

CUSTODY OF
INVESTMENTS:
LAW AND
PRACTICE

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A. Importance of the Nature of the Investor's Interest

- 2.04** Although investors would ordinarily enjoy contractual rights of a personal nature against their custodian for re-delivery of custody assets, it may be their common intention that the investor retains a proprietary, beneficial interest in assets in custody in order to insulate the assets from the insolvency of the custodian. However, the label attached to the investor's entitlement or declared intent of custodian and investor does not of itself determine the legal relationship between investor and custody assets. The relationship must be of such a nature that it produces the results desired according to legal principle.
- 2.05** As a rule, the issuer of securities is concerned only with the legal owner of the securities, to whom all benefits are passed. This raises the question of the treatment of such benefits as between the custodian legally entitled to the benefits and investors. The investor may be a creditor of the custodian or beneficial owner of the securities and their fruits. If the investor is a creditor of the custodian, he is limited to purely personal rights against the custodian. On the other hand, if the investor is beneficially interested in the custody assets, he may be in a position to determine how the fruits of the custody assets are applied.
- 2.06** As already indicated, the typical custodian will be under a personal obligation to return assets transferred into custody to the investor upon the conclusion of the term of custody. The re-delivery obligation may be specific or non-specific and the implications of this for the characterisation of the relationship between custodian and investor will be explored in the next chapter. It has already been asserted that many investors would, in addition, wish to establish a relationship with their custodian that confers on them, the investors, proprietary rights in relation to the custody assets. The principal reason for this relates to the risk to an investor of transferring his assets into the custody of another that turns on the distinction that English law draws between property rights and personal rights.¹ In the event of the custodian's insolvency, those investors able to assert proprietary rights in relation to assets in custody will enjoy priority *vis-à-vis* the custodian's general creditors in the recovery of the assets or their traceable substitutes,² whilst those enjoying personal rights will have to compete with the custodian's general creditors for a dividend. In case of insolvency, it is unlikely that those enjoying personal rights against the insolvent will have their claims fully satisfied.
- 2.07** The nature of the investor's interest is also of importance to potential creditors of the investor who might want to take security over the assets in custody. The cred-

¹ RM Goode, 'Ownership and Obligations in Commercial Transactions' (1987) 103 LQR 433, 434–453.

² *Re Nakashidze (No 2)* [1948] 2 DLR, 522, 529–534 per Urquhart J, Ontario SC; *Re Ord, Wallington, etc.* (1971) 15 CBR (NS) 66, 70 per Poultney, Registrar, Ontario SC.

itor will want to know the precise nature of the asset he is getting as security, as this would in part determine the quality of his security and the ease with which it could be realised.³

In the event of fraudulent or negligent misapplication of custody assets, the characterisation of the relationship of the various parties with the custody assets may be critical in determining who bears any losses, as well as the form of remedy which may be obtained by the aggrieved party. **2.08**

The nature of the investor's rights may also raise regulatory issues as to the capital regime to be demanded of institutions offering custodial services. If the custodian is regarded as the debtor of the investor, as are banks in relation to depositors of funds, there may be a case to be made for significant capital adequacy standards being imposed on custodians in order to increase the likelihood that an investor who has deposited assets in custody will be able to have his claims satisfied. **2.09**

The nature of the interest and the legal characterisation of the relationship between the parties may affect the custodian's duties. Beyond any agreement between custodian and investor, fiduciary and other obligations may be imposed by general law because of the investor's interest in the assets in custody. **2.10**

B. Proprietary Rights

Whilst the term 'proprietary rights' has been employed, no indication of the meaning of the term has so far been given. It is necessary to have an understanding of what is meant by the term in order to be in a position to assess whether the interests enjoyed by an investor in relation to custody assets are proprietary or not. **2.11**

'Property can be defined as that which is capable of being the subject-matter of property rights.'⁴ This definition relates to the use of the word 'property' in the sense of things that can be the subject of ownership. However, it should be recognised that the word may be applied to the state of ownership itself. Concentrating for the moment on the former use of the word, the way in which it is there defined indicates that the concept of property as the subject-matter of ownership is flexible, capable of application to both tangible and intangible assets.⁵ The concept of property as subject-matter is limited only by the type of rights that society is willing to recognise in relation to the particular asset. That willingness may be influenced, but not necessarily determined, by a number of factors, such as the **2.12**

³ R Ryan, 'Taking Security over Investment Portfolios Held in Global Custody' (1990) 10 JIBL 404.

⁴ AP Bell, *Modern Law of Personal Property in England and Ireland* (1989) 3.

⁵ WN Hohfeld, *Fundamental Legal Conceptions As Applied in Judicial Reasoning* (WW Cook (ed), 3rd printing, 1964), 85–91.

prevailing religion or morality of a society, economic considerations, as well as the practical feasibility of the recognition of proprietary rights in relation to the particular type of asset. If this definition is accepted, an examination of the nature of the asset claimed in a custodial arrangement will not be of particular significance in establishing whether the interests enjoyed in relation thereto are proprietary or not.

- 2.13** It is recognised that ownership is the ‘*greatest possible interest in a thing which a mature system of law recognizes*’⁶ and that ownership of any asset is comprised of a number of different interests in relation thereto. Depending on the asset, and general circumstances, ownership may entitle one, *inter alia*, to possess, use, manage, enjoy and alienate the asset.⁷ Further, the incidents of ownership in relation to any asset may be separated between different parties. Yet, even if the typical incidents of ownership are termed proprietary, this does not lead to a clearer understanding of why they are proprietary. Since some personal rights enable one, for example, to manage or use an asset, what makes an interest proprietary as opposed to personal?
- 2.14** Proprietary rights have been described as rights in or over things⁸ or against other persons in relation to a particular thing (*res*),⁹ the implication of the latter view being that rights or interests which arise out of contractual or fiduciary relations between individuals may be considered proprietary.¹⁰ Without entering into the debate as to whether the rights are in, against or simply in relation to a thing, the emphasis of proprietary rights would seem to be that they bind the generality of mankind. In the words of one commentator, a proprietary right is ‘*one of a large class of fundamentally similar yet separate rights, actual and potential, residing in a single person (or single group of persons) but availing respectively against persons constituting a very large and indefinite class of people*’.¹¹
- 2.15** One point needs to be made in relation to the question of rights being good against the generality of mankind. Proprietary rights are perceived as binding the generality of mankind, not necessarily every man. In this sense, they are not absolute rights. They do permit exceptions, and are therefore limited thereby. For instance, it is recognised that existing proprietary rights would be invalid in the face of the new interest of a bona fide purchaser for value without notice, regardless of whether the owner of the prior right knew of or consented to the sale. Thus,

⁶ AM Honoré, ‘Ownership’ in AG Guest (ed), *Oxford Essays in Jurisprudence* (1st Series, 1961) 107, 108.

⁷ For a fuller discussion, see Honoré (n 6 above) 113; and Hohfeld, *Fundamental Legal Conceptions* (n 5 above) 28–29.

⁸ *National Provincial Bank Ltd v Ainsworth* [1965] AC 1175, 1243 per Lord Wilberforce.

⁹ Hohfeld, *Fundamental Legal Conceptions* (n 5 above) 75–76.

¹⁰ *Federal Commissioner of Taxation v United Aircraft Corporation* (1943) 68 CLR 525, 548 per Williams J, HC of Australia.

¹¹ Hohfeld, *Fundamental Legal Conceptions* (n 5 above) 72.

the fact that an interest may be defeated or is invalid against an exceptional class of persons does not necessarily deprive an interest of its proprietary status.¹²

Whilst the general nature of rights is significant in the case of tangible assets such as land, the importance of interests in relation to intangibles is not best explained by the fact of their availing against the whole world. For instance, whilst it may be important that the owner of a plot of land is recognised to have proprietary rights in relation to the land which may preclude others from enjoying the land, where a share entitles an investor to rights against X company, the recognition or not of this right by third parties is largely irrelevant. Entitlement to exercise the rights that make up shares is essentially between issuer and shareholder only. Nevertheless, it is established that the investor's interest in the share is proprietary.¹³ This would suggest that there are other factors that may determine the classification of an interest as proprietary. **2.16**

The nature of proprietary rights has been considered by the House of Lords,¹⁴ where it was declared that as regards the distinction between property rights and personal rights, 'Before a right or an interest can be admitted into the category of property, or of a right affecting property, it must be definable, identifiable by third parties, capable in its nature of assumption by third parties, and have some degree of permanence or stability'.¹⁵ Examination of these criteria provides a further clue as to the constituent elements of proprietary rights. To the extent that a right must be definable, identifiable by third parties and possess some degree of permanence, it is not fundamentally different from any personal right. The real distinction turns on the need for it to be 'capable in its nature of assumption by third parties'; in short, it should be capable of alienation. **2.17**

In view of the foregoing, it is submitted that proprietary rights are rights in relation to determinate or identifiable assets that may be exercised against the generality of mankind and/or are assignable.¹⁶ Depending on the nature of the *res*, it may be sufficient that they are either good against the generality of mankind or assignable. **2.18**

C. Relationship between Investor and Custodian

The typical custodial scenario could bring about a whole range of legal relationships between investor and custodian, including contracting counter-parties, debtor-creditor, agency, bailment, fiduciary and trust. In order for investors to **2.19**

¹² *ibid* 73, 104–106.

¹³ *The Colonial Bank v Frederick Whinney* (1886) 11 AC 426.

¹⁴ *National Provincial Bank Ltd v Ainsworth* [1965] AC 1175.

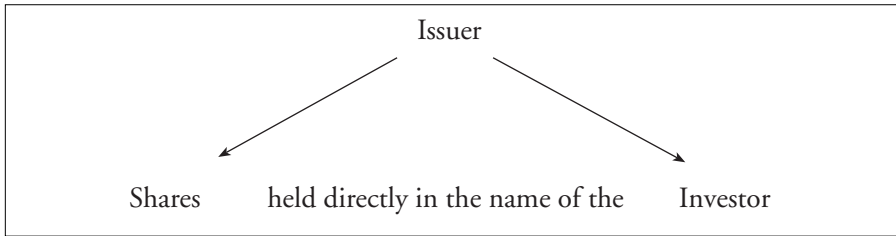
¹⁵ *ibid* 1247–1248, per Lord Wilberforce.

¹⁶ For a similar view, see Bell, *Modern Law of Personal Property* (n 4 above) 12–13.

enjoy beneficial proprietary rights in the assets transferred into custody, the relationship established between investor and custodian will need to amount to a bailment, whereby the investor is not deprived of legal title to the assets bailed, or a trust, whereby the investor enjoys beneficial title to the trust assets. The question is whether the structure of custodial operations permits recognition of these.

(1) *Non-Intermediary Custody*

Figure 2.1: Non-intermediary custody



- 2.20** With non-intermediary custody, the link between the issuer of the relevant securities and the investor is maintained. Investors enjoy continuing legal ownership of the securities represented by the certificate or other token of the securities transferred into custody. Custody here takes the form of depositing with a custodian the share certificate or certificate of negotiable securities indorsed to the investor.
- 2.21** This type of arrangement is of little import for the question of the investor's ownership of the securities. The investor is recognised by the issuer, as well as the custodian,¹⁷ as the owner of the securities. The certificate attesting to the investor's ownership is issued in the investor's name, and the investor remains entitled to, and continues to enjoy the features of ownership of, the securities. The certificate of negotiable securities will have been indorsed in favour of the investor or to his order. In order for the custodian to be able to act in relation to those securities for the investor, the investor may execute a power of attorney in favour of the custodian.

Bailment

- 2.22** With non-intermediary custody, the form of relationship which may be established to enable an investor to preserve proprietary rights is one of bailment. Fundamental to any bailment are various elements. There must be a transfer of possession to the bailee of a tangible thing belonging to someone other than the bailee on condition of the bailee's undertaking to do something with the thing, such as to return it to the bailor or deliver it according to the order of the bailor.¹⁸

¹⁷ A clause to this effect may be included in a custodial agreement.

¹⁸ *The Queen v McDonald* (1885) 15 QBD 323; *Sutcliffe v Chief Constable of West Yorkshire* [1996] RTR 86, 90 per Otton LJ. See also F Pollock and RS Wright, *An Essay on Possession in the Common Law* (1888) 163.

Further, for the receipt of possession to lead to the establishment of bailment, such receipt needs to have been voluntary.¹⁹ As such, bailment is simply the voluntary assumption of possession of a tangible thing,²⁰ it does not arise by the actions or wishes of the bailor but by the actions and intentions of the bailee.

The issue of bailment relates only to the safe-keeping of the token evidencing the investor's interests in relation to the securities. Since the securities represented by the token transferred into custody remain the property of the investor, so do the tokens. Therefore when the tangible tokens are transferred into custody, as typically obtains in non-intermediary custody, this would appear to conform to one of the basic requirements of bailment. Given that the typical custodial agreement will have expressed that the taking of possession by the custodian is voluntary, such possession will have occurred with the requisite intent, ie voluntariness, necessary to conform to the establishment of a bailment. The requisite intent need not be express; all that is required is that the custodian actually takes possession voluntarily. Thus, even in the absence of a custodial agreement expressing in terms the intent of the parties to form a bailment, or even that the custodian takes possession of the assets voluntarily, if the possession was taken voluntarily a bailment could nonetheless arise. **2.23**

Assuming that the establishment of a bailment is accepted, the distinction between the certificate and the underlying security must be underlined. The bailment under discussion is established only with respect to the certificate.²¹ Nevertheless, since the underlying rights continue to belong to the investor, the omission of these rights from the bailment relationship does not adversely affect the investor. **2.24**

(2) Intermediary Custody

The combination of the trends toward dematerialisation and immobilisation of securities, as well as the desire of investors to reap the efficiencies to be gained by the use of custodians, has increasingly led to a break in the link between investors and issuers. Custodians become legally entitled to the custody assets on the undertaking to hold the benefit of such for the investors who transferred the assets into custody. This may arise where registrable securities are registered in the name of the custodian or bearer securities are held by a custodian. Notwithstanding the fact that the benefits to be transmitted may be intangible rights, such as rights to a dividend, etc, it is proper to use the term 'custody' to describe the activity of holding these intangible assets for investors.²² **2.25**

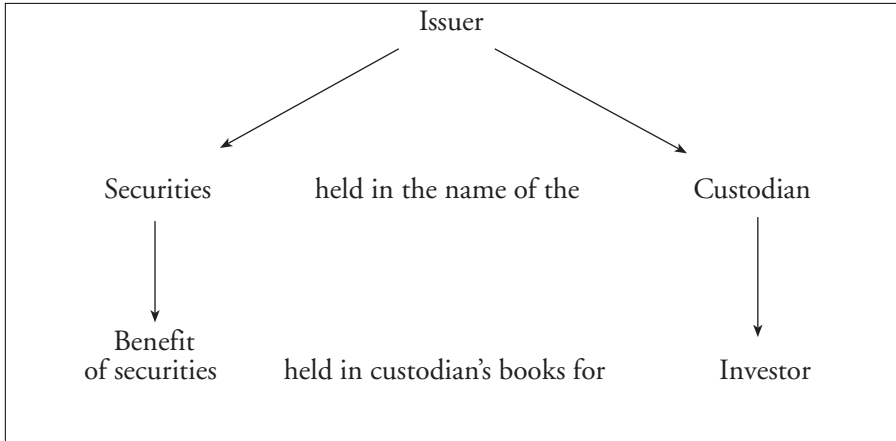
¹⁹ *The Pioneer Container* [1994] 2 AC 324, 339–340.

²⁰ *ibid* 342.

²¹ 'There can be no bailment of the rights of action represented by such documents': NE Palmer, *Bailment* (2nd edn, 1991) 8.

²² Support for this view may be derived from cases where it is stated that there may be custody, as distinguished from acquisition, of information, *North & South Trust Co v Berkely* [1971] 1 All ER

Figure 2.2: Intermediary custody



2.26 Which form of legal relationship would permit a beneficiary of custody assets proprietary rights in relation to the assets where the investor has exchanged full legal entitlement for beneficial entitlement in this way? Putting aside the issue of intent, which in these circumstances should not pose any real difficulties, the question is whether the assets held by the custodian in intermediary custody may form the basis of bailment. The custodian is invested with, and may thus be notionally described as holding: a legal title to securities, a certificate to evidence entitlement to securities, as well as rights against the issuer for the benefits of the securities which he may be obliged to pass on to the investor. Can any of these form the basis for a bailment?

Bailment?

2.27 Title by its very nature is intangible and cannot be possessed in order to form a bailment, nor can the intangible benefits of securities that the custodian may hold for an investor. Although the argument has been made that it may be possible to establish bailment in the absence of physical possession of a thing,²³ and analogies drawn between custody of an intangible and bailment,²⁴ the orthodox view

980, 993 per Donaldson J; and custody of goodwill, *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41, 101 per Mason J, HC of Australia.

²³ *Federal Commissioner of Taxation v United Aircraft Corporation* (1943) 68 CLR 525, 534 per Latham CJ, HC of Australia; *Roufos v Brewster* (1971) 2 SASR 218, 233 in a dissenting judgment per Zelling J, SC of South Australia. See also AW Beaves, 'Global Custody: A Tentative Analysis of Property and Contract' in NE Palmer and E McKendrick (eds), *Interests in Goods* (1993) 267, 274, 276–277.

²⁴ *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41, 101 per Mason J, HC of Australia.

remains that it is necessary for a bailment that there be physical possession of a chattel.²⁵

Even if there is a certificate to evidence legal entitlement to the securities, custodians cannot be constituted bailees of the certificates because in intermediary custody the certificates are legally owned by the custodian. The fact that the custodian may be obliged to hold the benefit of securities legally owned by him for an investor does not detract from the proposition that it is only the custodian that is recognised as legal owner of the securities.²⁶ As such, the certificate would be held by the custodian for himself, *qua* legal owner.²⁷ Such a scenario cannot ordinarily constitute a bailment because the custodian would have to constitute the bailment based on his own things. Although it has been held on one peculiar set of circumstances that a bailor may become (joint-) bailee of his own assets,²⁸ the general proposition is that a bailor cannot become bailee of his own assets.²⁹ **2.28**

The foregoing suggests that the structure of intermediary custody is not compatible with the establishment of a bailment.³⁰ The impediments to bailment in this case are that the things which might conceivably form the basis for bailment either belong at law to the custodian, with the result that he cannot become bailee thereof, or the things are intangible, incapable of possession, and therefore equally incapable of forming the basis for a bailment.³¹ **2.29**

Trust

If the relationship between investor and intermediary custodian is incompatible with bailment, the fact that there is a division between legal title and the entitlement to enjoy the benefit of the securities suggests that it could be a trust.³² **2.30**

²⁵ *Coggs v Bernard* (1703) 2 Ld Raym 909, 912–914 per Holt CJ, 92 ER 107. See also PV Baker and PStJ Langan (eds), *Snell's Equity* (29th edn, 1990) 91; NE Palmer, *Bailment* (2nd edn, 1991) 8, 99.

²⁶ Companies Act 1985, s 360: 'No notice of any trust, express, implied or constructive, shall be entered on the register, or be receivable by the registrar, in the case of companies registered in England and Wales'. In relation to bearer securities, the obligation of the issuer is to the holder or bearer.

²⁷ *MCC Proceeds Inc v Lehman Brothers International (Europe)*, *The Times*, 14 January 1998, per Hobhouse LJ.

²⁸ *Harding v CIR* [1977] 1 NZLR 337, 341–342 per Coates J, SC of NZ.

²⁹ *Dows v Nat Exch Bank of Milwaukee* 91 US 618, 23 L Ed 214, 219 per Strong J (1875). See also Palmer, *Bailment* (n 25 above) 2, 86.

³⁰ See J Benjamin, *The Law of Global Custody* (1996), 37–40.

³¹ This issue is addressed in J Benjamin, *The Law of Global Custody* (1996), ch 5.

³² A custodial relationship where legal title of the investment assets is vested in the custodian, whilst the benefit of the assets is for the investor, would appear to fit most modern definitions of a trust.

See *Underhill and Hayton, Law Relating to Trusts and Trustees* (15th edn, 1995) 1. 'A trust is an equitable obligation, binding a person (who is called a trustee) to deal with property over which he has control (which is called the trust property), for the benefit of persons (who are called the beneficiaries or cestuis que trust), of whom he may himself be one, and any one of whom may enforce the obligation.' This definition, as expressed in earlier editions of the work, was approved in *Re*

Indeed, some form of ownership by the custodian is a condition *sine qua non* for the recognition of a trust in relation to the assets in his custody. The establishment of a trust does not need a precise formulation of words; the necessary intent for the establishment of a trust may be inferred from any words that carry such intent, as well as the context of the relevant parties.³³ It is therefore likely that the typical intermediary custody scenario would suffice to form the basis for a trust. The necessary intent should be evident from the custodial agreement by which the assets were taken into custody or the general words and actions of the parties at the time, assuming that the words and actions led to the conclusion that the transfer of assets into custody was not a gift or loan to the custodian, but that the assets were to be held by the custodian for the benefit of others.

- 2.31** If the concept of intermediary custody seems to accord in general with the establishment of a trust, one question remains outstanding. The trust is a transitive concept and the question arises whether certain operational methods of custodians allow for sufficient identification of the relevant assets to permit the recognition of a trust. Since this question is likely to prove to be the most fundamental obstacle to the recognition of proprietary interests by investors, this question is dealt with separately in Chapter 3 on the identification of custody assets.
- 2.32** If a trust may be recognised in these circumstances, does it achieve the intention of the parties? It would seem so. Although the beneficiary of a trust does not enjoy legal title to trust assets, he enjoys equitable rights directly in relation to the assets. There used to be doubts as to whether the beneficiary of a trust enjoyed proprietary rights directly in relation to trust assets,³⁴ personal rights against the trustee³⁵ or an amalgamation of the two.³⁶ The argument may be made that because the beneficiary is recognised to enjoy more than personal rights against the trustee, the beneficiary must enjoy a direct interest in relation to the asset. Thus, the recog-

Marshall's Will Trusts [1945] Ch 217, 219 per Cohen J and in *Green v Russell* [1959] 2 QB 226, 241 per Romer LJ.

See also *Lewin on Trusts* (16th edn, 1964) 1; *Keeton and Sheridan's The Law of Trusts* (12th edn, 1993) 3; and Recognition of Trusts Act 1987, Schedule, para 2, which incorporates into English law The Hague Convention on the Law Applicable to Trusts and on Their Recognition.

³³ *Re Endacott* [1960] Ch 232, 241 per Lord Evershed MR; *Paul v Constance* [1977] 1 WLR 527, 530, 532 per Scarman LJ.

³⁴ See WG Hart, 'What is a Trust?' (1899) 15 LQR 294, 301; AW Scott, 'The Nature of the Rights of the Cestui Que Trust' (1917) 17 Columbia Law Review 269; Hohfeld, *Fundamental Legal Conceptions* (n 5 above) 96–114; PH Winfield, *The Province of the Law of Tort* (1931) 112; EJ Mockler, in an untitled note (1962) 40 Canadian Bar Review 265, 272; *Snell's Equity* (n 25 above) 23; and DJ Hayton, *Underhill and Hayton, The Law Relating to Trusts and Trustees* (15th edn, 1995) 40.

³⁵ See HF Stone, 'The Nature of the Rights of the Cestui Que Trust' (1917) 17 Columbia Law Review 467; and FW Maitland, *Equity: A Course of Lectures* (AH Chaytor and WJ Whittaker (eds), revised by J Brunyate 1936) 117.

³⁶ See HG Hanbury, 'The Field of Modern Equity' (1929) 45 LQR 196, 199; *Snell's Equity* (n 25 above) 24; and *Parker and Mellows, The Modern Law of Trusts* (6th edn, by AJ Oakley, 1994) 12.

dition of a trust where there is custody by intermediation allows investors to retain a direct proprietary link to the assets in custody.

D. Direct Proprietary Link?

The above suggests that most investors in single-tier custody would enjoy some sort of direct proprietary link with the assets in custody. **2.33**

With non-intermediary custody, the direct link is the same as with any direct securities holding, with the exception that the tangible token is in the custody of a party other than the owner. **2.34**

Where the link is via intermediary custody, the link differs radically from the typical direct ownership of securities. It is unlikely that the issuer would be aware of the investor's interest and, even if it was, the issuer is not likely to recognise the subsidiary interest.³⁷ Enjoyment of the benefits of the right is indirect, via the custodian through whom the investor claims. Instead of rights against the issuer of the underlying securities, the investor will enjoy a number of rights against the custodian in order to ensure that he, the investor, takes the economic benefit of the relevant securities holding. This does not deny the existence of the direct equitable right enjoyed by the investor. However, this direct right is largely only of utility upon the insolvency of the custodian, so that the securities can be claimed by the investors before they are appropriated by the custodian's creditors. These rights would also be of utility in the event of a misapplication of custody assets in circumstances where the custodian could not otherwise make good the loss and the misapplied assets remain identifiable. Other than that, they do not serve him in any meaningful way for the enjoyment of the benefit of the securities. For the enjoyment of the benefit of the securities, the investor will have to claim through his custodian and take from him. **2.35**

Thus, whilst investors in non-intermediary custody retain the same direct ownership rights as any owner of securities would enjoy, an investor with assets in intermediary custody would effectively have exchanged his rights in the relevant securities against the issuer for a new set of rights against the custodian through whom he claims. Beyond the rights against the custodian, however, the investor would also be recognised as enjoying direct equitable rights with respect to the securities so that the securities are not appropriated by the custodian's creditors in the event of his insolvency. **2.36**

³⁷ Companies Act 1985, s 360.