



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

(submitted by the Government of the Federal Republic of Germany)

1. The Federal Ministry of Justice, which bears overall responsibility in this matter within the Federal Government, should like to take the opportunity of submitting the following comments to the Secretariat of UNIDROIT.

2. The Federal Ministry of Justice would expressly like to thank UNIDROIT and its working groups for the more than seven years of outstanding work. The Federal Ministry of Justice hopes that upon continuation of the Diplomatic Conference a Convention can be adopted that is acceptable to all participating states. The German Delegation is still happy to see that the Draft is concerned with bringing about harmonisation of substantive rules on intermediated securities.

3. Furthermore, the German Delegation would like to thank the authors of the draft Official Commentary. The Commentary will make a substantial contribution towards an improved understanding of the Convention text.

4. Finally, the German Delegation would like to express its thanks for being given the opportunity of once again making submissions on the Draft and would therefore like to make the following comments:

I. Re the Draft Convention

a) *Insolvency protection (Articles 7, 14 and 21)*

5. Protection of a final investor in the insolvency of one or more intermediaries within the chain of intermediated holding has so far only played a subordinate role in negotiations on the draft UNIDROIT Convention, because it tended to be a theoretical question. However, through the financial markets crisis and, in particular, also because of the insolvency of the investment bank Lehman Brothers Holdings Inc., the environment in which the Convention will have to show its practical utility has undergone fundamental change. Insolvency protection for the final investor has taken on much greater significance.

6. Regarding insolvency protection for the final investor, the German Delegation takes the view that the property law model is superior to the law of obligations model. This is because it gives the final investor with ownership of the security, being ownership that is effective against all persons, a much stronger right vis-à-vis the intermediaries – that is to say vis-à-vis all intermediaries in the chain of intermediated holding – than could be conferred by a claim under the law of obligations. The owner *in rem* of a security can demand delivery of the securities from the insolvency administrator for the intermediary concerned (right of separation). The insolvency rules

in the Draft Convention should not – in the German Delegation’s view – lead to the situation where investor protection already provided in the property law regime is actually diminished by the Convention.

7. The authors of the draft Official Commentary propose a new fundamental change in the Convention’s relationship with national insolvency law. The German Delegation has considerable reservations about this. The German Delegation supported the change in insolvency law made at the first session of the diplomatic Conference. We do not share the fear of the authors of the draft Official Commentary that Article 7 might potentially disrupt most of the core provisions of the Convention (section 7-6). At the last Conference, the Convention was carefully revised with the changes in insolvency law in mind.

8. Moreover, the German Delegation has doubts as to whether the proposed declaration mechanism, an opt-in mechanism, will function properly. It is not clear to the German Delegation how - without legal *lacunae* developing and therefore legal uncertainty - the Convention is to provide both for the case where a Contracting State does not make a declaration regarding the application of national insolvency law, and to the case where a Contracting State declares its national insolvency law to be applicable to the greatest possible extent.

b) Re Articles 9, 11, 16 and 18

9. The German Delegation still has serious reservations regarding the proper functioning of Articles 9, 11, 16 and 18. We have stated on several occasions that for compatibility of the German property law regime with the Convention it is essential for the credit entry to be linked to a corresponding debit. This must also apply to acquisition in good faith. Otherwise the result would be a multiplication of securities which is incompatible *per se* with property law. This would mean that the Convention would not function in relation to the German property law regime, if it prohibits the non-Convention law from linking the validity of the credit entry, also in the case of acquisition in good faith, to a corresponding loss of rights. In the view of the German Delegation there is a need for clarification here.

10. Also for reasons relating to insolvency protection and protection of investors there are serious reservations to the effect that an eventual multiplication of securities will impair the proper functioning of the Convention. The admissibility of stock creation by crediting of securities to a securities account has a favourable impact in the situation where there is uncovered short selling. If a subsequent bear covering is no longer possible, for instance because of insolvency, the account holder’s stocks of this class will be subjected to proportional reduction, in accordance with Article 26, to the detriment of the final investor. In the view of the German Delegation, this does not, however, seem to be a satisfactory result where final investors who are not parties to the transactions concerned would be made, through *pro rata* loss of their securities, to suffer the consequences of speculation in the form of short selling by the intermediary.

II. Re the draft Official Commentary

a) Re Article 9

11. Under the German property law regime it is only the final investor and an intermediary acting for its own account who acquire ownership of intermediated securities - and not the intermediate entities (links) in the holding chain. Ownership passes directly – without transit acquisition within the holding chain – from the seller of the securities to the acquirer. This means that the final investor enjoys protection in the insolvency of the intermediaries involved. Insolvency protection for the final investor is particularly important to the German Delegation for the reasons

stated above. Since transfer of ownership, being “(an)other right(s)” within the meaning of Article 9(1)(d), is governed by the non-Convention law, the German Delegation would welcome clarification in the draft Official Commentary to the effect that a provision under non-Convention law excluding transit acquisition within the holding chain is compatible with the Convention.

12. From the German Delegation’s point of view, the final sentence should be deleted in section 9-25; this sentence obviously refers to German law and is not necessary. According to our understanding in Germany, all rights deriving from “Mitgliedschaft” (the status of shareholder) under Article 9(1)(a) devolve, not just the rights expressly mentioned there, since in Article 9(1)(a) the reference is to “any rights attached to the securities”.

b) Re Article 11

13. As already explained at the last Conference, Article 11(2) is very strange to persons who come from a German legal background. German property law does not make a distinction between legal effects *inter partes* and legal effects against third parties. Rights *in rem* always take effect *inter omnes*. Article 11(2) therefore has no field of application in German law. At the Conference in September 2008 an assurance was given that there would be elucidation of this particular German problem in the Official Commentary. It is true that the draft Official Commentary now explains under section 11-10 that validity requirements within the meaning of Article 16 are not inadmissible “further steps” within the meaning of Article 11(2). This explanation is not sufficient from the German Delegation’s point of view to dispose of the considerable irritation caused by the wording of Article 11(2). Hence the German Delegation requests inclusion of clarification in the Official Commentary to the effect that Article 11(2) shall have no effect in a legal system where rights *in rem* always take effect *inter omnes*.

c) Re Article 16

i) Corresponding cross-entry

14. As already stated and with reference to German property law, it is indispensable that each credit entry can be linked to a corresponding cross-entry. In the elucidations regarding conditional entries (section 16-22) the corresponding cross-entry is not, however, mentioned as an admissible condition within the meaning of Article 16. The corresponding cross-entry is only mentioned *en passant* at an unexpected point in the text (e.g. in section 15-26: “... even if, ..., the non-Convention law requires matching of debits and credits ...”). But the reader would expect this explanatory reference in the context of the relevant provision, i.e. under Article 16. The German Delegation therefore requests a corresponding supplementation of the elucidations given in respect of Article 16 and Article 18.

ii) Registered share with restricted transferability

15. Under German law there is a special type of registered share called a “*vinkulierte Namensaktie*” (registered share with restricted transferability). A “*vinkulierte Namensaktie*” can only effectively be acquired when the issuer consents to such acquisition. This type of registered share is to be retained under German law, also on the basis of the Convention. Hence the German Delegation requests clarification in the Official Commentary to the effect that the issuer’s consent in respect of a registered share with restricted transferability is an admissible condition within the meaning of Article 16.

d) *Re Article 29(2)*

16. The German Delegation has constantly proceeded on the assumption, and has repeatedly stated, that the provision in Article 8(2) takes priority over Article 29(2). However, the draft Official Commentary, in particular the general statement made in the first sentence under section 29-24, creates the impression that recognition of the nominee holding structure by Article 29(2) also takes priority over Article 8(2) - and not just over Article 8(1). The German Delegation therefore requests clarification in the Official Commentary to the effect that priority over Article 29(2) is restricted to Article 8(1).

17. The Federal Ministry of Justice is looking forward to the discussions when the diplomatic Conference continues and is confident that consensus can be achieved.

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