

Switzerland: new federal legislation on the custody and transfer of securities held by an intermediary

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The concept of securities has considerably evolved during the last few decades, as well as their custody. Swiss law did not follow this evolution. Instead, there was adaptation to changes through an extensive interpretation of contractual, securities and in rem rights rules. The result was legal uncertainty with regards to securities custodianship, transfer and pledge, which has affected the competitiveness of the Swiss financial market. Having overcome the opposition of the Swiss financial industry and following several years of drafting, the Swiss Parliament finally adopted on 3 October 2008, the Federal Act on the Custody and Transfer of Securities Held by an Intermediary or Federal Act on Securities held by an Intermediary (SHIA). This new law will enter into force on 1 January 2010 and will introduce a number of innovations.

The concept of securities in Switzerland and the creation of a new kind of legal property

Securities – defined by Swiss law as any document in which a right is incorporated in such a way that this right cannot be claimed nor transferred to others without the document (Article 965 of the Swiss Code of Obligations) – were created to allow simple and secure ownership and transfer of claims and were useful until the beginning of the 1960s. The transfer of securities and the rights embodied therein was made through the transfer of the document. However, as trade volume increased, the delivery of the document became cumbersome. As mentioned above, legal practice found ways to adapt by immobilising and dematerialising securities, which is not entirely satisfactory.

In Switzerland, most securities (materialised or not) are deposited with intermediaries. They are usually issued and held as follows: the securities are deposited with a custodian ('global deposit'); the custodian

holds a global certificate that comprises a certain number of, or all issued, securities in one single issuer ('global certificate'); or the securities are dematerialised and the corresponding rights are entered in a register ('book-entry' securities). However, requirements in relation to ownership, transfer and granting of a security for each of these forms of securities differ. Indeed, the transfer of securities held in a global deposit or in the form of a global certificate implies a transfer of possession (sometimes by delegation of possession) of the document. The transfer of a dematerialised security, on the other hand, is governed by the rules on the assignment of claims and requires a written contract. The creation of a pledge and the transfer of property rights on securities bring about problems that are difficult to contend with, as current Swiss law was conceived at a time when securities were materialised and physically transferred.

SHIA will introduce a new kind of legal property, the security held by an intermediary or intermediated security (in the language of UNIDROIT), and a single legal regime applicable to all the securities held by an intermediary whatever form of security is chosen by the issuer. The new law defines these securities as fungible claims (such as bonds) or corporate rights (such as shares) against an issuer, which are credited on a securities account and of which the account holder can dispose according to the law. Intermediated securities are constituted as soon as a custodian either receives securities to be held in a global deposit or a global certificate and credits the corresponding rights on a securities account; or enters the book-entry securities in the principal register and the corresponding rights on a securities account. Therefore, though issuers will still be able to choose the kind of securities they want to issue, a single regime will apply to all securities with regards to transfers, pledges and others.

Creating a security on securities held by an intermediary

As mentioned above, problems related to the creation or the transfer of a security over intermediated securities arise from their immobilisation or dematerialisation. For example, the constitution and opposability of a pledge on a book-entry security is problematic as the security is not physically held by the secured creditor.

Under Swiss current law, there are three different methods for creating a security over non intermediated securities:

- the pledge;
- the transfer of legal ownership for security purposes; and
- the irregular pledge, ie, the transfer of legal ownership of fungible securities.

The second and third methods allow the transfer of legal ownership and offer a more valuable guarantee. Indeed, the securities transferred do not fall into the bankrupt estate of the pledgor.

Under SHIA, the constitution of a security will be governed exclusively by SHIA and not by the general rules of the Swiss Civil Code. The new law provides for three different methods of constituting a security over intermediated securities:

- the pledgor transfers the securities to the pledgee's securities account (which is similar to a transfer of property for security purposes);
- by an irrevocable agreement between the pledgor and the custodian for the benefit of the pledgee entitling the pledgee to realise the securities if the conditions for doing so in the security agreement are fulfilled; and
- for a pledge in favour of the custodian of the securities only, by an agreement between the account holder and the custodian. It should be noted that a security can be granted on determined securities, on all the securities held on an account or only on part of them up to a maximum fixed amount, which is a true new type of security under Swiss law. This new type of security, which derogates to the in rem right principle of speciality, seems to offer a new flexibility in the constitution of securities. It also brings its own lot of questions that the new law did not address, as for example some relating to ranks and priorities.

The first method for creating a security over intermediated securities is an act of disposal: the pledgor disposes of the pledged securities by instructing his bank to operate their transfer to the account of the pledgee. This method should be used mainly to

transfer legal ownership for security reasons or to constitute an irregular pledge. Indeed, this way, the secured creditor acquires the exclusive control over the intermediated securities. But SHIA does not provide for any kind of public notice. As a result, the securities can be held on the account of the secured creditor without any indication that they are held for security purposes. Legal commentators have therefore suggested flagging the account to avoid disposal of the securities by the pledgee and acquisition by a *bona fide* purchaser.

The second way to create a security over intermediated securities is an irrevocable agreement between the pledgor and the custodian for the benefit of the pledgee (the 'control agreement'). Interestingly, SHIA does not require that the pledgor be party to the control agreement. He can nevertheless claim rights from this agreement. The intermediated securities are not transferred and remain on the pledgor's account. This second method of creating a security would be most appropriate for pledges. By entering into the control agreement, the custodian irrevocably accepts to execute all instructions given by the pledgee without requesting prior consent of the account holder. However, the new law does not require that the custodian execute only the instructions of the pledgee. As a result, one can identify three different degrees of control in favour of the pledgee: exclusive, shared and potential control. Exclusive control is the best situation for the pledgee as he enjoys complete control over the securities. Where control is shared, the pledgor can keep the right to manage his securities as long as he does not go beyond the limits set out in the security agreement (as distinct from the control agreement).

Lastly, it could be envisaged that the pledgor keeps the control over his securities. Control by the pledgee would thus be very limited and a control agreement under such conditions would be very risky for the pledgee. Indeed, if the pledgor enters into risky investments, for example, the pledgee might lose the substance of his security. Though risky, the possibility of entering into such a limited control agreement has also been envisaged by UNIDROIT. The following risks for the secured creditor should also be mentioned: the execution by the bank of an instruction given by the pledgor; no flagging of the securities to indicate the existence of a security or of a control agreement; and risk that the securities be bought by a *bona*

vide purchaser protected in his acquisition or that a third party acquire legal title of the securities in good faith.

SHIA also provides for a third method for constituting a security in favour of the custodian by an agreement between the account holder and the custodian. This agreement can very well be included in the general conditions of the bank as the new law does not provide for any particular form. As for the other two methods, the law does not provide for any particular form of public notice on the pledged securities. It is worth noting that whatever choice is made regarding the type of security, the principle of priority in time governs the relations among them.

Cross-border issues and conflict of laws

Besides the entry into force of SHIA, the Parliament has introduced new provisions into the Swiss Private International Law Act (PILA): Articles 108a (notion of security held with an intermediary); 108b (jurisdiction of Swiss courts); 108c (applicable law); and 108d (recognition of foreign decisions). These articles were greatly needed as transfer of securities or creation of a security on intermediated securities becomes even more problematic when these operations involve various countries. Furthermore, the majority of securities credited on accounts in Switzerland are foreign securities or are held for foreign account holders.

Under the current Swiss conflict of law rules, the regime applicable to the transfer of each of the different types of securities described above is different. While the transfer of securities held in a global deposit or comprised in a global certificate is governed by the law of the place of custody, the transfer of book-entry securities is governed by the rules applicable to the assignment of claims where the parties can freely choose the governing law. In the first case, the determination of the applicable law could lead to unforeseen results. Indeed, the law of the place where securities are deposited could very well be a law that is distant from the parties. It could also happen that the actual location of the securities is not known to the parties involved in the transaction. Furthermore, the parties have a limited right to choose the applicable law to the transfer and such a choice cannot be asserted against a third party. As regards book-entry securities, the parties have the right to decide on the

law applicable to their transaction, and such choice of law can be asserted against a third party. In cases where the applicable law has not been chosen, the assignment will be governed by the law applicable to the assigned claim.

The current Swiss conflict of law rules are not suitable. In particular, the principle of *lex rei sitae* is not adapted to a system where securities are transferred without having the document physically changing hands. The applicable law may prove difficult to determine when a transaction implies several intermediaries situated in different countries.

The new chapter of PILA will introduce a single regime applicable to all intermediated securities, whether held in a global deposit, in the form of a global certificate, or dematerialised. However, Articles 108a to 108d PILA will apply to international matters related to the holding, transfer and pledge only. Contractual aspects governing the relationship between the pledgor and the pledge will still be governed by the rules applicable to contracts.

The particularity of the new articles is the reference in Articles 108a and 108c PILA to The Hague Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary (the 'Hague Convention'). The Hague Convention, drafted to provide legal certainty and predictability as to the law applicable to securities held by intermediaries, has still not entered into force. As of today, Switzerland is the only country that has ratified the Convention; the United States and Mauritius have only signed it; entry into force will only occur three months after the third instrument of ratification has been received. Until its entry into force, the rules of the Hague Convention will be considered as Swiss substantive law and will be applied to cross-border situations.

Article 108a PILA does not define securities held by an intermediary but refers to the definition contained in the Hague Convention. Securities held by an intermediary are rights of an account holder resulting from the credit of securities to a securities account. The international notion of intermediated securities is an independent notion and the definition made by the Hague Convention is larger than the one adopted under the SHIA. This will allow Swiss authorities to include other concepts of securities that are known to foreign jurisdictions but not to Swiss law.

According to Article 108c PILA, the applicable law is determined by the Hague Convention. It is therefore Articles 4 and 5 of the Convention that will designate the applicable law. The Convention provides for a series of determining factors, the principal one being that the applicable law is determined according to the law applicable to each account agreement, that is to say, in a chain of holdings, the law designated by the Hague Convention is valid only to a particular relation and not to the entire chain of holdings. Therefore, a purchase of securities can be subject to laws of different States at each holding level, each being treated independently. Article 4's main determining factor is the express *electio juris* made by the account holder and its direct intermediary in the account agreement. Such *electio juris* can be made in the general conditions applicable

to the account relationship. However, the choice of the applicable law is limited. Indeed, it is valid only if the intermediary has an office in the state of the chosen law and that such office complies with the conditions provided for in the Hague Convention. Third parties may be affected as the transfer of securities may not be subject to public notice and they may not be aware of the applicable law. Therefore, the Hague Convention has provided for certain measures such as notice in case of change of applicable law or in case of bankruptcy.

In conclusion, one can say that the entry into force of SHIA will bring more legal certainty by applying one single regime to the different types of securities that coexist in Switzerland. However, the new law has already been subject to debate and many issues have not been resolved by the legislation.