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 Government of Austria)

The Austrian delegation is pleased to submit the following comments in advance of the September 2008 diplomatic Conference in Geneva:

General comment

Austria recognises a need for more legal certainty and for international harmonized rules for the transfer of securities and therefore is very interested that the negotiations of the Convention would result in a set of rules which are not only acceptable for as many States as possible but also would avoid legal problems and difficulties to apply it in practice. The rules should be formulated in a way that they do not give room for divergent interpretations under different legal systems. Finally the rules should be as comprehensive as possible.

In view of the crucial importance of book entries (credits and debits) under the new concept it is essential to regulate in the Convention itself the consequences of defective book entries. Austria believes that Articles 13 and 14 do not meet the said requirements.

The acceptability of the Convention will rely to a large extent on the solution to be found for this problem.

1. Comprehensiveness – reference to non-Convention law

In view of the introductory comments Austria requests that every effort be made to thoroughly discuss the outstanding issues and find a solution on the basis of broad harmonisation of substantive rules. It does not seem sufficient to agree only on basic principles of the effects of book entries of securities. An approach is required which regulates not only basic securities transactions under the new concept of book entries.

Limited harmonisation and reference to non-Convention law bears the danger of legal uncertainty and thereby missing the goal of the project.

2. Terminology (account provider instead of intermediary, "account held" securities instead of "intermediated" securities) – functional approach

There is general consensus that successful harmonisation of the relevant rules on a global level can only be reached by using a functional approach to the subject matter and the wording of the text. This means that the proposed regulations are formulated in a way which is neutral as to existing domestic legislation and concentrates on the functions of the entities involved and on the description of the results to be achieved.

This does not mean that domestic law does not play its role. To the contrary, the design of the Convention must be such that its regulations are easily adopted and implemented by the rules of domestic law. The functional approach means that any dogmatic concept and respective wording of national law or law families must be avoided not to create misconceptions, misunderstandings or incompatibilities.

The draft Convention was successful in achieving functional wording by using the term "account holder" instead of alternatives which might have been "owner", "beneficial owner" or "depository" for the person considered in various jurisdictions as the only person who is entitled to the enjoyment of all the rights which a security confers under the respective jurisdiction. The corresponding notion to "account holder" would be the "account provider" as the person that professionally offers accounts on which entries of securities held by that person in safe custody may be made. Instead of this functional approach the draft Convention chose to use the word "intermediary" and derivatives thereof which stem from the Uniform Commercial Code of the United States and is used in Anglo-American law. Since the securities holding pattern of this law family differs from the continental pattern, the use of the expression "intermediary" will create another understanding in the minds of practitioners of the Anglo-American legal environment as in that of practitioners of another legal background, which will rely on the definition of "intermediary" contained in the draft Convention. In Anglo-American law the security is held by the top level custodian who received the securities from the issuer, whereas the other custodians down in the chain of custodians to the "beneficial owner" are "intermediaries". The "continental" concept is the ownership of the security by the investor. This difference in the holding pattern will lead in practice to misunderstandings and confusions. Using a functional approach would mean to name the respective depositaries in a neutral way "account providers" (and derivatives thereof).

The pivot of the draft Convention is the concept of transferring and holding of securities by book entries only. To some jurisdictions this might not be a new concept, for others it has a revolutionary character. Book entries are made on accounts which are therefore of utmost importance for the new harmonised concept, where all book entries confer the same rights. It would therefore seem appropriate to speak of "account held" securities instead of "intermediated" securities which has the above described connotations of Anglo-American law.

3. Book entry (Article 9)

Article 9(1) of the draft Convention rules that subject to Article 13 (on invalidity and reversal) account held securities will be acquired by the account holder by their credit entry to his security account. Article 9(3) of the draft Convention rules that subject to Article 13 the account holder disposes of account held securities by a debit entry to the securities account.

The draft Convention does not distinguish to which account in the holding chain the credits and debits with the effect of Article 9 are made. The consequence is, that any account holder in the holding chain obtains the same rights as described in Article 9 or disposes of the same rights. Therefore any account holder up and down in the holding chain gets the same rights credited or

disposes of the same rights. But these rights should lay substantially only with one account holder. There can be only one securities account to which "the" security is credited, whereas the other accounts up and down the holding chain confer the same rights to the account holder, who, however, cannot use these rights unless (expressly or impliedly) authorised by the account holder to whose account "the" security has been credited. Speaking in terms of law families, in case of Anglo-American law the account to which the security was credited would be the highest in the chain. In the continental law family it would be the account holder at the bottom of the chain. In the case of so-called "transparent systems" the two accounts would coincide. In functional terms one could distinguish between account holders which are subject to instructions in the exercise of the rights conferred upon them by the book entry and those which are not subject to such instructions. The latter ones would be the "owners" or "beneficial owners" depending on the respective law family.

Austria thinks that the draft Convention should contain regulations which reflect the above considerations: There are account holders not subject to instructions by other account holders in respect of the exercise of the rights conferred by the book entry and others which will not exercise these rights without being instructed to do so. Such an amendment of the draft Convention seems required to ascertain the understanding and good functioning of the new system of account held securities.

4. Rights conferred by book entry (Article 7)

The rights conferred by book entry are listed in Article 7 of the draft Convention. Its paragraph 1 lists these rights in sub-paragraphs (a) to (c). Sub-paragraph (d) contains a reference to all other rights, including rights and interests in securities, which eventually are conferred by non-Convention law. This "catch all" clause should be improved since under the heading at the beginning of the paragraph it is said that the credit confers the then enumerated rights. As there are jurisdictions, such as Austria, where the non-Convention law does not confer rights by book entry itself (but only in conjunction with a valid title) the wording of sub-paragraph (d) must be adapted. According to the underlying intentions sub-paragraph (d) should say that any other rights (and obligations) which non-Convention law might include by a transfer of securities (change of ownership, change of beneficial ownership) or by creating a security right (pledge or other security interest) would also be conferred by the credit. Moreover, it seems important that examples of what is meant are given either in the wording of the Convention itself or in the explanatory materials thereto, by referring to the different ownership or pledging concepts.

5. Defective book entries (Articles 13 and 14)

The answer to the question of how to regulate defective book entries must be seen in light of the overall design of the draft Convention to create an effective, reliable and legally certain system of maintaining and cross border transferring of securities. The prior aim of the Convention must be the reliability of book entries, parties must be able to rely that book entries are not invalidated. Since electronic mass transfers of securities practically do not allow tracing, *i.e.* knowledge of which individual security has been transferred from account A to account B, cases of reversal must be limited. The only practical example of possible reversal would seem to be the case where the account holder is aware or must be aware that the entry made by his account provider is incorrect. In that case the account provider should be authorised to reverse the entry. All other cases where defective entries occur for whatever reason (invalid underlying contracts, mechanical errors, human errors and the like) must be regulated either outside the system or inside the system by correcting book entries.

Moreover, it must be said that the traditional concepts of "good faith acquisition" which have developed in the various jurisdictions cannot be used to solve the problem of defective book entries. The situations which lead to the traditional good faith acquisition differ profoundly from those occurring in the computerised world of book entries so that those traditional concepts cannot be used as a model for the regulation.

The means to cope with the problem of defective book entries seems to be daily conciliation by account providers of each level, in particular at the CSD level. In that case the account provider would become aware at least of those defective book entries which result in a difference in the number of securities issued and the number of book entries made so that he can comply with his obligation under Article 21(1) of the draft Convention timely.

The two measures suggested above, namely authority of the account provider to reverse a book entry which the account holder was not entitled to expect and a daily conciliation of the book entries seem appropriate to cope with the problem of defective book entries.

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