that may be exercised by the rightful owner or possessor with respect to a 'thing'. On this point see Bell (1989, p. 5). As mentioned in the introduction of this thesis, by using this expression the main objective was to highlight that the same *bundle of rights* is not necessarily attached to all forms of property. This 'flexible' idea of property can also be detected when analysing the concept of control.
489 The author is grateful to Habit Motani and Emma Chell for describing these different combinations.
490 Even though it can be considered the 'safest' way of creating a security interest, in practice this combination is likely to be preferred for full-title transactions.
491 See the case *Gray v. G-T-P Group Ltd Re F2G Realisations Ltd (in Liquidation)* [2010] EWHC 1772 (Ch).

Practical, legal and positive control

The third combination comprises three types of control, i.e. practical, legal and positive. In practice, this means that the collateral is transferred to the account of the secured party who has also acquired a contractual right to sell or transfer these assets without further consent from the debtor.

Practical, legal and negative control

Consistent with the third combination, in this fourth case the secured party enjoys both practical and legal control. The main difference between these two combinations is that in the latter case, unlike in the former, the secured party has a contractual right to prevent the debtor from dealing with the charged assets (negative control) rather than a right to dispose of the collateral (positive control).

Legal and positive control
Legal and negative control
Legal, positive and negative control

Each of the last three combinations is characterised by leaving the collateral credited on the debtor's account. Thus, in these cases the secured party only remains in a legal position (and not a practical one) to either dispose of the collateral ('legal and positive control'), prevent others from disposing of such assets ('legal and negative control') or both options ('legal, positive and negative').

The number of these different forms of control is increased even further owing to the existence of multiple degrees of legal control, whether positive or negative. For example, in cases of negative control, the debtor may undergo an absolute preclusion from dealing with the collateral or, alternatively, be restricted to exercising only limited rights (such as the right of substitution or to withdraw excess financial collateral[492]). Similarly,

[492] See text to nn. 500 – 502 in this chapter.

in cases of positive control the secured creditor may obtain either unlimited or more restricted rights to sell or transfer the collateral[493].

These examples provide further evidence of the compound nature of control, in terms of the creditor's ability to exclude others from using and enjoying the collateral. A careful analysis of the functioning of this new concept has shown that it is generally possible to identify multiple forms of control, where the content varies according to the intention of the parties. Hence, one of the main issues is to establish which of these forms of control can be envisaged under the different theories describing the nature of the investor's right.

3. The theories of a right against a right, of an interest in securities and of an indirect right *in rem* in the context of financial collateral arrangements

McFarlane and Stevens describe the right of a secured creditor over indirectly held securities as a persistent right rather than a proprietary right. This means, for example, that if A grants a security interest to B over 10,000 shares which are credited to an account held by T for A, B acquires a right against A's right, against T's right in the 10,000 shares. Consistent with this reasoning, B's security interest can be considered perfected only in those circumstances where B obtains control over the collateral (i.e. over A's right against T's right in the 10,000 shares).

The same argument can be used with regard to the theory of an interest in securities. Hence, nothing prevents us from stating that a security interest over a sub-property can be perfected by way of control.

A more challenging task seems to be that of adapting the notion of control to the concept of an indirect right *in rem*. The core idea lying behind this concept is that it creates multiple proprietary rights over the underlying securities, rather than interests over separate assets. If one were to accept this theory, then each person standing in the holding chain of intermediaries would be entitled to acquire control over the underlying

[493] Moreover, in the case of negative control the debtor's right of disposal may be subject to either prior authorisation by the creditor for each transaction or, alternatively, to a general authorisation released at the time of creating a security interest.

securities. This means that the same asset cannot only be managed[494] but can also be controlled by multiple parties at the same time.

Such a description of an indirect holding system raises certain reservations, given that the notion of control implicates (at least in its most restrictive forms) the ability to preclude others from disposing of the asset. Hence, with this notion in mind, it would be rather difficult to picture the underlying securities as being separately and simultaneously controlled by different parties[495].

Conversely, the theories of a right against a right and of an interest in securities can be easily accommodated to the practice of intermediated securities, as in both cases the account holder standing, for example, at the bottom of the chain acquires control over 'something' which is legally distinct from underlying securities.

The outstanding question is whether these two theories can also help us to understand more fully what exactly is meant by control: is it positive and/or negative, legal and/or practical? The answer to this question is that all the different forms of control (suggested in the previous section) can be potentially adjusted to the theories of a right against a right and of an interest in securities. This means that such theories do not seem to add significant value to the debate, the main difference being simply that of using a different 'label' to classify the right acquired by the secured creditor over the collateral. Hence, once could argue that B's right against A's right or B's interest in a sub-property can be perfected by way of control, without this statement offering any indication of the precise meaning of control[496].

The next step in this discussion is to determine whether the FCD casts any light on this matter, by identifying the different forms of control that can be applied in the practice of intermediated securities. Although McFarlane and Stevens do not believe that new provisions should be introduced on the notion of control, it may be demonstrated that

494 See text to nn. 196 and 197 in ch. 2.

495 The only way to explain this complex structure would be to describe the underlying securities as if they had been replicated onto the account at each level of the holding chain of intermediaries.

496 For example, it is possible to have a combination of legal and negative control in those circumstances where B is in a legal position to prevent A's right of disposal (regardless of whether the collateral is classified as a sub-property or as A's right against T's right in the 10,000 shares).

(due to the vague wording of the FCD) a statutory clarification is indeed a necessary requirement.

4. The uneasy case for understanding the meaning of 'control' under the FCD and the FCAR

Neither the FCD nor the FCAR defines exactly what constitutes 'control' and this uncertainty leaves ample room for debate.[497]

In the 2005 Report on Company Security Interest, the scope and the meaning of control were analysed in detail by the Law Commission, although no ultimate definition was recommended.[498]

Initially, the debate was focused primarily on the first set of distinctions suggested by Benjamin and Beale, in an attempt to understand whether EU law contemplates negative control, positive control or both.

The wording seems to suggest that 'negative control' alone is probably sufficient to satisfy the perfection requirement, while 'positive control' alone is not.[499] This interpretation relies on paragraph 10 in the Preamble to the FCD, which states that the directive covers 'only those financial collateral arrangements, which provide for some form of dispossession'

The rationale behind the dispossession requirement is to prevent the debtor from having control of the assets and hence from transferring or delivering them to third

---

[497] The literature on the meaning of control under the FCD has been quite productive. For an analysis see, for example, Goldsworthy (2013, p. 71); Chell et al. (2013, p. 43); Saoul (2013, p.143); Gullifer, p. 377); Turing (2005, p. 4); McCormick (2006, p. 263); Fawcett (2005, p. 295); Beale (2004, p. 117).

[498] English Law Commission, (2005, para. 5.44). The English Law Commission came to the conclusion that it could not define control for the purpose of the FCD as its meaning was far from clear in the Directive. 'We think it is in general very important that domestic measures implementing European legislation should give the parties clear guidance as to what is required. However, a correct interpretation of the FCD is rather hazardous due to its particularly unclear wording. We have argued that a party who has not prevented the debtor from dealing with the securities does not have 'possession or control' within the meaning of the Directive, but we reached this conclusion only by interpreting the relevant articles of the Directive in the light of the recitals,' English Law Commission (2005, para. 5.60). Cfr. English Law Commission (2004, para. 4.29).

[499] See on this point English Law Commission (2005, paras 5.46 – 5.50); Beale et al. (2012, para. 10-30) and Gullifer and Goode (2013, para. 6-35).

parties. If the debtor retains the ability to deal with the financial collateral, it cannot be considered as dispossessed.[500]

The last sentence of Article 2(2) of the FCD seems to confirm this analysis when it specifies that any right of the debtor to substitute equivalent financial collateral or withdraw excess financial collateral shall not prevent the secured creditor from being in possession or having control of the assets.[501] If the intention under the FCD were to contemplate the possibility of the debtor's disposing of the collateral this provision would be unnecessary, as the right of substitution or to withdraw excess financial collateral should be included in the debtor's retention of the right to trade the financial collateral. Thus, the clarification under Article 2(2) would be superfluous for cases in which the debtor had such a power and 'one would expect there to be some reference to that, but there is none.'[502]

This interpretation seems to suggest that the test of 'possession' or 'control' of the secured creditor under Article 2(2) of the FCD is satisfied only in those circumstances where the debtor is deprived of the ability to dispose of the financial collateral. This situation occurs when the secured creditor has either negative control alone, or both negative and positive control, but it does not allow for what the Law Commission calls 'positive control without negative control'[503].

There is another provision in the FCD that is often mentioned to confirm this approach, i.e. the provision on enforcement. Under Article 4 of the FCD, in the event of default the creditor has the right to appropriate the collateral as a means of discharging the obligations of the debtor without the need to obtain a court order

---

500 Paragraph 10 in the Preamble is far from clear when it uses the expression 'the provision of the financial collateral' to explain the form of dispossession required under the FCD. What does 'provision' mean? In order to understand this concept, the wording of paragraph 10 in the Preamble has to be interpreted in line with paragraph 9 in the Preamble and Article 2(2), which states that a financial collateral arrangement is considered to be 'provided' when the financial collateral is 'delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker.' This means that in order for the financial collateral to be in the 'possession or control' of the secured creditor, the debtor must be prevented from dealing with the collateral. On this point, see Reg. 4 (2) FMIR, English Law Commission (2005, paras 5.52 – 5.54); Gullifer and Goode (2013), para. 6-35).

501 See also Reg. 3 FCAR. However, Reg. 4 (2) FMIR replaces the expression 'equivalent financial collateral' with 'financial collateral of the same or greater value'.

502 English Law Commission (2005, para 5.54 - n. 66).

503 *Ibid.*, para 5.50.

(which is, instead, required in the case of foreclosure).[504] However, appropriation by the creditor is possible only if the parties had previously agreed to this as part of their security financial collateral arrangement.[505] Similarly, the wording of Article 4(1) of the FCD contemplates that parties may agree to limit the power of sale by deciding, for instance, that a judicial order is required to sell the collateral.[506] This means that for the purpose of the FCD a security interest is effective against third parties (i.e. perfected by way of control) even in those circumstances where there is no power to appropriate the collateral or where there is only a restricted power of sale. Having said that, the lack of any power to appropriate, or any restrictions on the sale in the agreement, seem to be inconsistent with the concept of 'positive control', which, on the contrary, requires the secured party to have the ability to sell or transfer the collateral without the debtor's concurrence or ability to take any action. Accordingly, it could be argued that 'positive control' is not sufficient to perfect a security interest and that 'negative control' alone is sufficient to satisfy the test of 'possession or control' required under Article 2(2) of the FCD.[507]

The approach that appears to be adopted by the FCD is not in line with the US law where, under revised Article 8 UCC, 'positive control' alone may be sufficient to perfect a security interest. In Comment 7 to § 8-106 UCC, the Drafting Committee for the revision to Article 8 argues that the key to the control concept is the ability of the purchaser or the secured creditor to have the securities sold or transferred without

---

504 Art. 4 (1) FCD and Reg. 17 FCAR. See also Reg. 4 (15) of the 2010 Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations ('FMIR').

505 Art. 4 (2) FCD.

506 Art. 4 (1) FCD states that: 'Member States shall ensure that on the occurrence of an enforcement event, the collateral taker shall be able to realise in the following manners, any financial collateral provided under, *and subject to the terms agreed* [emphasis added], in a security collateral arrangement: (a) financial instruments by sale or appropriation and by setting off their value against, or applying their value in discharge of, the relevant financial obligations and (b) […].' The italicised words suggest that the right to realise the financial collateral is subject to the terms agreed upon by the parties in the financial collateral arrangement. Therefore, nothing would prevent the debtor and the creditor from deciding to restrict such a right: they may decide to limit the secured party's power of sale, so that, for instance, a court order is required. On this point see Beale et al. (2012, para. 10-31). See also English Law Commission (2005, para. 5.55 -n. 71). Reg. 17 FCAR (which implements Art. 4 (1) FCD) was recently amended by Reg. 4 (15) FMIR. For an analysis of these amendments see Lomnicka (2012 b, paras. 18.27 - 18.32)
For an analysis of Regulation 17 FCAR which

507 There are, moreover, other indications that seem to confirm this orientation. According to Article 2(2) FCD and Regulation 3 FCAR, the existence of a right to substitute in favour of the debtor does not prevent the financial collateral from being under the control of the creditor; indeed, this specification 'would not be necessary if "negative control" was not required' under the EU legislation, Gullifer and Goode (2013, para. 6-35 n. 243). See also English Law Commission (2005, paras. 5.54 - n. 66 and 5.55 - n.71).

further action by the owner.[508] In particular, under certain circumstances there is no requirement that the powers held by the purchaser or the secured creditor be exclusive, as the owner may have concomitant rights to substitute, to receive dividends and distributions as well as to trade those securities.[509]

This form of control may occur (i) in the case of uncertificated securities when the issuer has agreed that it will comply with the instructions originally stipulated by the secured creditor without further consent by the registered owner (§ 8-106 (c) (2) UCC) and (ii) in the case of book-entry securities, when the debtor remains the entitlement holder and the securities intermediary has agreed to comply with the entitlement orders originated by the secured creditor without further consent by the entitlement holder (§ 8-106 (d) (2) UCC). In both cases, under §8-106 (f) UCC the concept of control is not vitiated merely because the parties have agreed that the registered owner or the entitlement holder can continue to give instructions to the issuer or securities intermediary or otherwise deal with the securities.[510]

This means that the UCC concept of control has a specific meaning when applied to investment property and that it cannot be considered *in toto* as a true equivalent of possession.[511] Comment 7 to § 8-106 UCC states that:

> 'The term control is used in a particular defined sense. […] The concept is not to be interpreted by reference to similar concepts in other bodies of law. In particular, the requirements of 'possession' derived from the common law of pledge are not to be used as a basis for interpreting subsection (c) (2) or (d) (2).

508 Official Comment, § 8-106 UCC para. 7.
509 § 8-106 (f) UCC.
510 Wood (2007, para. 36-018). On this point, see also Harris and Mooney (2011, p. 435). In accordance with Comment 5 to § 8-106 UCC '[f]or a purchaser [or a secured creditor] to have control under section (c) (2) or (d) (2), it is essential that the issuer or securities intermediary, as the case be, actually be a party to the agreement. If a debtor gives a secured party a power of attorney authorizing the secured party to act in the name of the debtor, but the issuer or securities intermediary does not specifically agree to this arrangement, the secured party does not have 'control' within the meaning of subsection (c) (2) or (d) (2) because the issuer or securities intermediary is not a party to the agreement.'
511 On the contrary, the right of a secured creditor to give instructions can be considered as exclusive (i) in the case of a certificated security in bearer form when the certificated security is delivered to the secured creditor (§ 8-106 (a) UCC); (ii) in the case of a certificated security in registered form when the certificate is endorsed to the secured creditor or in blank by an effective endorsement (§ 8-106 (b) (1) UCC) or when the certificate is registered in the name of the secured creditor (§ 8-106 (b) (2) UCC); (iii) in the case of an uncertificated security when the secured creditor becomes the registered holder (§ 8-106 (c) (1) UCC); and (iv) in the case of book-entry securities when the secured creditor becomes the entitlement holder (§ 8-106 (d) (1) UCC).

Those provisions are designed to supplant the concepts of 'constructive possession' and the like.'[512]

However, although the Drafting Committee clarifies that this 'new' concept of control is intended to satisfy the needs of modern securities holding practices,[513] it can still be argued that if the debtor retains complete freedom to deal with the collateral, the protection of the secured creditor will be significantly reduced, posing the risk of jeopardising the main purpose of a secured transaction.[514] This may be avoided only in those circumstances where the debtor delivers assets of equivalent market value or, alternatively, provides some other form of adequate protection against credit risk exposure.

Unlike Article 8 UCC, the FCD does not provide a precise definition of what amounts to 'control', although the leading opinion among UK academics and practitioners is to interpret the wording of the directive in the negative (rather than positive) sense.

With respect to the second set of distinctions suggested by Benjamin and Beale, the FCD does not provide clear answers as to whether it includes situations of practical control and/or legal control. The wording in the directive suggests that a combination of 'legal control' and 'practical control' can indeed satisfy the perfection requirement, while 'practical control' alone is not sufficient. This interpretation relies on Article 2(2) of the FCD which prevents the debtor from retaining a *right* [emphasis added] to trade the charged assets (with the exception of a right of substitution or withdrawal of excess collateral). Such a limitation on the debtor's *right* [emphasis added] to dispose of the asset is inconsistent with a scenario where the collateral is transferred into the creditor's

---

512 Comment 7 to § 8-106 UCC.

513 *Id.*

514 In the consultation paper, the English Law Commission evaluates § 8-106 (f) UCC and explains its initial doubts on this provision: '[w]hen we first learned of this provision of the UCC, we were worried by it. We could envisage a scheme that allowed the debtor to substitute other investment securities for those originally subject to the [security interest]; but if the debtor retained complete freedom to deal with the entitlement, what security would the secured party have? […] After informal consultation we have realised that this was a misconception. We had been thinking in terms of the old, fixed security: the debtor's freedom to trade in the securities would indeed be inconsistent with that. However, the floating charge allows a debtor to dispose of assets subject to the charge so long as the charge has not crystallised (and, depending on the terms of the charge, there is no guarantee that the proceeds of such activities will fall within the charge). Thus there is nothing incompatible between allowing the debtor to deal with the entitlement and having a [security interest], though obviously it will provide the secured party with less certain security than if it can prevent the debtor dealing.' See English Law Commission (2004, paras 4.62 – 4.65).

account but the debtor retains the *right* [emphasis added] to remove the collateral at any time prior to enforcement (i.e. practical control without legal control)[515].

The argument that practical control alone is not sufficient to satisfy the perfection requirements under the FCD has been criticised by the FMLC. In the Report of December 2010, the FMLC argues that security arrangements can be perfected either by way of legal or of practical (*de facto*) control[516]. The inclusion of practical control as a means of perfection of a security interest is based on the policy considerations that underlie the directive. In particular, paragraph 10 in the Preamble to the FCD refers to 'a balance between market efficiency and the safety of the parties to the arrangement and third parties, thereby avoiding *inter alia* the risk of fraud'[517]. According to the FMLC, this balance can be achieved when the secured creditor has practical control as 'the physical holding of the securities would prevent any dealing by the [debtor] without the co-operation of the [secured creditor] and would be sufficient to prevent the [debtor] giving an appearance of false wealth'[518]. However, setting aside these policy issues, little consideration is given to the wording of Article 2(2) of the FCD that prevents the debtor from retaining a general *right* [emphasis added] to trade the charged assets. Indeed, in contrast with the FMLC's argument, this specification under Article 2(2) of the FCD is inconsistent with a scenario where the creditor has practical (but not legal) control.

A more difficult aspect to establish is whether legal control alone can be considered sufficient to satisfy the perfection requirement. There seem to be different views on this point, given that the wording of the FCD has proven to be somewhat vague and ambiguous. In *Re Lehman Brothers International (Europe) (In Administration)* Briggs J suggests that the minimum requirement for a secured creditor to reach control should be legal control alone, while practical control without legal control is not sufficient[519].

---

515 Unlike the FCD, Article 8 UCC does include practical control alone. See on this point Mooney and Harris (2011, p. 435): '…the fact that the secured party has control, and thus "the *ability* [emphasis added] to have the securities sold or transferred without further action by the transferor (UCC 8-106, Comment 7)", does not necessarily mean that the secured party has the *right* [emphasis added], as against the debtor, to issue entitlement orders. The circumstances under which a secured party enjoys the right to issue entitlement orders is determined by the agreement of the debtor and secured party.'

516 FMLC (December 2010, paras 6.8 – 6.11). See also Parsons and Dening (2011, p. 168) and CLLS - Financial Law Committee (October 2010, paras. 5.15 – 5.19).

517 Recital 10 FCD.

518 Parsons and Dening (2011, pp. 167-168) and FMLC (December 2010, paras 6.8 – 6.11).

519 [2012] EWHC 2997 (Ch), paras. 131 and 136. See, however, on this point English Law Commission (2005, para. 5.54) where the English Law Commission states: '[d]ispossession suggests that, for the

However, one question that remains unanswered is to what extent this form of control can 'really be said to amount to dispossession'[520] and therefore adequately protect the parties to the arrangements and third parties from the risk of fraud[521] (as expressly required in paragraph 10 in the Preamble to the FCD).

The uncertainties surrounding the notion of control under the FCD have remained even after its implementation through the FCAR in the United Kingdom. In an attempt to 'underpin the FCAR'[522], the English Law Commission analysed the scope and the meaning of 'control', but came to the conclusion that it was unable to define 'control', as the concept had to be interpreted in accordance with EU law and that the wording in the FCD was far from clear.[523]

'Our initial analysis', writes the English Law Commission, 'was that it was simply up to national law or the *lex situs* to define "control", but we no longer think that is the case. We have to assume that the phrase has an "autonomous" meaning in European law - in other words, its meaning must depend on interpretation of the Directive and general principles accepted in Community law - and that national law must comply with that meaning.'[524]

The lack of a clear definition of 'control' was one of the key points raised by the City of London Law Society Financial Law Committee in its response to the European Commission's questionnaire evaluating the FCD.[525] It was argued that without adequate assurance of what constitutes control within the meaning of Article 2(2) of the FCD, there is a risk that certain transactions may not be considered perfected for lack of sufficient control and hence may be void against an administrator or liquidator of the debtor or against a subsequent creditor. This legal uncertainty can be considered as an

---

collateral to be in the possession or control of the collateral taker, at least the collateral provider must be prevented (whether legally *or* [emphasis added] practicall*y*) from dealing with the collateral'.

520 Gullifer and Goode (2013, para. 6–36).

521 HM Treasury (August 2010, paras. 3.3).

522 English Law Commission (2004, para. 2.147).

523 *Id.* (2005, para. 5.44). The English Law Commission proposes a clear set of rules to establish ways in which a chargee may obtain 'control' as well as deal with priority issues. Although it may be argued that its proposals adhere too closely to the provisions of Article 8 UCC, which - as already mentioned - introduced the concept of 'control', the English Law Commission deserves the credit for having attempted to clarify and simplify this very complex area of law.

524 English Law Commission (2005, para 5.52).

525 Turing (2005, p. 4); McCormick (2006, p. 263); Fawcett (2005, p. 295. See also HM Treasury (August 2010, paras. 3.2/3.4) and HM Treasury (November 2010, paras. 2.18/2.21); the CLLS - Financial Law Committee (October 2010, p. 5); the FMLC (April 2011, p. 2).

obstacle to the actual enforcement of a security interest and, more in general, to the efficient use of financial collateral arrangements in the European financial market.

Despite the legal uncertainties envisaged by market players, the recent amendments introduced to the FCD and the FCAR make no attempt to clarify what constitutes control for the purposes of the requirements that financial collateral be 'delivered, transferred or otherwise designated so as to be in the possession or under the control of the collateral taker […]'[526].

The Geneva Convention offers a clear guideline to the internationally recognised methods for the transfer of intermediated securities and for their use as collateral. If the EU Commission and the EU Member States were to ratify the Geneva Convention, a decision as to the meaning of control in the FCD would be necessary[527]. The reason for this is that under the Geneva Convention, it is up to a contracting state to declare what kind of agreement or notice is necessary in order to make an interest in intermediated securities effective against third parties and, more importantly, such a declaration must specify what type of control is included in the agreement or notice (i.e. whether EU law requires 'negative control' and/or 'positive control' as well as 'legal control' and/or 'practical control')[528].

---

526 EC Directive 2009/44 and FMIR which has recently amended the FCAR. In particular, Regulation 4 (2) of the FMIR introduces a new definition of possession, which applies specifically to investment securities, but it does not provide a definition of control. For an analysis of this provision see i*nfra* chapter 6 (section 2).

527 See on this point Gullifer and Goode (2013, para. 6-35).

528 While the Official Commentary to the Geneva Convention provides a definition of negative and positive control, no reference is made to the distinction between legal and practical control. However, a closer look at Articles 11 and 12 of the Geneva Convention shows that such provisions do include the second distinction. In particular, Articles 11 and 12 of the Geneva Convention set out three methods for perfecting a security interest by way of control. These methods are (1) crediting (and debiting) to an account, (2) conclusion of a control agreement and (3) earmarking of securities in an account. Further details on the methods recognised under Articles 11 and 12 of the Geneva Convention are provided in chapter 6 (section 4). However, for the purpose of understanding whether the Geneva Convention requires 'legal control', 'practical control' or both, it is worth mentioning that the first method is characterised by transferring the collateral to the creditor's account (which is a *conditio sine qua non* for obtaining practical control), while the second and the third methods are characterised by leaving the collateral credited on the debtor's account (which is a requirement that excludes practical control). This means that the Geneva Convention contemplates the possibility of having either a combination of practical and legal control as well as legal control alone. But is practical control alone sufficient to satisfy the perfection requirement? Article 12 (2) of the Geneva Convention leaves to the Contracting States the choice of determining whether practical control alone is sufficient for the perfection of a security interest, provided that one of the following conditions are met: (i) the secured creditor is the relevant intermediary (Article 12(3)(a)); (ii) a designating entry is made in favour of the secured creditor (Article 12(3)(b)); and (iii) the account holder enters into a control agreement with the secured creditor, the relevant intermediary or both parties (Article 12(3)(c)). See on this point Kanda et al. (2012, paras. 12-1/12-36).

5. Floating charges and the unresolved debate on inclusion within the scope of the FCD

Interestingly, under English law the interpretation proposed by most practitioners and academics would result in placing certain floating charges outside the FCD. If the level of control required under Article 2(2) of the FCD was intended to exclude those circumstances in which the debtor retains the right to deal with the financial collateral, there would be doubts as to whether certain floating charges were included in the FCD.

Before evaluating whether floating charges are consistent with the requirement of control provided under Article 2(2) of the FCD, it is worth clarifying the difference between floating charges and fixed charges.

Typically, a fixed charge attaches to a particular asset immediately, or upon the debtor acquiring an interest in it. The effect of such an attachment is that the debtor cannot deal with the asset free from the charge and needs to obtain the chargee's permission if the asset is to be disposed of or transferred.

A floating charge, by contrast, is a security interest over a pool of changing assets of the debtor, which 'floats' without attaching to any particular asset until it is converted into a fixed charge, i.e. 'crystallised' by attachment to specific assets. This means that the debtor is free to dispose of the charged assets in the ordinary course of business without the consent of the secured creditor, until the occurrence of a default or other prescribed event that causes the floating charge to 'crystallise' on a particular asset.[529] Thus, control of the charged assets by the debtor can be described as the defining feature of a floating

[529] In *Re Yorkshire Woolcombers Association Ltd* Romer LJ identifies three main aspects which would characterise the security interest as a floating charge: (1) the charge is granted over a class of present or future assets; (2) the content of that class of assets may change from time to time; and (3) the debtor is free to carry on the business in the ordinary way without interference from the creditor. See *Re Yorkshire Woolcombers Association Ltd* [1903] 2 (Ch) 284, 295. On appeal in the same case the language was echoed by Lord Macnaghten: 'I should have thought there was not much difficulty in defining what a floating charge is in contrast to what is called a specific charge. A specific charge, I think, is one that without more fastens on ascertained and definite property or property capable of being ascertained and defined; a floating charge, on the other hand, is ambulatory and shifting in its nature, hovering over and so to speak floating with the property which it is intended to affect until some event occurs or some act is done which causes it to settle and fasten on the subject of the charge within its reach and grasp', *Illingworth v. Houldsworth* [1904] AC 355, 358.

charge.[530] The main purpose is to facilitate access to credit without paralysing the debtor's business.[531]

In spite of its commercial benefits, a floating charge is a rather weak form of security, as it is characterised by certain disadvantages for the secured creditor, including primarily lower priority than the fixed charge holders and than various statutory creditors[532]. As a result, creditors in the financial market seek to ensure that their security interest does not constitute a floating charge, given that it provides limited protection in insolvency proceedings. On the other hand, from a debtor's perspective floating charges provide greater flexibility, particularly in the form of the debtor's right to actively manage the assets during the life of the secured transaction.[533]

Over the past few decades there has been an increasing demand for greater flexibility in the use of financial collaterals. Common examples of such flexibility may include: (i) a bank account, which the debtor is allowed to continue to use; (ii) a pool of receivables, where the debtor is entitled to collect debts; and (iii) a portfolio of securities, where substitution rights and continuing margining provisions enable the debtor to adjust the composition of the collateral portfolio. In particular, in the case of securities portfolios the 'freedom of the debtor to deal' has proven to be very important as the value of the financial assets serving as collateral may fluctuate from time to time. This means, for example, that in order to maintain the original ratio between exposure and collateral, it is essential for the debtor to make constant adjustments, by either withdrawing securities or providing additional collateral so as to eliminate possible shortfalls. This practice is called margining or marking to market and it may take place several times a day for the

---

[530] The test to distinguish floating charges from fixed charges is not so much whether the charged assets may shift from time to time or whether the security interest can be granted over present and future assets. It would be possible, in practice, to create a fixed charge over a changing class of assets as well as over future assets. In addition, floating charges can be granted even over assets that do not fluctuate at all in the ordinary course of business, *Re Atlantic Computers Ltd* [1992] (Ch) 505 (CA). Thus, the crucial test is whether or not the debtor is at liberty to dispose of the assets without the consent of the creditor. In other words, the test is control, *Re Cosslett (Contractors) Ltd* [1997] 4 All ER 115. However, the courts have experienced considerable difficulties in distinguishing between floating and fixed charges, particularly in the context of a charge over book debts. On this point, see *Agnew v. IRC* [2001] UKPC 28, [2001] 2 A.C. 710; *National Westminster Bank v Spectrum Plus and others* [2005] UKHL 41.

[531] The floating charge was developed in the late 19th century to enable manufacturing and trading companies to raise loan capital while at the same time leaving them free to deal with their assets and pay their trade creditors in the ordinary course of business.

[532] See s. 176A Insolvency Act 1986 and para. 65 (1) of Schedule B1 Insolvency Act 1986.

[533] Yates and Montagu (2013, paras. 4.40 and 4.41); Benjamin (2007, paras. 17.91/17.110); *Id.* (2000, para. 5.37); Fawcett (2005, p. 297) and Beale (2004, p. 119).

purposes of enabling the parties to manage their credit exposures.[534] Similarly, it is also customary in secured transactions to provide for substitutions, when the original collateral assets are returned to the debtor upon delivery of new assets of an equivalent market value. The rationale behind this practice is that 'the debtor retains a position in the collateral assets, having the risks and rewards of ownership, and may therefore wish to actively manage the assets during the collateral transactions'.[535] If the original collateral is falling in value, it is in the interest of the debtor to reduce losses by selling the assets; alternatively, if it is rising in value, the debtor may wish to regain a profit by selling the assets. Typically, the kind of flexibility provided by the secured transactions described above is considered the 'hallmark of a floating charge'[536].

In this regard, problems may occur when trying to establish whether floating charges are included within the scope of the FCD. Indeed, the main advantage of applying the FCD would be to avoid the registration requirement for 'the creation, validity, perfection, enforceability or admissibility in evidence of a financial collateral arrangement'[537]. The wording of the EU legislation seems at first sight to exclude floating charges as, in accordance with Article 2(2) of the FCD, a secured creditor is exempted from any registration requirement only if it has 'possession or control' over financial collateral.[538] In particular, the interpretation proposed by most practitioners and academics suggests that the test of 'possession or control' of the secured creditor under Article 2(2) FCD is satisfied only in those circumstances where the debtor is deprived of the power to retain the financial collateral. In other words, the ability of the

534 Yates and Montagu (2013, paras. 4.40 and 4.41).
535 *Id.*
536 Accordingly, a court might characterise such secured transactions as floating charges, regardless of how they are described in the financial collateral arrangement, Benjamin (2007, paras. 20.112/20.113); *Id.* (2000, paras. 5.37 – 5. 38). In particular, a secured transaction described by the parties as a fixed charge may be 'recharacterised' by a court as a floating charge. This occurs, for example, if the debtor is granted an unlimited power to withdraw or substitute securities in the collateral pool, which might be deemed to constitute sufficient control over the asset. The term 'recharacterisation' is based on the principle that the courts look at the substance rather than the form of a transaction and that policy should prevail over freedom of contract. This outcome is considered undesirable for a number of reasons, including the risk that a security interest has restricted protection in insolvency proceedings. Generally, market participants seek to limit the risk of 'recharacterisation' through standard documentation, by using clauses which narrow the debtor's authority and 'squeeze' the secured transaction into the category of fixed charges. However, even under these circumstances there will always be a margin of risk of recharacterisation, as at times the boundary line between floating charges and fixed charges is particularly difficult to draw. In particular, over the years the courts have tried to distinguish between fixed and floating charges over book debts and their money proceeds, but despite recent authoritative guidance, some doubts still persist, *Agnew v. IRC* [2001] UKPC 28; [2001] 2 A.C. 710; *National Westminster Bank v Spectrum Plus and others* [2005] UKHL 41.
537 Recital 10 FCD and Art. 3 (1) FCD.
538 Art. 2 (2) FCD.

debtor to dispose of the assets 'destroys' control, based on the argument that control must be negative (rather than merely positive).

If this interpretation is correct, a floating charge would fall outside the scope of the FCD. The main characteristic of a floating charge is the debtor's freedom to deal with the charged assets in the ordinary course of business and this aspect is inconsistent with the concept of negative control.

There is, however, an exception to this general rule. Under Article 2(2), it is expressly stated that the debtor may continue to substitute or withdraw excess financial collateral and that such power does not prevent the secured creditor from being in possession or having control of the financial assets.

The right to withdraw seems to be consistent with a floating charge, although the requirement that such a right should be limited only to excess financial collateral considerably reduces the debtor's ability to dispose of the assets.[539] Accordingly, while the debtor has a contractual right to withdraw the securities, such a right may only be allowed after the creditor has, for example, verified that the excess does indeed exist or that other criteria are met.[540]

On the other hand, the FCD does not seem to pose any limitation to the debtor's right to substitute new securities for those subject to the financial collateral arrangement. Nevertheless, the wording of the FCD cannot be interpreted as including a general advance authorisation to substitute, because such a clause would be inconsistent with the requirement that the financial collateral needs to be in the possession or under the control of the secured creditor. It is therefore preferable for the parties to agree that 'the release of any securities by the creditor is dependent on the debtor having firstly furnished the substitute securities' or having provided some other form of protection.[541]

The FCAR goes even further, determining under Regulation 3 that the right to substitute is limited to 'equivalent financial collateral'.[542] This means that substitutions

539 Reg. 3 FCAR. See also Reg. 4 (2) FMIR.
540 However, it can be argued, in the light of the Spectrum case, that even this limited right to withdraw may not be enough to avoid characterisation as a floating charge, Worthington (2006 a, pp. 31 – 32).
541 Gullifer and Goode (2008, para. 6-33).
542 Reg. 3 FCAR. However, see also Reg. 4 (2) FMIR.

are limited to securities of the same issues, or class, as the financial collateral which was initially granted to the creditor.[543] Such a limited power to substitute casts doubt on the efficacy of floating charges as financial collateral arrangements. Typically, a floating charge does not operate this way since the duty to substitute the original collateral with securities of the same issue significantly narrows the authority conferred to the debtor and may also jeopardise the function of substitution[544]. For example, if the debtor decides to sell the original collateral securities because they are falling in value, the purpose of reducing losses would most likely not be achieved in those circumstances where the debtor was forced to substitute the original collateral with securities of the same issue. The 2010 Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations ('FMIR'), which amended the FCAR, seem to overcome the limitations concealed in the wording of Regulation 3. In this regard, Regulation 4 (2) of the FMIR replaces the expression 'equivalent financial collateral' with 'financial collateral of the same or greater value'. This new wording should no longer limit the right to substitute the original collateral solely with securities of the same issue or class.[545]

Nevertheless, while the FCD and the FCAR expressly recognise that substitutions or withdrawals of excess collateral do not prejudice the control of the secured creditor, it is unclear whether the debtor's ability to deal with the collateral in other circumstances negates such control. Indeed, there are a variety of circumstances beyond rights of substitution or withdrawal of excess collateral where the debtor may reserve rights over the collateral. However, neither the FCD nor the FCAR mentions these other circumstances, which would most likely fall within the category of floating charges.[546]

In the United Kingdom there was an attempt to bring at least some floating charges within the realm of the FCAR. In particular, under Regulation 3 of the FCAR, it is

---

543 Reg. 3 FCAR.

544 Before crystallisation of a floating charge, the debtor's power to dispose of the collateral and carry on its business is fairly broad. The extent of this power is shown in the decision by the Court of Appeal in *Re Borax Co.* [1901] 1 Ch. 326. In this case the debtor had created a floating charge over all its property and assets both present and future (326). The debtor subsequently sold the whole of its business to another company in exchange for shares and debentures in that company, but would nevertheless continue as a going concern. The Court of Appeal held that the debtor was entitled to sell all its assets (and substitute a totally different property for them), if such a transaction was intended in furtherance of the business and not with a view to cease trading (340). See also *Re H. H. Vivian & Co Ltd.* [1900] 2 (Ch) 654. For an analysis of these cases see Calnan (2006, para. 4.37); Beale et al. (2012, para. 13.26) and Gullifer and Goode (2013, paras. 5.39 – 5.40).

545 Reg. 4 (2) FMIR.

546 Davies (2007, p. 72) and McCormick (2006, p. 266).

stated that floating charges are included 'where the financial collateral charge is delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker or a person acting on its behalf […].'[547] Furthermore, Regulations 8 and 10 of the FCAR are intended to disapply certain insolvency rules, which refer to floating charges and which, if applied, would restrict the enforcement of security interests in financial collateral.[548]

Despite the express reference to floating charges, the interpretation of these provisions is not very clear. Over the past few years, there has been heightened discussion in the market, with many scholars expressing opinions as to what level of control must be exercised by the secured creditor in order for a floating charge to fall within the FCAR.

One way to interpret these provisions would be to bring within the FCAR only those charges which confine the debtor's authority to trade securities merely to margining and substitution rights, as such interests are the only ones expressly protected by both Article 2(2) of the FCD and Regulation 3 of the FCAR. On the other hand, market participants have often claimed the need to protect also other types of floating charges (where secured creditors are 'able to remove assets in their discretion, not only under margining and substitution arrangements'[549]).

The only aspect that seems certain in this debate is that 'there must be a spectrum with fixed charges at one end (where control of the assets must be maintained by the creditor) and floating charges at the other (where no control of the creditor is exercised until crystallisation). A floating charge for the purposes of the FCAR then falls somewhere between these two.'[550]

Several years have passed since the implementation of the FCD within the United Kingdom but its position on control still remains uncertain. Without adequate assurances that certain floating charge arrangements fall within the FCAR, market participants are advised to register any charge which is not clearly a fixed charge[551]. If

---

547 Reg. 3 FCAR.

548 S. 176 A Insolvency Act 1986; s. 245 Insolvency Act 1986; s. 754 Companies Act 2006 and para. 70, Sch. B1, Insolvency Act 1986.

549 Benjamin (2007, para. 20.117) and *Id.* (2009, pp. 258 – 259). See also Turing (2005, p. 4); McCormick (2006, p. 266); Davies (2007, p. 73); Fawcett (2005, p. 297); Turing and Lester (2005, p. 67).

550 Fawcett (2005, p. 297).

551 Davies (2007, p. 72).

the charge is not registered and the secured creditor is found not to have sufficient control, such a charge may be void (under s. 874 of the Companies Act 2006) against the liquidator, administrator or any subsequent creditor . This particular scenario is reflected in *Gray v. G-T-P Group Ltd Re F2G Realisations Ltd (in Liquidation)*[552] (‘*Gray v. G-T-P Group Ltd*’), which is the first case that considers to what extent floating charges are included within the meaning of the FCAR. In *Gray v. G-T-P* the Court interprets the concepts of ‘possession’ and ‘control’ very narrowly, hence including only a limited number of floating charges within the scope of the FCAR. The decision was criticised as too restrictive particularly by market players who have stressed the urgent need for further clarity in the UK legal framework governing financial collateral arrangements[553]. In this regard, Reg. 4 (2) of the FMIR introduces a new definition of possession, which applies specifically to investment securities. However, such a provision does not provide a definition of control, nor does it explain the conditions under which the FCAR can be extended to floating charges. In *Re Lehman Brothers International (Europe) (In Administration)* Briggs J thoroughly analyses the *travaux preparatoires* of the FCD so as to clarify the meaning and intended purpose of Article 2. However, despite this analysis certain issues on the meaning of control still remain unresolved.

The concern expressed by a number of market players over the decision in *Gray v. G-T-P* as well as the amendments introduced by the FMIR and the more recent decision in *Re Lehman Brothers International (Europe) (In Administration)* are analysed in greater detail in the next chapter. Part of the inquiry will also aim to ascertain whether the new definition of possession set out under Reg. 4 (2) of the FMIR could be accommodated without difficulty by the theories of a right against a right and an interest in securities.

[552] [2010] EWHC 1772 (Ch).

[553] See FMLC (December 2010, paras 4.10 – 4.11).

Chapter 6: The new idea of possession under the FMIR and the reluctance to introduce the notion of control

1. *Gray v. G-T-P Group Ltd Re F2G Realisations Ltd (in Liquidation)*: the need for a clear legal framework governing financial collateral arrangements

In *Gray v. G-T-P Group Ltd*, the High Court of Justice considered whether the holder of a floating charge granted over financial collateral (specifically cash[554]) had the degree of control necessary under Regulation 3 of the FCAR to be exempted from the registration requirements.[555] The parties had entered into a secured agreement where, although the collateral was credited to a bank account in the name of the secured creditor, the debtor continued to have unrestricted rights to withdraw money from the account prior to an event of default. The Court decided that the secured agreement amounted to a floating charge that did not fall within the scope of the FCAR. Hence, the (unregistered) charge was void for lack of sufficient control.

In this case, the High Court of Justice had to face the 'difficult'[556] task of interpreting the precise meaning of 'possession' and 'control' under the FCD and reached the conclusion that (i) the concept of possession is intended to apply only to tangible assets and (ii) control, which concerns intangibles, means 'the substantive legal right to deal with the collateral […] as opposed to mere administrative control,'[557]. In particular, it emphasised that 'possession has no meaning in English law as regards intangible property'[558], so in this case (which concerned the use of money in the account) it was important to concentrate on the requirement of 'control'[559]. Although the secured creditor had 'physical' or practical control of the collateral (since it was credited into his/her account), this was held to be insufficient to fulfil the perfection requirements under the FCD as the debtor retained the right to dispose of the collateral. This interpretation relies primarily on paragraph 10 in the Preamble to the FCD which states

554 In this case, the relevant financial collateral arrangement was the credit balance standing 'from time to time' in the bank account (*Gray v. G-T-P Group Ltd)*, para. 3). Such a credit balance is considered 'cash' and thus 'financial collateral' for the purposes of the FCAR.
555 For an analysis of this case see McKnight (2011, pp. 96-97) and Cooke (2010, p. 518).
556 *Gray v. G-T-P Group Ltd)*, para. 41.
557 McKnight (2011, p. 97).
558 *Gray v. G-T-P Group Ltd)*, para. 54.
559 '[…] since possession has no meaning in English law as regards intangible property, the real question here is whether the collateral taker, namely G-T-P, has control over the collateral, that is the monies over which the Declaration of Trust bites, to use the money itself' *Id.*

that the directive applies only to 'those financial collateral arrangements, which provide for some form of *dispossession* [emphasis added]'. According to the Court, the reference to 'dispossession' in the directive was a clear indication that control is meant to prevent the debtor 'from using or dissipating the assets in the ordinary course of business'[560]. Thus, control needs to be interpreted in the legal rather than merely administrative or practical sense.

The decision in *Gray v. G-T-P Group Ltd.* was heavily criticised by the FMLC in the report of December 2010[561]. According to the FMLC, 'the judge's conclusion that possession has no meaning in English law as regards intangible property restricts the application of this concept to bearer securities in certificated form: a type of collateral which is rarely, if ever seen.'[562] Furthermore, 'the concept of possession has an "autonomous" meaning in EU law and it must be interpreted in accordance with the wording of the directive rather than with general principles of English law'. In this regard, the FMLC continues, the wording of the directive seems to suggest that there is 'no distinction […] between different types of collateral' and that 'possession is intended to apply to all types of collateral'[563]. In other words, '[p]ossession of securities […] should be regarded as synonymous with holding the securities, even in dematerialised form'[564].

With regard to the debtor's disposal of the charged assets, the FMLC argues that the secured creditor has 'possession or control' for the purpose of the FCAR, notwithstanding the debtor's unrestricted right to remove all the collateral at any time prior to enforcement. The idea that the secured creditor has physical control of the collateral (since the charged assets are in an account in his/her name) is deemed to be sufficient in this case. The FMLC believes that the debtor's unrestricted right to dispose of the assets 'would be no prejudice to the [secured creditor], as this would be no more

560 '[…] the Regulations are addressing what I termed 'real legal control' as opposed to simply administrative control. Real legal control means that the collateral taker must be able to prevent the collateral provider from using or dissipating the assets in the ordinary course of business.' *Id.*
561 FMLC (December 2010, paras 4.10 – 4.11). See also Parsons and Dening (2011, p. 168).
562 FMLC (December 2010, para. 4.6). There is 'no basis in logic', the FMLC continues, for giving a different treatment to certain types of collateral just because they are qualified as bearer securities in certificated form, *Id.* See also Parsons and Dening (2011, pp. 166-167).
563 FMLC (December 2010, para. 4.8).
564 *Id.*

than the parties had agreed'[565]. Moreover, 'the risk of a third party unwittingly acquiring an asset that is subject to a prior equity […] is eliminated where the [debtor] no longer holds the assets, regardless of whether it has the right to demand their return'[566].

In its report of December 2010, the FMLC stresses the need for further clarity in the UK legal framework governing financial collateral arrangements and proposes to introduce a definition of both possession and control[567].

With regard to the notion of possession, it is suggested to include the case where the financial collateral is credited to an account in the name of the secured creditor (or a person acting on his/her behalf), notwithstanding the debtor's right to dispose of the assets[568].

As for control[569], the FCAR should be amended to embrace the following two different scenarios. Firstly, the parties may agree to leave the collateral in the debtor's account. In this case, in order to acquire 'control', the creditor needs to have a contractual right to prevent the debtor from dealing with the asset (legal and negative control)[570]. Secondly,

---

565 FMLC, (December 2010, paras 4.10): 'even if the collateral provider were able to remove all the collateral from the arrangements on demand, so as to release it from the scope of the charge, there would be no prejudice to the collateral taker, as this would be no more than the parties had agreed.'

566 *Ibid.*, para 4.11. The FMLC acknowledges the difficulty in showing consistency between such an interpretation and the wording of Article 2(2) of the FCD (when it specifies that any right of substitution or to withdraw excess financial collateral in favour of the debtor shall not prejudice the creditor from being in possession or having control of the assets). In this regard, according to the FMLC the debtor's power to dispose of the assets is not limited to those rights which are expressly indicated in the directive, i.e. the right of substitution or to withdraw excess financial collateral: 'the objective of this provision is probably to remove any doubt about the impact of such a provision' FMLC (December 2010, paras 4.12). In other words, 'it is designed to ensure that the Regulations should be construed widely rather than given a narrow construction.' *Id.*

567 The intention is to allow all floating charges to be exempted from registration (bearing in mind that the proposal is limited to floating charges over financial collateral). According to the FMLC, these amendments to the FCAR should have been included in the provisions that implement the EU Directive 2009/44 EC. On this point, see section 2 of this chapter.

568 The FMLC also includes within the notion of possession the situation where the secured creditor is the debtor's intermediary. In this particular case, the collateral may be either (i) credited into the debtor's account, or (ii) transferred to the intermediary's own account with another intermediary at a higher level in the holding chain or within a depository system (such as Euroclear, Clearstream or the Depository Trust & Clearing Corporation ('DTCC'). Thus, 'there is very little risk that other creditors of the collateral provider would mistakenly think the collateral is available to them', FMLC (December 2010, para. 6.7).

569 For an analysis of the different types of control and how the FMLC's definitions relate to Joanna Benjamin's classification, see text accompanying nn. 484 – 493 in ch. 5.

570 FMLC (December 2010, paras 6.8-6.11). It is expressly stated in the report that 'negative control can still be achieved in a collateral arrangement where the collateral provider has the right to substitute collateral or to withdraw excess collateral'. Furthermore, 'consent would, for the avoidance of doubt, include the case where the parties pre-agree terms on which consent is deemed to be given by the collateral taker to a disposal/charge', *Id.*

the collateral may be transferred to the creditor's account. Under these circumstances, there is no need to obtain legal control as the creditor retains practical control[571].

2. The concept of possession applied to intangibles

The UK legislation on financial collateral arrangements was recently amended through the FMIR. The intention was primarily to implement EC Directive 2009/44 within the United Kingdom so as to expand the FCD's scope of application to cover credit claims.[572] However, the drafting of the FMIR was also an opportunity to overcome at least part of the uncertainties or the limitations concealed in the wording of the FCAR[573].

With regard to the method of perfection of financial collateral arrangements, Reg. 4 (2) of the FMIR introduces a new definition of possession, which applies specifically to investment securities[574]. In particular, it states that for the purposes of the FMIR, possession 'includes the case where [the] financial collateral has been credited to an account in the name of the [secured creditor] or a person acting on his behalf […]'[575].

The introduction of a new definition of possession seems to contradict the recent decision in *Gray v. G-T-P Group Ltd* insofar as such a decision emphasises that 'possession has no meaning in English law as regards intangible property'[576]. Although the solution to apply the notion of possession to investment securities was warmly welcomed by most market players[577], it constitutes a clear break from the traditional principles of personal property.

Prior to the introduction of the FMIR, it was widely accepted in English law that 'in the case of intangible personal property, possession is impossible'.[578] The reason for this is

571 *Id.*
572 See Recital 5 of the Directive 2009/44.
573 Parsons and Dening (2011, pp. 166-167). See also FMLC (April 2011).
574 Reg. 4 (2) FMIR.
575 *Id.*
576 *Gray v. G-T-P Group Ltd)*, para. 54.
577 Parsons and Dening (2011, pp. 166-167). See also FMLC (April 2011).
578 Bridge (2002, pp. 15 and 144). Recently, this principle has been confirmed in *Your Response Ltd v. Datateam Business Media Ltd* [2014] EWCA Civ. 281 where the Court of Appeal strengthens the idea that while 'possession is concerned with the physical control of tangible objects', 'practical control is a broader

that 'rights in these choses in action [as opposed to those in choses in possession] have to be asserted through the medium of legal action'[579]. This is particularly emphasised by Lawson and Rudden, when they argue that '[t]he rules governing the recovery of property vary with the nature of the property'[580]: '[s]ome kinds of property can be possessed, others cannot'[581].

Reg. 4 (2) of the FMIR overrides these common law requirements by introducing a new idea of possession, which applies to investment securities. The issue was also addressed in *Re Lehman Brothers International (Europe) (In Administration)* which concerned the interpretation of the FCD and FCAR prior to the 2010 amendments. In his decision, Briggs J. confirms the idea that 'it would be wrong to limit possession in such a way as to exclude any application to intangibles'[582].

It is difficult to understand the reasons that lie behind this position. Indeed, for the purpose of Art. 2(1) of the FCD, 'financial collateral' includes both bearer securities in certificated form (which are treated as tangibles) as well as securities in dematerialised form. Thus, there is no inconsistency with the scope of the directive in using the notion of possession for tangibles as well as for documentary intangibles and the notion of control for all other intangibles. If the intention in the directive is to apply the concept

---

concept, capable of extending to intangible assets and to things which the law would not regard as property at all', *Ibid.*, para. 23. Interestingly, in this case no reference is made to Reg. 4(2) of the FMIR.

579 *Id.* See also Lawson and Rudden (1982, p. 20): '[c]hattels personal are classified as choses in possession and choses in action, according as they can be enjoyed by taking possession of them or only by bringing an action.' Choses (or things) in action embrace diverse types of intangible (or incorporeal) property and they are traditionally divided into 'pure intangibles' (such as debts, copyright and goodwill) and documentary intangibles (such as share certificates, bills of lading and bills of exchange). While 'pure intangibles' can never be possessed, 'choses in action that amount to documentary intangibles can be possessed', Bridge (2002, p. 15). The reason for this is that in the latter case, unlike in the former, 'the intangible right is so firmly locked up in the document embodying it' (*Ibid.*, 145) that it 'takes on some characteristics of a chattel' (*Ibid.*, 8). In other words, 'the document recording the right is itself a tangible thing and thus a chattel, and the right is thoroughly fused with the document', (*Id.*). On this point see also *Dearle v Hall* Chancery Division, 24 December 1828, 38 E.R. 475, 485; *1 OBG Ltd and another v Allan and others* [2007] UKHL 21, [2008] 1 A.C. 1, 43 and 67;

580 Lawson and Rudden (1982, p. 40).

581 *Id.*: '[t]he rules governing the recovery of property law vary with the nature of the property. Some kinds of property can be possessed, others cannot. Of the former the possession can be lost and pass into the hands of a person not the owner, and recovery means a recovery of possession. Of the others some, such as patents, copyrights, or goodwill, can be infringed, and the only meaning that recovery can have is a suit to restrain infringement and perhaps to obtain damage or a return of the profits made by the infringer. Where a trust fund is concerned, the only remedy can be a suit for enforcement of the trust or, in the last resort, for removal and replacement of the trustees.'

582 [2012] EWHC 2997 (Ch), para. 131. 'Intangibles', Briggs continues, 'are, and were by the time the Directive was being prepared, the very stuff of modern financial collateral', *Id.*

of possession to all types of collateral, what reason would there be to add the concept of control as a new method of perfection?[583]

This new idea of possession, which applies to all types of collateral (regardless of their nature) is consistent with the FMLC's proposal that 'possession of securities' should not refer exclusively to bearer securities in certificated form but it should be extended to securities in dematerialised form[584].

Although the FMLC makes a valuable comment where it states that nowadays bearer securities issued in the form of a paper instrument are rarely used in practice[585], it does not provide a convincing argument for having to apply the notion of possession to all types of collateral[586].

Furthermore, there is no reason for elaborating three methods of perfection (i.e., possession, negative/legal control and practical control). A closer look at the FMLC's recommendations shows that the concepts of possession and practical control are almost equivalent as (a) they have exactly the same meaning[587] and (b) they apply to the same types of collateral. The FMLC could have reached a similar outcome to the one obtained with its proposal by using on the one hand, possession for tangibles and on the other, control for intangibles[588].

Unlike Reg. 4(2) of the FMIR and the FMLC's proposal, the interpretation which confines the notion of possession to tangibles and to documentary intangibles seems to be more in line with the US law where it states that 'security interests in intangibles for

---

583 Alternatively, the directive could be interpreted in the sense of allowing EU Member States to choose between two different options: either extend the meaning of possession to include intangible assets or introduce the concept of control, which is specifically addressed to cover intangibles. Consistent with this reasoning, the scope of the directive is simply to introduce a new method of perfection for financial collaterals, leaving the decision about how to name it to Member States.
584 FMLC (December 2010, para 4.8).
585 See on this point also *Re Lehman Brothers International (Europe) (In Administration)* [2012] EWHC 2997 (Ch), para. 131).
586 FMLC (December 2010, paras. 4.6-4.8).
587 With respect to indirectly held securities, both in cases of possession and practical control the collateral is transferred to the debtor's account. The only difference seems to be that unlike practical control, possession includes also those circumstances where the creditor is the debtor's intermediary.
588 There would have been no substantial difference in stating that control (either legal/negative or practical) applies (unlike possession) to securities in dematerialised form. Consistent with this reasoning, (i) legal/negative control would be required in those circumstances where the collateral remains in the debtor's account and (ii) practical control (which is sufficient to fulfill the perfection requirement) would be achieved by transferring the collateral to the creditor's account.

which there is no indispensable *res* to possessed (like a negotiable instrument) cannot be perfected by possession.'[589] These forms of intangibles are perfected, under Articles 9 and 8 of the UCC, by way of 'control'[590]. In particular, Comment 7 to § 8-106 UCC expressly states that '[a] principal purpose of the control concept is to eliminate the uncertainty and confusion that results from attempting to apply common law possession concepts to modern securities holding practices.'[591] On these grounds, it would have been preferable to avoid using, under Reg. 4(2) of the FMIR, terminology that immediately recalls common law possession concepts. However, English law has chosen to take a different path than the UCC. Hence, whatever requirements the common law has imposed in defining possession, they have now been overridden by Reg. 4(2) of the FMIR.

This definition of possession, which applies specifically to investment securities gained a positive response from the FMLC for rejecting the Court's decision in *Gray v. G-T-P Group Ltd*. Nevertheless, the wording of the provision reveals that Reg. 4(2) of the FMIR neither follows the recent decision in *Gray v. G-T-P Group Ltd* nor seems to fully reflect the FMLC's recommendations. In this regard, unlike the FMLC's proposal, Reg. 4(2) of the FMIR does not provide a definition of control (in addition to possession) and prevents the debtor from retaining unrestricted rights to dispose of the collateral[592]. In particular, the provision specifies that the concept of possession allows the debtor to maintain certain rights over the assets provided that such rights 'are limited to the right to substitute financial collateral of the same or greater value or to withdraw excess financial collateral.'[593]

The wording of Reg. 4(2) FMIR clearly rejects the FMLC's argument that the 'physical' or 'practical' holding of the securities is sufficient to satisfy the requirements of possession (notwithstanding the debtor's right to remove all the collateral at any time

589 White and Summers (2000, p. 775).
590 Thus, as for investment securities the UCC provides two principal methods for perfecting a security interest, i.e. filing and control (§ 9-312(a) UCC and § 9-314(a) UCC). In particular, '[a]s one might suspect, the meaning of control differs depending on whether the collateral is a certificated security, an uncertificated security, or a security entitlement. See § 9–104(a) UCC and § 8-106 UCC. In addition, a security interest in a certificated security may be perfected by taking delivery. See § 9-313 (a) UCC and § 8-301(a) UCC. In the case of a certificated security, *delivery* [emphasis added] occurs when the secured party acquires possession of the security certificate § 8-301(a)(1) UCC', Harris and Mooney (2011, pp. 434-435).
591 Comment 7 to § 8-106 UCC.
592 Cf. FMLC (December 2010, paras 4.3, 4.4, 6.5/6.7 and 6.8/6.11).
593 Reg. 4(2) FMIR.

prior to enforcement). In this regard, it seems to embrace the traditional idea, which is often stressed by English scholars, that possession 'is a question of fact as well as of law'[594]. To a certain extent, the meaning of possession under Reg. 4(2) of the FMIR may consists of two essential elements: 'first the exercise of factual control over the [assets]'[595]; and secondly, the 'concomitant intention to exclude others from the exercise of control'[596]. When dealing with indirectly held securities, the combination of these two elements is typically reflected in those circumstances where (i) the collateral is transferred on to the secured creditor's account and (ii) the debtor is deprived of the power to dispose of such assets, which are subsequently 'blocked' on the creditor's account, used or re-hypothecated by the creditor itself (subject, of course, to a contractual obligation to redeliver equivalent securities once the secured obligation has been performed).[597] This scenario resembles the traditional meaning of possession to the extent that, as the creditor has 'exclusive control' over the assets, there is no risk of such assets being subject to competing claims. However, the FMIR goes slightly further by also including in Reg. 4(2) a scenario where the debtor maintains 'certain rights over the assets', i.e. the right to substitute equivalent financial collateral or to withdraw excess financial collateral.[598] The inclusion of this scenario under Reg. 4(2) of the FMIR was necessary in order to comply with the FCD where it specifies that 'any right of substitution or to withdraw excess financial collateral in favour of the [debtor] shall not prevent the secured creditor from being in possession or having control of the asset'[599].

---

594 Pollock and Wright (1888, pp. 10 – 20); Becker (1980, p. 190); Holmes (1963, p. 169); Bridge (2002, p. 17) and Benjamin (2007, para. 16.07).

595 Possession involves the physical control of the assets. As an element of 'practical' control, 'the existence of the *de facto* relation of control or apparent dominion [is] required as the foundation of the alleged [proprietary] right', Pollock and Wright (1888, p. 10).

596 The expression was used by Bridge with regard to the concept of possession over tangibles. See on this point Bridge (2002, p. 17). Possession has been described often as 'one of the most difficult concepts in English, or for that matter any other, law', Lawson and Rudden (1982, p. 41). The reason for this difficulty is that historically the concept of possession has taken many different shapes, depending on the circumstances (see among others, on this point Harris (1961, p. 69 and Pollock and Wright (1888, para. 1 - 10.). A very clear and comprehensive analysis of possession is offered by Frederick Pollock where he states that possession is a combination of three elements: (i) physical control or *de facto* possession, i.e. the exercise of factual control over the chattel; (ii) legal possession, i.e. the intention to exclude others from the exercise of control (in civil law jurisdictions such intention would be described as '*animus possidendi*'); and (iii) constructive possession, i.e. the right to possess or to have legal possession (this includes the right to physical possession). With respect to constructive possession, Frederick Pollock emphasises that it is not considered an essential element of possession, as it only occurs when the first two aspects are separated from the rightful possessor). These three elements 'are quite distinct in conception and though very often in combination are also separable and often separated in practice', *Ibid.*, 26.

597 It should be borne in mind that if the securities are used or re-hypothecated by the secured creditor, the transaction is likely to be re-characterised as a repo.

598 Reg. 4(2) FMIR.

599 Art. 2(2) FCD.

In this particular scenario, the collateral that is in the possession of the secured creditor seems to have 'an identity distinct from its component parts'[600]. Consistent with the wording of Reg. 4(2) of the FMIR, possession is acquired over the assets that from time to time are transferred into the creditor's account rather than on the specific assets that were initially included in the collateral[601]. Accordingly, provided that the overall value of the collateral remains unchanged, the 'object in possession' (i.e., the portfolio of assets that constitute such collateral) may vary from time to time, like a box whose contents change regularly.

This approach is quite far from accepting the proposal suggested by the FMLC and was judged by most market players to be too restrictive and not sufficient to remove the uncertainties surrounding the notion of both possession and control. On a number of occasions, the FMLC as well as the City of London Law Society Financial Law Committee stressed the need to introduce more substantive changes (on the perfection requirements) than those introduced through the FMIR. In particular, they suggest that all floating charges over financial collateral (or at least those which form part of a wholesale arrangement) should be brought within the scope of the FCD and that a definition of control (in addition to possession) should be included within the law governing financial collateral arrangements[602].

During the consultation period, aimed at considering proposals by experts for the implementation of EC Directive 2009/44/EC, the HM Treasury expressly stated that 'it will give further consideration to widen the issues raised around the treatment of floating charges.'[603] However, in the consultation paper of December 2010, it also noted that these issues could not 'be given proper consideration within the timescale imposed by the immediate need to make amendments to implement the Amending Directive [2009/44]'[604], and that they could 'be considered separately to those amendments'[605] at a later stage.

600 McKendrick and Goode (2009, p. 65). The argument was originally elaborated by Goode to explain the nature of a proprietary or possessory interest in a fund.
601 *Id.*
602 See letters of the FMLC (April 2011) and the CLLS - Financial Law Committee (October 2010).
603 HM Treasury (November 2010, para. 2.21).
604 *Id.*
605 *Id.*

Concerns were raised by HM Treasury on the proposal to extend the regulations to all floating charges. Indeed, 'this would raise questions about the appropriate level of protection for third parties, particularly unsecured creditors who (in the absence of a registration requirement) would be unaware that a floating charge had been created by the company, and who may consequently believe their claim to be more senior than in fact it is'[606]. This sort of consideration 'is acknowledged by the FCD which cites (at paragraph 10 in the Preamble) the importance of balancing market efficiency, on the one hand, and the safety of parties to the arrangements and of third parties, on the other, thereby helping to avoid – among other things – the risk of fraud'[607]. However, there may be certain floating charges that need to be exempted from registration in order to ensure financial stability and avoid systemic risk. In this regard, HM Treasury considers the opportunity of including within the scope of the FCD those types of floating charges granted in favour of CREST settlement banks (known as system charges)[608].

It will be interesting to see whether HM Treasury eventually decides to introduce new forms of exemptions from the registration requirements. If so, will these exemptions be included within the existing legal framework through the notion of control and, more importantly, which types of floating charges will benefit from such exemptions?

In the absence of a statutory clarification on this point, Briggs J has recently attempted to analyse the exact meaning of control for the purposes of the FCD and came to the conclusion that practical control without legal control is not sufficient to perfect a security interest over financial collaterals[609]. Notwithstanding this restriction, Briggs J contemplates the possibility where the collateral remains on the account of the debtor, 'but on terms which give a legal right to the [secured creditor] to ensure that it is dealt with in accordance with its directions'[610] (i.e. legal and negative control).

---

606 HM Treasury (August 2010, paras. 3.3).
607 *Id.*
608 HM Treasury (August 2010, paras. 3.5 and 3.6): 'The daily average value of securities moving through the CREST system in March 2010 was in the order of £1,442 billion, while the daily average value of cash moving through CREST was in the order of £908 billion, including self-collateralising repo transactions. CREST settlement banks assume their exposures, in the great majority of cases, in reliance on floating charges from CREST members over their securities and other entitlements in CREST. Given the extent of the use of system charges under CREST, there may be a case for bringing system charges within the scope of the protections of the 2003 regulations. One way of achieving this might be to give protection to floating charges which qualify as "collateral security charges" under the 1999 Regulations'.
609 *Re Lehman Brothers International (Europe) (In Administration)* [2012] EWHC 2997 (Ch), paras. 131 - 132.
610 *Ibid.*, para. 136.

The question is whether in these circumstances the debtor can retain certain rights over the securities (other than the right of substitution or withdrawal of excess collateral). In other words, what is the degree of (legal and negative) control that can be conferred on the secured creditor for the purposes of the FCD? According to Briggs J. 'the concept of dispossession of the debtor is little more than meaningless if the terms of the arrangement are such that the [debtor] can demand, at any time, either the return of the collateral, or its disposition in accordance with the [debtor]'s instructions, without any right in the [creditor] to refuse'[611]. This means that in such cases it would not only be 'meaningless' to consider the creditor as having control of the collateral but also 'contrary to business commonsense' to describe the financial collateral as 'dispossessed'[612].

Briggs J clearly interprets the concept of legal and negative control in a rather restrictive manner. However, he does believe that the debtor can exercise certain limited rights over the collateral[613]. The problem is to establish what other rights (apart from substitution and withdrawal of excess collateral) the debtor may be entitled to exercise (e.g. voting rights or rights to dividends)[614].

To conclude, the extensive and ongoing debate over the meaning of possession and control for the purpose of the FCD seems to be proceeding in the direction of recognising in the United Kingdom at least four different combinations of control: (i) practical, legal, negative and positive control; (ii) practical, legal and negative control; (iii) legal and negative control and (iv) legal, positive and negative control. Of these combinations the first two coincide with the new definition of possession provided by Reg. 4(2) of the FMIR, while the last two should most likely be included in the notion of control. While Reg. 4(2) FMIR and the decision in *Re Lehman Brothers International (Europe) In Administration*) have contributed to clarify the perfection requirements in

611 *Ibid.*, para. 134.
612 *Id.*
613 *Ibid.*, para, 132
614 The decision in *Re Lehman Brothers International (Europe) (In Administration)* does not seem to clarify this point. For an analysis of Briggs J's interpretation of control see Gullifer and Goode (2013, para. 6–36) and Goldsworthy (2013, p. 73).

financial collateral arrangements, there is still some degree of uncertainty concealed in the existing legal framework[615].

3. The new definition of possession and the theory of a right against a right

Recent developments on the meanings of both possession and control bring us to evaluate whether such developments are fairly consistent with the theories of a right against a right and of an interest in securities.

With regard to control, it is possible to confirm that such a concept can be easily adjusted to the two theories concerning the nature of the investor's right. In other words, one could say that the secured creditor obtains, for example, a combination of legal and negative control, without this statement necessarily proposing any suggestion on the nature of the collateral (being either a sub-property or simply a right against right). Hence, once again the notion of control does not have a relevant impact on the debate concerning the problem of securities ownership in an indirect holding system[616].

Regarding the revised meaning of possession, the new concept is likely to create some friction with the theory of a right against a right. McFarlane and Stevens make no reference in their article to this matter, given that Reg. 4(2) FMIR as well as the decision in *Re Lehman Brothers International (Europe) (In Administration)*[617] are subsequent to the publication of their work. Having said that, it is difficult to imagine that they could favourably welcome Reg. 4(2) FMIR in the part where possession is applied to all types of collaterals, regardless of their nature[618].

---

[615] These considerations have recently brought the FMLC to propose an amendment of the existing legal framework so as to allow a less restrictive interpretation of the meaning of possession over intangibles and the introduction of the concept of control (partly along the lines of the decision in *Re Lehman Brothers International (Europe) In Administration*), FMLC, Issue 1: Collateral Directive - *Analysis of uncertainty regarding the meaning of "possession or control" and "excess financial collateral" under the Financial Collateral Arrangements (No. 2) Regulations 2003*, December 2012. The overall intention is to strengthen the rights that the debtor may retain over the collateral as well as accommodating English law to the practice developed in many other jurisdictions, *Meaning of "possession", "control" and "excess financial collateral" under the Financial Collateral Arrangements (No. 2) Regulations 2003*, 13 April 2015. In this regard, the HM Treasury has recently expressed its intention of giving further consideration to a possible amendment of the existing legal framework and is now evaluating the FMLC's proposal.

[616] There are, however, difficulties in accommodating the notion of control to the theory of an indirect right *in rem*. See on this point text accompanying nn. 493 - 494 in ch. 5.

[617] [2012] EWHC 2997 (Ch), para. 131.

[618] Although McFarlane and R. Stevens's article entitled 'Interests in Securities. Practical Problems and Conceptual Solutions' was published prior to the entry into force of FMIR, it is reasonable to assume that they would have had some difficulty in accepting the new meaning of possession.

One of the main principles lying behind the theory of a right against a right is that property is strictly limited to the use of specific things, i.e. of 'object[s] that can be *physically* [emphasis added] located'[619]. For example, 'B's ownership of a bike or of land can count … as a proprietary right (and so deserves a capital letter)' since 'bikes and land are both [material] things'[620]. This means that proprietary rights do not include rights over intangibles which are classified by McFarlane and Stevens as *sui generis* rights.

Following this analysis, the idea of extending the meaning of possession to include all types of assets (whether tangibles or intangibles) is certainly open to criticism. Indeed, according to McFarlane and Steven, possession implies the taking of '*physical* [emphasis added] control of a thing'[621] and is therefore restricted (like all other proprietary rights) to the use of tangibles.

Contrary to the above argument, the theory of an interest in securities (based on a 'flexible' idea of property) would find it easier to explain the new concept of possession. The underlying principle of this theory is that property is not limited to a close list of rights *in rem* and may include tangibles or intangibles as well as direct or indirect relationships with the asset. In particular, over the centuries this flexible idea of property has allowed courts and statute law to accommodate rights *in rem* to commercial needs rather than creating new categories of law.

Although in the case regarding financial collateral arrangements there was no real need to extend the notion of possession to intangible property[622], Reg. 4(2) FMIR and the decision in *Re Lehman Brothers International (Europe) (In Administration)* do confirm the (statutory and judicial) trend of stretching (wherever possible) the meaning of traditional legal concepts so as to include a larger number of circumstances[623].

4. Does control or possession comply with 'publicity' requirements?

619 McFarlane (2008, p. 132). See n. 94 in ch. 2.
620 *Id.*
621 *Ibid.*, 156.
622 As mentioned earlier, it would have been more consistent with the scope of the FCD to limit the notion of possession to certificated securities in bearer form and use control for all other financial collaterals (see *supra* section 2 of this chapter).
623 See text accompanying nn. 166 – 169 in ch. 2.

Setting aside the notion of possession another example of a legal concept whose meaning seems to have been adjusted to commercial needs is the idea of perfection.

The general rule is that in order to make a security interest against third parties, it is necessary to use methods of perfection that ensure some form of public notice. This principle raises the question of whether the new ideas of possession and control offer sufficient notice to third parties, so as to promote the stability and transparency of financial markets.

As mentioned earlier, the method stated under Reg. 4(2) FMIR is the safest way of perfecting a security interest over indirectly held securities. Indeed, transferring the collateral on the creditor's account and preventing the debtor from disposing of the collateral is probably the closest one could get to the traditional meaning of possession. This means that the creditor is in a position to closely monitor the assets, with the result of avoiding the risk of competing claims[624].

The problem arises in cases where the secured creditor acquires merely legal control (which can be either negative or both positive and negative). In this context, it is possible to identify two methods by which an account holder may grant legal control over his/her securities to third parties.

The first method is the execution of a control agreement, which is typically a three party contract among the intermediary, the account holder/debtor and the creditor.[625] The second method, is a designating entry in favour of the creditor in which securities are 'ear marked' on the securities account of the debtor for the purpose of signalling the existence of a security interest[626].

A designating entry is entered into a securities account by the intermediary upon instruction from the account holder (i.e. the debtor) and may not be made if not authorised by the latter. The main difference between these two methods is that the

[624] Of course, this would be the case only under the assumption that the intermediary acts honestly and professionally and carefully follows the instructions given by the secured party.
[625] Article 12 (3) (c) of the Geneva Convention; Principle 4.1.5 (b) set out by the European Commission (2010, para. 9.2). See also Recommendation 5 (a), LCG (August 2008, para. 5).
[626] Article 12 (3) (c) of the Geneva Convention; Principle 4.1.5 (a) set out by the European Commission (2010, para. 4.1.5). See also Recommendation 5 (a), LCG (August 2008, para. 5).

former, unlike the latter, is a 'private matter' between the contracting parties and hence it is not visible on any account statement or to any persons authorised to review such an account. The element common to both methods is that the intermediated securities remain credited in the debtor's account and consequently, the secured party's control over those assets is somewhat more limited than the method stated under Reg. 4(2) FMIR. The degree of control is even further exacerbated if the debtor retains certain rights over the collateral as a result of a general authorisation granted by the secured creditor at the time of entering into the security agreement[627].

The main problem is whether legal control (without practical control) is able to alert third parties to the existence of a security interest. A careful consideration of the Geneva Convention highlights that in this case a potential secured lender 'has no way of assessing the existence, value and availability of the assets in the accounts other than to rely on the information disclosed by the intermediary with the consent of the account holder'[628]. For these reasons, it seems that this form of control cannot provide *public* [emphasis added] notice.

This lack of publicity is emphasised when the security interest is created by way of the conclusion of a control agreement, which is a 'private matter' and so not visible to whoever has access to the account or to an account statement. Therefore, in this case third parties must rely exclusively on the information provided by the intermediary. On the other hand, designating entries offer an element of transparency, i.e. the visibility of the existence of this interest within the IT system of the intermediary or within the statement account. Thus, third parties wishing to create a security interest over those assets may discover the existence of a previously created security interest when obtaining an account statement[629].

As emphasised in the Official Commentary of the Geneva Convention, this element of transparency is the reason why Article 19(7) allows contracting states to make 'a declaration that, under its [domestic law], any interest granted by a designating entry has

[627] Clearly, the creditor's degree of control is broader in those circumstances where any possible action of the debtor over the collateral is subject to the prior authorisation of the secured creditor for each transaction.
[628] Thèvenoz (2008, p. 443).
[629] Kanda et al. (2012, paras. 1.46 – 12.28).

priority over any interest granted by a [control agreement]'[630]. This concern was also raised by the European Commission in one of its consultation documents for the preparation of the SLD[631] as well by the FMLC in its 2004 Commentary on Principles for Investment Securities Statute[632]. The outcome was that both the European Commission and the FMLC recommended that 'interest in book-entry securities, which are acquired by [designating entry] have priority over interests acquired in the same book-entry by means of a control agreement […]'[633].

However, the fly in the ointment is that such an element of transparency provided by designating entries 'is restricted to the persons who get access to the account and only provides a snapshot of existing interest at the time of the access (or of the account statement)'[634].

As a result of these considerations it can be argued that in cases involving legal control alone the effectiveness of a security interest against third parties does not seem to be based *stricto sensu* on publicity requirements but rather on the ability of the secured party to simply protect the collateral from unauthorised dispositions.

This brings us to partially reconsider the concept of 'perfection' of a security interest which – at least with regard to financial collaterals – does not seem to be necessarily associated with actions that put third parties 'on notice' of the security interest.

5. Summary of the analysis

Chapters 5 and 6 attempt to establish what exactly is meant by control (under Article 2(2) of the FCD) when setting out the method of perfection of a security interest over indirectly held securities.

---

630 *Ibid.*, paras. 12-30 and 19-7. The general rule under Article 19 (3) of the Geneva Convention is that interests acquired through designating entries and control agreements are ranked on the basis of when each of them becomes effective (i.e. first in time priority rule). However, paragraph 7 of the same Article allows a Contracting State to give priority to an interest granted by a designating entry.
631 Principle 9 (1) (1) (c) set out by the European Commission (2010, para. 9.2). See also Recommendation 8 (c), LCG (August 2008, para. 8.3.2).
632 *Commentary on Principles For Investment Securities Statute*, Principle 7 (d) in FMLC (July 2004, p. 17).
633 Recommendation 8 (c), LCG (August 2008, para. 8.3.2).
634 Kanda et al. (2012, para. 12-30).

As a general rule, control can be positive and/or negative as well as legal and/or practical. This means that there is no absolute or single definition of control, since the content of this concept may vary significantly depending on the terms and conditions of the security agreement. In this regard, it is possible to identify at least seven different combinations of control: (i) practical, legal, negative and positive control; (ii) practical, negative and positive control; (iii) practical, legal and positive control; (iv) practical, legal and negative control; (v) legal and positive control; (vi) legal and negative control and (vii) legal, positive and negative control. The question is which of these combinations can be considered applicable for the purposes of the FCD?

None of the three theories related to the nature of the investor's right is able to provide an answer to this question. The reason for this is that the theoretical debate on the proprietary or *sui generis* characterisation of the investor's right is irrelevant when determining the exact meaning of control. At least at first sight, all three theories can be applied, given that a security interest is perfected by way of control, regardless of the type of collateral involved (that can be either the sub-property, the right against a right or simply the securities standing at the top of the chain).

With regard to the theory of an indirect right *in rem*, some difficulties may arise when looking closer at the practical consequences related to the notion of control. Indeed, if one were to accept this theory each account holder standing in the chain would find his/herself in the unusual position of having control over the underlying securities, simultaneously as well as independently of one another. This description may come up against some friction with the concept of control, given that such a concept implies the possibility for the secured creditor to *exclude others* [emphasis added] from disposing of the collateral. On the contrary, the theories of a right against a right and of an interest in securities do not seem to create similar problems with the practice of intermediated securities.

The point that remains to be determined (and that, moreover, cannot be solved by the theories related to the nature of the investor's right) concerns the need to establish which of the seven different combinations mentioned above would be consistent with the FCD. In the United Kingdom the debate on this issue has been rather a heated one due to the wording of Article 2(2) of the FCD being far from clear on this particular point. The entry in force of Reg. 4 (2) of the FMIR as well as the recent decision in *Re Lehman Brothers International (Europe) (In Administration)* has (at least in part) cast some light on the issue, leading us to identify four different combinations which should fall within the scope of the FCD, i.e. (i) practical, legal, negative and positive control, (ii) practical, legal and negative control, (iii) legal and negative control and (iv) legal, positive and negative control.

Of these combinations the first two are now included under Reg. 4(2) of the FMIR within the meaning of possession. This provision may be difficult to reconcile with the theory of a right against a right, given that such a theory is based on the idea that all proprietary rights (including possession) are strictly linked to physical objects and therefore cannot be applied to any form of intangibles (such as securities).

As regards these last two combinations, the decision in *Re Lehman Brothers International (Europe) (In Administration)* confirms the idea that they should be included within the meaning of control. However, it is yet not quite clear which specific rights the debtor is entitled to retain over the collateral without jeopardising the control of the secured creditor. More specifically, an appropriate question to put forward here might be: what are the rights (other than the right of substitution and withdrawal of excess collateral) that the debtor may be entitled to exercise over the securities? The market practice considers a statutory clarification on this point to be most urgent.

7. Conclusions

English law has been able to accommodate many issues concerning the practice of indirectly held securities to the well-developed principles of trust and sub-trust. However, the complexity of the custody chain as well as limits posed to the enforceability of the investor's rights (along the multi-tiered holding structure), may cause reservations on the proprietary nature of such rights.

In regard to this, McFarlane and Stevens proposed a solution defining the right of the investor as a 'right against, or to, a right' (rather than a right *in rem*). More specifically, the investor (who stands at the bottom of the chain and acts as the beneficiary of a sub-trust) is considered to hold a *sui generis* right, since such a right does not attach to a thing but simply relates to the right of another. The advantage of classifying this interest as a right against a right is that it can better explain the structure of intermediation and demonstrate that there is no need for a statutory reform in this area of law.

This thesis critically evaluates McFarlane and Stevens' argument, showing firstly, that the proprietary classification of the investor's right is to be preferred to a *sui generis* solution and secondly, that a statutory clarification may still be useful in certain circumstances, given that neither the proprietary nor the *sui generis* approach can offer adequate answers to *all* [emphasis added] problems involving the practice of intermediated securities.

7.1 The concept of a right against the intermediary's right cannot be considered more convincing than the proprietary theory

Regarding the first of the above mentioned points, it is possible to identify two theories based on the proprietary nature of the investor's right, namely the concept of an indirect right *in rem* and that of an interest in a sub-property or in a derivative asset. While the first theory suggests that the investor holds an indirect right in the underlying securities (standing at the top of the chain), the second is based on the idea that the investor's right does not attach to the underlying securities but simply to a different asset which coincides with the proprietary right of the relevant intermediary.

The thesis points out that the concept of an indirect right *in rem* may entail difficulties in explaining consequences related to the structure of intermediation. For example, it fails to explain the application of PRIMA in cross-border transactions, without the introduction of a statutory exception to the well-established *lex rei sitae* rule. At present PRIMA has only been introduced in SFD and FCD and these are limited exclusively to collateral arrangements. In all other cases involving the resolution of proprietary issues the *lex rei sitae* rule continues to apply. Hence, in order to satisfy the needs of market practice it would appear necessary to introduce a statutory provision that would extend PRIMA to all dealings involving intermediated securities. Another example that could create difficulties is the lack of transparency typically associated to the practice of intermediated securities. In particular, when using *omnibus* accounts the investor's interest in the securities is only registered in the books of the relevant intermediary (with no reference being made to the investor's title higher up the holding chain). This lack of transparency is in conflict with the theory of an indirect right *in rem*, as it cannot provide an explanation as to why there is no clear tracing thread between the investor and the underlying securities. Thirdly, it may also be difficult to reconcile the theory of an indirect right in *rem* to the coexistence of multiple rights of possession and control along the holding chain of intermediaries. Indeed, if one were to accept such a theory, each account holder standing in the holding chain would have possession or control over the underlying securities. This description, however, can be somewhat confusing given that it conceives of more than one party having exclusive and immediate control over the same asset at the same time as well as independently of one another.

Notwithstanding these considerations on the theory of an indirect right *in rem*, it is possible to assert that the concept of an interest in a sub-property or in a derivative asset is generally capable of explaining the complexity of the holding structure of intermediaries. It can justify the application of PRIMA as a development of the traditional *lex rei sitae* rule[635] as well as explaining the lack of transparency and the meaning of possession or control in an indirect holding system. Thus, contrary to McFarlane and Stevens' argument, the (latter) proprietary approach does not create inconsistencies when used to describe financial practice and therefore proves to be a valid theoretical basis for assessing the nature of the investor's right.

[635] This makes it possible to avoid the need for a statutory in cross-border transactions.

A closer look at the theory of an interest in a sub-property shows that it has much in common with the theory of a right against a right, the main difference being simply one of labels rather than substance. More specifically, while the first theory recognises the right of the intermediary as the *item of property* [emphasis added] held by the investor, the second simply considers the investor's right against the intermediary's right as a *sui generis* title. This means that the two theories are interchangeable and can be adapted without difficulty to the practice of intermediated securities. However, the author has included evidence demonstrating that the concept of an interest in a sub-property is to be preferred to that of a right against a right as it reflects the historical development of English legal taxonomy (which extends the category of proprietary rights to include a large number of intangibles, such as mere rights).

In support of the proprietary characterisation of the investor's right, it should be mentioned that initially, in the United States, the intention of the Drafting Committee for the revision to Article 8 UCC was to classify security entitlements as pure *sui generis* rights, without labelling them either as proprietary or personal rights[636]. The objective was clearly to prevent academics and practitioners from analysing the new concept through the lens of the existing principles of contract or property law. However, the Drafting Committee soon realized that lawyers would have had difficulties in understanding (and dealing with) this concept without qualifying security entitlements within the classical dichotomy between personal rights and proprietary rights. For these reasons, during the final stages of the revision they decided to introduce § 8-503 UCC, that defines security entitlements as a '*sui generis* form of property interest'[637] (on consideration of the many features of this concept that are typically associated to proprietary rights)[638].

As a result of this analysis, one could argue that the problem should not really be about choosing between a proprietary or a *sui generis* classification of the investor's right but rather about identifying the specific asset or thing which attaches to the proprietary right of the account holder.

---

[636] The proprietary classification of the investor's rights has been recently confirmed in *Pearson v. Lehman Brothers Finance SA* [2010] EWCA 2914 (Ch) which defines the interest of a beneficiary under a trust as a right *in rem* rather than a *sui generis* right. .

[637] Official Comment, § 8-104 UCC para. 2.

[638] The author is grateful to James S. Rogers' considerations on this point (telephone conversation of May 2014).

7.2 Is there a need for statutory reform?

In regard to the second point, the theory of a right against a right and that of an interest in a sub-property cannot overcome *all* [emphasis added] the problems which may arise when attempting to apply the existing principles of trust law to the practice of intermediated securities.

For example, in cases of shortfall neither of the two theories can help us determine the most appropriate solution for allocating losses in an *omnibus* account. Although from a theoretical prospective the tracing approach can be considered the most appropriate answer to this problem, such an approach is extremely difficult to apply to the practice of intermediated securities and it is likely to prevent investors from obtaining immediate access to their own securities. Such a difficulty has recently led to the introduction (under Regulation 12 SAR) of the *pro-rata* sharing solution which is meant to substitute the tracing rule in cases of failure of investment firms[639]. While on the one hand, this provision has significantly improved the existing legal framework, on the other, it does not take into consideration certain issues, like for example the proposal put forward by practitioners to apply the *pro-rata* sharing rule to all customers' assets (rather than dividing the property on an issue-by-issue basis)[640].

Similarly, the theory of a right against a right and that of an interest in a sub-property cannot explain the exact meaning of control, as a method of perfection of a security interest. Consequently, in this case it is still necessary to establish which specific rights can be retained by the debtor (whilst at the same time allowing the secured creditor to maintain control over the collateral)[641]. The FMLC and the CLLS - Financial Law Committee believe that (at least in cases where charges form part of a wholesale agreement) it would be useful for the debtor to have unrestricted rights over the

---

639 In this regard, Bloxham emphasises in his *Final Review of the Investment Bank Special Aministration Regulations 2011* that during the last financial practice the problem with the UK Client Asset Protection Regime has been its exclusive reliance on trust law concepts, which are sometimes difficult to apply to sophisticated investment markets. 'The most commonly cited example' in this case, continues Bloxham, 'is the doctrine of tracing', Bloxham (January 2014, para. 3.15). Cfr. n. 648.

640 This suggestion would pose the UK *pro-rata* sharing solution along the lines of the distribution scheme adopted in the United States under SIPA.

641 *Re Lehman Brothers International (Europe) In Administration*) [2012] EWHC 2997 (Ch), para. 132.

collateral[642]. Even though this proposal may raise concerns on the level of protection for third parties[643], it does highlight the need for greater flexibility in the use of financial collaterals, particularly in the form of the debtor's rights to dispose of the collateral (which should not be limited to the mere right of substitution and withdrawal of excess collateral).

As for the problem concerning insufficient certainty in an *omnibus* account, a solution is offered by the existing principle of co-ownership which is based on the idea that in a trust fund each beneficiary maintains a portion of a single bulk (rather than a right in specific assets). Such a principle can easily be applied to the practice of intermediated securities[644], regardless of whether the interest of the investor is defined as a right against a right or as an interest in a sub-property[645]. There are, however, specific issues related to *omnibus* accounts which would certainly benefit from a statutory clarification. For example, it would be useful to introduce the concept of an implied consent between co-owners of a trust fund, given that such a concept would allow investors to dispose of their share in the bulk independently of one another[646].

These considerations show that the discussion on the nature of the investor's right does not necessarily demonstrate that no statutory reform is required in the practice of intermediated securities. Indeed, such a discussion can assist us in understanding more fully the complexity of the legal structure of intermediation (explaining, for example, the application of the no-look-through principle, the lack of transparency associated to *omnibus* accounts as well as the use of PRIMA when selecting the applicable law in cross-border transactions). Yet, there are still limited areas where the conceptual differences between a right against a right, an indirect right *in rem* and also an interest in a sub-

---

642 See letters of the FMLC (April 2011) and the CLLS - Financial Law Committee (October 2010).

643 See, on this point, HM Treasury (November 2010, para. 2.21) and *Id.* (August 2010, paras. 3.3).

644 *Pearson and others v. Lehman Brothers Finance SA* [2010] EWHC 2914 (Ch) and (2011 EWCA Civ. 1544).

645 Indeed, the conceptual differences between the two theories have no relevant impact on the discussion about the potential uncertainty of the subject matter in a trust fund.

646 Consistent with this argument, it is worth mentioning another aspect that is not analysed in the thesis but that also requires a statutory intervention, i.e. the need to provide an adequate level of protection for good faith purchasers who acquire intermediated securities. In this respect, while purchasers of directly held securities can benefit from the general rules of mercantile law, which protect the good faith purchaser of negotiable instruments, there is a lack of protection under English law for a purchaser who acquires intermediated securities by way of a transfer on the books of an intermediary. The FMLC and the English Law Commission believe that there should be no difference in legal treatment between investors and that consequently good faith purchasers of intermediated securities should not be allocated the risk of the intermediary's negligence or fraud. See on this point English Law Commission (May 2008, para. 5.6) and FMLC (July 2004, para. 6.8).

property have no impact on market practice and where the case for law reform has certainly been proven.

As pointed out in its report to HM Treasury of May 2008, the English Law Commission looked favourably upon a legislative reform in the practice of intermediated securities but it believed that such a reform should be implemented, at least in part, at an international level, through the UNIDROIT Convention and the future EU legislation[647]. Seven years have passed since the publication of this report and it now seems most unlikely that a common legal framework will ever be implemented in this specific practice, due to the Member States' strong resistance to harmonisation of certain areas of law, particularly those related to insolvency and proprietary issues[648]. As a result, it is recommended that a legislative reform be passed in the United Kingdom, so as to overcome the uncertainties remaining in this complex area of law and ensure greater security for transactions and entitlements.

In his *Final Review of the Investment Bank Special Administration Regulations 2011* of January 2014, Bloxham proposes a radical reform of the client asset protection regime. In particular, he stresses the importance 'in [...] modern and sophisticated investment markets'[649] to stop relying on the existing principles of trust and introduce *ad hoc* legislation on intermediated securities[650]. This proposal finds some resistance among

647 English Law Commission (May 2008, para. 1.17): 'As already mentioned, the FMLC have recommended that domestic legislation be passed to rectify various legal uncertainties and deficiencies concerning the ownership, transfer and pledge of intermediated securities under English law. We believe, however, that subject to one exception concerning purchasers of intermediated securities, it makes little sense for us to propose a range of changes to English law while the work of UNIDROIT and the Legal Certainty Group is ongoing. A number of consultees have expressed the concern that we avoid a situation in which domestic legislation is passed only it to be modified shortly thereafter as a result of new European or international measures. The Treasury shares this view.'

648 At present the UNIDROIT Convention it has been signed by only one of the forty negotiating States (i.e. Bangladesh). In addition, the working programme of the European Commission for 2015 does not include the SLL and therefore it seems likely that no further development on this project can be expected in the near future.

649 Bloxham (January 2014, para. 3.15).

650 *Ibid.*, paras. 3.15 - 3.16: 'During the course of my discussions with interested parties, a number of different experts, notably from within the legal profession, forcefully made the point that a fundamental problem with the UK Client Asset Protection Regime is its reliance on general English property and trust law concepts, which are increasingly difficult to apply to the fast moving and intangible rights typically the subject of modern and sophisticated investment markets. The most commonly cited example is the doctrine of Tracing, but others (such as the varieties of set off) exist. One of the objectives for the SAR in the Act is to maximise the efficiency and effectiveness of the financial services industry in the United Kingdom. I consider that in view of this clear and understandable policy objective, it makes sense to listen to those who take the view that a more radical review should be undertaken of the legal basis under which client entitlements can arise and in particular whether trust and property law concepts are still well enough adapted to interests in products in the financial markets. This should be done on the basis of a very

English scholars, who believe that 'the use of property rights under a trust remains a sound private law basis for client asset protection in traditional custody'[651].

As mentioned earlier there are still important issues within the existing legal framework that may indeed require statutory intervention, but this cannot bring us to exclude *in toto* trust law concepts as the legal basis for the practice of intermediated securities.

Indeed, it was emphasised, during the conference 'Law After Lehmans' held at the LSE on October 13th 2013, that (with the exception of certain aspects, such as the doctrine of tracing) the existing principles of trust were overall able to overcome the many issues arising from the collapse of Lehman Brothers. Hence, rather than introducing a radically different regime (along the lines of Article 8 UCC), it is likely that English law will attempt to overcome the uncertainties remaining in the existing legal framework while continuing to rely on trust law concepts. This confirms once again that contrary to McFarlane and Stevens' view, the general trend in English law is to elaborate (wherever possible) an elastic conception of property that can 'readily adapt to the many efficiency-driven market practices'[652].

specific call for evidence. It may also require a preliminary investigation of what flexibility there is under mandatory European law to move to a radically different regime.', Cfr. n. 638.

[651] Benjamin (2014, p. 333).

[652] *Id.*

Appendix to Chapter 2

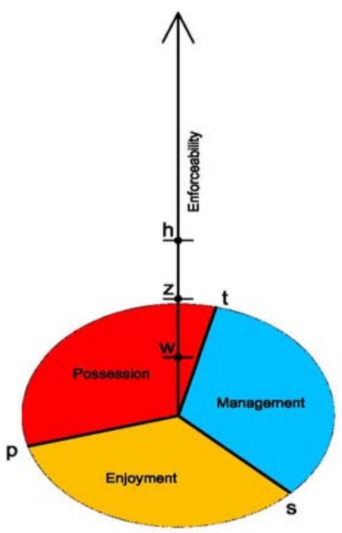


Figure 5

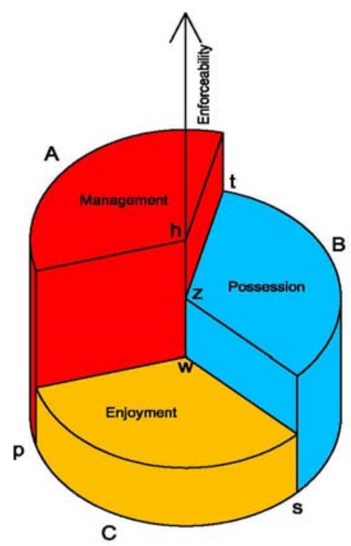


Figure 6

Bibliography

1. BOOKS AND ARTICLES

Ames, J. B. (1913). *Lectures on Legal History and Miscellaneous Legal Essays*. Cambridge: Harvard University Press.

Amos, M. S. (1936/1937). The Common Law and the Civil Law in the British Commonwealth of Nations. *Harvard Law Review* 50, pp. 1249-1274.

Austen-Peters, A. O. (2000). *Custody of Investments: Law and Practice*. Oxford: Oxford University Press.

Barker, K. (1998). Equitable Title and Common Law Confusion: The Limits of the Fusionist Ideal *RLR* pp. 150 - 156.

Becker, L. C. (1980). The Moral Basis of Property Rights in Pennock, J. R. & Chapman, J. W. (eds.), *Property*, Nomos XXII. New York: New York University Press, pp. 187 - 200.

Beale, H. et al. (2012). 'Perfection of Security Interests over Financial Collateral' in Beale et al *The Law of Personal Property Security*. 2nd ed. Oxford: Oxford University Press, pp. 387 - 404.

Beale, H. (2004). Reform of the Law of Security – Another View *JIBFL* 4, pp. 117 – 122.

Bell, A. P. (1989). *Modern Law of Personal Property in England and Ireland*. London: Butterworths.

Benjamin, J. (2014). The Law and Regulation of Custody Securities Cutting the Gordian Knot *CMLJ*, 9, 3, pp. 327 - 338.

Benjamin, J. (2009). Securities Collateral in de Lacy J. (ed.), *The Reform of UK Personal Property Security Law Comparative Perspectives*. London: Routledge – Cavendish, pp. 223 - 269.

Benjamin, J. (2007). *Financial Law*. Oxford: Oxford University Press.

Benjamin, J. (2003). Dematerialisation of Money Market Instruments in Worthington S. (ed.) *Commercial Law and Commercial Practice*. Oxford: Hart Publishing, pp. 249 - 304.

Benjamin, J. (2000). *Interest in Securities. A Property Law Analysis of the International Securities Markets*. Oxford: Oxford University Press.

Bernasconi, C. et al. (2002). General introduction: legal nature of interests in indirectly held securities and resulting conflict of laws analysis in Potok, R. (ed.), *Cross Border Collateral: Legal Risk and the Conflict of Laws*. London: Butterworths LexisNexis, Ch. 1.

Blackstone, W. (1765 - 1769). *Commentaries on the Laws of England*, Oxford: Clarendon Press.

Bridge, M. G. (2014). *The Sale of Goods*. 3rd ed. Oxford: Oxford University Press.

Bridge, M. G. et al. (2013) *The Law of Personal Property*, London, Sweet & Maxwell.

Bridge, M.G. (2008). The Scope and Limits of Security Interests *ECFR* (Special Volume: The Future of Secured Credit in Europe), pp. 180 – 214.

Bridge, M. G. (2006). The Law Commission's Proposals for the Reform of Corporate Security Interests in Getzler, J. and Payne, J. *Company Charges: Spectrum and Beyond*. Oxford: Oxford University Press, pp. 267 - 290.

Bridge, M. G. (2002). *Personal Property Law*, Clarendon Law Series. 3rd ed. Oxford: University Press.

Calnan, R. (2006). *Taking Security. Law and Practice*. Jordans: Bristol.

Chan, D. et al. (August 2007). *The Securities Custody Industry*. European Central Bank, Occasional Paper Series, no. 68.

Chell, E. et al. (2013). Possession and control: financial collateral remains a Gray area, *JIBFL* 1, 43.

Coke, E. (1639). *The First Part of the Institutes of the Laws of England: or a Commentary on Littleton*. 4th ed. London.

Conaglen, M. (2005). Contests Between Rival Trust Beneficiaries Cambridge *L.J.* 64, pp. 45 - 48.

Cook, W. W. (1915). The Powers of Courts of Equity *Colum. L. Rev.* 15, pp. 106 - 141.

Cooke, C. (2011). Lehman Brothers: certainty of trusts and the RASCALS litigation *J.I.B.F.L.* 3, pp. 136 - 137.

Cooke, C. (2010). F2G Realisations: floating charges and the Financial Collateral Regulations *JIBFL* 9, pp. 518 - 519.

Davies, G. (2007). Using Intermediated Securities as Collateral: Equitable Interests with Inequitable Results *JIBFL* 2, pp. 70 - 73.

Collins L. et al. (2012). *Dicey, Morris & Collins on the Conflict of Laws*. 15th ed. London: Sweet and Maxwell.

Dilnot A. and Harris, L. (2012). Ownership of a fund *JIBFL* 5, pp. 272 - 274.

Edelman, J. (2013). Two fundamental questions for the law of trusts *LQR* pp. 66 - 86.

Ellinger, E.P. et al. (2011). *Ellinger's Modern Banking*. 5th ed. Oxford: Oxford University Press.

Facciolo F. J. (1999 – 2000). Father knows best: revised article 8 and the individual investor. *Fla. St. U. L. Rev.*, 27, pp. 615 - 714.

Fawcett, A. (2005). The Financial Collateral Directive: an examination of some practical problems following its implementation in the UK *JIBLR*, pp. 95 - 99.

Gardella, A. (2007). *Le garanzie finanziarie nel diritto internazionale private*. Milan: Giuffré.

Gardner, S. (2011). *An Introduction to the Law of Trusts*. 3rd ed. Oxford: Oxford University Press.

Goldsworthy, S. (2013). Taking possession and control to excess: issues with financial collateral arrangements under English law *J.I.B.F.L.* pp. 71 - 73.

Goode, R. (2009). *Principles of Corporate Insolvency Law*. London: Sweet & Maxwell.

Goode, R. et al. assisted by Bernasconi C. (2005). *The Explanatory Report: Hague Securities Convention: Explanatory Report*. Hague Conference on Private International Law.

Goode, R. (2003). Are intangible assets fungible? *LMCLQ* pp. 379 - 387.

Goode, R. et al. (1998). Oxford Colloquium on Collateral and Conflict of Laws *B.J.I.B.F.L.* 9 - Special Supplement.

Goodman, J. (2012). Lehman "Rascals" *J.I.B.F.L.*, 1 p. 57.

Gorla, G. (1981). *Diritto comparato e diritto comune europeo*. Milan: Giuffré.

Gorla, G. (1964). Diritto Comparato in *Enc. Dir.*, XII. Milan: Giuffré.

Gray J. and Metzing P. C. (2013). Defining and Delivering Judgement-Based Supervision: The interface with the legal system *JBR* 14, 3/4, pp. 228–240.

Gray, K. and Gray, S. F. (2009). *Elements of Land Law*. 5th ed. Oxford: Oxford University Press.

Grey, T. C. (1980). The Disintegration of Property, in Pennock J. R. & Chapman J. W. (eds.), *Property*, Nomos, XXII. New York University Press, pp. 69 - 85.

Gullifer, L. and Goode, R. (2013). *Goode on Legal Problems of Credit and Security*. 5th ed. London: Sweet & Maxwell.

Gullifer, L. (2012). What should we do about financial collateral? *C.I.P.* 65, p. 377.

Gullifer, L. (2010). Ownership of Securities. The Problems Caused by Intermediation in Gullifer, L. and Payne, J. (eds.), *Intermediated Securities. Legal Problems and Practical Issues*. Oxford: Hart Publishing, pp. 1 - 31.

Gullifer, L. and Goode, R. (2008). *Goode on Legal Problems of Credit and Security*. 4th ed. London: Sweet & Maxwell.

Guynn, R. D. (1996). *Modernizing Securities Ownership, Transfer and Pledging Laws - A Discussion Paper on the Need for International Harmonization*. Capital Markets Forum, International Bar Association.

Hanbury, H. G. (1935). *Modern Equity* 1st ed. London: Stevens & Sons Ltd.

Hargreaves, E. (2011). The Nature of Beneficiaries' Rights under Trust *TL* 4, pp. 163-183.

Harris S. L. and Mooney, C. W. (2006). *Security Interest in Personal Property. Cases, Problems and Materials*. 4th ed. New York: Foundation Press.

Harris, J. (2002). Property - Rights *in Rem* or Wealth? in Birks P. and Pretto-Sakmann *Themes in Comparative Law. In Honour of Bernard Rudden* (eds), Oxford University Press, pp. 51 - 63.

Harris, R. (1961). The concept of possession in English Law in Guest, A. G. *Oxford Essays in Jurisprudence*. Oxford: Oxford University Press, pp. 69 - 106.

Hawes, C. (2011). Tortious Interference with Goods: Title to Sue *Canta LR* 17, 2, pp. 331 - 353.

Hayton, D. et al. eds. (2010). Underhill and Hayton Law of Trusts and Trustees. 18th ed. London: Lexis Nexis.

Hayton, D. J. (1994). Uncertainty of Subject-Matter of Trusts *LQR* 110, pp. 335 - 340.

Holland, T. E. (1882). *The Elements of Jurisprudence*. 3rd ed. Oxford: Clarendon Press.

Holmes, O. W. (1963). *The Common Law* (ed. by M. De Wolfe Howe). Boston: Little, Brown and Company and Harvard University Press.

Honoré, A. M. (1961). 'Ownership' Chapter V, in Guest A. G. (ed.), *Oxford Essay in Jurisprudence*. Oxford: Oxford University Press, pp. 107 - 147.

Hudson, A. (2013). *Understanding Equity & Trusts*. 4th ed. London: Routledge.

Hudson, A. (2009). *Equity and Trusts*. 6th ed. London: Routledge-Cavendish.

Huston, C. A. (1915). *The Enforcement of Decrees in Equity*. Cambridge MA: Harvard University Press.

Johansson, E. (2009). *Property Rights in Investment Securities and the Doctrine of Specificity*. Berlin Heidelberg: Springer Verlag.

Kahan, M. and Rock, E. (2009). *On Improving Shareholder Voting in Armour J. & Payne J. (eds.), Rationality in Company Law: Essay in Honour of DD Prentice*. Oxford: Hart Publishing.

Kanda H. et al. (2012). *Official Commentary on the UNIDROIT Convention on Substantive Rules for Intermediated Securities*. Oxford: Oxford University Press.

Khimji, M. F. (2007). The Role of Legal Concepts in Commercial Law: Comments on Spink, Rogers and Scavone *Can. Bus. L.J.* 45, pp. 94 - 102.

Langdell, C. C. (1908). *A Brief Survey of Equity Jurisdiction*. 2nd ed. Cambridge MA: The Harvard Law Review Association.

Lawson, F. H. and Rudden, B. (1982). *The Law of Property*. Clarendon Law Series 2nd ed. Oxford: Clarendon Press.

Lawson, F. H. (1975). Common Law. *International Encyclopedia of Comparative Law* IV/2, VIII. Tübingen-Paris.

Lomnicka E. (2012a). 'Financing Devices Involving the Transfer or Retention of Title' in Beale et al., *The Law of Personal Property Security*. 2nd ed. Oxford: Oxford University Press, pp. 177 - 244.

Lomnicka E. (2012b). 'Financing Devices Involving the Transfer or Retention of Title' and 'Enforcement of True Security Interests' in Beale et al., *The Law of Security and Title-Based Financing*. 2nd ed. Oxford: Oxford University Press, pp. 235 - 302 and pp. 559 - 590.

Low, K. F. K. (2010). Equitable title and economic loss *LQR*, pp. 507 - 512.

Lowrie S. and Todd, P. (1997). In Defence of the North American Rolling Charge Denning *L.J.* 12, pp. 43 - 62.

Lyons, H. et al. (2012). Effect of intercompany arrangements on ownership of securities *JIBFL*, 3, pp. 195 - 196.

Maitland, F. W. (1936). *Equity. A Course of Lectures* (2nd rev. ed. by Brunyate J.). Cambridge: Cambridge University Press.

Martin, J. E. (2012). *Hanbury & Martin - Modern Equity.* 19th ed. London: Sweet & Maxwell.

Mattei, U. (2000). *Basic Principles of Property Law. A Comparative Legal and Economic Introduction.* Westport: Greenwood Press.

Matthews, P. (2002). From Obligation to Property, and Back Again? The Future of the Non-Charitable Purpose Trust in D. Hayton (ed.) *Extending the Boundaries of Trusts and Similar Ring-Fenced Funds*, Kluwer Law International, pp. 203 - 241.

McCormick, R. (2006). EU Directive on Financial Collateral Arrangements: Replies of a Working Group of the CLLS Financial Law Committee to the Questionnaire of February 2006 to the Private Sector From the European Commission for the Drafting of the Evaluation Report *JIBFL* 6, p. 263.

McFarlane, B. and Stevens, R. (2010 a). Interests in Securities. Practical Problems and Conceptual Solutions, in Gullifer L. & Payne J. (eds.), *Intermediated Securities: Legal Problems and Practical Issues*, Oxford, Hart Publishing, pp. 33 - 59.

McFarlane, B. and Stevens, R. (2010 b). The Nature of Equitable Property, *Journal of Equity*, 4, pp. 1 - 28.

McFarlane, B. (2008). *The Structure of Property Law.* Oxford: Hart Publishing.

McKendrick E. and Goode R. (2009). *Goode on Commercial Law.* 4th London: Lexis-Nexis.

McKnight, A. (2011). A review of 2010: part 2 *Law & Fin. Mkt. Rev.* 5 (2) March, pp. 95 - 112.

McKnight, A. (2006). The Reform of English Law Concerning Secured Transactions *JIBLR* pp. 587 - 598.

Micheler, E. (2014). Intermediated Securities and Legal Certainty. *LSE Legal Studies Working Paper* No. 3/2014.

Micheler, E. (2010). The Legal Nature of Securities: Inspirations from Comparative Law in Gullifer, L. and Payne, J. (eds.), *Intermediated Securities. Legal Problems and Practical Issues*. Oxford: Hart Publishing, pp. 131 - 148.

Micheler, E. (2007). *Property in Securities. A Comparative Study*. Cambridge: Cambridge University Press.

Moffat, G. et al. (2009). *Trusts law: text and materials*. Cambridge: Cambridge University Press.

Mooney, C. W. and Kanda, H. (2010). Core Issues under the UNIDROIT (Geneva) Convention on Intermediated Securities: Views from the United States and Japan, in Gullifer L. and Payne J. (eds.), *Intermediated Securities: Legal Problems and Practical Issues*. Oxford: Hart Publishing, pp. 69 - 129.

Mooney, C. W. (2008). *Law and Systems for Intermediated Securities and the Relationship of Private Property Law to Securities Clearance and Settlement: United States, Japan, and the UNIDROIT Draft Convention*. Discussion Paper No. 2008-E-7. Imes Discussion Paper Series. Institute for Monetary and Economic Studies – Bank of Japan**.**

G. Morton (2003). Commentary on The Dematerialisation of Money Market Instruments in Worthingon S. (ed.) *Commercial Law and Commercial Practice*. Oxford: Hart Publishing, pp. 249 - 304.

Moss, G. (2010). Issues Arising from Insolvency in Gullifer, L. & Payne, J. (eds.), *Intermediated Securities. Legal Problems and Practical Issues*. Oxford, Hart Publishing, pp. 61 - 68.

Nathan J. A. and Marshall, O. R. (1967). *A Casebook on Trusts*. 5th ed. London: Stevens.

Neave, M. and Weinberg, W. (1978-1980). The Nature and Function of Equities *U. Tas. L. Rev.* 1, 6 pp. 24 - 38.

Nolan, R. C. (2006 a). Equitable Property *LQR* 122, pp. 232 - 265.

Nolan, R. C. (2006 b). Understanding the Limits of Equitable Property *Journal of Equity* 1, pp.18 - 40.

Ooi, M. (2003). *Shares and Other Securities in the Conflict of Laws*. Oxford: Oxford University Press.

Paech, P. (November 2012). Market Needs as Paradigm: Breaking Up the Thinking on EU Securities Law. *LSE Law Working Paper Series*.

Palmer, N. E. (1986). The Vindication of Commercial Security over Commodities: Equitable Pledges and Conversion *LMCLQ* pp. 218 - 234.

Parsons, R. (2011). HM Treasury's consultation paper on financial collateral: extracts from the CLLS Financial Law Committee's response *JIBFL* 1, pp. 6 - 11.

Parsons, R. and Dening, M. (2011). Financial collateral – an opportunity missed *Law & Fin. Mkt. Rev.* 5 (3) May pp. 164 - 175.

Payne, J. (2010). Intermediated Securities and the Right to Vote in the UK in Gullifer L. and Payne J. (eds.), *Intermediated Securities: Legal Problems and Practical Issues*. Oxford: Hart Publishing, pp. 187 - 216.

Penner, J. (2014). The (True) Nature of a Beneficiary's Equitable Proprietary Interest *Can. J. L. & Jurisprudence*, 27, pp. 473 - 500.

Penner, J. E. (2012). *The Law of Trusts*. 8th ed. Oxford: Oxford University Press.

Penner, J. (2009). The Structure of Property Law (Book Review) *RLR* pp. 250 - 258.

Penner, J. E. (1997). *The Idea of Property in Law*. Oxford: Clarendon Press.

Penner, J. E. (1996). The "Bundle of Rights" Picture of Property *UCLA Law Review*, 43, pp. 711 - 820.

Pettit, P. H. (2012). *Equity and the Law of Trusts.* 12th ed. Oxford: Oxford University Press.

Pollock F. and Wright, R. S. (1888). *An Essay on Possession in Common Law*. Oxford: Clarendon Press.

Pretto-Sakmann, A. (2005). *Boundaries of Personal Property*. Oxford: Hart Publishing.

Pretto-Sakmann, A. (2002). Primary Rights and Rights *in Rem* in Birks P. and Pretto-Sakmann *Themes in Comparative Law. In Honour of Bernard Rudden* (eds), Oxford University Press, pp. 65 - 80.

Rahmatian, A. (2009). Review of B. McFarlane - The Structure of Property Law. Hart Publishing, Oxford, 2008, *MLR* 72(5), pp. 877 – 881.

Rogers, J. S. (2006). Conflict of Laws for Transactions in Securities Held Through Intermediaries *Cornell Int'l LJ.* 39 pp. 285 - 328.

Rogers, J. S. (1996). Policy Perspectives on Revised UCC Article 8 *UCLA Law Review* 43 pp. 1431- 1503.

Rogers, J. S. (1995). An Essay on Horseless Carriages and Paperless Negotiable Instruments: Some Lessons From the Article 8 Revision *Idaho L. Rev.* 31, pp. 689 - 698.

Rudden, B. (1987). Economic Theory v. Property Law: The Numerus Clausus Problem in Eekelaar, J. and Bell, J. *Oxford essays in jurisprudence* (eds), Third Series. Oxford: Clarendon Press, pp. 239 - 263.

Rushworth, A. and Scott, A (2010). Total Chaos? Shell v Total *LMCLQ* pp. 536 - 543.

Saoul, D. (2013). Lehman: liens untied *JIBFL* 3, pp. 143 - 145.

Schroeder, J. L. (1996). Death and Transfiguration: The Myth that the UCC Killed Property *Temp. L. Rev.* 69, 4, pp. 1281 - 1341.

Schroeder, J. L. (1994). Bundle-O-Stix: Feminist Critique of the Disaggregation of Property *Mich. L. Rev.* 93, pp. 239 - 319.

Schroeder (1994) Is Article 8 Finally Ready This Time? The Radical Reform of Secured Lending on Wall Street *Colum. Bus. L. Rev.* pp. 291 – 502.

Scott, A. W. (1917). The Nature of the Rights of the Cestui Que Trust *Colum. L. Rev.* 17, pp. 269 - 290.

Scott, A. W. (1913-1914). The right to follow money wrongfully mingled with other money *Harv. L. Rev.* 27, pp. 125 - 138.

Sherman and Sterling LLP (2012). United Kingdom: dematerialized securities – intercompany funding agreements *J.I.B.L.R.* p. 77.

Simpson J. and Dahan, F. (2005). Publicity of Security Rights: Why and How 1 *JIBFL* p. 3.

Smith, M. (2008). Equitable owners enforcing legal rights? *LQR*, pp. 517 - 523.

Smith L. (2008). Trust and Patrimony *Revue générale de droit*, 38, pp. 379 - 403

Smith, L. (2000). Tracing in Bank Accounts: The Lowest Intermediate Balance Rule on Trial *Can. Bus. L. J.* 33, pp. 75 - 91.

Smith, L. D. (1997). *The Law of Tracing*. Oxford: Oxford University Press.

Stone, H. F. (1917). The Nature of the Rights of the Cestui Que Trust *Colum. L. Rev.* 17, pp. 467 - 501.

Swayze, F. J. (1915). The Growing Law 25 *Yale L. J.* 25, pp. 1 - 19.

Tettenborn, A. (1996). Trust Property and Conversion *CLJ* 55, pp. 36 - 42.

Thévenoz, L. (2008). Intermediated Securities, Legal Risk, and the International Harmonisation of Commercial Law *Stan. J. L. Bus. & Fin.* 13, pp. 384 – 452.

Toube, F. (2011). Rascals: indirect holding systems and trusts *Insolv. Int.* pp. 74 - 76.

Turing, D. (2005). New Growth In The Financial Collateral Garden *JIBFL* 1, pp. 4 - 9.

Turing, D. (August 2005). *Omnibus Accounts, European Commission Legal Certainty Group Document.*
Retrieved from
http://ec.europa.eu/internal_market/financialmarkets/clearing/certainty/index_en.htm.

Turing, D. and Lester, K. (2005). Implementation of the EU Directive on Financial Collateral Arrangements in the United Kingdom *JIBLR* pp. 65 - 71.

Turner, P. G. (2010). Consequential Economic Loss and the Trust Beneficiary *CLJ*, 69, 3, pp. 445 – 447.

Turner, R. W. (1931). *The Equity of Redemption: Its Nature, History and Connection with equitable estates generally*. Cambridge: Cambridge University Press.

Virgo, G. (2012). *The Principles of Equity and Trusts*. Oxford: Oxford University Press.

Waters, D. W. M. (1967). The Nature of the Trust Beneficiary's Interest *Can. Bar Rev.* 45, pp. 219 - 283.

Webb, C. and Akkouh, T. (2013). *Trusts Law*. 3rd. ed. London: Palgrave Macmillan.

White, J. J. and Summers, R. S. (2000). *Uniform commercial code: secured transactions*. New York: Hornbook Series.

Wood, P. R. (2007). *Comparative Law of Security Interests and Title Finance*. 2nd ed. London: Sweet & Maxwell.

Worthington, S. (2009). *Equity and Property: Fact, Fantasy and Morals*. The McPherson Lecture Series, IV. University of Queensland Press.

Worthington, S. (2006-2007). The Disappearing Divide Between Property and Obligation: The Impact of Aligning Legal Analysis and Commercial Expectation, *Tex. Int'l L. J*, 42, pp. 917 - 940.

Worthington, S. (2006 a). Floating Charges: Use and Abuse of Doctrinal Analysis in Gezler J. and Payne J. (eds.) *Company Charges: Spectrum and Beyond*. Oxford: Oxford University Press.

Worthington, S. (2006 b). *Equity*. 2nd ed. Oxford: Oxford University Press.

Worthington, S. (2001). Shares and shareholders: property, power and entitlement: part I *The Company Lawyer*, 22 (9), pp. 258 - 266.

Worthington, S. (1999). Sorting Out Ownership Interest in a Bulk: Gifts, Sales and Trusts *J.B.L.* pp. 1 - 21.

Yale, D. (1961). *Lord Nottingham's Chancery Cases*. vol. II. London: Selden Society.

Yates, M. and Montagu, G. (2013). *The Law of Global Custody*. 4th ed. West Sussex: Tottel Publishing.

Vaaler, B. R. (1996). Revised Article 8 of the Mississippi UCC: Dealing directly with indirect holding *Miss. L.J.* 66 (2) pp. 275 - 323.

Vandevelde, K. J. (1981). The New Property of the Nineteenth Century: the Development of the Modern Concept of Property *Buff. L. Rev.*, 29, pp. 325 - 368.

Zacaroli, A. (2010). Taking Security over Intermediated Securities: Chapter V of the Unidroit (Geneva) Convention on Intermediated Securities in over Intermediated Securities in Gullifer L. & Payne J. (eds.), *Intermediated Securities. Legal Problems and Practical Issues*. Oxford: Hart Publishing, pp. 167 - 184.

2. POLICY DOCUMENTS

Association for Financial Market in Europe - AFME (8 April 2013). *Post Trade Settlement Committee Task Force on Settlement Internaliser (with links to Account Structure) - Settlement Internaliser considerations: issues and proposals*. Retrieved from http://www.afme.eu.

Association for Financial Market in Europe – AFME (March 2012). *Post Trade Settlement Committee Task Force on CSD Account Structure - CSD Account Structure: Issues and Proposals*. Retrieved from http://www.afme.eu.

Bloxham, P. (January 2014). *Final Review of the Investment Bank Special Administration Regulations 2011*.

Bloxham, P. (April 2013). *Review of the Investment Bank Special Administration Regulations 2011*.

English Law Commission (October 2013). Consultation Paper No 215, *Fiduciary Duties of Investment Intermediaries.*

English Law Commission (May 2008). *Updated Advice: The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities.* Retrieved from http://www.lawcom.gov.uk/.

English Law Commission (March 2006). *Project on Intermediated Investment Securities. First Seminar: Objective for a Common Legal Framework.* Retrieved from http://lawcommission.justice.gov.uk.

English Law Commission (June 2006). *Project on Intermediated Investment Securities. Second Seminar: Issues Affecting Account Holders and Intermediaries.* Retrieved from http://lawcommission.justice.gov.uk.

English Law Commission (2005). *Company Security Interests* - Report No 296.

English Law Commission (2004). *Company Security Interests* - A Consultative Report No. 176.

European Commission (May 2013). *Securities Law Legislation, Non-paper of the Services of the Directorate-General Internal Market and Services.* 7th meeting of the Member States Working Group.

European Commission (October 2012). *Discussion Paper 'Legislation on Legal Certainty of Securities Holding and Dispositions*, 6th Meeting of the Member States Working Group.

European Commission (2011). *Summary of Responses to the Directorate-General Internal Market and Services.* Second Consultation. Legislation on Legal Certainty of Securities Holding and Dispositions.

European Commission (2010). Legislation on Legal Certainty of Securities

Holding and Dispositions. *Second Consultation Document of the Services of the Directorate-General Internal Market and Services*.

Financial Conduct Authority - FCA (September 2014). *Getting the right investor outcomes*.

Financial Conduct Authority - FCA (June 2014). *Review of the client assets regime for investment business – Feedback to CP13/5 and final rules*.

Financial Conduct Authority - FCA (July 2013). *Review of the client assets regime for investment business* (CP 13/5).

Financial Markets Law Committee – FMLC (December 2015). *Meaning of "possession", "control" and "excess financial collateral" under the Financial Collateral Arrangements (No. 2) Regulations 2003*. Retrieved from http://www.fmlc.org/.

Financial Markets Law Committee – FMLC (December 2012). Issue 1: Collateral Directive - *Analysis of uncertainty regarding the meaning of "possession or control" and "excess financial collateral" under the Financial Collateral Arrangements (No. 2) Regulations 2003*. Retrieved from http://www.fmlc.org/.

Financial Markets Law Committee – FMLC (April 2011). *Implementation of EU Directive 2009/44/EC on settlement finality and financial collateral arrangements*. Retrieved from http://www.fmlc.org/.

Financial Markets Law Committee – FMLC (December 2010). *Issue 87 Control Gray v. G-T-P Group Ltd*. Retrieved from http://www.fmlc.org/.

Financial Markets Law Committee – FMLC (July 2004). *Issue 3 Property Interests in Investment Securities – Analysis of the Need for and Nature of Legislation Relating to Property Interests in Indirectly Held Investment Securities With a Statement of Principles for an Investment Securities Statute*. Retrieved from http://www.fmlc.org/.

Financial Services Authority - FSA (September 2012). *Client assets regime: EMIR, multiple pools and the wider review* (CP12/22).

Financial Services Authority - FSA (January 2010). *Client Money & Asset Report.*

Financial Stability Board - FSB (April 2012). *Securities lending and Repos: Market Overview and Financial Stability Issues - Interim Report of the FSB Workstream on Securities Lending and Repos.*

HM Treasury (November 2010). Consultation Paper, *Implementation of EU Directive 2009/44/EC on settlement finality and financial collateral arrangements.*

HM Treasury (September 2010). *Special administration regime for investment firms.*

HM Treasury (August 2010). Consultation Paper, *Implementation of EU Directive 2009/44/EC on settlement finality and financial collateral arrangements.*

International Organisation of Securities Commissions - IOSCO (January 2014). *Recommendations Regarding the Protection of Client Assets.* Retrieved from http://www.iosco.org.

International Organisation of Securities Commissions - IOSCO (February 2013). *Recommendations Regarding the Protection of Client Assets.* Consultation Report. Retrieved from http://www.iosco.org.

International Organisation of Securities Commissions - IOSCO (February 2013). *Appendix A – Client Asset Protection Summary.* Retrieved from http://www.iosco.org.

Legal Certainty Group – LCG (August 2008). *Solutions to Legal Barriers related to Post trading within the EU* - Second Advice of the Legal Certainty Group. Retrieved from http://www.ec.europa.eu/.

Private Property Law to Securities Clearance and Settlement: United States, Japan, and the UNIDROIT Draft Convention. Discussion Paper No. 2008-E-7. Imes Discussion Paper Series. Institute for Monetary and Economic Studies – Bank of Japan.

Organisation for Economic Co-operation and Development - OECD, (September 2011). *New Sources of growth: intangible assets*. Retrieved from http://www.oecd.org/sti/inno/46349020.pdf.

The City of London Law Society ("CLLS") - Financial Law Committee (October 2010). *HM Treasury: A Consultation on the Implementation of EC Directive 2009/44/EC on Settlement Finality and Financial Collateral Arrangements: August 2010*. Retrieved from www.citysolicitors.org.uk.

The Group of 30, (1989). *Clearance and Settlement Systems in the World's Securities Markets Report*. Retrieved from http://www.group30.org/publications.htm.

UNIDROIT (December 2004). *Explanatory Note of the Preliminary Draft of the UNIDROIT Convention on substantive legal rules regarding securities held through securities accounts*. Retrieved from http://www.unidroit.org/.

3. TABLE OF CASES

UK

Agnew v. IRC [2001] UKPC 28, [2001] 2 A.C. 710.

Ashurst v. Pollard [2001] 2 All ER 75.

Barclays Bank Ltd v Quistclose Investments Ltd [1970] A.C. 567, [1968] 3 W.L.R. 1097, [1968] 3 All E.R. 651.

Barlow Clowes International Ltd v. Vaughan [1992] 4 All ER 22.

Commerzbank Aktiengesellschaft v. IMB Morgan Plc [2004] EWHC 2771 (Ch), [2005] 2 All ER (Comm) 564.

Concorde Constructions Co Ltd v. Cogan Ltd. [1984] 29 BLR 120.

Dearle v Hall [1828] 3 Russ. 1, 38 E.R. 475.

Devaynes v. Noble [1816] 35 E.R. 781, [1816] 1 Mer. 572.

Don King Productions Inc v Warren [2000] Ch 291.

Eckerle v Wickeder Westfalenstahl GmbH [2013] EWHC 68 (Ch).

Foskett v. McKeown [2001] I AC 102.

Gray v. G-T-P Group Ltd Re F2G Realisations Ltd (in Liquidation) [2010] EWHC 1772 (Ch).

Hallett's Estate (Re) [1880] 13 Ch. D. 696 (CA).

Hayim v. Citibank NA [1987] AC 730.

Healey v. Healey [1915] 1 KB 938.

Hunter v. Moss [1993] 1 WRL 934, [1994] 1 WRL 452.

Illingworth v. Houldsworth [1904] AC 355.

International Factors v. Rodriguez [1979] QB 351.

LBIE v. RAB Market Cycles [2009] EWHC 2545 (Ch).

Lehman Brothers International (Europe) v CRC Credit Fund Ltd and others, [2010] EWCA Civ. 917, [2012] UKSC 6.

Leigh & Sillivan v. Aliakmon Shipping Co. Ltd (The Aliakmon) [1986] AC 785.

Livingstone v. Commissioner of Stamp Duties (Queensland) (1960) 107 C.L.R. 411.

London Borough of Hounslow v. Jerkins [2004] EWHC 315 (QB).

Mac-Jordan Construction Ltd v. Brookmount Erostin Ltd [1992] BCLC 350.

MCC Proceeds Inc v Lehman Brothers International (Europe) [1998] 4 All E.R. 675 CA.

McPhail v. Dalton [1971] AC 424.

Money Markets International Stockbrokers Ltd v London Stock Exchange [2001] 1 WLR 1150.

National Westminster Bank v Spectrum Plus and others [2005] UKHL 41.

Neste Oy v. Lloyds Bank plc [1983] 2 Lloyd's Rep 658.

1 OBG Ltd and another v Allan and others [2007] UKHL 21, [2008] 1 AC 1.

Parker-Tweedale v. Dunbar Bank Plc. (C.A.) [1991] Ch. 12.

Pearson and others v. Lehman Brothers Finance SA [2010] EWHC 2914 (Ch), [2011] EWCA Civ. 1544.

Prazic v. Prazic [2006] EWCA Civ. 497.

Nelson v Greening & Sykes (Builders) Ltd [2007] EWCA Civ 1358.

RAB Capital Plc v Lehman Brothers International (Europe) [2008] EWHC 2335 (Ch).

Rayack Construction v. Lampeter Meat Co. Ltd. [1979] 12 BLR 30.

Re Atlantic Computers Ltd [1992] Ch 505 (CA).

Re CA Pacific Finance Ltd. [2000] 1 BCLC 494.

Re Celtic Extraction Ltd [2001] Ch 475 (CA).

Re Cosslett (Contractors) Ltd [1997] 4 All ER 115.

Re Goldcorp Exchange Ltd [1995] 1 AC 74 (PC).

Re Gulbenkian's Settlements [1970] AC 508.

Re Harvard Securities Ltd [1997] 2 BCLC 369.

Re H. H. Vivian & Co Ltd. [1900] 2 Ch. 654.

Re Jartray Development Ltd. [1982] 22 BLR 134.

Re Kayford Ltd (in liquidation) [1975] 1 WLR 279.

Re Lehman Brothers International (Europe) (In Administration) [2012] EWHC 2997 (Ch).

Re Lehman Brothers International (Europe) (No. 2) [2009] EWCA Civ 1161.

Re London Wine Company (Shippers) Ltd [1986] PCC 121.

Re Stapylton Fletcher Ltd.; Re Ellis, Son & Vidler Ltd [1994] 1 WRL 1181, [1995] 1 All ER 192.

Re Wait [1927] 1 Ch 606.

Re Yorkshire Woolcombers Association Ltd [1903] 2 Ch 284.

Roberts v Gill & Co and another [2010] UKSC 22, [2011] 1 A.C. 240.

Russell-Cooke Trust Co. v. Prentis [2002] EWHC 2227 (Ch), [2003] 2 All ER 478.

Saunders v Vautier [1841] 41 E.R. 482.

Shell UK Ltd v. Total UK Ltd [2010] EWCA Civ. 180, [2011] QB 86.

Stroud Architectural Services Ltd v John Laing Construction Ltd [1994] 2 BCLC 276.

Swift v Dairywise Farms Ltd [2001] EWCA Civ 145, [2003] 1 WLR 1606 note.

Tailby v. Official Receiver [1888] 13 App Cas 523.

Tinsley v. Milligan [1994] I AC 340.

Tito v. Waddell (No 2) [1977] (Ch) 354.

UK Ltd. v. Total UK Ltd [2010] EWCA Civ. 180, [2011] QB 86.

Westdeutsche Landesbank Girozentrale v. Islington London Borough Council [1996] AC 669.

Australia

Re French Caledonian Travel [2003] NSW SC 1008, [2004] 22 A.C.L.C. 498.

White v. Shortall [2006] NSW SC 1379.

New Zealand

Registered Securities Ltd [1991] 1 NZLR 545.

Re International Investment Unit Trust [2005] 1 NZLR 270.

Canada

Boughner v. Greyhawk Equity Partners Limited Partnership (Millenium) [2013] ONCA 26, [2012] ONSC 3185.

Cummings Estate v. Peopledge HR Services Inc. ONSC 2781, [2013] W.D.F.L. 2886.

Law Society of Upper Canada v. Toronto Dominion Bank [1998] 42 O.R. (3d) 257.

Ontario Securities Commission v. Greymac Credit Corporation [1986] 55 O.R. 2nd 673.

Paddock v. Paddock [2008] CarswellOnt 8794, [2009] W.D.F.L. 2783, 78 R.F.L. (6th) 54

Toronto Dominion Bank v. 2026227 Ontario Inc. [2012] ONSC 2992.

United States

Re Esteem Settlement [2002] Jersey L.R. 53.

Re Walter J Schmidt & Co, ex p. Feuerbach [1923] 298 F. 314.

Ruddle v. Moore 411 F.2d 718 (D.C. Cir. 1969)

Court of Justice of the European Union

Webb v. Webb Case C 294/92 [1994] QB 696.

4. TABLE OF LEGISLATION

European legislation

Directive 2011/61/EU *on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.*

Directive 2009/44/EC *amending Directive 98/26/EC on settlement finality in payment and securities settlement systems and Directive 2002/47/EC on financial collateral arrangements as regards linked systems and credit claims*.

Directive 2006/73/EC *implementing Directive 2004/39/EC as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive*.

Directive 2004/39/EC *on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC*.

Directive 2002/47/EC *on financial collateral arrangements*.

Directive 2001/24/EC *on the reorganisation and winding-up of credit institutions*.

Directive 98/26/EC *on settlement finality in payment and securities settlement systems*.

Regulation (EU) No 909/2014 *on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012*.

Regulation (EU) No 648/2012 *on OTC derivatives, central counterparties and trade repositories*.

Council Regulation (EC) No 1346/2000 *on insolvency proceedings*.

Conventions

Unidroit Convention on Substantive Rules for Intermediated Securities, October 2009.

Hague Convention on the law applicable to certain rights in respect of securities held with an intermediary, December 2002.

UK legislation

Banking Act 2009.

Companies Act 2006.

Companies Act 1900.

Enterprise Act 2002.

Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations No. 2993/2010.

Financial Collateral Arrangements (No. 2) Regulations 2003.

Financial Services and Markets Act 2000.

Insolvency Act 1986.

Trusts of Land and Appointment of Trustees Act 1996.

Sale of Goods (Amendment) Act 1995.

Sale of Goods Act 1979.

Uncertificated Securities Regulations No. 3755 2001.

US legislation

Security Exchange Act 1934.

Securities Investor Protection Act 1970.

Uniform Commercial Code (UCC).

Canadian legislation

Securities Transfer Act 2006.

Italian legislation

Italian Civil Code – *Codice civile* 1942.

German legislation

German Civil Code - *Bürgerliches Gesetzbuch* 1900 (BGB).

Austrian legislation

Austrian Civil Code - *Allgemeines bürgerliches Gesetzbuch* 1811 (ABGB).

Swiss legislation

Swiss Civil Code 1907.

French legislation

French civil code - *Code civil des Français* 1804.

5. TABLE OF ACRONYMS

Allgemeines bürgerliches Gesetzbuch = 'ABGB'

Alternative Investment Fund Managers Directive 2011/61/EU = 'AIFMD'

Association for Financial Markets in Europe = 'AFME'

Assets under Management = 'AUM'

Bürgerliches Gesetzbuch = ‘BGB’

Canadian Securities Transfer Act = ‘STA’

Certificateless Registry for Electronic Share Transfer = ‘CREST’

Central Securities Depository = ‘CSD’

Chapter = ‘Ch.’

Client Asset Sourcebook = ‘CASS’

City of London Law Society = ‘CLLS’

Confront = ‘Cfr.’

Depository Trust & Clearing Corporation = ‘DTCC’

Financial Conduct Authority = ‘FCA'

Directive on financial collateral arrangements (2002/44/EC) = ‘FCD’

Financial Collateral Arrangements (No. 2) Regulations = ‘FCAR’

Financial Markets Law Committee = ‘FMLC’

Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations = ‘FMIR’

Financial Services Authority = ‘FSA’

Financial Services and Markets Act 2000 = 'FSMA'

Footnote = ‘n.’

Footnotes = ‘nn.’

Ibidem = ‘Ibid.’

Idem = ‘Id.’

International central securities depository = ‘ICSD’

International Institute for the Unification of Private Law = ‘UNIDROIT’

International Organization of Securities Commissions = ‘IOSCO’

Investment Bank Special Administration Regulations 2011 = ‘SAR’

Legal Certainty Group = ‘LCG’

Lehman Brothers International – Europe = ‘LBIE’

Lowest Intermediate Balance Rule = ‘LIBR’

Markets in Financial Instruments Directive II (2014/65/EU) = 'MiFID II'

Markets in Financial Instruments Directive (EC) 2004/39 = 'MiFID'

Markets in Financial Instruments Regulation (600/2014/EU) = ‘MiFIR’

National Conference of Commissioners on Uniform State Laws = ‘NCCUSL’

Organisation for Economic Co-operation and Development = ‘OECD’

Place of the Relevant Intermediary Approach = ‘PRIMA’

Repurchase Agreements = ‘Repos’

Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories = 'EMIR'

Regulation (EU) No 909/2014 on securities settlement and on Central Securities Depositories = 'CSDR'

Settlement Finality Directive (98/26/EC) = 'SFD'

Sale of Goods Act 1979 = 'SGA'

Sale of Goods (Amendment) Act 1995 = 'SGAA'

Securities Investor Protection Act = 'SIPA'

Securities Law Legislation = 'SLL'

United States Uniform Commercial Code = 'UCC'