Legal Issues Associated with the Development of Custody Business

—A comprehensive analysis of the current custody business condition and a review of the remaining legal issues for further development —

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Overview

The characteristics of custody business, which used to be called "securities settlement and custody agency," and whose main focus was only the safekeeping of securities, have greatly changed in recent years. One of the reasons for that change was the deregulation of the Japanese public pension systems in 1995, which allowed investment of public pensions using investment advisory companies. Since then, during the transition from "self investment management" to "outsourced investment management," a movement in which fund managers whose investment management results are always sought after use easy-to-use fund administrators, in other words, global custodians, has been generally accepted. In the world of custody business, what value-added services can be offered has become an important criterion when selecting a custodian. And some of such value-added services include those that are beyond the "custody" concept, such as securities lending, cash management of surplus funds, and exercise of voting rights in order to satisfy the needs of fund managers. Furthermore, since investments by foreign investors in corporate securities and bonds in Japan have been increasing, mega banks, trust banks, and foreign banks in Japan have gradually been placing more weight on custody business. However, on the other hand, legal issues not having been well discussed in the past, such as bankruptcy remoteness and segregated accounts, balance between the duty not to delegate and the authorization legal theory, and issues associated with governing laws due to increases in international trade, etc., have come to the surface, as the aforementioned changes have been taking place. It is our intention to point out in this paper the limits of the fundamental legal principle of custody business which have been explained based on the concepts of deposit, delegate authorization, and agency as well as the possibility that utilization of trust legal theory may be effective for further development of Japanese custody business, while analyzing not only the said transition of the custody business but also discussing issues arising as a result of our analyses.

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Introduction

In recent securities transactions there has been an increasing shift from the custody of securities by investors themselves to by third parties, when investors manage their stocks and bonds. In domestic stock trading, the number of investors who deposit their stocks with securities depositary organizations and use them for custody has already been increasing. Also, as for government bonds, the Japanese Government Bond Book-Entry System, by which Bank of Japan holds custody of government bonds, is widely used. Furthermore, in cases where securities are managed overseas, overseas financial institutions (global custodians) are commonly used for securities custody. On the other hand, in cases of investment in Japanese securities by foreign investors, Japanese financial institutions act as their agents, performing custody business by providing a wide range of services, such as custody of securities, delivery settlement, preservation of rights, exercise of voting rights, etc.

While various examinations and analyses on the legal positioning of these global custodians have been attempted in the field of trust law[1], in Japan the authorization legal theory has in practice been applied to custodians, who are asset administrators, as standing proxies[2].

As regards these custody management systems for securities, etc., the legal aspects concerning custody services for foreign investors is being examined in this paper. As for custody services, financial institutions provide standing proxy and custody services, ranging from simple custody of securities, etc. to margin account management, and to preservation of assets. Furthermore, they act as liquidity vehicles as well as trusts' back offices; thus, providing a wide range of services, with sophisticated service contents. However, there have been only several publications related to various legal issues concerning the custody business, which have tried to clarify some trust law related issues, reflecting recent business practices; however, not many of them seem to have touched on the aforementioned issue. The purpose of this paper is to point out unclear legal areas and to examine the direction of the fundamental legal principles for conducting custody services in Japan, using the comparative-law method, while looking at the custody service conditions which have been changed and developed greatly due to increases in investment in Japanese stocks and bonds issued by corporations, etc. by foreign investors, and progress in computerized trading of securities and corporate bonds.

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[1] Examples are seen in the following publications: on pages 251 and beyond of Issue No. 2 of Vol. 21 of *Financial Research*: "Trusts Using Custodian Trustees and Legal Issues Associated with Them" written in 2002 by Hiroto Dogakiuchi, Financial Research Center, Bank of Japan; pages on 52 and beyond of Issue No. 753 of *NBL:* "Custodian trustees' Duty Not to Delegate and Use of Third Parties (Second Half of the Edition)" written in 2003 by Yujiro Kishimoto; on pages 15 and beyond of issue No. 203 of "Lectures on Modern Trust Law (4)" written in 2000 by Yoshihisa Nomi; on pages 75 and beyond of Issue No. 1164 of *Jurist:* "Various Trust-Law-Related Issues Associated with Securities Management" written in 1999 by Osamu Fukui; and on pages 185 and beyond of *Annual Research Report (Year 1999):* "Duties and Responsibilities of Custodian Trustees of Trusts and Their Execution Assistants – Focusing on Relationships That Use Custodians" written by Yasushi Miyano, University of Tokyo Graduate Schools for Law and Politics. Practical examples are found on pages 19 and beyond of Issue No. 1 of Vol. 10 of *Financial Research:* "About Global Custody" written in 1991 by Takashi Nanjo, Institute for Monetary and Economic Studies, Bank of Japan

[2] On pages 14 and beyond of Issue No. 1338 of *Commercial Law*: "Custody Business Provided by Japanese Banks and Securities Lending Business" written in 1993 by Akihiro Wani; on pages 232 and beyond of Vol. 2 of *Corporate Jurisprudence:* "Practical Handling of Forgotten Stocks – Standing Proxy System and Securities Custody and Settlement System" written in 1993 by Akihisa Shibuya, compiled by The Japanese Society of Corporate Jurisprudence.

Furthermore, while maintaining the aforementioned purpose, we will categorize trust business and analyze the recent transition of and trends in the custody services in the first half of the paper up through the end of Chapter 2, so as to have a bird's-eye view of the current custody business condition. After that, in Chapter 3, we will examine what mechanisms or systems support overseas custody business, specifically looking at US, UK, and German cases. In Chapter 4, we will discuss the existing issues, while taking into consideration the analyses and opinions contained up through Chapter 3, point out newly arising legal problems and so forth due to the recent revision of the trust law, etc., and state our personal views on how custody business should be interpreted legally as well as its future direction.

We have received much cooperation from many business people working at trust banks, city banks, and foreign-capital financial institutions while we were writing this paper. We would like to express our sincere appreciation for these people. There may be, however, some contents or expressions that are inappropriate due to our insufficient awareness or understanding, although we have received such cooperation from them. Needless to say all the responsibility of this writing lies with the authors. Also, the opinion portions of this paper are not those of the organizations to which Sugiura or Shibuya belong, but they are their own individual opinions.

1. What Is Custody Business?

1-1. Legal Definition of Custody Business and Its Range

As mentioned above, custody business[3] means the business of standing proxies who provide a wide range of services, such as custody of securities, delivery settlement, preservation of rights, exercise of voting rights, etc., on behalf of investors; in other words, on behalf of investors who invest in securities. (There are two types of proxy business: one is limited proxy with a limited level of proxy authorization for only specified matters and the other is standing proxy with an overall proxy authorization.)

Although investors can assign a custodian for depositing securities separately from a standing proxy, in almost all the cases, the same entity performs the duties of both the custody and the standing proxy; generally speaking, the term custodian includes all of them. Custodians are in a position in which they have to manage and safekeep the securities of their client investors, receive dividends and collect principals and interests, and consider exercising the rights for securities holders, such as exercising the rights to share warrant and corporate bonds with share warrant, and exercising the voting rights at general shareholders' meetings, etc. Obviously, this standing proxy system is not obligatory; however, in practice, proxies are necessary due to issues associated with the cost of transporting stock shares and insurance. Furthermore, proxies are necessary for dealing with cumbersome procedures and applications related to title changes and dividend payment methods (especially when the investors reside overseas). In particular, in cases when submissions of applications and reports related to withholding taxes, etc. based on foreign exchange law and tax treaties are needed, proxies who are well versed in such processes are necessary.) For these reasons, they are needed[4].

[3] In this paper certain phrases are used with the following definitions for clarification: Custody = standing proxy system; Custodian = standing proxy/custody organization, a term used in practice. Standing proxy (contract or system) is a legally used term. Sometimes the Japanese phrase *jonin-dairinin* is used for the translation of standing proxy. Overseas systems are simply called herein "custody."

[4] Also, in cases of foreign shareholders of Japanese corporations, since it is desirable for them to receive various notices and exercise their shareholders' rights through their standing proxies, many Japanese corporations stipulate

What is the range of authority and services that custodians deal with? The following is a general categorization of the range of currently practiced authorizations and services:

(1) Acquisition, disposition, and transfer of securities per instructions and fund settlements associated with such transactions.
(2) Management of the deposited funds, title change of securities, and management of the said securities.
(3) Collection of the principals and interests associated with securities in custody, receiving of dividends, and handling notifications related to such interests and dividends (re: tax treaties, etc.).
(4) Exercise of rights related to share warrants and corporate bonds with share warrants, etc.
(5) Exercise of voting rights on behalf of (foreign) shareholders per instruction.
(6) Receiving various types of other notices and sending holding securities reports.

From the conventional legal point of view, custody business in Japan has been viewed such that it has characteristics of both consignment contract (Article 634 of the Civil Law) and deposit contract (Article 657 of the Civil Law); therefore, custodians are bound to the duty of care of a good manager. Also, custody business is widely provided by banks in Japan, reasoning that banks are permitted to provide services for the custody of securities, precious metals, and other types of items as auxiliary business by Section 2, Article 10 of the Banking Act[5]. As for academic theories, specifically regarding the legal characteristics of custodians, the following analyses have been done in relation to trustees' duty not to delegate that is stipulated in Article 26 of the Trust Law.

(1) Shinomiya Theory (Commonly Accepted View)

The fiduciary relation of a trust requires the trustees themselves to handle the administration of trust affairs. Section 1, Article 26 of the trust law stipulates that "the trustees can have administration of trust affairs handled by others (a third party) due to unavoidable circumstances or in case there is a specific stipulation in the trust deed." In this case, the third party that handles administration of trust affairs on behalf of the trustees is regarded as a "delegate" and the delegate is defined as a person who handles and executes the administration of trust affairs based on his "own views and opinions." In regard to delegate-authorization deeds, the trustees are said to be responsible only for the assignment and supervision of the delegates. On the other hand, in addition to such delegates, the trustees are permitted to use "execution assistants" (such as lawyers, patent attorneys, bankers, engineers, brokers, etc.) as a way to handle administration of trust affairs on their own responsibility. Execution assistants do not hold independent views and opinions, unlike delegates. The trustees have to take full responsibility for all the deeds of the execution assistants, whether willful or negligent; however, the trustors and beneficiaries cannot directly question the execution assistants about their responsibilities[6].

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in their articles of incorporation and/or company stock handling regulations that shareholders residing abroad provide temporary addresses in Japan for the purpose of receiving various notices or that they set up and report their proxies in Japan to the companies whose shares they hold. "The Asset Management Specialty Banks—All about Their Business Practices," compiled by Japan Trustee Services Bank, Ltd., published by Kinzai in 2003, page 227.)

[5] The aforementioned book by Japan Trustee Services Bank, Ltd., page 228.

[6] "Trust Law (new edition)]"by Yuhikaku Publishing Co., Ltd. (1989), written by Kazuo Shinomiya, pages 236 – 240.

(2) Nomi Theory

The aforementioned conventional view, which calls for responsibility for the default of duty by the obligor based on the "negligence of the execution assistants" theory for "use on their own responsibility" and the risk-allocation problem that occurs to trust assets, such as a bankruptcy by a person who manages the trust assets, cannot sufficiently be handled by the conventionally accepted theory[7]. In order to clarify the argument the problem of whether or not the use of other people is permitted should be separated from that associated with the responsibility of the trustees in cases where other people are used. In other words, there are two cases: (I) When it is outside the range of duty not to delegate (this means that other people, such as assistants, can be freely used) and (II) When it is within the range of the duty not to delegate. In the case of (II) above, there are three types of exceptions of duty not to delegate: (1) When others are used under the responsibility of the trustees, (2) When such use is permitted in the trust deed, and (3) When circumstances beyond one's control arise. (I) above is when the trustees cannot perform their administration of the trust affairs unless they use services by others, such as delivery or transportation vendors, and issues associated with the responsibility of the trustees in such a case should be handled based on "the duty of care of a good manager". (II) (1) above is in the case of an employee of a corporate trustee. In this case, the trustee is responsible for the negligence made by the execution assistant or negligence associated with the appointment and/or supervision. (II) (2) above refers to the very case in which securities are to be in the custody of a custodian and as in the case of (3) above, the responsibility of the trustees is limited only to that associated with appointment and supervision according to Section 2, Article 26 of the trust law. However, (2) above is determined according to a special agreement in the trust deed. Specifically, Professor Nomi performs detailed analyses of the responsibility types associated with appointment of custodians by the trustees[8]. First of all, the method of management and custody of trust funds is the nucleus and essential part of the trust, which is within the range of the trustees' duty not to delegate. Secondly, the trustees decide the appointment of custodians based on the trust deed; however, the default rule for the trustees' responsibility is limited to the appointment and supervision in accordance with Section 2, Article 26 of the Trust Law. The third is when trustees use a global custodian. As long as the trustees monitor information, including the risks of the use of sub-custodians via the global custodian, they are not to be held responsible in their relation to the beneficiaries.

(3) Fukui Theory

On the other hand, according to an opinion which has been gaining dominance recently, the position of a custodian should not be regarded only as a "delegate" but should be separately argued from the range of the duty not to delegate of the trustees, in order to reflect the actual securities custody practices and realities overseas[9].

When analyzing the legal characteristics of custodians, basically, custodians satisfy the requirements for "delegates" of the commonly accepted theory and have the discretion to act and hold independent opinions; however, "independent opinions" is a vague definition and it has a "delegate element" from a practical point of view. Also, regarding the responsibility for the

[7] Yoshihisa Nomi, "Modern Trust Law" by Yuhikaku Publishing Co. Ltd. (2004), page 109

[8] Aforementioned book by Nomi, pages 111-118.

[9] Compiled by Dogakiuchi, Kimura, and Takizawa, "Trust Business and Civil Law Jurisprudence" published by Yuhikaku Publishing Co. Ltd., (2003), *Shintaku ni okeru kasutodhian* [Custodians in Trusts] by Osamu Fukui, pages 211-215

trustors and beneficiaries (Section 3, Article 26 of the Trust Law), if losses are caused to trust assets due to negligence by custodians, practically and generally speaking, overseas custodians cannot be held legally responsible, depending on the contents of the trust contracts. Fukui theory conducts legal analyses of custodians from the following three viewpoints: The first viewpoint is, when analyzing custodians from a point of view of realities, they are used as a means to perform administrative duties of trust affairs. As long as there is no recognition of or obligation to overseas custodians, they should not be held legally responsible, according to Japanese trust law. As regards custody services, the trustees are not assumed to perform custodial services as their primary business interests; therefore, they are outside the range of duty not to delegate. Thus, the trustees should only be mindful about default of the duty of care of a good manager as it relates to the assignment of custodians and supervisory responsibility. The second is, from the viewpoint that the custody of trust assets is the essential trust element, how can we position the custody of trust assets as overseas custody of securities? As overseas wire transfers are made up of a chain of contracts of commission among banks, it is pointed out that securities management consists of a chain of custodian accounts in a hierarchical structure. Also, even if the real-rights structure is not necessarily accomplished throughout, the rights which the trustees directly hold are those to global custodians; therefore, it is not necessary to remove them from the range of the trust, which practically hold securities (even including cases like account management). The third viewpoint is about a move toward relaxation of duty not to delegate. In the modern world where division of work has become so prevalent, there has been a movement that delegation of the administration of the trust affairs to a professional third party is regarded as more rational. As we have seen in the UK and US legal systems, it is obvious that the direction of duty not to delegate will be moving toward a relaxation[10].

(4) Summary

The Nomi and Fukui theories mentioned above can each be considered to be a stepping stone in the legal analyses of custody services, reflecting actual business practices and realities, in light of the conventionally accepted view.

However, there is a big difference between the Nomi and Fukui theories: that is, whether to position custodians inside or outside the range of duty not to delegate. Nomi theory assumes that the management and custody of trust assets are the central and essential parts of the trust; thus, the custodian's responsibility should be regarded as a part of the fiduciary responsibility under the trust legal principle. Fukui theory assumes, however, that custody services are not the primary businesses of the trustees but seem to be positioned as a responsibility under the custody contract, which is outside the framework of the trust legal principle. The attached information provided hereinafter is a graphic representation that explains each theory and the relationships among contractual parties.

1-2. Types of Custody Services

Custody services provided by banks can be further categorized into the following four types, in light of the aforementioned legal concepts.

[10] Makoto Arai, "Trust Law (Second Edition)," Yuhikaku Publishing Co., Ltd., (2005), page 149. Professor Arai said, "The new idea of the duty to be delegated can be evaluated as such in that it starts from the value of "the best interest of the beneficiaries." By analogy this viewpoint can be extended to the standard code of conduct by custodians.

(1) Deposit Type

Deposit means a contract in kind that becomes effective when one party receives something in consideration of providing custody to another party (Article 657, Civil Law). When an owner of securities simply transfers the possession of the securities he owns without transferring his ownership to another person, it is regarded as deposit, but not trust. The difference between deposit and trust is determined by the expression of the depositor's intention, upon transferring his securities to another person, for his own benefit or for that of a third party. That is to say, if the expression of his intention is transfer of the ownership of securities to another party, who will hold them in his custody in accordance with a specific purpose, it is considered to be a trust deed.

(2) Delegate-Authorization Type

On the other hand, in the case of delegate authorization, one party delegates the other party his authority to take legal action. Upon the acceptance of the delegated authority by the other party the delegate authorization becomes effective (Article 653 of the Civil Law). The delegate is required to deliver money, other things, and the fruits of these to the authorizer while conducting delegated administrative work (Section 1, Article 646 of the said law). The rights the delegate has obtained in his own name for the sake of the authorizer will have to be transferred to the authorizer (Section 2, Article 646 of the said law). Also, the delegate who is authorized to handle commercial transactions can take action that has not been delegated to him insofar as it is within the range of the essence of the delegate authorization (Article 505 of the Commercial Law).

(3) Agency, Brokerage (Wholesale) Type

Custody business also has some similarity to the concept of agency or brokerage. For example, in case of agency, the contents of communications an agency expresses for the sake of the Self within its authority has direct effect on the Self (Section 1, Article 99 of the Civil Law). Even in custody business this concept can apply and be used for explanation, when the agency is given instructions in entirety from the authorizer. The things held in custody are generally securities, which can be explained with the concept of brokerage. Regarding the types of delegation of securities transaction according to Item 3, Section 8, Article 2 of the Securities and Exchange Law, they are intermediary, brokerage, and agency. Of these, the fact that so-called "paper brokerage" is allowed for banks, according to Section 2, Article 65 of the said law, should be noted. The idea of brokerage under the Securities and Exchange Law means selling and buying of securities using one's own name for the calculation of the other, which is equivalent to wholesale under Article 551 of the Commercial Law. In this case, legally speaking, the self is the subject of the rights and obligations; however, the economic effect belongs to the other. When the broker sells and buys for a third party, he himself acquires the rights and obligations for the other party (Section 1, Article 552 of the Commercial Law). Also, since the regulations related to "wholesale operations" and those related to authorized delegates and agencies (Section 2, Article 552 of the said law) are to be applied for the relationship between the brokers and authorizers, the rights the brokers have acquired have to be transferred to the authorizers.

(4) Trust Type

Furthermore, at present there is another view on providing custody services as a part of trust business, which can be provided only by trust banks or licensed banks under the mixed

bank regulations. Needless to say, trust under the existing Trust Law is said to be an authorized deed that allows transfer or other types of execution of one's property rights (act of disposition), which enables a third party to manage or dispose of the assets for a certain purpose (Article 1 of the Trust Law). Establishing trust as a legal act is called trust creation and the deed of the trust-establishing party is called a trust deed. (Also, since trusts encompass deed/actions similar to those of authorized delegates, it is said that in the Trust Law there are quite a few provisions that are the same as or similar to provisions or modified provisions on delegation of the Civil Law[11]; for instance, Article 20 of the Trust Law (or Article 644 of the Civil Law) regarding the duty of care of a good manager, Article 26 (or Article 104 and 105 of the said law) regarding the delegation of the administration of trust affairs, Article 35 (or Article 648 of the said law) regarding trust fees, Article 36 (or Article 650 of the said law) regarding the claim right to indemnification, etc.

A brief summary of the characteristics of trust contract are herein examined. The deed of disposition between the trustors and the trustees is a nude and unilateral contract, while onerous and bilateral elements relate to the delegated portion of the trust mentioned above. Whether it is nude or onerous makes a difference in legal binding force. As regards onerous contracts, since the legal binding force lacks the quality of contract in kind and consensual contracts are permitted, in cases of operating trusts, trust contracts are formed with legal binding based on the agreement between the trustors and the trustees, and this legal binding comes into force upon disposition of property rights and so forth; for example, the duties of management and restitution. (It has been interpreted that the legal binding of operating-trust contracts are stronger since they require written documents.[12])

As regards these trusts, the one which has stronger relevance to custody is the comprehensive trust (Item 9, Section 1, Article 3 of the regulations for mixed banking), which is the type of trust which allows two or more of different types of assets to be placed in one trust deed (= one trust agreement). This type allows not only multiple types of assets to be placed in trust, but also the following situation: only monetary delivery is made at the beginning, but later on securities will be transferred to a trust. In such a case, a trust can be established by concluding a comprehensive trust into which monetary delivery is made, and the trust comes into force for the money delivered. Later on when the securities are transferred to the trust, the transferred securities portion of the trust comes into force.

2. Systematic Characteristics of Modern Custody

In 1 above, an overview, organization of the definitions of various legal theories, and classification of services associated with the custody business were discussed. The biggest argument in the field of custody business (especially from the legal point of view) is what kind of responsibilities should those financial institutions (business entities), which act as custodians, have[13]?

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[11] Page 92 of the aforementioned publication by Shinomiya.

[12] Page 451 of the aforementioned publication by Japan Trustee Services Bank, Ltd.

[13] Joann Benjamin & Madeleine Yates, *The Law of Global Custody – Legal Risk Management in Securities Investment and Collateral*, Sec. Ed., Butterworths (2002), P. 1, Unfortunately, no systematic Japanese textbook about standing proxy system exists in Japan, since this is a special system and has gotten very little recognition. *The Law of Global Custody* describes in detail the most recent system, real business practices, and the manifold legal issues in England. Other than the aforementioned book, the following book is also available: A. O. Austen-Peters, *Custody of Investment – Law and Practice*, Oxford (2000). We also used this book for quotation when necessary.

There are two points concerning the essence of custody: one is management and the other responsibility. That is, management is described as the structure of possession of the assets in custody (who holds the custody in what form) and it is categorized to two types: direct possession and indirect possession. As regards the responsibility matter, whether it should be interpreted as the responsibility of the delegate within the scope of authorization legal theory or whether it should be interpreted as the responsibility of the trustee within the scope of trust law. When a party gets custody of someone else's assets and when the form of possession of the property in custody is either authorized delegation or deposit, they should be held in custody under the ownership title of the self. However, in the case of a trust, the ownership is transferred to the trustees. Thus, two elements, management and responsibility, act as a foothold when examining various views of custody. Recent custody business has been changing greatly from the conventional, simple, and management-type custody business. Therefore, we would first like to clarify hereinafter the position of custody as a system and examine and deliberate on the realities of current custody business and changes in order to clarify future legal issues and arguments.

2-1. Hierachicalization of the Parties Involved

Generally speaking, the role of custodians as institutional investors is played by financial institutions. In the world of internationally distributed investment, European and US major financial institutions provide global custodian services[14]. Some financial institutions specialize in this business, whereas many others have international networks with sub-custodial bases or partners in each country (Vertical Relationship: Types of Hierarchical Structure of Possession). On the other hand, the important part of custody business is the financial institutions that act as custodians: some are trust banks (called custodian trustees) and others are commercial banks, investment banks, and Japanese city banks, in which case without trust business license from the legal point of view (called custodian banks) as part of their auxiliary services. For the sake of convenience, the former is called trust custody and the latter authorized custody. In the case of trust custody, the trustees are in two categories: custodian trustees and management trustees. In the case of authorized custody, custodians are composed of mixed parties of agency, delegate authorization, and deposit contracts (Horizontal Relationships: Types of Responsibilities of the Custodians Involved). We have to note here that no custodians are to be found among institutional investors (precisely speaking, they perform their daily investment work without much awareness of this matter) and the same applies to the custodian side.

The ownership of the deposit account associated with the titles of the securities in custody and fund management is generally expressed with a nominee name[15]. Because of this nominee system, the original investors or legal owners cannot be inferred from the custodian side. That means the standard code of action should be in accordance with the instructions from the overseas institutional investors and their tie-up financial institutions, the other party of the direct

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Especially, *The Law of Global Custody* describes in detail the most recent system, real business practices, and manifold legal issues in England.

[14] From the legal standpoint, these services are provided by banks, trust banks, and securities companies as auxiliary businesses (Item 10, Section 2, Article 10 of the Bank Act, Trust Law (Mixed Banking Services), Items 1 & 7, Article 5 of the industry law, Article 43 of the Securities and Exchange Law "Approval of Dual Business," No. 1879 from 1967.

[15] "Nominee name" is also called "street name," and sometimes "nominee number" is given. This nominee system, a name-lending system, has been in use for a long time in the securities custodial business in the US. (Please refer to 3. (3) of this paper for "Nominee Names and the Rights of the Indirect Owners in England" as well.)

contracts (custodial contracts). Furthermore, custodians generally deposit the securities in custody to a securities clearing organization (CSD: Central Securities Depository) for settlement (book entry)[16]. At this level, titles of the original investors and owners are hierarchically ranked in the form of indirect ownership, in a dual sense. Therefore, it is our understanding that the custodial responsibilities of the custodians have to be discussed in the context of the hierarchicalized ownership relationships.

2-2. Separation of Management Institutions from Custodial Institutions

When financial institutions, as legal entities, manage their clients' assets, it is customary that the management of the assets is separated from the custodial operation, each of which is assigned to a specialized division or to other companies (master trustees, etc.)[17]. In regard to the division between the management and custodial institutions, it is advisable to consider issues associated with which institutions will be involved and the background of the division. In this case, custodian trustees (trustees of maintenance-and-management-type trusts) are not necessarily limited to trust banks (trustees under the trust law and the industry law). The reason is from the point of view of the custodian banks, it can be said that there is no functional difference in the positioning of trust custody and delegate custody, in the case of becoming a custodian trustee. There is a movement toward reviewing the legal positioning of custodian trustees[18].

Also, in modern investment management, the following four aspects are known to be present as the characteristics of institutional investors[19]:

The first is that the scale of the funds they handle is big. The second is for that reason distributed investment becomes possible and they manage their funds in ways for maximizing the profits of the total holding assets (portfolios). The third is they have a plentiful information and analytical capability as investment experts and therefore are capable of exploiting sophisticated investment methods. The fourth is they are responsible for the management of others' funds; in other words, they hold responsibilities to their clients. As regards the responsibilities of the fund management trustees to their institutional investor clients with pension funds, their goal is to maximize the profits of the holding portfolio, and it becomes the standard code of action for these entrusted fund managers . That means the role of institutional investors as management institutions is to

[16] They are JASDEC in Japan, DTC in the US, CREST in UK, SICOVAM in France, and EUROCLEAR for international securities settlement. For overall securities cleaning systems, please refer to "All about Securities Clearing Systems" authored by Masashi Nakajima and Junichi Shukuwa, published by Toyo Keizai Inc. (2002).

[17] As regards division of management and custodial institutions of trust assets by custodian trustees, please refer to page 218 of the aforementioned book by Mr. Shinomiya as well as pages 251 and beyond of the aforementioned book by Mr. Dogakiuchi. Also, it is said that one-dimensional securities custody by master trustees can expect cost savings as a way of the rationalization of business administration for financial institutions. As a result, Japan Trustee Services Bank, Ltd. was founded in 2000, having financial institutions as central figures. This was not only due to the expectation of effective cost savings, but also high expectation by the trustors of the development of expertise and specialization of management institutions as well as the advent of all-encompassing one-dimensional management. (Please refer to "Report on Asset Management of the Pension Funds in the Era of Management Deregulation" (Nov. 1998) by Asset Management Study Group of the Pension Fund Association, and other publications)

[18] The legal positioning of custodian trustees has been under review. Please refer to pages 6 and beyond of the "Interim Report Concerning Trust Business" (July 28, 2003) prepared by No. 2 Financial Study Group, Council on Financial Services.

[19] Mari Miki: "Transaction Costs and Transaction Systems by US Institutional Investors," *Research on Securities Economy*, No. 37 (2002), P 38.

maximize the effectiveness of the portfolios; therefore, to increase the investment profits (and to decrease transaction costs) becomes the fiduciary duty of loyalty. It is said that the following are the existing types of transaction costs: (1) Commissions that the clients have to pay, (2) Opportunity costs in cases where execution of immediate transactions were not available (request for higher execution rates), and (3) Costs necessary for securing the maintenance of anonymity and liquidity in the market, and so forth[20]. Institutional investors demand heavily the maximization of the profits of their portfolio assets in custody; thus a lowered transaction cost due to the division between the management and custody will lead to a total cost reduction. That is to say, the division between investment management and custody management reflects an intricate relationship with the duty of loyalty of the trustees (in other words, the duty to maximize the effectiveness of the portfolios) in the complicated securities settlement system. From the point of view of the "delegated custody" performed by custodial administrators, this has the same effectiveness as in the case of the "trust custody".

Also, the consolidation of European and global settlement organizations is an inevitable move toward globalization, which will enable further centralization and reduction of administrative costs and settlement risks[21]. Custodians with trustees' obligations will be required to exert themselves to go along with this movement.

2-3. From Custodial Institutions to Providers of Information Services

Furthermore, the advancement of information and telecommunications technologies and the advancement and sophistication of modern portfolio theory in recent years have had the following impacts in the financial and asset management world[22].

The first is institutional investors do not necessarily have to have a large volume of equipment and human resources. The second is, due to the promotion of paperless business practice in the securities industry and the downsizing of international fund settlement systems, the merits of using conventional custody-focused services have decreased, while the efficiency in transaction cost reduction and seamless delivery of settlement instructions and securities information has been enhanced. Furthermore, the third is that diversification of the investment management method of the institutional investors and expansion of the assets they manage make fund managers compete in asset investment management as trustees. As a result, objective evaluation benchmarks of their investment performances have become more complicated than ever before.

These changes also have had the following impact on the custody business:
First of all, due to pressure for the reduction of transaction costs including custody fees, etc., the conventional business model that focuses on custodial services started losing its competitive power. Many European and US custody banks are influenced by the expansion of scales and fee reduction in the process of restructuring. On the other hand, at the same time, custody of securities has been shifted to central securities depository organizations owing to the paperless movement and some institutional investors have begun to provide in-house custody services. There is, however, a reverse movement as well, due to a movement toward functional

[20] Please refer to pages 43 and beyond of the aforementioned publication by Miki.
[21] Masahiro Yoshikawa: "Consolidation of the European Securities Settlement Market," *Research on Securities Economy*, No. 42, P 155 and beyond
[22] For example, please refer to publications, such as pages 10 and beyond of *The Law of Global Custody—Legal Risk Management in Securities Investment and Collateral*—"Sec. Ed. Butterworths (2002), by Joanna Benjamin & Madeleine Yates.

sophistication and independence of reporting and notification. Outsourcing of the middle-back offices of institutional investors to custodians has become the mainstream in the recent European and US situations in order for them to concentrate on fund management.

In order for the pension fund trustees to measure and evaluate the performances of the pension funds, an accurate and speedy reporting function for the assets entrusted to them is necessary. Comparison by fund leads to decisions necessary for more important investment principles. The most important value-added service for the custody function is to provide timely information about the assets in custody as well as settlement transaction statuses. On the other hand, it is possible for custodians to independently act as a trustee-monitoring function and send evaluation reports of the trustees to the necessary parties involved. Because of advanced information and telecommunications technologies, there may be a possibility that non-financial organizations will become such service providers.

2-4. Summary

In summary, it is time for us to discuss the scope of modern custody services in the direction toward enhanced value-added services, where the scope of custody business is not only "safekeeping" but also giving wider functions to custodians. In particular, as regards custody for institutional investors, efficient functioning, maintenance, and management of custody is necessary in order to maximize the effectiveness of the asset portfolios (managed investment profits). For example, the following services are required of custodians as part of value-added services: (1) Securities lending services by acquiring lending fees for lending unemployed portfolios of institutional investors in the stock and bond loan markets in order to increase the investment profits, (2) Cash management services by automatically investing the surplus funds waiting for settlement in overnight loans, (3) Proxy services for providing information regarding exercise of voting rights of the shareholders, as part of corporate governance support, and (4) Contractual settlement services to avoid failure (lack of funds or lack of face amounts) on settlement dates.

As mentioned above, custody business seems to have been expanding from simply providing custody of securities to finding new directions in utilization, by offering not only conservation, maintenance, and management of assets but also providing advancement and functional expansion of private autonomy.

Similar changes and trends are also seen in the US and England where custody services are widely conducted. In Chapter 3 below, the system that supports custody business in each country is examined to review what systems handle the aforementioned expansion of the custody business. It is the authors' hope that by doing this we can find some suggestions for the current situation in Japan.

3. Systems of various countries to support custody service

As we explained above, the custody service of financial institutions in Japan have made a dramatic change. In this chapter, we will provide an outline of the laws and regulations in various countries such as The United States of America, The United Kingdom of Great Britain and Northern Ireland, and Federal Republic of Germany, etc., where the custodian system started, and compare their systems and laws with ours so that we can understand how custody services have been used and what legal theories are used.

3-1 System in The United States of America

3-1-1 Outline

In The United States of America, a custodian was originally differentiated from a fiduciary, which generally has discretionary authority, and was merely considered a person or an organization to manage trust assets (this idea is similar to the concept of "safekeeping" of assets in Japan).

In other words, in the relation to the ERISA law of The United States of America (regulations for pension-related matters), a fiduciary has discretionary authority including giving financial advice, and it was not limited to the narrow meaning of a "fiduciary". While a fiduciary has fiduciary duty under ERISA law, a custodian did not have that because he/she did not have discretionary authority. In fact, the main reason for using custody services was because financial institutions normally held securities, which could not be taken out of the country, etc., on behalf of the principal. However, the central control system for paper-based securities developed, and it became possible for us to send orders electronically. This enabled custody service to change from an operation for keeping securities for clearance to an investment management of trust assets and an agent of corporate actions, etc. As a result, custody service which is provided at financial institutions (mainly banks) is more than just keeping securities. It seems that a custodian has fiduciary duty under ERISA law[23]

3-1-2 Security Entitlements

Since custody service in The United States of America is changing, security entitlements can be listed as an important system/idea in correlation with custody service. When Article 8 of UCC was revised in 1994, investors' indirect ownership of securities is the essence of multiple-layered book entry system which investors own securities through financial institutions as intermediaries, and an entitlement holder is positioned as an entitlement holder, which is different from the debtor-creditor relationship between an investor and an issuer of a security.

[23] As for the current trend in this issue, please refer to Richard Stanley, Global Custody Operations of Banks, 114 Banking L.J. 418-428 (1997), James Essinger, "Global Custody", 15 (Longman ed, 1991), and Nomi's previously listed book, P 114 etc.

This is the outline of Article 8 of UCC[24]

① An entitlement holder's property interest with respect to a particular financial asset is a pro rata property interest in all interests in that financial asset held by a securities intermediary(UCC8-503(b)). To the extent necessary for a securities intermediary to satisfy all security entitlements with respect to a particular financial asset, all interests in that financial asset held by the securities intermediary are held for entitlement holders, are not property of the securities intermediary (UCC8-503(a)).
② A securities intermediary shall promptly obtain and thereafter maintain a financial asset in a quantity corresponding to of all security entitlements it has established in favor of its entitlement holders with respect to that financial asset. Except to the extent otherwise agreed by its entitlement holder, a securities intermediary may not grant any security interests in a financial asset it is obligated to maintain (UCC8-503(b)).
③ An entitlement holder's property interest with respect to a particular financial asset may be enforced against the securities intermediary only by exercising the entitlement holder's rights. An entitlement holder's property interest with respect to a particular financial asset may be enforced against a purchaser of the financial asset or interest therein, only if insolvency proceedings have been initiated by or against the securities intermediary, and the securities intermediary does not have sufficient interests in the financial asset to satisfy security entitlements of all of its entitlement holders to that financial asset, and the securities intermediary violated its obligations under Section 8-504 by transferring the financial asset or collateralizing it to a third party (UCC8-503(d))
④ A securities intermediary takes action to obtain payment or distribution made by the issuer of the financial asset (UCC8-505(a)), and it is obligated to deliver payment or distribution received to its entitlement holder (UCC8-505(b)). It must exercise its rights regarding a financial asset when its entitlement holder orders it to be done (UCC8-506), and it must follow an order of transfer or redemption (entitlement order) when its entitlement holder requests it (UCC8-507(a)).
⑤ A securities intermediary shall act at the direction of an entitlement holder to change a security entitlement into another available form of holding for which the entitlement holder is eligible (UCC8-508).

This revision of Article 8 of UCC was thought meaningful since it solved the following issues which are unique to the business of indirect ownership of securities, especially in a global custody service which performs diversified foreign investments.

(1) Before the revision, it was necessary to specify securities themselves and previous owners when securities were indirectly owned by financial institutions and were transferred. This caused a priority issue in the transfer of securities and setting collateral right, depending on the order of acquiring ownership and also whether it was a bona fide purchase. For investors, who were also customers of financial institutions, uniform and equal treatment made collective ownership of securities as a whole, was positioned as a value similar to property right which could be substituted.
(2) Collective and substitutable ownership was managed by financial institutions in each layer of the multi-layered security market while several substitutable groups were sometimes managed by one financial institution. In indirect ownership which is supported by financial institutions with various layers in the market, the status of customer's rights which is understood only by the specific financial institutions of such customer. Each financial institution knows only its customers and their positions, and financial institutions in the upper layer do not know about customers in financial institutions in

[24] Atsushi Kiminami, Security clearing system; the legal structure of property interest and legal structure of liability, the treatment of Article 8 in UCC, "Current mixture of property interest law and liability law" Yuhikaku (1998), Yuhikaku (1998), P 129. Detailed explanations and analysis of the system of security entitlement is provided in Development and issues of international security clearing system by Tetsuro Morishita, Sophia Legal Thesis Volume 47, the 3rd issue, 172 and later issues.

the lower layer. Therefore, ownership of security entitlements meant that customers had property rights, and they had absolute rights during regular transactions, instead of treating security entitlements as deposits, which are considered as claims.

3-1-3 Expansion of fiduciary duty to custodian (SEC regulation 17f-5 and 7)

In The United States of America, the legal theory of custodian was established in an operation trust which keeps customers' assets and invests them. In 1972, Guarantee Trust was established (***) with New York Curb Exchange, and started the distribution of American Depositary Receipt (ADR). Back then, there was already a system to establish custodians to keep the original securities overseas. After the Great Depression, the Security Act of 1933 laws (known as the blue sky laws) regulated interstate security transaction as part of the new deal policy. Also, a new law, Invest Company Act of 1940 was established in 1940 to protect investors, which created a base for fiduciary regulations. Meanwhile, trustee laws in The United States of America were codified into Restatement (accumulation of cases) and statutory laws from 1950. With respect to the duty of care of a trustee, detailed rules of the traditional theory "Prudent Man Rule", which was established in the case of "Harvard College v. Amory", were created with "Prudent Investor Rule (the Restatement (Third) of Trusts, Article 227 of Uniform Trust Code in 1990), "Uniform Prudent Investor Act 1994", and "Article 8 of Uniform Trust Code".[25]

In addition, there are detailed regulations for foreign custodians keep assets of investors in US as diversified foreign investments. SEC rules 17f-5 and f-7 indirectly apply to sub-custodians in Japan when they manage pension funds for The United States of America. Also, detailed SEC regulations apply when mutual funds in The United States of America conduct diversified foreign investments as well as those who keep their assets in a foreign country.[26] Basically, these two regulations control foreign custodians.

(1) SEC rule 17f-5

When mutual funds select global custodians, it is the global custodians' responsibility to select sub-custodians to manage securities in a foreign country. However, this responsibility is called "delegated responsibility"[27], and it was considered a problem because the responsibilities of a global custodian were the same as a central securities depository institution or clearing house, which is too much a burden for a global custodian.

(2) SEC rule 17 f-7

The new rule was created in June 2000, and the rule f -7 for using foreign securities depositary institutions (similar to Japan Securities Depository Center) was added, which is separate from the rule for sub-custodians in a foreign country (f-5). According to the rule f-5, it is a global custodian's responsibility as a financial institution in the upper layer to select a sub-custodian for a mutual fund. According to the rule f-7, it is a mutual fund's responsibility to select and supervise a securities depository institution in a foreign country. However, global custodians, similar to sub-custodians, are

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[25] Robert C. Lawrence III, "Development of trust asset investment operation standards in US – new opportunities and responsibilities for operation managers " translated by Makoto Arai, Shintaku the 213th issue, (2003), P 154 and after

There are six characteristics of Prudent Investor Rule

(1) Recovery of universality and flexibility in the traditional Prudent Investor Rule
(2) Focus on the behavior of trustees, not the result of investment operations
(3) Evaluation of each investment judgment as part of the overall portfolio
(4) Management of risk and return
(5) Necessity of distributed investments
(6) Saving of operation costs

[26] 17FR270.17f-5, 17f-7. "SEC Release" No. IC-24424, Final Rule: Foreign Custody of Fund Assets

[27] Page 117 of the aforementioned publication by Nomi

responsible for the continuous monitoring of securities depository institutions in foreign countries as well as selecting sub-custodians.

This expansion of a fiduciary's responsibility to a custodian matches the current interpretation of Prudent Investor Rule, and proves that the function of a custodian is necessary for diversified foreign investments with respect to the following points.

(1) Recovery of universality and flexibility in the traditional Prudent Investor Rule;
(2) Focus on the behavior of trustees;
(3) Evaluation of each investment judgment as part of the overall portfolio;
(4) Management of risk and return;
(5) Necessity of distributed investments; and
(6) Saving operation costs (comments for UPIA Article 9 and UTC Article 805: If trustees delegate business and authority with regards to investment and operation of trust assets to external investment companies, they need to consider cost effectiveness)

3-2 System in The United Kingdom of Great Britain and Northern Ireland

3-2-1 Outline

As investments in The United Kingdom of Great Britain and Northern Ireland became more international after 1980s, financial institutions, particularly trust banks, started various custodian services. This created the necessity for more consideration to improve the system. Especially, the CREST system, which actually performs securities transactions, was designed so that indirect owners who had access to the market had legal rights of securities. This and other several issues made it necessary to clarify legal positions of custodians and nominees, and lead to the establishment of the Trustee Act 2000.

3-2-2 Nominee system

(1) Position of a nominee in the Trustee Act of The United Kingdom of Great Britain and Northern Ireland

"Nominee" can be considered a legal name for indirectly owning securities. "Standing proxy" manages owner's assets owned indirectly under a nominee's name within the authorities received from an owner or fiduciary (nominee institution and standing proxy become the same). Once the name is changed to a nominee's, it becomes hard for a third party to recognize whether an asset is a trust asset (it becomes a sort of safekeeping for commingling). It is normal in The United States of America and The United Kingdom of Great Britain and Northern Ireland to change the name of the managed securities to the name of a nominee. They do that largely due to its convenience; that is, when a fund manager controls funds and assets, he/she can transfer them without the owner's signature if they are under the nominee's name. If the securities and fund accounts of many investors are under the same nominee's name, a custodian can smoothly perform various procedures such as name change, fund transfer, etc. However, there is still a legal problem in the relationship between a custodian, who is an indirect holder of securities, and an investor, who is the real owner of investment. We will consider this issue by studying the treatment of nominees in the Trustee Act of The United Kingdom of Great Britain and Northern Ireland.

According to the regulation in Article IV of Trustee Act 2000, all trustees can jointly delegate their own authority to a third party (an agent, nominee, and depository institution). However, when there are several trustees in one trust and each trustee individually delegates his/her right, Article 25 of Trustee Act 1925 and Article 1 of Trustee Delegation Act 1999, the law regarding delegation of authorities to

trustees, still apply. [28] Before the revision of Trustee Act in 2000, if there are several trustees in one trust, the name for trust assets had to be a joint name of all trustees unless they did not agree. In that case, breach of fiduciary duty occurs on the trustee's side by changing the name of trust assets to a nominee's name or leaving trust assets at a depository institution unless specified otherwise in the certificate of trust. Therefore, a trustee had restrictions in the following: (1) a method for letting a nominee manage and invest trust assets; (2) settlement of transaction in CREST, which is a paperless book entry system at the London Stock Exchange; and (3) purchase and sell securities by a fund manager in discretionary investments.[29] Article 16 of Trustee Act 2000 allows a trustee to appoint a nominee and make the nominee own trust assets (under the nominee's name) which are acquired as investments, as long as the following three conditions are met: (1) a nominee is appointed by a written statement or there is a written statement that proves that a nominee was appointed; (2) there is no trustee as a depository institution when a nominee is appointed; and (3) trust assets which were acquired as investments are not under the name of the public depository institution.[30]

Qualification requirements for a nominee and depository institutions are specified as follows in Trustee Act 2000: (1) He/she is currently in the nominee or depository institution business (it does not matter whether he/she has other businesses); (2) a corporation under the control of the trustee who has the appointing authority; and (3) a corporation which is in the nominee business for solicitors (it must be authorized by regulations in Article 9 of Administration of Justice Act 1985). If a corporation can be used, a trustee is able to use a special purpose corporation/organization as a nominee or depository institution. According to Item 5 of Article 9 of the new law, a trustee can appoint a trust corporation as a depository institution or an agent, and several trustees can be appointed as a joint nominee or joint depository institution. If a trust has only one trustee, however, he/she cannot become a nominee or depository institution. [31]

Article 20 of Trustee Act 2000 stipulates the conditions for appointing a nominee and depository institution. Regulations in Article 14 prohibit appointing a nominee or depository institution if any of the following conditions applies, or it is considered inevitable. (1) Condition which grants a nominee and depository institution the right to appoint an agent; (2) Condition which limits the liabilities of a nominee, depositary institution, or an agent thereof, who was appointed inevitably; or (3) Condition that allows acts of a nominee or depository institution, which cause conflict of interests for a nominee or depository institution. Furthermore, the new act imposes the duty for a trustee to review the appointment of an agent, nominee, and depository institution. According to Articles 21 to 23, a trustee is liable for the acts of an agent, nominee, or depository institution. [32]

In The United Kingdom of Great Britain and Northern Ireland, there are no laws for indirectly-owned securities. However, widely accepted is a structure like a trust where intermediary financial institutions (custodian, nominee institution etc.) are understood as trustees, and investors are beneficiaries.[33] Supervisory responsibilities have the same structure for a custodian of trustees in Trustee Act 2000. Unlike a substitute structure under Japanese laws, a nominee institution and custodian owe direct responsibility as a trustee.

3-3 Systems in Federal Republic of Germany

[28] Paul Matthews, Trustee Act 2000, translated by Makoto Arai (2002), P 74
[29] Page 76 of the aforementioned publication by Paul Matthews
[30] Page 77 of the aforementioned publication by Paul Matthews
[31] Page 77 of the aforementioned publication by Paul Matthews
[32] Page 77 of the aforementioned publication by Paul Matthews
[33] Page 205 of the aforementioned publication by Morishita, Joanna Benjamin & Madeleine Yates "The Law of Global Custody –Legal Risk Management in Securities Investment and Collateral – "Sec. Ed. Butterworths (2002) P 25

- Security Custody System -

In the Federal Republic of Germany, there are no trusts similar to that in The United Kingdom of Great Britain and Northern Ireland or The United States of America. However, Investment Company Act (KAGG) 1957 regulates investment trusts in relation to custody services. Investment trusts consist of special assets (Sondervermogen), depository banks (Depotbank), and joint owners (beneficiary). A deposit bank is an administrator continuously monitoring the status of real estates, custody of cash and securities (which are categorized as special assets), payment of dividends, and redemption of equity securities by order of an investment company. We will start by studying the system of depository banks.

(1) Depository banks (Depotbank)

① Functions and roles of depository banks[34]

(a) Legal forms
- Depository bank must be established separately from investment companies (Article 12 Item 1) in order to systematically guarantee the safety of special assets.
- Managers of depository banks and commercial agents who are delegated to all operations of a depositary bank cannot serve as employees of investment companies at the same time (Article 12 Item 1).
- Selection of a depository bank or change of a depository bank that was to be chosen must be reported to the authorities at financial institutions, at the latest, two weeks before the closing date of a contract. (Article 12 Item 1 and 2).

(b) Description of services
- Continuously monitoring the status of real estates, custody of cash or securities which are categorized as special assets, and issuance and redemption of equity securities (Article 12 and 31).

(c) Authorities and duties
- Depositary banks have authorities and duties which are carried out in its name. While the role of description of services in (b) is passive, this is positioned as a positivetask.
- Depository banks can exercise an owner's claim to an investment company or a depository bank before dismissal (Article 12 Item 8 – 1).
- When execution is made based on a claim where special assets are not liable, it is possible for depository banks to file lawsuits, etc. (Article 12 Item 8-2).
- Depository banks can exercise a claim of joint ownership to the recipient of special assets in its own name (Article 31 Item 8).

② Special assets

Special assets are assets which were acquired by paying an investment company for issuing equity securities (beneficiary securities) (Article 6 Item 1). Special assets is a technical concept to represent the whole asset which is managed as a unit of the said law. Special assets are normally managed / processed by an investment company, and enjoy a high level of independence as the center of investment trust laws.

Trustee Act of Federal Republic of Germany is distinctive with a high level of independence and the fact that the position of a trustee is separated into an investment company and a depository bank. Exclusive management rights as a trustee are separated in two. Legal supervisory authority goes to the investment company, and actual supervisory authority and execution right based on the execution law, go to the depository bank. Also, a joint owner's claim for an investment bank can be executed by a depository bank.

[34] Makoto Arai, previously listed note 10, Page 168, Makoto Arai, Legal System of Germany, "Comparison of investment trust legal systems" edited by Seichi Ochiai, Yuhikaku (1996), P160 and onwards

Investment Company Act of Federal Republic of Germany has the form of the investor protection law, as above. In order to achieve its objective, the theory of trust law provides a high level of independence with trust assets. Investment trusts can be a trust because it protects investors (beneficiaries) by using the function of bankruptcy remoteness for trust assets etc.

In the Federal Republic of Germany, the following legal theories also exist in trust bank businesses of universal bank.[35]

When trust in the Federal Republic of Germany is compared with a management contract which is combined with delegated authority, the following characteristics exist.

① Exclusivity of the right of disposition and authority to set liabilities of a bank which manages assets;

② Independence from cancellation of request or management by customers or beneficiaries, and independence from a death of a customer who delegated management of his/her asset to a bank;

③ Continuity and stability which make it possible to subsequently distribute profits of managed assets to descendents

④ Position of a trust as a special asset which is not liable to banks or individual creditors and the fact that the responsibility of management is limited to trust assets.

⑤ Safety of customers when objective conflict of interests exist

⑥ (This is related to items listed above) Possibility that a bank can ask the courts for an opinion when a problem occurs

(2) Securities Depository Act (Depotgesetz)

In the Federal Republic of Germany, Securities Depository Act (established in 1937, and revised several times as book entry transactions change) regulates depository, management, purchase, and transfer of securities by financial institutions for their customers. According to Banking Act of Federal Republic of Germany Article 1 Item 1-2-4 and 1-2-5, it is especially recognized as banking transactions for banks to deposit, manage, purchase, and transfer securities.

Furthermore, the relationship of securities, which are stored domestically, shows the following ideas which are based on the traditional legal theory of property rights.[36]

- Investors have direct ownership (or joint ownership) of their securities, and central deposit institutions or intermediary financial institutions hold its securities only as an intermediary. In commingling deposits, investors as depositors have pro-rata joint ownership of the balance of commingling deposits which are managed by depositary banks (central depositary institution) (Security Trustee Act Article 6 Item 1).
- When a third party such as a security depositary bank are asked to hold securities by a financial institution where custody of securities is their business, it is considered that such third party knows that securities belong to customers, not to the financial institution unless the financial institution gives the third party a written statement that the securities belong to the financial institution (Security Trustee Act Article 9 and Article 4 Item 1).

(3) Positioning of foreign security depository bank (Treuhaender)

A different legal structure is applied to securities which are held outside of the Federal Republic of Germany.[37]

- When securities are purchased and held overseas based on a contract with an investor, transaction banks are free from their duty to acquire ownership of such securities for their

[35] Tsuyoshi Yamada, Conflict of interest in banking business and investment trust business, "Securitization of finance and protection for investors", Shinzansha publication (2000), P145 and onwards

[36] Page 92 and onwards of the aforementioned publication by Morishita

[37] Page 183 of the aforementioned publication by Morishita

investors (Depository Act Article 22 Item 1).

- In that case, the bank acquires its own ownership for specific securities, joint ownership of a pool of securities which can be substituted and are held by a central clearing institution overseas, or an equivalent right which investors normally own in the country where the securities are held.
- Such transaction banks are positioned as trustees (Treuhaender) in relation to the investors.
- The transaction bank acquires ownership etc., and registers its customer's share (Gutshrift in Wertpapierrechnung) in his/her account to complete the transaction.
- In such international book entry transactions, a customer gains right of delivery based on the trust contract which he/she requests purchase and custody of securities in a foreign country for his/her transactional bank. The customer also gains the right of beneficiary (treuhandeigentum) for economical profits received from his/her securities which are held overseas by the bank.
- In that case, investors do not own direct property rights for their securities, and they do not own direct rights for issuers.
- When an intermediary financial institution deposits securities in a financial institution etc., in a foreign country, the intermediary clarifies three items, including the fact that a financial institution in a foreign country is aware that securities belong to the intermediary's customers, not to the intermediary financial institution etc. This reduces the risk that securities are treated as assets of the intermediary financial institution, not as assets which are deposited by their customers, and also the risk of the exposure to bona fide purchases.

The legal system in the Federal Republic of Germany appropriately acknowledges that they have to partially depend on foreign laws to decide what rights investors own in transactions of securities which are held overseas. Meanwhile, it can be assessed that their domestic laws have a legal framework to protect the rights of investors. [38]

3-4 Summary

Custody systems in various countries are based on different basic laws such as civil law or security and exchange law etc. For example, The United States of America implemented the idea of security entitlements in UCC Article 8, as already described, and entitlement holders have a pro rata property interest for financial assets which are held by intermediary financial institutions (UCC Article 8-503 (b)). In Security Depository Law in the Federal Republic of Germany, however, actual ownership/joint ownership can be claimed by a similar concept to deposit and trust. Also, each country has a system to protect investors in some way when an intermediary financial institution goes bankrupt. In The United Kingdom of Great Britain and Northern Ireland, for example, practices and Trustee Act establish a structure where intermediary financial institutions and nominee institutions are trustees, and investors are beneficiaries. In the Federal Republic of Germany, trust banks are understood as trustees (treuhaender) in relation to investors when securities are held overseas. Such legal systems clarify the rights of trustors (investors) (= through the protection of property rights) even in indirect ownership of securities which occur in a custody service. Although these systems have different backbones of legal theories, they are created based on the link to the trading system of securities, and actual business is taken into consideration to a large extent when rules were established.

On the other hand, the legal theory of trust is mixed with the legal theory of agency and deposit in Japan's custody service. Also, trustors (investors') rights of securities depend on which legal theory applies for custody service, and this is not a stable form. It is time to consider the legal structure which is based on the concept of indirect ownership of securities as well as highly complicated service, which cannot be understood only by the type of liability which is defined in the contract of standing proxy.

[38] Page 182 of the aforementioned publication by Morishita

4. Legal issues in custody service and legal theory of trust

4-1 Legal issues in custody service

As explained in 3-4, our legal system for supporting custody service is not as stable as those in Europe and The United States of America. Such instability can be due to legal issues including the following aspects of actual business.

(1) Function of bankruptcy remoteness and duty of segregation management

Deposit function of custody is the main part of management function no matter where actual securities are held, as long as they are treated with indirect ownership. In that case, transactions are not stable if legal effect varies depending on whether the custody position is considered as "trust custody" in a trust relationship or "delegated custody" as a fiduciary in a delegation contract. It is necessary to specify assets based on segregation management. It is also necessary to evaluate bankruptcy risk and legal risk for a custodian who manages assets for other people.

(2) Responsibility of self-execution and legal theory of delegation

In many cases, it is inefficient in reality for an institutional investor to manage all global security clearing. Custody is positioned as a supplemental function of self-execution even when institutional investors are considered trustees, or when they are considered as trustors who have delegated rights from his/her customers based on the legal theory of delegation. In the current trend, they are under trustees' liabilities in duty for others.

(3) Risk of using a custodian in a foreign country

It is necessary to investigate the risk of using a custodian in a foreign country where custody service is involved with management of foreign assets.

As previously described, assets are becoming diversified, and they will be managed under different legal systems and transaction customs, as foreign assets are owned/invested worldwide. Therefore, it is inevitable to use other people to make up for the limitation of domestic trustees and custodians, and a sub custodian is appointed for each country.[39] It is an important issue for trustees to perform risk management in order to prevent accidents with foreign custodians and loss caused by how foreign custodian hold assets, and also to secure assets. Bankruptcy of foreign custodian, especially, should be considered first when the safety of assets, which are managed by foreign custodians, are discussed. In that case, substantial confusion could be expected in reality since foreign countries have different legal systems for bankruptcy.[40]

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[39] According to Trustee Act, a third party can perform trustee's trust service when it is defined or necessary.

[40] This issue became more serious in Japan when the British merchant bank Bearing went bankrupt in 1995. Bearing was a financial conglomerate which had banks, securities companies, and investment companies as holding companies, and they also had Bearing securities companies in Tokyo and Osaka. Eventually, ING, a Dutch financial/insurance group took over Bearing's business and debts so there was no actual damage. However, Bearing was the foreign custody of the bank/trust bank of our country, and there was concern regarding how we would have coped with the situation where trust assets could not have been recovered if ING had not rescued them and Bearing had filed a special liquidation. As we previously slightly mentioned, in many countries, actual securities or registration are not required for securities which are held by custodians, and such securities are recorded as customers' assets on custodians' books. Therefore, in general, such securities are protected. However, when bankruptcy occurs, securities may not be able to be collected for a certain period of time, and they are exposed to market risks. Furthermore, in order to avoid complexity for individual contracts in each country, fiduciaries normally have a contract with a global custodian and manage the assets in one central location. In that case, a sub custodian (used by a global custodian) is not in a relationship of direct contract, and it is important to understand how a global custodian manages a sub custodian.

(4) New issues regarding custody

As Trust Business Law was revised at the end of last year, the following issues are appearing in custody service which is offered not only by banks, but also by trust banks.

In the previous Trust Business Law, there was no regulation for external delegation. Therefore, there was no special regulation for trust banks which let third parties manage their securities. In the revised Trust Business Law, however, a regulation for delegation was established, and it has become unclear whether this can apply to "delegation" in Article 22 of Trust Business Law. If it does, it will require more administration. Therefore it is discussed that it should not be "delegation" based on Trust Business Law because it is simply a delegation of depository, and delegation of securities does not provide any discretion for external delegation. This issue needs more consideration when custody service is delegated to an institution in a foreign country (cross-border) since different rules may apply. When custody is delegated to a financial institution in a foreign country through a foreign custodian and such a financial institution is a public institution established by the appointment of the country etc. (the same way as in Japan), it is possible to judge that such custody of securities does not apply to delegation. It is merely a matter of whether the delegation of administration of rights related to securities (which is written on the book) should be considered as "delegation". In the Japanese system, it is simply a delegation of administration to manage records on the book for financial institutions (participants). If the form of security entitlements is used in the legal structure of execution of rights as in The United States of America, the rights of securities are transferred to the delegated party, as already described. In order for investors to exercise their authorities of securities, they need to do so through delegated financial institutions and book entry institutions. This is different from in Japan, which investors can directly exercise their rights, and it becomes an issue whether this can be considered as a simple delegation of administration. Simple delegation of administration could mean not only managing books, but also mean exercising the right on behalf of investors.

If the exercise of rights becomes different depending on where to delegate custody, we could consider that discretion exists. Therefore, if there is a difference in the exercising of rights by investors, depending on how well/poorly delegation is chosen, such delegation applies to "delegation" in trust Business Law as delegation with discretion (however, it may not apply to "delegation" in Article 22 of Trust Business Law if there are no differences by the selection of delegation since it is a simple delegation of administration).

4-2 Custody service and legal theory of trust

When legal theory of custody service to support business is considered while the practice situation of custody service is focused on, custodians as delegated parties (=trustees) have more discretion than simple delegation of administration. Therefore, it does not seem to make sense to consider custody service as a traditional delegation/deposit contract. It may even be better to consider that as trust business.

Originally, an approach from the agent system and explanation from the trustee system were used when the asset management system to hold/manage other people's assets under civil law was considered.[41] Meanwhile, the approach from the theory of the relationship of each party's responsibility

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In order to avoid such risks, a global custodian normally stipulates in a contract that securities of the global custodian which are managed by the sub custodian are defined as that of the global custodian's, not as the sub custodian's, and they are separately managed from the assets of the sub custodian. Although this system reduces risks, the actual effectiveness of such a system and regulations are not certain.

[41] Jun Ueda," Application of the legal theory of trust and its analogy", Trust 60 report, "Asset management and operation system and trust", Trust 60 (2002), P3 and onwards

in a delegation contract (mainly about the duties of trustees) was tried.[42] Furthermore, we started discussing the implementation and application of fiduciaries, influenced by the theory of trust and responsibility of trustees in foreign countries.[43]

Under such circumstances, custody service as "standing proxy" can be positioned as a contractual asset management system which the system of agency is combined with the traditional contract under civil law. "Standing proxy contract" can be considered part of sub-traditional contract under civil law. Custodian service is derived from actual business in diversified foreign investments, and it is based on the system of agency and delegation of administration.

However, some laws concerning asset management system use the legal theory of trustee by analogy. In fact, the type of custodian's (standing proxy's) responsibilities in a custody (standing proxy) contract is similar to that of a trustee. The following are some examples to explain the similarity.

(1) Duty of self-execution

Regulations for approving the use of discretion for a sub custodian to reduce duty of self-execution, and this indicate that the range of trustee's duties in Trustee Act are increasing.

(2) Ownership of assets in custody and rules of segregation management

A custodian holds all securities as owner's assets on behalf of the owner. A name of the standing proxy is added to the name of an owner, and the internal relationship of the agency becomes clear, and ownership remains. Also, assets of a standing proxy are managed separately, and assets for owners are separately held for the individual owner. This has the same effect as transfer of ownership from owner to trustee, and managing trustee's assets and owner's assets separately in the trust system (however, in the standing proxy system, funds (cash) are held under the name of the owners, which is different in the trust system).

(3) Duty to provide information

As delegation law, duties of a standing proxy to report, record, and check for owners can be compared with the trustee's duty under Trustee Act. The information regarding the balance of assets and the record of all transactions performed by a standing proxy according to the contract are provided.

(4) Duty of loyalty

There is no rule for the duty of loyalty in a standing proxy contract. However, some people recognize the duty of loyalty in the legal theory of agency and delegation. The issue is to define the duty of loyalty for a standing proxy.

(5) Duty of due care

Duty of confidentiality is sometimes positioned as a regulation of compliance. In terms of the law, however, it is part of a custodian's duty of due care , and a custodian shall not release any information regarding owners and owners' customers to a third party without written permission by the owner himself/herself unless approved in the contract, it is required by the objectives in the contract, or required by the laws, orders, and regulations which control the custodian.

(6)Owner's right to order and trustee's discretion

As for items which are not on a standing proxy contract, a custodian can choose to make a judgment and take action, or not do so if the owner does not give him/her any orders by a specified time. A custodian is not liable for anything resulting from his/her action or action not taken. The intention of

[42] Masaaki Yasunaga," Agent in agency/delegation and the code of conduct for fiduciary", Trust 60 report, "Fiduciary and any equivalent position in asset management and the rule of conduct for them", Trust 60 (1994), P5 and onwards

[43] Hiroyasu Nakata, "Deposited Cash" , Trust 60 report, "Confusion of Trustee Act and Civil Law", Trust 60 (1998)

parties in this contract is that the owner's customer or a third party does not have any rights, claim, or method of rescue for the custodian's action, or action not taken, and negligence to carry out duties in the contract.

This means that a standing proxy has the discretion as trustee for what owners do not have the authority to order, which is similar to discretionary trust for a trustee.

(7) Termination of contract

Parties in the contract can terminate the contract at their discretion. It is different from a trust contract by how much discretion is allowed.

When custody service is considered based on the legal theory of trust, the following benefits occur when compared to an agency contract combined with the right of agency.[44]

(1) It establishes the right of disposition and exclusiveness of the right to set debts for banks which manage trust assets
(2) It secures banks' independence from orders and cancellation of management of customers and beneficiaries, and also death of a customer
(3) It realizes continuity and safety which enables to subsequently distribute profits of managed assets to descendants
(4) It clarifies the position of a trust as special assets which are not liable for creditors of a bank or individual creditors. It also limits the liability of management only to trust assets and clarifies the breakpoint of legal responsibility
(5) It secures customer's safety when there is subjective conflicts of interest in trust assets
(6) It enables banks to ask the court for an opinion when a problem occurs

When we consider the relationship between the actual business of custody service and legal issues regarding the rights of assets based on those benefits, at the current stage in Japan, it might better clarify the relationship of legal responsibility as financial institutions, trustees, and beneficiaries by using the legal theory of trust. Originally, custodians do not have liabilities when they invest their assets, according to orders of creditors (requestors). However, it exceeds the concept of "deposit" under banking law if substantial amounts of liberty in investment choice are granted to a custodian in a contract even if financial institutions define it as "deposit". Also, a problem arises when they fail to invest and it is necessary to clarify legal liability. In such a case, it is useful to use the legal theory of trust.

Conclusion

As what we have studied, the current custody service has several unclear, legally "uncomfortable parts", including issues regarding the issue of international civil laws. When we consider the further development of custody service, it is important to solve those issues. It is also simultaneously linked to the necessity of clarifying discussions of the current mixed status of the system of agency/delegation contract and the legal theory of trust, as well as trust relationship in the custody service in our country. Clarifying that could be a stepping stone to solving issues of custody service listed above.

However, until recently trust business was limited to trust banks, and only corporations and individual investors with large accounts (including foreigners) were using custody service. Because of that, the discussion of the system of agency/delegation contract with regards to the legal system

[44] "Development of the legal theory of Civil Law and Trustee Act", "Comparative study of fiduciary as an asset management system", Page 496, Line 15. Custody service is analyzed/explained by the legal theory of trust by "Custodian in fiduciary" in "Fiduciary transaction and legal theory of civil law" by Osamu Fukui, published by Yuhikaku (2003). In his thesis, he claims that a contract similar to fiduciary can be made by a fiduciary contract. However, it does not fully explain the relationship between custody service and the legal theory of trust.

concerning standing proxy and the legal theory still cannot exceed the range of the legal theory of transactions between corporations. Also, only commercial trust has been discussed in the field of trust. However, Trust Business Law was revised, and various corporations are developing trust businesses. Some of them are specializing in non-commercial trust, and trust banks are also actively developing their businesses in the field of non-commercial trust. Traditionally, very few people used non-commercial trusts in Japan compared to the long history of non-commercial trust in Europe and US.[45] In this thesis, however, we are aware that there will be a system of private custody in the future, as well as the fact that the legal theory for custody service is not clear, which has been a problem, and we attempted to point out the necessity of interpreting custody service by the legal theory of trust. We hope that there will be more active discussions of custody service at academic conferences and in the industry now that the Trust Act has been revised.

[45] Yoshihisa Nohmi "Lecture of Current Trustee Act (1)" Shintaku Vol. 203 (2000), P15 and after

(Reference) Relationship of custody contract