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
Geneva, 1 to 13 September 2008

UNIDROIT 2008
CONF. 11 – Doc. 15
Original: English
July 2008

Comments

(submitted by the European Banking Federation)

Set up in 1960, the European Banking Federation is the voice of the European banking sector, with over 30 000 billion EUR assets and 2.4 million employees in 31 European countries. The EBF represents the interests of some 5000 European banks: large and small, wholesale and retail, local and cross-border financial institutions.

Following the outcome of the last UNIDROIT session in May 2007 and in view of the forthcoming diplomatic Conference to be held in Geneva in September 2008, the European Banking Federation (EBF) is pleased to provide its comments on the last draft of the UNIDROIT Convention on substantive rules regarding intermediated securities (the "Convention"; see CONF. 11 – Doc. 3).

1. General comments

The EBF has followed the drafting of the UNIDROIT Convention on intermediated securities with great interest and supports this initiative which aims at providing a much needed improved harmonisation and legal certainty in the field of securities at the international level.

The EBF also appreciates the efforts made by UNIDROIT to draft a Convention compatible with the European framework. In that respect, the EBF welcomes the fact that the Convention's provisions relating to collateral transactions (Articles 28 to 33) are in line with the European Directive on Financial Collateral Arrangements which is currently being reviewed.

It is however important to stress that more work has to be done regarding consistency between UNIDROIT and the European legal framework since the Legal Certainty Group (LCG), the group of experts which is currently working under the auspices of the European Commission, seeks the same objective of clarifying the regime relating to book-entry securities and will soon deliver a Report that should give way to a proposal for a Directive.

The EBF would like to reiterate its concern regarding possible inconsistencies and conflicts between the outcome of the LCG's study on book-entry securities and the future UNIDROIT Convention as already expressed in a letter of 16 May 2008 *(see EBF Ref. N° 0258)* to both European Union Governments and European Commission officials.

It seems indeed that the final outcome of the UNIDROIT Convention remains uncertain in some respect and some changes could still be brought to the text during the diplomatic Conference, scheduled for September 2008.

In particular, potential problems could arise from the issues still left open in the draft Convention, such as insolvency-related issues, securities clearing and settlement systems, and good faith. It is striking to note that these "officially remaining issues" which were further analysed in the *ad hoc* intersessional Working Groups' Reports are all extremely important for the functioning of the entire Convention. Despite lengthy discussions during the negotiations, neither clear drafting proposals nor recommendations were delivered by the Working Groups, only different options to be debated during the diplomatic Conference have been provided. Should the diplomatic Conference of September not find acceptable solutions for such issues, the overall functioning of the draft Convention might result affected. A substantial change in the structure of the draft Convention would then require to seek again the advice of the Governmental experts. This also implies that the LCG risks not having a clear framework for these crucial matters to refer to, before its final report due in July 2008.

In addition, it seems that some incompatibilities already appear between the LCG's work and the UNIDROIT draft Convention, for example on the protection of the good faith acquirer and priority rules.

The EBF believes that an EU Directive which would not be compatible with the UNIDROIT Convention and *vice-versa*, a UNIDROIT Convention that would not take into account the still to be agreed European position, would inevitably result in a deadlock situation such as the current *status quo* on the Hague Convention and should absolutely be avoided.

That is why the EBF which already encouraged the European Commission and Council Members to make every effort to reach a globally agreed solution in respect of the future UNIDROIT Convention and the future European instrument based on the outcome of the LCG's Report, also urges the Convention signatories to maintain their efforts to draft an instrument which will be consistent with the European legal framework, although more time than initially planned is needed.

In the end there should be a consistent global framework for intermediated securities as the global development on the security market needs a legal framework which gives legal certainty to everybody involved. Although we have certain general and specific remarks we are supporting the UNIDROIT Convention as a milestone on a way to fully integrated market for securities.

2. Specific comments

Preamble

The EBF generally agrees with the proposed text for the preamble (see CONF. 11 – Doc. 7) and would only like to suggest a small addition as follows: "Mindful of the need to enhance the international compatibility of legal systems with regards to both direct and indirect holdings, as well as the soundness of domestic and international rules relating to intermediated securities (…)".

With regard to the reference, throughout the draft Convention, to declarations by Contracting States we would appreciate a clarification on the general (binding or not binding) effect of such declarations over the whole text of the Convention and its enforceability within those Contracting States having made use of a declaration.

Article 1: Definitions

Article 1(d) broadens the definition of "intermediary" to include central securities depositories. We believe that the word "intermediary" is not consistent with the functional approach and should, in our view, be replaced by the more neutral notion of "account provider".

We also think that the functional approach makes it unnecessary to specify the inclusion of Central Securities Depositories (CSDs) "if and to the extent that" they act "in that capacity"; such a specification could thus be removed.

Furthermore, the EU framework under preparation has not yet taken any position on the merit of whether or not to include in its scope the unauthorised account providers which, by contrast, are currently covered by the draft Convention. We see a potential discrepancy here that should be removed.

Article 1(k) defines "control agreement" as an agreement between the account holder, the relevant intermediary and another person or between the account holder and another person.

In a previous draft of the Convention (see Study LXVIII - Document 42), the third player in the agreement was defined as the "collateral taker", which clarified that the control agreement was a financial collateral arrangement. On the contrary, the use of "another person" in the new text makes it difficult to identify control agreements as a type of collateral agreement. The EBF would therefore suggest to go back to the definition in Document 42 or to clarify by other means that a control agreement can be used as a financial collateral arrangement.

Article 1(m) (Definition of non-Convention law) and Article 3 (Sphere of application)

The EBF fears that the reference to "non-Convention law" in place of "domestic non-Convention law" in a previous draft (see Study LXVIII - Document 42) can result in an unpredictable legal framework since it could give way to the application of any other law chosen by the parties to regulate their relationship, as is often the case in for conflict of laws rules.

The EBF would therefore call for the Convention to clarify the status of cases where the applicable law is contractually chosen by parties.

Article 2: Declaration concerning certain system operators

New Article 2 states that "A Contracting State may declare that a person who is the operator of a system for the holding and transfer of securities on records of the issuer or other records which constitute the primary record of entitlement to them as against the issuer is not an intermediary for the purposes of this Convention".

In our opinion, the present wording of this article reflects Article 1(5) of the Hague Securities Convention and changes the general approach (functional) of the rest of UNIDROIT draft Convention.

It is the EBF's opinion that the draft Convention should keep consistency with the functional approach without switching here to an institutional approach. Indeed, the EBF is concerned that some unintended consequences might derive from using such an institutional approach. If the operator of a system for the holding and transfer of securities on records for the issues, also happens to be the CSD that operates a Settlement Securities System (SSS), a Contracting State may declare that the CSD in question will not be an intermediary for the purposes of the Convention, without any distinction of its functions. This might create discrepancies in the application of the functional approach.

Therefore Article 2 should be deleted since the qualification as intermediary (or rather "account holder" as suggested above by EBF) under the Convention is already addressed in Article 1 by the definition of "intermediary".

Article 5: Performance of functions of intermediaries by other persons

The newly introduced Article 5 should also specify what form the declaration should have to be enforceable under non-Convention law. In addition, the article lacks of clarity regarding the type of person that could be authorised to perform some functions of intermediaries which could generate different interpretations under the various legal systems and thus create market fragmentation.

Article 7: Intermediated securities

The EBF welcomes the clarification brought by Article 7(1) regarding the fact that it is the investor (account holder) and not the intermediary (except when he acts for its own account) who can exercise the rights attached to the securities.

However the reference to "the law under which the securities are constituted" might not be precise enough and could cause differences of interpretation amongst different markets. Here the EBF would like to recall that Article 1(2) of the Shareholders' Rights Directive provides that "the Member State competent to regulate matters covered in this Directive shall be the Member State in which the company has its registered office". Any further improvement of Article 7 should be compatible with this provision of the Directive, also in the light of the expected outcome of the work of the LCG as regards the differentiation between creation and issuance of securities.

Article 9: Acquisition and disposition by debit and credit

Article 9 of the draft Convention provides for the transfer of securities credited to an account, without any other formality, in order to render the acquisition effective against third parties.

The EBF approves the newly added paragraph 5 which states that the Convention does not limit the effectiveness of debit and credit to securities accounts which are executed on a net basis.

Article 10: Grant of interests in intermediated securities by other methods

Article 10 introduces a complex mechanism which could render difficult the grant of interests in intermediated securities. In addition, paragraph 7 provides the possibility to grant interests according to non-Convention law without specifying whether it also covers the law chosen by the parties. This results in a fragmented and unpredictable framework and could result in intermediaries having to manage different types of security interests.

Furthermore, it should be clarified that the condition under paragraph 1(a) to enter "into an agreement" will not create a formal requirement to that effect; indeed it is not uncommon that a pledge document is in its form a unilateral document issued by the collateral provider while the agreement between the latter and the collateral taker is only implied but not made evident.

Finally, we would appreciate if UNIDROIT could consider including in these provisions an express reference to the possibility of automatic creation of a security interest in situations where the intermediary has advanced funds on behalf of the account holder, which corresponds to frequent market practice in some States.

Article 11 (Other methods under non-Convention law) and Article 12 (Evidential requirements)

Article 11 provides that the Convention does not forbid any method provided for by non-Convention law:

- for the acquisition or disposition of intermediated securities;
- for the creation of an interest in intermediated securities and for making such an interest effective against third parties.

The EBF welcomes the deletion of the reference to other methods provided by non-Convention law for the acquisition or disposition of intermediated securities, which could have generated concerns for the sphere of application of domestic law and the Convention.

However, it seems that further improvement could be brought to the provision since the current text appears vague and could compromise the framework of substantive rules applicable to securities that the Convention aims to establish. Additional clarification could also be included in, e.g., the explanatory materials.

Article 13: Invalidity and reversal

In case of interests granted under Article 10 it seems that the requirement that a collateral taker should also authorise the debit, goes beyond what currently applies according to national legal systems in some countries. We think that the authorisation of the collateral provider should be sufficient in these cases.

As regards the reference to Article 15, it is in our view to be deleted, as it is not necessary and may even be misleading. Indeed, Articles 13 and 14 deal with the question of invalidity or irreversibility of a book entry, which is upstream to the issue of priority.

Article 14: Acquisition by an innocent person of intermediated securities

The EBF is concerned that the issue of good faith which is of primary importance is still under discussion and regrets that the Working Group did note make any drafting proposal or at least recommendations on this issue.

Regarding the current wording of Article 14, some provisions would need to be clarified as follows:

- The term “innocent person” seems too vague and should be defined with respect to the provision’s purpose, which is to protect third parties who act in good faith.
- The term “defective entry” should also be defined.

The EBF would also suggest to replace the acquisition of security interests made “by way of gift or otherwise gratuitously” in paragraph 3 by “by any other mean besides payment”.

The reference under paragraph 4(c) to an organisation might hinder the acquisition in good faith as such.

Article 15 (Priority among competing interests) and Article 16 (Priority of interests granted by an intermediary)

The EBF fears that Article 15 would not be compatible with non-Convention laws applicable to priority among interests since this article provides that interests created under Article 10 of the Convention have priority over any other interest created by other methods provided by non-Convention law. Moreover, the effect of paragraph 6 should be clarified since it allows parties to vary the priorities provided by Article 15, and provides at the same time that such an agreement does not affect third parties.

Article 17: Effectiveness of rights in insolvency proceedings

The scope of Article 17 should be clarified. It is doubtful if the article refers only to the relationship between the account holder and the account provider or, to the contrary, intends to have a wider scope, as a general rule governing the relationship between the Convention and the different national insolvency laws. This comment has a direct connection with Article 18 as far as this article seems to have a wider scope of application than Article 17. Both articles should be clarified in order to restore internal coherence between them.

Article 26: Position of issuers of securities

The EBF welcomes the simpler wording of Article 26 and would like to suggest further improvement:

- “Securities that are permitted to be traded on an exchange or regulated market” should be replaced by "securities admitted to trading on";
- The difference between exchange and regulated market should be clarified.

- END -