

# A CIVIL LAW JURIST'S PERSPECTIVE ON INTERMEDIARY RISK IN THE INDIRECT HOLDING SYSTEM FOR SECURITIES

## A COMMENT ON SCHWARCZ & BENJAMIN

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### I. INTRODUCTION

Professors Schwarcz and Benjamin classify the situations in which an intermediary holds securities for investors in their highly stimulating article entitled *Intermediary Risk in the Indirect Holding System for Securities*. The authors identify two situations in which an intermediary holds securities for investors: that in which the intermediary does, and does not, have beneficial rights.<sup>1</sup> The authors seemingly assume that intermediary risk does not arise where the intermediary has no beneficial rights. This point is made explicitly in an article published previously by Professor Schwarcz.<sup>2</sup> In *Intermediary Risk in a Global Economy*, Professor Schwarcz discusses two cases in which the intermediary has no beneficial rights: namely, trust and bail. In civil law countries, however, there is yet another example: the case of the so-called commission agent. A commission agent is a merchant who executes contracts for commission in its own name, on behalf of the customer's account. Securities brokers are the most common example. Securities brokers normally hold securities for their customers. Yet whose claim will prevail if a broker goes bankrupt, the broker's creditors or its customers? In the absence of special statutory provision, one cannot be sure that the latter has priority over the former.<sup>3</sup> Thus, in theory, substantial intermediary risk may

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

2. Steven L. Schwarcz, *Intermediary Risk in a Global Economy*, 50 DUKE L.J. 1541, 1566-71 (2001).

3. The Korean Commercial Code specifically indicates that "goods or valuable instruments which have been received by the commission agent from his principal, goods, valuable

exist in a jurisdiction with no special provisions on this issue. Schwarcz and Benjamin, however, focus on the situation in which an intermediary transfers an undivided fractional interest in securities to an investor. They emphasize that in some civil law jurisdictions, the investor may not necessarily prevail over the intermediary's general creditors. Thus, the authors propose that such states enact into law a rule clearly indicating that such a transfer constitutes a valid and enforceable transfer, and that the transferee may assert its rights only against the intermediary in privity. I do not object to, and even welcome, the authors' proposal as a general proposition. In the Korean context, however, the authors' proposal may not be relevant.

## II. THE INDIRECT HOLDING SYSTEM UNDER THE SECURITIES TRANSACTION ACT

Korea, like other civil law countries such as Germany and Japan, has special provisions on the indirect securities holding and book-entry transfer system. While Germany and Japan have enacted separate acts for those provisions, Korea has incorporated them into the Securities Transaction Act (STA), the primary legislation for regulating securities markets.<sup>4</sup> Under the STA's indirect holding provisions, the intermediary risk discussed by the authors is addressed adequately. Ultimate investors, rather than intervening intermediaries, are regarded as holders of securities, as long as the books are kept properly. The provisions are applicable only to those securities deposited with the Korea Securities Depository (KSD), the only authorized securities depository in Korea. Thus, in theory, the provisions are inapplicable to those securities not deposited with the KSD. In practice, however, there is virtually no instance in which an intermediary fails to deposit with the KSD. Under the STA, brokers are required to deposit investors' securities with the KSD.<sup>5</sup> Other financial firms including banks are under no such duty, but may choose to use the KSD as sub-custodian, which they do consistently. Indeed, financial firms serving as custodians for foreign investors are required

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instruments, or claims acquired through sales and purchases in the commission agency are regarded as the possession of or claims of the principal in the relations between the principal and the commission agent or the latter's creditor." SANGBOP [Commercial Code], Act No. 1000 of 1962, art. 103 (S. Korea). The Japanese Commercial Code has no such provision. SHÖHÖ (Jap.).

4. Chungwon Koraebop [Securities Transaction Act], Act No. 2920 of 1976, arts. 173-178, translated in 11 KOREAN LEGIS. RES. INST., STATUTES OF THE REP. OF KOREA 720 (1997).

5. *Id.* art. 44-4.

to deposit them with the KSD.<sup>6</sup> While institutional investors may deposit their assets directly with the KSD, individual investors must go through their brokers. Brokers must keep a book and list such information as the names and holdings of investors.<sup>7</sup> The KSD must keep its own book for the holdings of depositing institutions and distinguish between their house and customer accounts.<sup>8</sup> As a legal matter, investors registered in the broker's book are regarded as co-owners of the securities.<sup>9</sup> As a practical matter, however, they are treated as owners of the securities equivalent to their co-ownership shares. For example, an investor registered as a beneficial shareholder in the book of an intermediary may exercise most of his shareholder rights directly, although he cannot request the delivery of his share of securities from the KSD. The proposed rule thus will add virtually nothing to the rule existent under the STA. The proposed rule, however, may be useful in countries that lack such provisions.

### III. THE SITUATION IN JURISDICTIONS THAT LACK INDIRECT HOLDING PROVISIONS

As Schwarcz and Benjamin discuss, the situation with respect to intermediary risk is unclear in jurisdictions that lack indirect holding provisions. In my opinion, in such jurisdictions, an investor who has acquired from an intermediary an undivided fractional interest in securities should have priority over the intermediary's general creditors. Such a result may frustrate the creditor's expectations, especially if he or she has been misled into thinking that the intermediary is the sole owner of the securities it holds. A creditor is not entitled, however, to rely on the appearance of an intermediary holding securities. Under the Korean Civil Code, for example, transfer of ownership of a physical asset does not necessarily require an actual delivery of the asset in question. Transfer may be made by the transferor's declaration to serve as an immediate possessor of the asset for the transferee.<sup>10</sup> If transfer is completed by this method, those creditors extending credit to the transferor without knowledge of this transfer may be disappointed later. But such a result may be unavoidable, as the parties may achieve the same result by first having the transferor actually de-

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6. Chunggwonup Kamdok Kyujong [Securities Business Supervision Regulation], art. 7-15 (on file with the Duke Journal of Comparative and International Law).

7. Chunggwon Koraebop, *supra* note 4, art. 174-2, § 1.

8. *Id.* art. 174, § 3.

9. *Id.* art. 174-4, § 1.

10. *Id.* art. 189 (concerning the recharacterization of possession).

liver the asset to the transferee and then having the transferee deposit it back to the transferor. If transfer by the possession recharacterization method can be made for all the assets of the intermediary, there is no reason why it should not be allowed for a part of the assets. So even in a civil law country, transfer of an undivided fractional interest in securities by the recharacterization possession method should be allowed in the absence of special legislation. In such a case, the transferor and the transferee are deemed to co-own the assets. The transferee can make a claim to the transferor-custodian for delivery of his share of securities.

Why, then, should one need the rule proposed by Schwarcz and Benjamin? When the intermediary directly holds the assets, such a rule may not be necessary.<sup>11</sup> But when the intermediary wishes to transfer a fractional undivided interest in the securities held by a higher-tier intermediary, it is not necessarily clear in civil law countries whether the transfer can be validly completed by the transferring intermediary's notice to the higher-tier holder.<sup>12</sup> Under the conventional view, a property interest may not be transferred without specifying the subject of the interest. The rule proposed by the authors will clarify that transfer of such a fractional undivided interest may be completed without going through the cumbersome process of specification.

#### IV. PROBLEMS WITH THE CO-OWNERSHIP APPROACH UNDER THE STA

As mentioned earlier, thanks to the indirect holding provisions in the STA, intermediary risk does not matter for investors in Korean securities.<sup>13</sup> But it by no means follows that the co-ownership approach adopted by the STA creates no problems in other respects. First, the co-ownership concept does not correspond well with so-called dematerialized securities, as investors' interest in such securities may not be regarded as ownership from the technical legal perspective.<sup>14</sup> Second, the co-ownership approach generates substantial

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11. Of course, it is good to eliminate any uncertainty surrounding this issue.

12. See, e.g., Kinyūhō iinkai [Financial Law Board], Shōken no furikae Kessai ni Kakaru hōsei ni Kansuru chūkan ronten seiri ni tsuite [Interim Note on Legal Rules Relating to Book-Entry Securities Settlement], at 6 n.13 (Apr. 3, 2000), available at <http://www.flb.jp/publication/06-j.PDF> (last visited Feb. 2, 2002).

13. On the other hand, it may matter for those Korean investors who invest in foreign securities.

14. Chungwon Koraebop, *supra* note 4, however, does not distinguish between certificated and certificateless securities.

transaction costs in cross-border securities transactions, since it often may be difficult for the parties to identify and comply with the governing laws applicable to the transaction in question. Although unifying conflict-of-laws rules may somewhat reduce the uncertainty involved, unification has its own problems.<sup>15</sup> In that respect, I join many experts in thinking that the “security entitlement” concept adopted in the U.C.C. Article 8 is preferable.

## V. CONCLUSION

The securities entitlement under the U.C.C. Article 8 is a mixture of property and *in personam* rights. It has a property right feature as its holder has priority over the intermediary’s general creditors; at the same time, it has an *in personam* feature as its holder can assert his or her right only against the intermediary with whom he or she directly deals. A holder of security entitlements may, however, determine how the voting rights are exercised. In effect, the rights of entitlement holders are not significantly different from those of shareholders under the STA. They differ only at a conceptual level. Importing a foreign concept like security entitlement is not easy, especially because it directly undermines the fundamental division between property and *in personam* rights in traditional civil law. The neat distinction between the two kinds of rights, however, has already been subject to challenge. Although the indirect securities holding system in civil law countries such as Korea, Japan, and Germany has been consistent with the co-ownership approach, the element of possession in the co-ownership of securities is becoming increasingly abstract and artificial. And when we give up the notion of certificate, which is not really essential in the book entry settlement system, we will no longer be able to maintain the concept of ownership, and we will be forced to devise a new concept to represent the interest of lower-tier investors.

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15. Schwarcz & Benjamin, *supra* note 1, at 329–30 & nn.66–71.