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Zurich, 25 January 2006

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**Legal Certainty Group – Information about non-EU legal systems
MARKT/G2/MT/ccD(2005)9489**

Dear Sir:

We are referring to your letter dated July 5, 2005, seeking information about non-EU legal systems rules on the holding of securities by intermediaries for consideration by the Legal Certainty Group. Since Switzerland has a keen interest in the work of this group, we are more than happy to answer to your query and are pleased to submit a brief report on the substantive law governing the holding of securities by intermediaries in Switzerland. As you suggested, we will focus our presentation on the draft Federal Act on the Custody and Transfer of Securities Held with an Intermediary. This draft act has been prepared by a group of experts and is expected to be submitted to the parliament by the Federal Council (executive branch of the federal government) in early summer 2006. Since the draft act has been welcomed both by the financial services industry as well as by the bar and academics, it is safe to assume that it will find broad support in parliament as well. Nevertheless, it must be stressed that what we will subsequently describe will mostly be future law.

Our presentation includes two parts. First, we will briefly describe the current situation regarding the law on intermediary held securities in Switzerland and the reasons which led to the conclusion that a comprehensive law reform should be tackled. Secondly, we will provide an overview over the draft act. You will find the text of the act attached in French as well as in an unofficial English translation.

The reform of the substantive law of intermediary-held securities is part of a comprehensive package which also includes the ratification of the Hague Convention on the law applicable to certain rights in respect of securities held with an intermediary and the transposition of the EU financial collateral directive into Swiss law.

1. Status of law reform project

Switzerland currently has no codified body of law governing the holding of securities by intermediaries. Rather, the legal foundation of the global custody business as well as CSD services rely on general concepts of contract and property law as well as on a series of

legal opinions. Three basic concepts are being used: global deposit of certificated securities (Sammelverwahrung), global certificate and uncertificated securities (Wertrechte). The first two concepts are based on property law, thus securities held in a global deposit or as a global certificate are transferred by transfer of possession. Uncertificated securities are defined by the Stock Exchange and Brokerage Act 1995 (art. 2(a)) without clarification of their legal concept. However, both for certificated and uncertificated securities which clients hold with an intermediary protection against the intermediary's bankruptcy has been improved by an amendment to the Banking Act in 1995 (art. 16 and 37b Banking Act).

While calls from academics for a securities law reform have been frequent for a couple of years, it should be pointed out that these three concepts were working satisfactorily and that they have not been challenged in court so far. In fact, there is virtually no case law that would question the soundness of the current system. Nevertheless, in 2001 a group of financial market lawyers came to the conclusion that a codified statutory framework for the custody of securities was necessary considering the importance of those services for financial markets as a whole. A decisive factor in coming to this conclusion was the extremely high percentage of cross-border holdings in Switzerland. The group commissioned an industry working group led by the Swiss Banking Association with preparing a proposal for a securities custody act. The result of their work was basically to codify the concepts of global deposit, global certificate and uncertificated securities and to flesh the latter out by declaring property law rules applicable to the transfer of uncertificated securities. A final proposal for a securities custody act was submitted to the Federal Ministry of Finance in 2003 which appointed a second working group led by the Swiss National Bank, Switzerland's central bank, with representatives from the financial services industry, the bar, regulators and the ministries of finance and justice.

This working group (the Working Group) submitted the draft act on the Custody and Transfer of Securities Held with an Intermediary (Intermediary-Held Securities Act) in summer 2004. In an informal consultation procedure with financial services institutions in Switzerland and abroad, market organizations, and academics, the draft act found broad support. In August 2005 the Federal Council decided to finalize the draft act in view of the comments made in the consultation procedure and to propose legislative action to the parliament not later than June 2006. Should the parliament follow up on the government's proposals, the act could become effective in 2007 or early 2008.

The Working Group was mandated to review the proposal presented by the industry working group. However, it quickly concluded that a mere codification of current practices would not permit to achieve legal certainty and that a more radical approach to securities law reform would be needed. In particular, the Working Group decided to discard a property law based foundation for intermediated securities and designed instead a new species of property, called "intermediary-held securities" (Bucheffecten, titres intermédies). As a guideline, the Working Group outlined a number of policies. Most important, any legal framework would have to ensure cross-border compatibility. In order to achieve this policy objective it followed closely the work done by the Unidroit Study Group, which was much facilitated because the Swiss member in that study group – Prof. Luc Thévenoz – was also a member of the domestic Working Group. Secondly, the Working Group decided to follow established market practices unless there was a clear need to

depart. Since the holding of securities with intermediaries relies on sophisticated IT-systems, any change in market practice could cause expensive changes in those IT-systems. It would be important to weigh carefully the benefits of such a change against those costs. Finally, the Working Group strived for designing a statutory framework that would easily adapt to future technologies, provide an open architecture and not create factual or legal monopolies¹.

2. The draft Intermediary-Held Securities Act

The draft Intermediary-Held Securities Act comprises 6 chapters with 31 articles. Chapter 1 defines the purpose and scope of the act and provides a legal definition of the term "securities held with an intermediary", lynchpin of the draft act. Chapter 2 covers the creation and extinction of intermediary-held securities. Chapter 3 deals with the rights and duties of investors and depositories and chapter 4 governs the disposition of these securities. Chapter 5, with just one article, regulates aspects the depository's liability and chapter 6 lays down the usual interim and final provisions. The schedule to the act contains various amendments to existing acts.

2.1. Purpose and scope

The draft Intermediary-Held Securities Act (D-IHSA) describes the purpose of the act as the creation of a uniform legal basis for the custody of certificated and uncertificated securities by financial intermediaries as well as the transfer of such securities (cf. art. 1 para. 1 sentence 1 D-IHSA). The act aims to guarantee the property rights of investors and to contribute to the efficient settlement of securities transactions and the stability of the financial system (cf. art. 1 para. 1, sentence 2 D-IHSA). It also wishes to establish legal predictability in the settlement of cross-border securities transactions by taking internationally recognised standards into account, with particular focus on the draft of a Unidroit securities convention².

The scope of application of the draft act is restricted to depositories that maintain securities accounts (cf. art. 2 para. 1 D-IHSA). Only a limited group of financial intermediaries are suitable to be depositories (cf. art. 5 para. 1 D-IHSA). The reason for this restriction is that the draft act makes the transfer of ownership and the grounds for restricted physical rights to intermediary-held securities dependent on registration in private books. In order for this to be possible, the said books must guarantee a high level of correctness and reliability. Financial intermediaries sufficiently meet this guarantee as their business activities are subject to strict supervision and regulation³. It follows that the draft act creates special private legislation which takes precedent over the general securities act as *lex specialis* and supersedes it in this respect.

¹ See for an extensive discussion of underlying policies Bericht der vom Eidg. Finanzdepartement eingesetzten technischen Arbeitsgruppe zum Entwurf eines Bundesgesetzes über die Verwahrung und Übertragung von Bucheffekten vom 15. Juni 2005 ("Working Group Report"), 32-37. The report is available at < <http://www.efd.admin.ch/d/dok/berichte/2005/09/bucheffekten.pdf>> (visited January 22, 2006).

² Cf. Preliminary Draft Convention on Harmonised Substantive Rules regarding Securities held with an Intermediary, Unidroit 2004, Study LXXVIII – Doc. 19 (December 2004); Cf. Working Group Report, 40.

³ Cf. Working Group Report, 35.

As regards the subject matter, the draft act governs proprietary aspects of the custody of securities by financial intermediaries (intermediary-held securities custody). It contains, in particular, provisions on the rights and obligations of the account holder and depository (cf. chapter 3, arts. 11–19) and the disposition of the intermediary-held securities (cf. chapter 4, arts. 20–27). By contrast, the concepts global deposit, global certificates and uncertificated securities do not occupy a central role in the regulation. Once certificated or uncertificated securities have been credited to a securities account, it is irrelevant whether this was as a result of a deposit of one or more certificated securities or the registration of an uncertificated security. The form that the underlying instrument takes is neither important for relations between the investor and the depository nor for the transfer of intermediary-held securities. It is for this reason that the draft act presupposes the concepts global deposit, global certificates and uncertificated securities, and even does not govern them. Instead, the Working Group suggests including a short statutory provision in the fifth division of the Code of Obligations, which codifies the securities act (cf. art. 973 a–c CO).

The draft act does not make any reference to its geographical applicability, which is currently governed by the provisions of the Federal Act on Private International Law (PILA). Under the dispositions of this act intermediary-held securities are governed by the conflict provisions of either the international property law (cf. art. 100 et seq. PILA) or the international assignment law (cf. art. 145 PILA) apply⁴. The autonomous conflict of laws provisions ought to be replaced as soon as possible by the Hague Securities Convention, the ratification of which is strongly supported by the Working Group.

2.2. Intermediary-held securities

2.2.1. Definition

The lynchpin of the draft act is the concept of the intermediary-held security. The legal definition in art. 4 comprises three elements: intermediary-held securities are (1) monetary and voting rights of a fungible nature against an issuer that (2) are credited to an account holder's security account and of which the account holder may dispose of by means of a credit in a securities account and (3) which may be asserted against the depository and any third parties (cf. art. 4 para. 1 D-IHSA).

The main aspect of the definition is the *constitutive effect of the book entry*, both with regard to the creation of intermediary-held securities (cf. art. 7–9 D-IHSA) which is finalised upon crediting the related rights in the securities account and, in principle, also with regard to the disposition of intermediary-held securities (cf. arts. 20–27 D-IHSA)⁵.

This book entry *establishes monetary and voting rights of a fungible nature against an issuer*. Consequently, the draft act explicitly recognises that an immediate legal relationship exists between the investor and issuer (debtor). Unlike Article 8 of the US Uniform Commercial Code (UCC), the draft act does not view the legal relationship within a depository system as a chain of bilateral relationships within the safekeeping chain⁶.

⁴ For the PIL point of view, cf. Working Group Report, 30–31 (Need for reform), 94 et seq.

⁵ Cf. Working Group Report, 42–43.

⁶ Cf. Working Group Report, 42.

Finally, the monetary and voting rights of a fungible nature *may be asserted against the depository and any third parties* (cf. art 4 para. 1(b) D-IHSA). This third-party effect is evidenced primarily in that the depositories' creditors do not have access to the depository-held securities (cf. art. 17, D-IHSA; cf. below 2.4.2).

The introduction of the term "intermediary-held security" allows a uniform regulation of an investor's right in intermediary-held securities irrespective of whether the underlying right is certified by a number of certificated securities or by a single security (global certificate) or completely dematerialised (uncertificated securities). It should be stressed, however, that the intermediary-held security is not a generic term for different forms of safekeeping – global deposit of certificated securities, global certificate or uncertificated security.

2.2.2. The intermediary-held security as an asset *sui generis*

According to the Working Group Report, the intermediary-held security is a "new asset *sui generis*"⁷. It is created by depositing certificated securities or global certificates or by registering uncertificated securities with a depository as well as by crediting a securities account (cf. art. 7 D-IHSA; and also below 2.3). The connection of a right with a certificate, which is so central to the concept of the certificated security, is severed. The certified right becomes the focal point, and the "packaging" (i.e. the certificate) loses its legal significance for the duration of the custody with intermediaries. The transfer of intermediary-held securities is also governed by its own rules (cf. art. 21 et seq. D-IHSA; and also below 2.5); a transfer by means of an instruction to take possession is not possible during the period of intermediary-held custody.⁸

With the introduction of the concept of the intermediary-held security and its recognition as an independent legal object, the Working Group departed from current law in that this law – with regard to the concepts of global deposit and global certificate – is based on the legal concept of modified and unstable co-ownership.

The following considerations were of decisive importance for abandoning the co-ownership model: In intermediary-held securities custody, investors normally do not know where and in which form securities are physically held and whether physical certificates even exist. Conversely, the ultimate depository generally has no knowledge of who has beneficial ownership of the securities held in custody. Consequently, the function of allocating *categories* is already largely fictitious, if physical certificates are still available. In the case of uncertificated securities, there is no object at all that could be subject to physical control. The Working Group, therefore, concluded that "the notion of a direct, immediate legal relationship between an investor and the securities held with an intermediary thus bears little resemblance with reality; it can no longer be maintained where physical certificates are no longer available".⁹

⁷ Cf. Working Group Report, 42.

⁸ Cf. Working Group Report, 64-65.

⁹ Cf. Working Group Report, 32.

2.3. Creation and extinction of intermediary-held securities

Intermediary-held securities come into being in two stages: *first* the securities are immobilised and *secondly* the related rights are credited to the account holder's securities account¹⁰. The instruments are immobilised when certificated securities or global certificates are deposited with a depository (cf. art. 7 para.1 (a) and (b) D-IHSA). Since uncertificated securities cannot be deposited, they are entered in a main register (cf. art.7 para. 1 (c) D-IHSA) kept at a central depository and consisting, essentially, of a website with information about the relevant issue (cf. art. 7 para 3 D-IHSA). The procedure by which the intermediary-held securities come into existence is concluded when the relevant rights are credited to the account holder's securities account; consequently this action has a constitutive effect.

With the creation of intermediary-held securities, the legal position of the account holder with respect to the securities credited to its account is governed, in principle, by the provisions set out in the third chapter of the draft act (cf. arts. 11–19 D-IHSA). In particular, the creation of intermediary-held securities means that the investor's co-ownership of a global deposit or a global certificate – based previously on physical documents – is suspended. The investor may not derive any rights from its co-ownership as long as the documents are deposited with the depository and the related rights entered in the securities account¹¹. Similarly, disposition of intermediary-held securities is governed by the provisions of chapter 4, and by this chapter alone (cf. arts. 20–27 D-IHSA), i.e. by means of a credit (cf. art. 21 D-IHSA) or a control agreement (cf. art. 22 D-IHSA).

A major concern on the part of the Working Group is to draw up a legal basis for intermediary-held securities custody that would not lead to the systems being closed off¹². In particular, the draft act does not specify that securities must be held by financial intermediaries. On the contrary, the idea is that investors should be able to withdraw securities from the system of intermediary-held securities custody and place them in the custody of non-financial intermediaries or in an individual securities account ("open architecture"). Consequently, art. 10 D-IHSA provides a mechanism for the delivery of intermediary-held securities. This is only possible if the intermediary-held securities are held in the form of certificated securities or that the investor at least has a claim to documentation of its intermediary-held securities in the form of certificated securities (cf. art. 9 para. 2 D-IHSA). However, it is also important not to provide inappropriate incentives. The public interest in smooth and efficient systems is accommodated by ensuring that the obstacles to the withdrawal of securities from the system are not maintained at an artificially low level¹³.

¹⁰ Cf. Working Group Report, 42-43.

¹¹ Working Group Report, 46-47.

¹² Cf. Working Group Report, 34.

¹³ Cf. Working Group Report, 50-51.

2.4. Rights and obligations on the part of the depository

The third chapter (cf. arts. 11–19 D-IHSA) lends substance to the concept of intermediary-held securities by specifying the rights and duties of investors and the depository. It is made up of 9 articles of differing importance. Two sets of regulations are important for understanding the concept of intermediary-held securities: first, the provisions on collateral for client holdings as well as the distribution of shortfall risks in the event of a depository's bankruptcy (cf. next section); and secondly, the provisions on the investor's right to preferential treatment in the event of a depository's bankruptcy..

2.4.1. Duty relating to cover for securities holdings and shortfall risks

One of the risks implicit in intermediary-held securities custody is the shortfall risk. This refers to the possibility that the credit balance of an account holder is not always covered by the holdings of its depository at an upper-tier depository. A shortfall may come about as the result of operational problems (fraud, forgery, IT problems) or false entries¹⁴. Shortfalls may also arise out of the procedures for the settlement of securities transactions. For instance, although transactions on the Swiss Exchange SWX are processed at time T+3, under the system of "contractual settlement" the purchaser's securities account will already have been unconditionally credited at time T+0. Where shortfalls occur in a custody chain, the investor incurs risks that do not arise in a purely static custody system¹⁵. In particular, the investor incurs a performance risk in situations where the depository is temporarily unable to comply with the investor's right to dispose of its intermediary-held securities (cf. art. 21 D-IHSA) or to withdraw them from the system (cf. art. 10 D-IHSA). Finally, in the event of the depository's bankruptcy, the investor runs the risk of its claim to separation of his assets from the bankruptcy estate not being fully covered.

In principle, shortfalls should be avoided. Consequently, the draft act specifies that the securities credited to a depository client's account must, in principle, be covered by a corresponding quantity of available securities (cf. art. 11 para. 1 D-IHSA). Disposable securities are deemed to be, on the one hand, intermediary-held securities credited to the securities account which the depository maintains with an upper-tier depository (cf. art. 11 para. 2 (a) D-IHSA)¹⁶. On the other hand, readily available rights to delivery of intermediary-held securities are eligible as available securities (cf. art. 11 para. 2 (c) D-IHSA). These rights to delivery may also be segregated out in the event of a depository's insolvency (cf. art. 17 para. 2 (c) D-IHSA). To ensure the eligibility of delivery rights, the depository required to make delivery must be in good standing and may not be in default with the delivery¹⁷. Delivery rights are therefore only eligible during the customary

¹⁴ Cf. Working Group Report, 52.

¹⁵ Shortfall risks are inherent in intermediary-held securities custody systems, irrespective of the model upon which they are based. Shortfalls can also occur in a model since there are factual and/or legal limits to the possibilities of a reversal of defective credits ("tracing").

¹⁶ There is no upper-tier depository in the case of a final depository. In this case collective holdings (global deposit of certificated securities, global certificates or registered uncertificated securities) should be taken into consideration; cf. art. 11 para. 2 (b) D-IHSA.

¹⁷ Cf. Working Group Report, 54.

settlement period for the corresponding market, but not exceeding eight days. However, the depository's own holdings are not eligible, even though these could be used – in a subsidiary manner – to cover client credits:

Should a shortfall occur, the depository is obliged to remedy it by acquiring intermediary-held securities of the same kind (cf. art. 11 para 3 D-IHSA). Naturally, acquisitions will not be possible in the event of the depository's bankruptcy. In such a situation, investor's rights for separation of their assets from the bankruptcy estate (cf. art. 17) will first be satisfied from the depository's own holdings. This applies irrespective of whether the depository's own holdings have been segregated from client's holdings (cf. art. 12, art. 17 para. 2, art. 18 para. 1 D-IHSA). If the account holders' claims are still not fully met, even after resorting to the depository's own holdings, the shortfall must be divided up proportionately amongst the account holders (cf. art. 18 para. 2 D-IHSA).

The depository's duty of avoiding shortfall is very similar to the provisions of supervisory law. However, the draft act does not address this matter. The Working Group Report explicitly states that the powers of the supervisory authority to order measures designed to identify, restrict and control the risks associated with shortfall are untouched¹⁸. The legal basis for this is to be found not in the Intermediary-Held Securities Act, but in the relevant supervisory legislation.

2.4.2. Protection of investors in intermediary's insolvency

The draft act views intermediary-held securities as "absolute" rights. The most important aspect of this exclusivity is the account holder's right to the preferential treatment of its securities in the event of the depository's bankruptcy (cf. art. 4 para. 1 (b) D-IHSA). Consequently, the securities do not become part of the depository's estate in bankruptcy, but must be separated, i.e. transferred ex officio to another depository where they will be at the account holder's free disposal again. The corresponding regulations are set forth in art. 17 of the draft act.

Subject to separation are also securities that the insolvent depository kept at an upper-tier depository (cf. art. 17 para. 1 (a) D-IHSA)¹⁹. Likewise eligible for separation are the depository's freely disposable claims against third parties for the delivery of securities (cf. art. 17 para. 1 (c) D-IHSA). The separation entails the transfer of the securities and delivery claims to a depository named by the account holder or the delivery of the securities to the account holder (cf. art. 17 para. 3 D-IHSA).

2.4.3. Segregation of client and own securities (cf. art. 12 D-IHSA)

At present, there is no international agreement on the issue of whether the mixing of client and own holdings in the same collective account should be permitted or whether segregation should be prescribed²⁰. The draft act therefore remains neutral on this point

¹⁸ Cf. Working Group Report, 34, 54.

¹⁹ In the event of the bankruptcy of an ultimate depository, the certificated securities and global certificates or uncertificated securities deposited with such depository are the object of separation; cf. art. 17 para. 1 (b) D-IHSA.

²⁰ Cf. Working Group Report, 55.

and confines itself to setting out rules on the legal consequences of segregation on the basis of an agreement between parties or in accordance with supervisory regulations.

2.4.4. Depository's right of retention and use (cf. art. 13 – 15 D-IHSA)

The draft act accords the depository a right of retention to secure connected debts (cf. art. 13 para. 1 D-IHSA). Moreover, the depository may have itself authorised to dispose of an account holder's securities in its own name and on its own securities account (cf. art. 14 D-IHSA) or to pledge or dispose of securities that the account holder has pledged or transferred as collateral to the depository (cf. art. 15 D-IHSA)²¹ Art. 15 D-IHSA is intended to bring Swiss legislation in line with art. 5 of the EU financial collateral directive²².

2.4.5. Account holder's statements (cf. art. 16 D-IHSA)

In addition to fulfilling the function of transport, certificated securities of public faith also have a legitimisation purpose: they serve to assert the right evidenced by a document (cf. art. 965 and art. 975 et seq. CO). Securities held with intermediaries can obviously not fulfil these functions because the account holder does not have immediate ownership of the papers. In practice, account holders legitimatise themselves vis-à-vis the issuer with a statement of their depository. By virtue of the draft act, the account holder may at any time require its depository to draw up a statement (cf. art. 16, page 1 D-IHSA). The statement merely serves as an evidentiary document, not as a certificated security (cf. art. 16, page 2 D-IHSA). Consequently, the issuer cannot rely on the entitlement of a person presenting a statement within the meaning of art. 16, and thus meets the obligation in a valid way only by performance in favour of the material beneficiary²³. The draft act does not deal with further aspects of enforcing investors' rights in a system of intermediary-held securities, e.g. services with respect to the payment of interest or dividends, or with other aspects of corporate action. As explicitly set forth in art. 7 para. 2 D-IHSA, the relationship between account holder and issuer is not affected by the establishment of intermediary-held securities. Therefore, it is governed exclusively by the conditions of the issue or by the company by-laws.

2.4.6. Exclusion of upper-tier attachment (cf. art. 19 D-IHSA)

Since Intermediary-held securities are generally held in collective accounts, the upper-tier depository does not normally know the identity of individual investors or their shares of the collective holdings. Therefore, there is broad international consensus that attachment measures are to be taken exclusively by the depository that maintains the securities account of the debtor against whom the measure is being taken. By contrast, upper-tier attachments are to be excluded (cf. art. 19 para. 1 D-IHSA).

2.5. Transfer of intermediary-held securities

Chapter 4 (arts. 20 – 27 D-IHSA) governs the disposition of intermediary-held securities. Disposition encompasses both the transfer of full legal rights and the establishment of a limited material right. The chapter is divided into two sections. The first section deals

²¹ Cf. Working Group Report, 56-57.

²² Cf. Working Group Report, 33.

²³ Cf. Working Group Report, 59.

with the necessary preconditions for and the legal effects of the disposition. The second section sets forth the effects of the disposition vis-à-vis third parties.

2.5.1. Requirements for transfer of intermediary-held securities

The disposition of intermediary-held securities consists of two elements: first, an instruction by the account holder to its depository to transfer intermediary-held securities (cf. art. 21 para. 1, (b) D-IHSA). Secondly, a credit entry in the transferee's account of the securities transferred (cf. art. 21 para. 1 (b) D-IHSA). In lieu of a credit entry, material rights may also be established by concluding a control agreement. In such an agreement, concluded between account holder, depository and pledgee, the depository undertakes to carry out the pledgee's instruction without the need for any further consent or cooperation of the account holder (cf. art. 22 para. 1 D-IHSA).

The depository's entries are based on the account holder's instruction. The instruction is a unilateral, contractual declaration by the account holder which requires a receipt²⁴. The instruction's subject is the manifestation of the account holder's will to carry out the transfer of the intermediary-held securities to the transferee. The existence of an instruction is mainly relevant for assessing inaccurate dispositions. The preconditions for an effective instruction are governed by art. 20 D-IHSA. In principle, the depository is obligated to execute instructions given by the account holder with regard to the disposition of intermediary-held securities (cf. art. 20 para. 1 D-IHSA). The instruction is separate from the underlying transaction; hence the depository has neither the right nor the obligation to verify whether the instruction is based in a valid transaction (art. 20 para. 2 D-IHSA). Finally, art. 20 para. 3 D-IHSA sets forth that the instruction will be irrevocable at the time of the debit by the depository at the latest, unless otherwise stipulated in the custody agreement.

A transfer of intermediary-held securities will be effective only if the transferor had power to dispose (*nemo plus*). In principle, such power is vested only with the ultimate investor who is an account holder, not with his depository. However, the depository has the capacity to cause his account holder's securities being transferred to another account. If the transferee acquires the securities in good faith and against value, he will be protected from any adverse claim of the initial owner (cf. art. 26 para. 1 D-IHSA). Nevertheless, it is important to point out that the ultimate investor's legal relationship to the securities credited to his account is different from the legal relationship a depository has with respect to client securities.

In accordance with art. 21 para. 2 D-IHSA, the transfer is completed with making of the credit entry in the securities account of the transferee. In other words, the transferor maintains the said right until final completion of the disposition process, even if he may in fact no longer be able to dispose of its securities. This rule specifically aims to prevent the creation of rights without subjects which would otherwise be unavoidable.²⁵ However, the draft act does not stipulate that the credit be dependent on a previous debit. Consequently, it is technically possible that the purchaser is credited before the

²⁴ Cf. Working Group Report, 66.

²⁵ Cf. Working Group Report, 69

corresponding securities have been debited to the seller. It is thus theoretically conceivable that, by virtue of the credit entry in the purchaser's securities account, additional securities are created temporarily. In any case, making a credit contingent upon a previous debit would create the need for far-reaching interventions into existing systems. In the opinion of the Working Group, such interventions would not have been justified in view of the risk situation.

2.5.2. Reversal

The credit in the transferee's securities account transfers ownership in intermediary-held securities (cf. art. 21 para. 1-2 D-IHSA). In principle, this transfer is final. However, if the instruction for the transfer of such securities was seriously flawed, the transfer may be reversed (cf. arts. 23-24 D-IHSA). Reversal means that a credit is offset by a corresponding debit (cf. art. 23 para. 2 D-IHSA)²⁶.

An account holder has a claim against his depository for reversal of a debit if such debit was caused by an invalid instruction, e.g. if it is issued by a person without legal capacity to act (cf. art. 23 para. 1 (a) D-IHSA), or if a representative has no power of attorney (cf. art. 23 para 1 (b) D-IHSA), if the account holder was induced by mistake, fraud, or duress to issue an instruction (cf. art. 23 para. 1 (c) D-IHSA), or if such instruction was forged or falsified (cf. art. 23, par. 1 Ingress: „...ohne ...Weisung...“). Please note that only flaws in the instruction may give rise to a reversal, but not defects in the underlying transaction. The depository may refuse to reverse a debit if it can prove to the effect that it was unaware of the defect in the instruction and, in spite of taking reasonable measures and procedures, it was not in a position to know that such a defect existed (cf. art. 23 para. 4 D-IHSA).

A credit to a securities account may be reversed by the depository whenever such credit was not covered by a valid instruction, e.g. if securities were credited to the wrong account or too many securities were credited to an account. Reversal is excluded if the account holder already has disposed of the securities (cf. art. 24 para. 2 D-IHSA).

2.5.3. Protection of the bona fide purchaser

The protection of bona fide purchasers is one of the main purposes of any securities legislation. The draft act also provides that any purchaser of intermediary-held securities shall be protected against adverse claims provided it acquired the securities in good faith and against value (cf. art. 26, para. 1 D-IHSA). Under general principles of Swiss private law, good faith is presumed (cf. art. 3 para. 1 Civil Code, CC). However, good faith may not be pleaded in case the transferee could not have acted in good faith if it had given the matter the attention that must have been expected of it in the given circumstances (cf. art. 3 para. 2 CC). Good faith relates to the absence of defects in the disposition (i.e. the instruction) as well as in the transferor's power of disposal. Art. 26 D-IHSA does not remedy any absence of legal capacity to act on the part of the transferor (cf. arts. 17-18 CC). Swiss law does not recognise any protection of good faith in another person's capacity to act²⁷. Likewise, there is no remedy for the loss of legal power to dispose due to the

²⁶ Cf. Working Group Report, 73.

²⁷ Cf. Working Group Report, 79

commencement of a bankruptcy procedure, even if the transferee had no possibility of be aware of such procedure (cf. art. 204 para. 1 Swiss Bankruptcy Act)²⁸. Dispositions by participants in securities settlement systems, however, are protected by art. 27 para. 2 Banking Law which has been drafted after the EU Finality Directive.

If the purchaser acted in bad faith or acquired the securities gratuitously, he will not be protected and is under a duty to return the securities (cf. art. 26, para. 2, D-IHSA). Please note that in such a case the return of securities is not governed by property law rules on claim to ownership (Vindikation) (cf. art. 641 para. 2 CC), nor by those on protection of possession (cf. arts. 927, 933 et seq. in conjunction with arts. 938-946 CC). Instead, the draft act makes reference to the provisions on unjust enrichment contained in the Swiss Code of Obligations (cf. arts. 62 et seq. CO)²⁹. The owner's claim for the return of such securities is protected in the case the transferee becomes insolvent (cf. art. 26 paras. 3 and 4 D-IHSA).

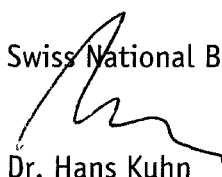
2.5.4. Priorities

Art. 27 D-IHSA governs the priority of competing rights in intermediary-held securities. In principle, the order of priority is established through the order in which credits to securities accounts are made (cf. art. 27 para. 2 D-IHSA). Rights of the depository created under articles 13 and 22 para. 2 D-IHSA prevail over all other rights irrespective of whether the credit has been made before or after such right was created. Finally, if intermediary-held securities are being transferred by way of assignment case the rights of the assignee are subordinated to those of an investor who acquired the securities pursuant to the provisions of the Intermediary-Held Securities Act. This applies irrespective of whether the assignment took place before or after the disposition by means of a credit (cf. art. 27 para. 3 D-IHSA).

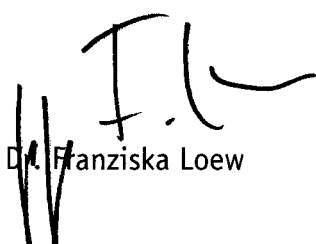
We hope, this overview over the status of securities law reform in Switzerland will be useful to your work. We would be more than happy to answer any question you might have in that respect or to provide additional information.

Sincerely yours

Swiss National Bank



Dr. Hans Kuhn



Dr. Franziska Loew

Encl. Draft Federal Act on Intermediary-held Securities (English/French)

²⁸ Cf. Working Group Report, 80-81

²⁹ Cf. Working Group Report, 80-81