INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW
INSTITUT INTERNATIONAL POUR L'UNIFICATION DU DROIT PRIVE

DIPLOMATIC CONFERENCE TO ADOPT A CONVENTION ON SUBSTANTIVE RULES REGARDING INTERMEDIATED SECURITIES
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Comments

(submitted by the Commission of the European Community)

The Commission of the European Community would like to submit the following observations, in advance of the diplomatic Conference to be held in Geneva in September 2008. The Commission reserves the right to submit additional observations in the future.

1. Declaration concerning certain system operators: Article 2

This provision was introduced at the last session of negotiations and reflects Article 1(5) of the Hague Securities Convention.

We consider that, as currently drafted, Article 2 may affect the scope of application of the future Convention. The Convention is based on a functional approach. Nonetheless, new Article 2 adopts an institutional approach; it allows Contracting States to exempt from the application of the Convention the operator of a system for the holding and transfer of securities on records for the issuers or other records which constitute the primary record of entitlement. However, to the extent that (a) the operator of such a system may also be a Central Securities Depository (CSD) operating Securities Settlement Systems (SSSs) etc., and that (b) the declaration is not limited to the functions covered by this provision but focuses on the operator, it is possible that a Contracting State might exclude from the scope of the Convention such an entity without any distinction as regards its functions. This seems to us to be an undesirable consequence of this provision.

The relationship of this provision with Article 4 needs also to be carefully considered. They both cover the relationship between a CSD and an issuer and seem to overlap, to a great extent.

2. Performance of functions of intermediaries by other persons: Article 5

We consider that the term "responsible for" needs to be clarified in order to make clear that the Convention refers to "legal" rather than "operational" responsibility.

3. Intermediated securities: Article 7(2)(b)

Under this provision, the credit of securities to a securities account confers on the account holder the right to receive and exercise the rights attached to the securities, including in particular dividends, other distributions and voting rights. These rights may be exercised by the account holder against the relevant intermediary or the issuer of the securities, or both, in accordance with the Convention, the terms of the securities and the law under which the securities are constituted.

We consider that the words *"the law under which the securities are constituted"* are of a generic nature so as to encompass, as the case may be, the law of the place of the issuer's incorporation, the law of the country where the company has its registered office, the law of the issue, or the law determined by any other point of attachment as provided for by the applicable law.

If our understanding is correct, we suggest that a proper explanation is provided in the explanatory materials.

4. Effectiveness of rights in insolvency proceedings: Article 17

It is our view that the scope of application of Article 17(1) is limited to the relationship between the account holder and the account provider. It forms part of a series of provisions which try to ensure the integrity of the intermediation chain and to protect the rights of an account holder against his relevant intermediary. This was best expressed in the explanatory notes of the preliminary draft of the Convention (Study LXVIII – Doc. 19 – December 2004) which state that: *"The protection of the account holders' securities in the insolvency of the relevant intermediary is the core of any sound legal framework with respect to securities held with an intermediary. Article 11* [now Article 17(1)] *sets out a rule of recognition, making it clear that the status of the rights of an account holder is not affected by the commencement of insolvency proceedings in respect of the intermediary and are therefore effective against the insolvency administrator and creditors. The Article should be read together with Article 15* [now Article 22]*, which, as explained below, states that securities held by the intermediary or credited to accounts held by the intermediary with a higher-tier intermediary are, to the extent required to ensure that the intermediary's account holders' rights are protected, appropriated to the account holders' rights, are not property of the intermediary and are not available for distribution among the intermediary*['s creditors] *or otherwise subject to their claims"*. In that respect, we have never viewed this paragraph as a general provision setting out the relationship of the Convention with national insolvency laws.

Article 17(2) has a completely different scope from paragraph 1 and we wonder whether its place is in Article 17. Its material scope is less wide; it is limited to "interests in intermediated securities" and does not cover "rights of account holders". Second, its personal scope is wider; it applies to all relationships and not only the "account holder-relevant intermediary" one.

Taken together, we are hesitant to consider Article 17(1), (2) as the basic provision setting the relationship between the Convention and national insolvency laws.

5. Effects of insolvency: Article 18

Article 18 has a much wider scope of application than Article 17. It encompasses all relations, not only the account holder-relevant intermediary one (as in paragraph 17(1)) and is not limited to "interests in intermediated securities" (as in paragraph 17(2)). As regards its substance, we support the general approach and the analysis made by the Chairman of the Working Group on Insolvency-related Issues, cf. UNIDROIT Study LXXVIII, Doc. 97.

An important issue that needs clarification is the relationship of Article 18 with Articles 24 and 33.

As regards Article 24, we consider that national avoidance rules should still be applied, in the sense that they could allow the recovery or restitution of securities though <u>subsequent</u> transfer orders. In other words, while avoidance rules should not lead to the unwinding, revocation etc., of particular transfer orders, they should be able to restitute the prior situation through new and reverse transfer orders.

As regards Article 33, we consider that national avoidance provisions could still question the financial collateral arrangement and the provision of the collateral assets where this has been intentionally done to the detriment of the other creditors in fraud or on other similar grounds.

6. Insolvency of operator or participant in an SSS: Article 24

We have the following comments in relation to this provision.

6.1 Non-Convention law issue

The overriding effect of the rules of a system is dependent upon non-Convention law permitting it. "Non-Convention law" is a term defined in the Convention under Article 1(m). Under this provision, non-Convention law is the law in force in the State whose law is applicable under Article 3, other than the provisions of this Convention.

The purpose of Article 24 is to maintain the integrity of the system. For this reason, we consider that it is the law governing the system that should define whether the rules of the system would have such overriding effect. If that were not to be the case, the whole

protection mechanism introduced by Article 24 will fall apart. We are not sure that the definition of "non-Convention law" under the Convention will always yield this result.

We consider, therefore, that the reference to "non-Convention law" should be replaced by a reference to "the law governing the system".

6.2 Limitations

One of the questions raised in the report on insolvency is whether the Convention will allow, or not, Contracting States from limiting the effects of insolvency provisions only to transfer orders that have entered into a system before the moment of opening of insolvency proceedings.

It is our view that the Convention allows such limitation. The exact conditions and possible limitations of the overriding effects of the rules of systems will be defined by the non-Convention law (see wording of para 1, namely *"to the extent permitted by the non-Convention law [...]"*). Thus, the law governing the system may provide that transfer orders are effective notwithstanding the impact of insolvency laws, to the extent that the transfer orders concerned have entered into the system before the moment of opening of insolvency proceedings. Or, the law governing the system may provide that in some specific cases and under strict conditions, such protection could even be offered to transfer orders entered into a system after the opening of insolvency proceedings. Or, on the contrary, the law in question may have no such limitation so that all transfer orders are protected, even if they have entered a system after the opening of insolvency proceedings.

7. Position of issuers of securities: Article 26

It is our understanding that:

(a) the reference of Article 26(2) to the fact that the law of a Contracting State shall "recognise" the holding of securities by a person acting in his own name on behalf of another person, does not have the meaning that all Contracting States would have to introduce the nominee concept in their own legal systems. It simply ensures the interconnectivity of different legal systems.

(b) the last sentence of Article 26(2), under which the Convention does not determine the conditions under which a nominee is authorised to exercise his rights, will allow Contracting States to maintain requirements in relation to the exercise of voting rights, such as amongst other things, the need for the nominee to disclose (a) the identity of each client, (b) the number of shares voted on their behalf, and (c) the content of any voting instructions.

8. Certain insolvency issues disapplied

The draft Convention does not contain a provision under which collateral agreements and the provision of collateral should not be declared void on the sole basis that they came into existence or that it was provided, as appropriate, on the day of commencement of the

insolvency proceedings but prior to the order making the commencement, or in a prescribed period prior to that commencement. In other words, the conclusion of a collateral agreement and/or the provision of collateral after the commencement of the insolvency proceedings may be declared invalid or void or be reversed.

We consider that such a provision should be incorporated in the future Convention.

9. "Enforcement event": Article 28(2)(h)

The Convention defines an enforcement event in relation to a collateral agreement as *"an event of default or other event on the occurrence of which, under the terms of that collateral agreement, the collateral taker is entitled to enforce its security or operate a close-out netting provision"*.

We consider that the Convention should specify that the same effects might be achieved by the operation of law.

10. Recognition of title transfer collateral agreements: Article 29(1)

Article 29(1) of the draft Convention provides that the law of the Contracting State shall permit a title transfer collateral agreement to take effect in accordance with its terms. We understand that this provision tries to eliminate domestic provisions that would permit the re-characterisation of the agreement. While we fully support this objective, we are concerned that the current drafting of this provision is wider and would appear to permit each and every term of the title transfer financial collateral arrangement (irrespective of purpose) to be effective. We could not agree with such a wide interpretation. We would therefore propose that the scope of this provision is expressly limited to the *"re-characterisation risk"*.

11. Right to use collateral securities under security collateral agreement: Article 31

There has been a long debate during previous sessions of negotiations on whether collateral agreements may provide that a collateral taker exercising a right of use may re-transfer to the collateral giver any type of assets, if they have so agreed in the collateral agreement. The main point of contention is whether the provision of such other assets (i.e., non-equivalent collateral) could be decided freely between the parties or whether such facility needs to be limited in situations which follow "the occurrence of any event relating to or affecting any securities provided as collateral". Disagreement on this issue is demonstrated by the presence of square brackets in the text of Article 31(2) of the Convention.

Such limitations exist in a number of countries and they stem from particularities of the laws of these States on pledge and the rights that flow from pledging.

We consider that full harmonisation on this issue is not necessary. We propose therefore that Contracting States should still be able to restrict substitution of collateral assets only in cases where the original collateral assets themselves are affected by any event. We also

consider that the best way to express this is to make it an exception to the general rule which should enshrine contractual freedom in this respect. In other words, we propose that the words within the square brackets should be removed from Article 31(2) and a new phrase should be inserted providing that Contracting States may declare that they limit the right of substitution to the occurrence of any event relating to or affecting any securities provided as collateral.

12. Top-up or substitution of collateral: Article 33

As we have already stated, we consider that Article 33 should be subject to avoidance rules.

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