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Financial Law Board

Interim Note on Legal Rules Relating to Book-Entry Securities Settlements

This Note is a compilation of what has been accomplished by the Financial Law Board in its study of legal issues involved in sales and collateral transactions of Japanese Government Bonds, corporate bonds, stocks and other securities, with a particular emphasis on the legal issues involved in cross-border aspects.

Securities and cash are delivered and settled when a trade in Government Bonds, corporate bonds, stocks or other securities takes place on the marketplace. It is extremely important for settlements to be completed simply, timely, and safely, in order to achieve market efficiency, to improve liquidity, and to reduce the risks of market participants such as investors and financial institutions. In this sense, securities settlement systems constitute a vital component of the infrastructure for financial and capital markets. This is all the more the case today, given the increase in volume of transactions, and the fact that many of those transactions take place across borders. Deliberations have begun concerning the reform of Japan's securities settlement systems, as the First Committee of the Financial System Council has recently established a working group to study reform of the securities settlement systems, and the Japan Securities Dealers Association has established a discussion group to take up reform of the securities settlement systems. It is likely that these new steps are based on awareness that Japan needs to improve the safety, efficiency and convenience of its securities settlement systems in order to meet international standards, given the reforms that are taking place in other countries, including further reductions in the settlement lag.

Given the role of the securities settlement systems as a vital element of the infrastructure for financial and capital markets, the first issue from a legal perspective is that the rights, interests and obligations involved in securities settlements must be clear and easily understood, so that securities can be settled safely and efficiently. Second, with the increase in the volume of sales or collateral transactions of foreign securities in Japan, there is an increasing possibility of legal disputes surrounding these transactions being brought to the Japanese courts. In such cases, it would be necessary to determine the governing law on the basis of the Law concerning the Application of Laws in General (*Horei*). However, there is legal uncertainty regarding the governing law in the case of paperless securities settlements.

On the basis of the foregoing situation, this note discusses (1) issues on the book-entry securities settlements in Japan, and (2) issues on conflicts of laws rules for book-entry securities settlements.

There are still outstanding issues that require further study and the Board intends to continue its review of the subject.

The following is a set of recommendations the Board proposes on these issues.

Recommendation 1

It is necessary to enact legal rules for book-entry securities settlements which include both certificated and dematerialized securities (these rules should make it possible to issue dematerialized securities). In this case, it is desirable that "securities" includes Japanese Government Bonds, corporate bonds, stocks, CP and others, so that the scope of these rules be comprehensive. Moreover, a new law should be enacted for international private law on the governing law in connection with legal issues surrounding the securities settlements with taking into consideration securities issued under a foreign law as well as under the Japanese law.

Recommendation 2

With regard to possible approaches towards legislation, if (A) an approach is taken which sets forth provisions concerning a central securities depository and designs the overall book-entry structure with the central securities depository as its basis, the legislation should provide that an entity recorded in the securities account will acquire securities (such as the right to demand payment of principal and interest from the issuer of corporate or government bonds); and if (B) the approach is that of a tiered structure for the book-entry system, wherein the statute sets forth the legal relationships between direct parties regarding securities accounts such as the relationship between investors and intermediaries, provision should be made for book-entry interests similar to the security entitlement of Article 8 of the Uniform Commercial Code.

Further, it would be desirable to clearly state in the legislation that in the event that the intermediary or the central securities depository is failed, the aforementioned holder of the book-entry interests has priority over general creditors of the intermediary or the depository, to the extent of the securities that the intermediary or the depository holds.

Recommendation 3

These rules for the book-entry interests should stipulate that the entry into the securities account (meaning certain data processing) should be required to validate and perfect the transfer of interests, and that the transfer should be completed and final when this entry is processed.

Recommendation 4

A method whereby investors and others can exercise book-entry interests in securities should be provided by law, and this method should be consistent with the nature of the relevant securities and the structure of the book-entry arrangement.

Recommendation 5

With regard to collateral transactions, consideration should also be given to having parties engage in collateral transactions in the same manner that they do in sales without devising a special structure for the purpose of creating security interests (for examples, utilizing such as a collateral sub-account).

Recommendation 6

While giving consideration to maintaining consistency with the current approach towards international private law in Japan, for the purposes of legislation, it would be desirable for the governing law that determines the effectiveness of an assignment of interests of an investor or provision of these interests as collateral (including the effectiveness of perfecting the same) to be the law having jurisdiction over the custodian or the central securities depository which holds the account in which the investor's name is recorded, when a Japanese investor holds securities through a foreign custodian or a central securities depository. However, further study is necessary concerning issues such as the nature of the interests held by the investor, and how to treat a bona fide purchaser if a certificate has been diverted.

Interim Note on Legal Rules Relating to Book-Entry Securities Settlements

1. Types of Book-Entry Arrangements for Securities Settlements, and Related Legal Issues

(1) Book-Entry Arrangements and Basic Legal Issues

As is well known, currently physical transfers of securities certificates between the parties rarely take place when securities are sold or pledged. Instead almost all securities are transferred without physical movements of the securities certificates (paperless settlement).[1]

The classic arrangement of achieving paperless settlements uses a transfer of interests by debits and credits to the securities accounts of the two parties. Ordinarily there is a tiered structure comprising a large number of investors, intermediaries (securities brokers, banks, others that act as custodians) in whom the investors deposit securities, and an entity in whom the intermediaries deposit securities and who keeps the book for securities accounts (central securities depository). Such an arrangement is called book-entry securities settlements. A number of depositories provide such settlement function, including the Depository Trust Company (DTC) in the United States, Euroclear in Belgium, SICOVAM in France, and the Depository and Book-entry Transfer System for Stock and the Government Bonds Book-entry System in Japan.[2, 3]

Book-entry securities are settled by debits and credits to the securities accounts within the tiered structure consisting of investors, intermediaries and the central securities depository. For example, say 100 units of securities owned by investor A who has a securities account at intermediary P are sold to investor B who has an account at intermediary Q. When the securities sold are settled within a book-entry system, (1) 100 units are debited from the

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[1] Regarding paperless securities settlements, see Hideki Kanda, "Dematerialization and the Principles of Law for Certificated Securities in the Future," in *The Modern Corporation and Principles of Law for Certificated Securities*: *A Memorial Book Commemorating the Seventieth Birthday of Professor Ichirô Kawamoto*, (Yuhikaku, 1994), p. 155ff. and Kazunori Ishiguro, "Securities Settlement Systems and International Corporate Failures," in *International Financial Failures* (Keizai Hôrei Kenkyûkai, 1995), p. 370ff. and references cited in both.

[2] With regard to paperless securities settlement arrangements, Japan has registration systems for Japanese Government Bonds and corporate bonds, under which a transfer of rights is perfected by registering the transfer with a registration institution (under the Law for Registration of Corporate Debentures and Article 3 of the Law concerning Government Bonds) as well as book-entry systems. The registration systems call for direct registration by final investors in the name of the investors, and although it is not founded on a tiered structure, and thus differs from the book-entry system, they are referred in the discussion below.

[3] Recently, some have argued on behalf of electronic certificates as a new form of uncertificated security (e.g., in the joint Ministry of Justice and Ministry of Finance study group on paperless securities, there has been a discussion on electronic certificates as well as book-entry sysytems as a legal framework for paperless commercial paper (CP) book-entry (details are available [in Japanese only] at the Ministry of Justice website, http://www.moj.go.jp). Electronic certificates are a certain type of electronic data to represent securities, just as in the case of paper certificates. Information technology such as electronic signatures would make it sufficiently possible, technically, to create electronic certificates. This is, however, a totally new framework that has not yet been realized in any country, and the Board has not examined the legal aspects of it in detail. In this report, therefore, the discussion is confined to book-entry securities.

account of investor A at intermediary P; (2) 100 units are debited from the account of intermediary P at central securities depository X, and 100 units are credited to the account of intermediary Q at depository X; and (3) 100 units are credited to the account of investor B at intermediary Q.

There is a question in legal theory, however, as to what interests are transferred when the transfer is made by "debits and credits to the securities accounts." That is, the nature of the interests that are transferred (to investor B in the above case) by debits and credits is an important legal issue with respect to the legal framework for the book-entry settlement (hereafter, the rights and interests obtained by the person whose securities account are credited to are referred to as "book-entry interests").

On the other hand, certificates are originally a legal technique which was created in order to represent certain rights and interests. For example, a corporate bond certificate represents the corporate bond securities. Hereafter, rights and interests traditionally represented by a certificate in such cases are referred to as "securities ".

Various types of book-entry arrangements are possible depending on whether a physical certificate exists, and, accordingly, the legal issues may vary. However, the legal frameworks for the book-entry interests in such arrangements can be categorized as follows: (1) frameworks under which the book-entry interests are securities themselves; and (2) frameworks under which the book-entry interests are distinct from securities. The following is a categorization of book-entry arrangements, and legal issues related thereto.

(2) Categories Based on Existence/Absence of a Certificate

Book-entry securities settlements can be categorized in accordance with existence/absence of a certificate.

A. Immobilization of, or Use of Global Certificates for, Certificated Securities

Immobilization of, or issuing global certificates for, certificated securities involves safekeeping of the certificates by a central securities depository or its custodians so that the certificates do not physically move, and the transfer of rights is accomplished by book-entry on securities accounts of the two parties. The forms of safekeeping are either safekeeping of commingled certificates, or that of a global certificate (i.e., only one actual certificate) (common with Euroclear). In all cases of immobilization and use of global certificates, physical certificates are issued and kept in safekeeping with the book-entry system.

The securities remain represented by the certificate in the case of immobilization or use of global certificates. In this case, there are two possible legal frameworks regarding the makeup of the book-entry interests of the party whose securities account is credited to.

One possible framework is to make use of the legal principles such as "commingled custody" (*Konzo Kitaku*) in order to ensure that a person whose name appears in the book has co-ownership of the certificates (and thus has securities). In this case, book-entry interests are securities. This is the situation in Japan with regard to book-entry for securities such as stock certificates.

The second possibility is that ownership of the certificates is transferred to the central securities depository (and therefore so too are the securities), and book-entry interests are distinct from securities (book-entry interests are regarded as, for example, the interests to request receipt of the physical certificates). In this case a legal issue arises with regard to the connection between book-entry interests and securities.

B. Voiding Certificates of the Certificated Securities

Another possible legal framework is one under which the securities shall be separated from the paper certificates for the portion of certificated securities which are placed in the book-entry system. Consequently by discarding the certificates as mere paper, the securities will become paperless in the true sense of the term (separating the securities from the certificates can be called "voiding certificates"). Examples of this, although they are distinguished from the book-entry systems, are the registration systems for Japanese Government Bonds and corporate bonds in Japan, wherein the registered part of the certificates is voided. Even this category, however, is the same as the immobilization or issuing of global certificates, in that a certificate has been initially issued.[4]

Regarding the legal structure of book-entry interests in this category, there are two possible options as to who has the securities corresponding to the certificates that had been voided (meaning the securities that were represented in the certificates). These two options correspond to the possible legal frameworks of immobilization or use of global certificates as discussed in A. above.

If the securities represented by the certificates are deemed to obtained by the owner of the certificates before the certificates were voided, the book-entry interests would be the securities.[5]

In contrast to this, it is possible to have a structure in which the securities are transferred to and held by the central securities depository and the book-entry interests are

[4] The systems for registration of Japanese Government Bonds and corporate bonds make it appear that securities are immediately registered when investors intend to hold securities in the form of registered bonds from the time of issue (see Article 4(1) of the Law for Registration of Corporate Debentures, and Article 21 and Article 27 of the Ministerial Ordinance concerning Japanese Government Bonds). In such a case issuance of certificates is not conceived, and consequently there is no procedure for voiding certificates.

[5] For corporate and Japanese Government bonds, registration is required to assert the ownership against the issuer and third parties, where it is taken as a precondition that the securities accrue to the person whose name is recorded when the securities are registered.

regarded as different rights and interests from the securities. In such a case, the same legal issue arises as to the connection between book-entry interests and securities as discussed in A. above.

C. Dematerialized Securities

Dematerialized securities are securities for which no certificates shall be issued under any circumstances (no certificates were printed at the stage of issuing securities, and the person acquiring interests cannot request issuance of certificates). Since no certificates exist, there can be no ownership of certificates.

Even in this case, the concept of securities (that is, rights and interests which would have been represented by certificates if certificates had been issued) still applies to dematerialized securities, but the legal nature of book-entry interests will differ depending upon who would be regarded as the holder of securities.

For example, in France, where all securities are dematerialized by law, "the book entries inure to the securities."[6] Thus it is possible to think of account holders as securities holders.

In the United States, on the other hand, while issuance of dematerialized securities is possible, the matter of who has direct claims against the issuer of such securities (that is, who possesses the securities) is defined according to Article 8, §8-207[7] of the Uniform Commercial Code (UCC) which provides that the registered owner has securities. In Article 8 of the UCC, book-entry interests held by account holders are defined as "security entitlements", which are different from securities.

(3) Types of Legislation with respect to Legal Rules Related to Book-Entry Securities Settlements

Two types of legislation would be possible with respect to book-entry securities settlements.

One type (A) is the legislation providing for the entire structure of a book-entry system. Such legislation would define a central securities depository in the center of the system, intermediaries as participants who open accounts at the central securities depository and investors as customers who open accounts at intermediaries. Entries made in the

[6] In France, a 1982 law eliminated certificates of securities. See Sei'ichi Yamada, "Elimination of Physical Certificates of Securities in France," in Ichirô Kitamura (ed.), *Development of Modern European Law* (Tokyo: Tokyo University Press, 1998), p. 309ff.

[7] Regarding the UCC, see Atsushi Kinami, "Rights and Interests in Book-entry Securities Settlement Systems from a Viewpoint of a Right in rem and a Right in personam -- Provisions in Article 8 of the Uniform Commercial Code," in *Intermixture of a Right in rem and a Right in personam Today: A Memorial Book for Prof. Ryôhei Hayashi:* (Tokyo: Yuhikaku, 1998), p. 119ff.

securities accounts of the central securities depository and intermediaries are given certain legal effects. The Law concerning the Depository and Book-Entry Transfer System for Stock is a classic example of this type. The situation in Germany ("Depotgesetz") and in France (the 1982 Financial Law, Article 94-II) are also of this type.[8]

The nature of the rights and interests of a person whose name appears in the securities account, under this type of law, would be ownership of the physical certificates, certain claims against intermediaries, or the securities themselves, depending on whether physical certificates exist.

The other type (B) is the legislation providing for direct relationship between parties in the book-entry system, such as relationship of an investor and an intermediary. In this case, a tiered book-entry system as a whole is structured as piles of such direct relationship between parties involved. This is the type provided for in the United States UCC.

Article 8 of the UCC provides for a "security entitlement" as an interest inuring to investors for certain types of securities that are processed by book-entry. A security entitlement includes the right to make claims against the intermediary who controls an investor's securities account, and a priority right to fungible securities of the same type that are held by the intermediary.[9] Here, a security entitlement that the intermediary holds against the entity that manages the intermediary's account is included in "fungible securities of the same type." Thus the law states that if the intermediary has a security entitlement against the entity on the next higher level (such as the central securities depository), the investor has a priority claim to this security entitlement (§8-503(a)). It is the superimposition of these relationships that makes up the book-entry system.

(4) Two Fundamental Requirements for Book-entry Arrangements

Thus there are several types of the book-entry arrangements for securities, and the accompanying legal structures vary accordingly. Whatever the type, two fundamental effects must be ensured by law.

First, in case of a failure or bankruptcy of a central securities depository or a securities intermediary, the holder of book-entry interests must be given priority over general creditors of the failed entity, in the same sense as if the holder of the book-entry interests were the

[8] The EU Directive on Settlement Finality in Payment and Securities Settlement Systems (98/26/EU, 19 May 1998, OJ L166/45), which was adopted by the EU in 1998, appears to have been created on the assumption of this type of law.

[9] Kinami, *supra*, at 9 and 128 *ff*. Kinami states the following regarding amendment of the UCC Article 8 in 1994 when the new concept of security entitlement was introduced:

"The 1994 amendment has the objective of stipulating provisions the content of which matches the realities of indirect ownership of securities. The revised Article 8 makes use of the new term "security entitlement" in order to deal with the rights of a person who indirectly owns securities. A security entitlement is a special right by itself. The term is used to designate the package of rights against the financial institution and the assets held by that institution that apply when a person comes to own securities through a financial institution."

Specific instances of security entitlement are described in p. 130ff.

holder of the securities. This is necessary because under the book-entry arrangement the holder of book-entry interests is the "substantial holder" of the securities.

Second, the transfer of book-entry interests must have finality with the entry on the books. The book in a book-entry system is prepared for the transfer of book-entry interests and it is thus desirable that the making of entries in securities accounts (or certain data processing by computers) at a central securities depository and intermediaries be accorded immediate legal effect. This would eliminate the possibility of claims being made against a purchaser (or holder of a security interest) by an bankruptcy trustee or creditors of a bankrupt entity claiming that the book-entry interests are still held by the seller in the event of bankruptcy of the seller (or the party which provided the security interest).

The following is the analysis of the nature of the book-entry interests in terms of priority rights and transfer of book-entry interests in case of events such as failure of a central securities depository or intermediaries.

A. Co-ownership of certificates

The legal principles of "commingled custody" are often used in connection with the immobilization and the use of global certificates of "certificated securities" as discussed in (2) A above, so that the persons recorded in the book in reference to fungible securities have co-ownership of the certificates (and therefore securities). Under this structure, the owner of the certificates (the holder of the securities) has title to the certificates (a right similar to a *right in rem* or "property right") through indirect possession using an intermediary and a central securities depository, and consequently the securities would not be a part of any bankruptcy estate of a central securities depository or an intermediary. Thus the persons recorded in the book would retrieve the certificates even in the event of bankruptcy of a central securities depository or an intermediary. In this case, the book-entry interests of securities account holders are protected as title to the certificates which represent securities. This follows from the legal principle of certificated securities.[10]

Under this legal structure, the book-entry interests (co-ownership of the certificates) are transferred by the instruction by the account holder to a central securities depository or an intermediary, whereby indirect possession of the certificates be transferred from the account holder to the purchaser of the securities. This transfer of possession enables the purchaser to perfect the transfer of ownership over the certificate.[11]

[10] Having a right to demand return of a certificate, similar to a *right in rem*, is not indispensable for protecting the securities through exercise of right of recovery. Rather the important issue is to be the holder of the securities. When one considers this fact, the more accurate statement is that the existence of a certificate as a tangible object constitutes the basis for being able to effectively obtain the securities (and not ownership of the certificate), through transferring indirect possession at one's instructions.

[11] There is a theoretical issue of how certificates shall be handled in a depository or intermediary. As transfer of possession are deemed impossible with respect to co-ownership according to traditional theory, traditional method to perfect an assignment of a co-ownership of securities when the certificates are held in commingled custody is to identify and

B. Uncertificated Securities

When there is no certificate (the case of (2) B and C above), an account holder cannot have the title to a certificate, even if the securities inure to a person holding book-entry interests. This would seem to imply that if the securities themselves are taken to be merely *rights in personam* or "claims", then even if the book-entry interests are the securities themselves, the holder of book-entry interests will not have priority rights in the event of failure of a central securities depository or an intermediary and will only have claims as a general creditor.

However, this is not true if the book-entry interests are the securities themselves and the transferee has perfected his/her status as securities holder against third parties by the book-entry. That is, even if the securities are simply claims (*rights in personam*), the person who holds claims (i.e., the person who asserts that the claims are his/her own and not included in a bankruptcy estate) should be able to exercise the right of recovery.[12] Even so, this reasoning would not prevent setting forth clear provisions by legislation to confirm this right of recovery, and it would probably be desirable to do so.[13]

In contrast to this, in the case that book-entry interests are distinct from the securities, without a clear stipulation (in the law) there would be difficulty in granting account holders priority rights, whether or not a certificate exists. In other words, when book-entry interests differ from securities, it is necessary to make a clear stipulation, such that "in the event of failure of a central securities depository or similar entity, securities held by the failed entity shall not be regarded as the assets of the entity and shall be retrieved by securities account holders with the entity" (See, also Article 8 of the UCC (§8-503 (a))). What then of the matter of transfer of interests? Because there is no physical certificate, there can be no transfer of possession regarding a certificate. In this case, it has interpreted that the procedures for transfer of the book-entry interests must be pursuant to the method for assigning claims or *rights in presonam* (*Shimei Saiken*). In that case legislation is necessary to make it possible to perfect transfer of book-entry interests by a book-entry.

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concentrate one's own share into certain certificates that have been placed in commingled custody, and transfer possession through an instruction given on that basis (ibid., 1, Kanda). In contrast to this approach, some opinions were also expressed before the Financial Law Board, stating that it is possible to perfect a transfer of share in commingled securities by transferring possession through giving an instruction, without going through the process of identifying and concentrating the share of co-ownership concerned.

[12] That the rights do not accrue to the bankruptcy estate is consistent with the fact that even in the event of a failure a bond registration institution, the bonds registered are not treated as being part of the bankruptcy estate.

[13] In France according to the law of January 25, 1985 (No. 85-98) that revised the law of January 3, 1983 (No. 83-1), Article 30 provides that in the event of failure of an intermediary the following rule determines priority relative to general creditors [translating from the Japanese except for quoted terms]: Item 1 / When juridical procedures for reorganization ("redressement judiciare") have been begun for a financial intermediary institution with whom securities accounts are opened, the holders of rights can transfer all their rights to another financial intermediary institution or to issuers. Such transfers are reported to the judge ("juge-commissaire.") / Item 2 / When there has not been adequate securities registered the holder of rights can request the representative of holders of rights ("représentant des créanciers") to supplement the rights."

2. Current Legal Issues in Japan

Paperless securities settlements in Japan have primarily been accomplished thus far by (1) the use of book-entry arrangements that use commingled custody as the underlying legal principle (an example being the Deposit and Book-Entry Transfer System for Stock and the Government Bonds Book-Entry System, and (2) the registration system wherein no physical certificates are issued and the transfer of interests is perfected by registration at the registration institution (based on the Law for Registration of Corporate Debentures, and Article 3 of the Law concerning Government Bonds). It is a fact that the present system has been operating smoothly on the basis of the above. Yet it cannot be denied that the following issues exist in connection with the legal structure involved.

First, each type of securities has its own legal basis for paperless settlements. Thus, even if new need for facilitating paperless settlement with respect to certain types of securities arises, it might be impossible to set up new paperless settlements unless new legislation is enacted. This presents the possibility that the legislation may not be fully able to meet the demands that may occur. Further, some securities are placed in custody, and others are registered, so that the laws for each necessarily differ. Even though it is to be expected that the legal requirements will vary according to the type of securities concerned, domestic and foreign investors alike will find Japanese financial and capital markets to be difficult to comprehend and hard to use if there are differences in the content of statutes in connection with a paperless settlement unless such differences are reasonable.

Second, under the present legal system of Japan, book-entry can only be taken as being based on the existence of physical certificates.[14] For example, the Government Bond Book-Entry System, according to the principle of commingled custody within the framework of the Civil Code and the Commercial Code, is constructed as a system that enables the above-mentioned immobilization of or use of global certificates for certificated securities ("(2) A" above). The Depository and Book-Entry Transfer System for Stock is based on the same legal principle, although the system is based on the special legislation for it (the Law concerning the Depository and Book-entry Transfer System of Stock). [15]

[14] There are systems for registering corporate bonds and Japanese Government Bonds that belong to the "voiding certificates of the certificated securities" category stated in section B above, however, in these systems the name of the final investor is registered directly by the registry entity and there is no tiered structure. It would seem that one could only conclude that there is a problem in the existing legal system if the fact that the registration system is the only system available prevents the use of a tiered structure for securities which need this structure, even if the need might be quite small.

[15] In Japan, the book-entry system for warrants is the first system based upon commingled custody and co-ownership of certificates (established in 1967). The discussion regarding possible legal framework for book-entry such as consumable deposits, entrustment, commingled custody and co-ownership took into account the understanding that transfer of rights by book-entry could be derived from the existing legal principles of certificated securities. It also took into account the thinking that it was possible to provide protection to the depositor similar to a property right under the legal rules for commingled custody. The commingling and co-ownership arrangement was thereafter applied to stocks (from 1971) and Japanese Government Bonds (from 1980). The Law concerning Depository and Book-Entry Transfer System for Stock was enacted in

The legal basis for book-entry using the principle of commingled custody has the advantages of maintaining continuity for the existing principles for certificated securities, and making it easy to grant investors priority right. Paperless securities settlements, however, have been achieved by innovations in information technology that have made it possible to process and transfer data easily, swiftly, safely and in large quantities. In that context, certificates have no economic significance. More, they now create problems in terms of legal complexities and concepts.[16]

Third, similar to the situation described as the second point immediately above, unlike France and the United States, issuance of dematerialized securities is impossible in Japan. This situation has the potential for keeping issuer and intermediary costs high, detracting from social and economic efficiency. It would be inappropriate not to be able to issue dematerialized securities because the legal underpinnings do not exist, even if issuers, investors, intermediaries and others would prefer to have such securities.

Fourth, when international aspects of the issue is taken into account, if it is not indisputably clear what country's laws govern transactions in book-entry securities (recorded in the form of electronic data), parties to a transaction cannot know the governing law for the transaction. The section for civil and commercial transactions of the Law concerning the Application of Laws in General, Japan's law concerning international private law, remains as it was initially enacted, in 1898, while the section concerning family law was amended through Law No. 27 of 1989. Because of that, the subject under discussion here is now regulated only by two articles: (1) contracts concerning a *right in personam* (i.e., a claim) shall be governed by the law agreed upon by the parties and if not so stipulated the contract shall be governed by the law of the location in which the contract is signed (Article 7 of the Law concerning the Application of Laws in General); (2) relationships concerning a *right in rem* (i.e., a property right) shall be governed by the "law of the situs of the objects" (Article 10 of the same law).

Therefore, the owner of a certificate and, consequently the holder of the securities, is determined by the law of the situs of the certificate as long as the securities are represented by

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order to resolve the need to temporarily return share certificates to the owner of the stocks prior to the last day of the accounting period, in order to carry out a title transfer.
This law is based on the commingled custody and co-ownership arrangement. (Regarding the above, see Ichirô Kawamoto, *Annotated Corporate Law / New Edition (4)* (Tokyo: Yuhikaku, 1986), pp. 267-76.

[16] One issue is how the law handles certificates that were kept in custody by a central securities depository or the like and were never intended to be circulated in the market, but wind up being distributed because of an illicit act or theft by an employee at the depository. Further, regarding the legal aspects of commingled custody, for example, there has been criticism concerning the book-entry settlement system for Japanese Government Bonds, namely "[i]nterpretations up to this time have only taken book-entry bonds as extensions of bonds in certificate, and pretended that they constituted holding of bonds in certificate, so there are some inconsistencies in the interpretations." (Koichirô Iida, "The Settlement System for Japanese Government Bonds and Requirements for Perfection," Koji Shindo, *The Cutting Edge in Financial Transactions* (Tokyo: Shôjihômu Kenkyûkai, 1966), p. 31. It is also thought that a problem exists as to whether the legal relations are clear concerning the Depository and Book-Entry Transfer System for Stock in cases when stock certificates do not exist, through use of the system for non-bearer stock certificates (Article 29, Paragraph 2 of the Law concerning Depository and Book-Entry Transfer System for Stock).

a certificate and the owner of the certificate is regarded as the holder of securities under the governing law concerning the effects of a certificate determined by Article 7 of the Law concerning the Application of Laws in General. Thus in the case of immobilization and or the use of global certificates, the holder of the securities is determined by the law of the situs of the certificate, which might be deposited in the jurisdiction that has little relationship with a transaction. If on the other hand, the securities are voided or dematerialized , then the situs of the certificate cannot be determined, and consequently the governing law would be determined on the basis of a different concept. This could only lead to a result that would contradict the intention of the parties to the transaction, and consequently it must be said that the Law concerning the Application of Laws in General has reached its limit in addressing transactions, given that this law assumes transaction structures as they existed at the end of the 19th century.

In conjunction with the foregoing, the Board thinks it necessary to take steps to adopt a comprehensive legal framework for book-entry settlements of both certificated and dematerialized securities.

Recommendation 1

It is necessary to enact legal rules for book-entry securities settlements which include both certificated and dematerialized securities (these rules should make it possible to issue dematerialized securities). In this case, it is desirable that "securities" includes Japanese Government Bonds, corporate bonds, stocks, CP and others, so that the scope of these rules be comprehensive. Moreover, a new law should be enacted for international private law on the governing law in connection with legal issues surrounding the securities settlements with taking into consideration securities issued under a foreign law as well as under the Japanese law.

3. Issues in Preparation for Legislation

Section 2 above discussed the issues with respect to the present legal system and the need for legislation. In this section attention is given to several issues to be confronted in legislation.

(1) Type of Legislation

As discussed in section 1 above, two approaches are possible for the purpose of legislation for book-entry securities settlements, Type (A) and Type (B) in subsection (3) of 1 above. Whether (A) or (B) is suitable is at issue.

Whichever type is selected would make little difference in actual book-entry at a central securities depository (E.g., SICOVAM and Euroclear are based on type (A) and the DTC is based on type (B) and there is little real difference in their functioning.)

This is not to say there are no differences at all. Type (A) is the approach taken in the Law concerning the Depository and Book-entry Transfer System of Stock, and so it has the advantage of being familiar. Type (B), on the other hand, has no precedent in Japan but is characterized by a flexible structure[17] that is easily applied to situation in which there are a number of tiers, and a number of central securities depositories can be involved.[18] Further study should be conducted before choosing which approach to adopt.

(2) Nature of Book-Entry Interests

As is discussed in section 1, various legal frameworks are possible concerning the interests to be acquired by a person whose name is recorded in the securities account. In the case of legislation, there would be a difference depending on whether type (A) or type (B) is chosen in this respect.

If the choice is made to use type (A) in legislation, the simplest approach would provide that securities (for example the right to demand payment of interest and principal from the issuer in the case of corporate bonds and Japanese Government Bonds) are (proportionally) acquired corresponding to the quantity recorded in the securities account, regardless of whether the securities are certificated or dematerialized[19] (even if a new law is enacted, there would appear to be no merit in treating the book-entry interests as being different from the securities). Further, by choosing type (A), it would be possible to provide for priority rights for the holder of book-entry interests.

On the other hand, in type (B), there is no alternative but to draft the law so that book-entry interests are similar to the security entitlement provided by the UCC. It is thought that

[17] For example, (1) It is not clear what rights X, a foreign investor, has under the Law concerning Depository and Book-Entry Transfer System for Stock when X deposits Japanese stocks with overseas intermediary Y, Y deposits them with Z who is a participant in the book-entry system in Japan, and Z deposits the stocks with the central securities depository in Japan (even if the governing law is Japanese law). Thus, if the rules are made pursuant to Type (A), issues will occur of how to handle the situation when there are several tiers interposed, unless a separate provision is made in the law. (2) Application of Type (A) would also be difficult when there are several central securities depositories involved, such as when a person P who has book-entry interests at a foreign depository assigns the securities to a person Q in Japan, and Q then deposits the securities with a Japanese central securities depository.

[18] A further difference is possible in which Type (A) would be suited to having the central securities depository and the participants responsible for a shortfall in securities (see Article 25 (Duty to Compensate) of the Law concerning Depository and Book-Entry Transfer System for Stock), while Type (B) would be suited to having the intermediary and the investor responsible for a shortfall (see UCC §8-503(b)). Nevertheless, even under Type (A) compensation need not necessarily be performed jointly, and this can be handled as set forth in UCC§8-503(b). Consequently this is more of a policy decision than an issue of the type of law.

[19] But if certificated securities are immobilized or represented by global certificates, rights remain represented by the certificate and thus there is no departure from the legal principle for certificated securities. In contrast, uncertificated or dematerialized securities would depart from the legal principle for cerrtificated securities, and consequently it would be difficult to treat both certificated and uncertificated securities as having completely the same legal structure, unless a legal fiction is used to construct certificates.

this will be a new interest that belongs to both of the traditional *right in rem* or *right in personam* categories. That is, the holder of the book-entry interests would have a right against the intermediary who holds the relevant books. This part can be considered to be a *right in personam*. Further, as stated above, it would be necessary to provide that a person holding book-entry interests has a priority right to the securities and book-entry interests held by the intermediary against an entity in a higher tier within the book-entry system. This part can be considered to have an effect similar to a *right in rem*.

Whichever type is adopted, it would be desirable to clarify in the statute that in the event of bankruptcy of an intermediary or a central securities depository, the aforementioned holder of the interests has priority over general creditors of the intermediary, etc., to the extent of the securities that the intermediary, etc., holds. In some cases the same result might be achieved through interpretation even in the absence of this stipulation, but there appears to be good grounds for stating this clearly in the statute as a confirmation clause and in order to avoid uncertainty in interpreting the law.

Recommendation 2

With regard to possible approaches towards legislation, if (A) an approach is taken which sets forth provisions concerning a central securities depository and designs the overall book-entry structure with the central securities depository as its basis, the legislation should provide that an entity recorded in the securities account will acquire securities (such as the right to demand payment of principal and interest from the issuer of corporate or government bonds); and if (B) the approach is that of a tiered structure for the book-entry system, wherein the statute sets forth the legal relationships between direct parties regarding securities accounts such as the relationship between investors and intermediaries, provision should be made for book-entry interests similar to the security entitlement of Article 8 of the Uniform Commercial Code.
Further, it would be desirable to clearly state in the legislation that in the event that the intermediary or the central securities depository is failed, the aforementioned holder of the book-entry interests has priority over general creditors of the intermediary or the depository, to the extent of the securities that the intermediary or the depository holds.

(3) Requirements for Transfer of Interests

As stated above, entry in the securities account (meaning certain data processing) should be the only requirement for a transfer of book-entry interests. For this purpose it would seem that greater clarity could be obtained by stipulating entry into an account as a requirement to effect and perfect an acquisition of book-entry interests. The actual situation today is that delivery and receipt of a certificate is required to effect and perfect a transfer of stocks or corporate bonds to be transferred (Commercial Code Articles 205 and 519). In

addition, since interests that concern book-entry are not necessarily limited to rights that have been represented by a certificate, and it would seem that there is no need to make a particular distinction when interests of these types are to be covered by book-entry settlements.

Recommendation 3

These rules for the book-entry interests should stipulate that the entry into the securities account (meaning certain data processing) should be required to validate and perfect the transfer of interests, and that the transfer should be completed and final when this entry is processed.

(4) Method of Exercising Rights

Regardless of the type of book-entry interests, having the holder of the interests exercise its right to demand payment of principal and interest directly against the issuer, etc., under normal circumstances, would interfere with the operation of the book-entry system, and consequently the method of exercising said rights should be provided by law, corresponding to the characteristics of the securities in question, as well as the structure of the book-entry system. Separate consideration must also be given to the possibility of an "emergency" such as the failure of an intermediary, a central securities depository, or an issuer, and legal provisions for such situations are necessary.[20]

Recommendation 4

A method whereby investors and others can exercise book-entry interests in securities should be provided by law, and this method should be consistent with the nature of the relevant securities and the structure of the book-entry arrangement.

(5) Treatment of Collateral Transactions

The need for processing and facilitating transfers of a large quantity of interests in a simple, timely and safe manner by computerized book-entry securities settlements exists not only for securities sales but also for transactions which use securities as collateral. The risk of failure of banks, brokers and others has become a reality in Japan in recent years. And this has lead to an increase in using securities that have high liquidity, as collateral for large financial transactions between financial institutions. This raises the issue of how to treat a

[20] Under the book-entry system it is possible that the issuer will not have a relationship directly with the holder of the book-entry interests. Nevertheless it would not appear appropriate to have a structure in which the issuer does not have any duty at all to the holder of the book-entry interests, and will not have any liability as long as the issuer pays the interest and principal to the central securities depository or the intermediary. This issue requires further study.

transaction which uses securities as collateral, when book-entry is used for transfer of the securities. To address this issue, a special scheme could be devised for the creating of securities interests (e.g., by creating a collateral sub-account within the securities account). For example the Law concerning Depository and Book-Entry Transfer System for Stock provides for accounts for the purpose of pledges (see, *inter alia*, Articles 15, 17, and 26).

This, however, does not mean that the purposes of a secured transaction cannot be obtained without creating a "security interest" as prescribed by law. In Japan, use of assignment as collateral has been more frequent for securities than creating a pledge.[21] Recently in Japan secured transactions have been performed by use of a "loan of securities with set-off." Also, it is possible to define repo transactions in an economic sense as being "transactions where credit is provided in cash, which is secured against securities." In such a case, the parties engage in a secured transaction by means of a transfer of interests.

That being the case there is some room for argument as to whether it is actually necessary to devise a special structure for the purpose of creating security interests (for example establishing a collateral sub-account within a securities account). Possibly there would be little merit in using a pledge type structure for securities that have high liquidity, and a re-pledge or the like might even complicate the legal issues surrounding settlement. Nevertheless this issue should depend on the extent to which there is a need to use a collateral sub-account.

Recommendation 5

With regard to collateral transactions, consideration should also be given to having parties engage in collateral transactions in the same manner that they do in sales without devising a special structure for the purpose of creating security interests (for examples, utilizing such as a collateral sub-account).

(6) Conflicts of Laws Rules

In a case such as when Japanese investor A has an "indirect holding" of securities through overseas custodian C, it is common for the physical certificates and the issuer to be overseas. In this event if for example investor A transfers securities to financial institution B, or pledges them as collateral, the requirements for B to perfect the assignment or the security interest against a third party must be met under the relevant law of jurisdiction. As discussed above under the Law concerning the Application of Laws in General as it currently stands, the property rights to the certificate would be governed by the law in the jurisdiction in which the certificate is located. Consequently A's *right in rem* to the certificate as well as perfecting of

[21] Hideki Kanda, "Theoretical Structure of Legal System for Collateral, and Current Issues," 12 Kinyu Kenkyu no. 2, at 42.

the assignment or provision as collateral would have to comply with the law of the jurisdiction in which the certificate is located. Second, when there is no physical certificate, the governing law for the rights against the issuers (such as a right to demand payment of corporate debt) can be considered as being agreed between the issuer and the underwriter. If no such agreement has been made, however, the governing law would probably be that of the jurisdiction in which the action occurs (i.e., the law of the jurisdiction in which the securities were issued, or the jurisdiction of the issuer). Therefore, if an investor has rights against an issuer, conditions such as the creation of the rights, as well as perfection of the assignment or provision as collateral, would have to comply with the law of the jurisdiction of the issuer. In actual practice, however, even though the name of investor A is recorded in the account at custodian C, no entry is made at the next higher level of a custodian or a central securities depository (e.g., DTC, in the United States) within the indirect holding structure (that is, the name of C is recorded in the account of the custodian or central securities depository at the next higher level). Thus in practice it is almost impossible for B to accurately identify the governing law, and to meet the conditions such as the requirements of perfection in accordance with the governing law, for each of its securities.

Accordingly, it is desirable to reform the rules of international private law regarding the rights of an investor (to transfer, provide collateral, etc.) in such cases of indirect holding as this, giving attention in the process to trends in other countries,[22] and while giving full consideration to achieving consistency with the current approach to international private law in Japan. In this case, it is necessary to make clear the nature of the interests held by investors. The simplest solution would be to consider the interests held by investors to be applicable against the assets directly held by a custodian or under the control of a custodian. Then whether the rights are *in rem* or *in personam*, it is thought to be desirable to adopt a rule that the legal relationship(including those related to assignment or provision as collateral) shall be determined in accordance with the laws of the locale of the custodian or similar entity controlling the account wherein the pertinent investor's name appears. It is necessary to give further attention to issues such as how to treat a bona fide purchaser if a certificate has been diverted and placed on the market.

Recommendation 6

While giving consideration to maintaining consistency with the current approach towards international private law in Japan, for the purposes of legislation, it would be desirable for the governing law that determines the effectiveness of an assignment of interests of an investor or provision of these interests as collateral (including the effectiveness of perfecting the same) to

[22] Regarding trends in countries other than Japan, see Potok, "Legal Certainty for Securities Held as Collateral," *International Financial Law Review*, December 1999, at 12. In the United States rules of governing law are set by UCC 8-110 in the United States and in the EU these are set by the Directive on Settlement Finality in Payment and Securities Settlement Systems, 98/26/EC, 19 May 1998, OJ L166/45, Art. 9, 2.

be the law having jurisdiction over the custodian or the central securities depository which holds the account in which the investor's name is recorded, when a Japanese investor holds securities through a foreign custodian or a central securities depository. However, further study is necessary concerning issues such as the nature of the interests held by the investor, and how to treat a bona fide purchaser if a certificate has been diverted.