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INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW

**STUDY GROUP FOR THE PREPARATION OF HARMONISED
SUBSTANTIVE RULES ON TRANSACTIONS
ON TRANSNATIONAL AND CONNECTED CAPITAL MARKETS**

Restricted Study Group on Item 1 of the Project:

**Harmonised Substantive Rules regarding
Securities Held with an Intermediary**

(Second session, Rome 12-14 March 2003)

Summary Report

(prepared by the UNIDROIT Secretariat)

Rome, April 2003

1 INTRODUCTION

The *Restricted Study Group for the Preparation of Harmonised Substantive Rules for the Use of Securities Held with Intermediaries as Collateral*, set up pursuant to a decision taken by the UNIDROIT Governing Council at its 80th session, held in Rome from 17 to 19 September 2001¹ and endorsed by the General Assembly of the organisation at its 55th session held on 7 December 2001,² met in Rome at the seat of UNIDROIT for its second session from 12 to 14 March 2003. The session was opened at 10:00 a.m. on 12 March by Mr Herbert Kronke, Secretary-General of UNIDROIT, on behalf of Mr Berardino Libonati, President of UNIDROIT and Mr B. Sen, member of the UNIDROIT Governing Council and Chairman of the Study Group who especially welcomed the new members of and observer to the Study Group, Mr Li Ruiqing, Mr. Wu Zhipan, Mr Edgar Jelonche and Mr Antoine Maffei.

The meeting was attended by the experts and representatives set out in *Appendix 1*.

The materials set out in *Appendix 2* were submitted to the members of the Study Group.

The Study Group approved the draft agenda after deciding to insert point 4a in the agenda as it is set out in *Appendix 3* to this Report. However, the Chairman suggested to handle the draft agenda in a flexible way.

The Study Group approved the report on its last session from 9 to 13 September 2002 (UNIDROIT 2002, Study LXXVIII, Doc. 5).

The Study Group essentially used its second session to outline the future instrument.

2 PROCEEDINGS REGARDING THE SCOPE OF THE PROJECT

2.1 Findings of the Fact Finding Missions

The first part of the discussion on the scope of the project dealt with the findings of the inter-sessional work carried out between the first and second session of the Study Group, namely the so called Fact Finding Missions³. Representatives of the Study Group and the Secretariat had carried out two such missions, the first one to the United Kingdom (London) on 20-21 February, the second one to France (Paris) on 26-27 February 2003. The missions aimed at analysing the factual bases of rules currently in force and arrangements developed by practitio-

¹ See UNIDROIT 2001, C.D. (80) 21.

² See UNIDROIT 2001, A.G. (55) 8.

³ See UNIDROIT 2002 Study LXXVIII Document 5, sect. 2.4.1 and UNIDROIT 2003 Study LXXVIII Document 6 sect. 3.

ners with a view to providing the group with a fuller understanding of the relevant difficulties with respect to the scope of the project in a range of countries.

Both meetings with legal experts had essentially the same agenda prepared by the Secretariat on the basis of what the Study Group had developed at its last session as key issues of internal soundness and compatibility.

The findings will be set out in detail in a separate report. Therefore, this summary report merely resumes the oral reports on the missions given during the Study Group meeting.

2.1.1 United Kingdom

Two meetings took place on successive days, each of which consisted of 8 to 10 experts drawn mainly from private sector with a few representatives of the Government and the regulatory authority.

The Members of the Study Group were informed that, as to the robustness of investors' interests in securities held indirectly in the UK, there was general agreement among experts that this objective is achieved under the current arrangements. As to the manner in which it is achieved, the rule was that there is no special insolvency regime under English law governing this subject; that meant that the robustness of investors' interests depends upon it being recognised as a property right and, therefore, the fundamental insolvency law principle that only property of the insolvent party is available to be realised by a liquidator for distribution among its creditors. This flows from the English law distinction between legal and equitable, in this particular case trust property. The trustee is the legal owner while the investor is the beneficial owner of the asset. Traditionally there had been some discussion among English lawyers as to whether a custody relationship is truly a trust relationship or merely a relationship of bailment. The majority, however, nowadays considers the trust model the appropriate one for paperless indirect holding of securities.

The question of clear rules governing a transfer and priorities was more difficult to answer; there was a general acknowledgement that English rules, in this area, were not at present entirely satisfactory. The reason lies in the above described character of the investor's interest under a trust. Traditionally, English law had, and to some extent continues to have, separate rules about transfer of legal property and transfer of interests under a trust. This distinction becomes particularly important when looking at priorities, because the rules on priorities are different as between the two kinds of property interest. In the case of legal interests the traditional rule says that no one can confer an interest greater than that the one he himself possesses ("nemo dat" rule).

Under the current system the question of priorities between competing interests will largely depend on administrative and practical aspects and the situation was generally agreed not to be satisfactory because in principle, cases where the substantive merits were identical would be decided in opposite ways merely because the parties e.g. happened to use different holding arrangements.

Moving on to the question of upper-tier attachment, it was generally thought that upper-tier attachment would not be a problem because the nature of the interest

that investors have under indirect systems was not an interest in specific underlying securities but a co-ownership interest in a pool of securities held by custodians at higher levels and it was thought to be unlikely that a court would be willing to entertain an attachment claim but, to some extent, that proposition needed to be tested in practice.

As to the current settlement and transfer systems which are operating in the UK, there was the CREST dematerialised security transfer system, which included a so-called in/out option. Therefore, individual custody of securities was possible. They were a matter of individual agreement between parties.

Furthermore, the experts discussed the consequences of a situation in which an intermediary, for whatever reason, loses some of the investor's securities. There was general agreement that the rule was not entirely clear. There had been case-law which was either directly or indirectly relevant. The traditional English judge's approach was an attempt of tracing movements of underlying securities. In practice, this was extremely difficult to apply to modern holding patterns and opinion seems to be moving towards a more pragmatic rule of loss sharing pro rata among the accountholders.

As to linkages with other legal systems there were discussions about whether English principles are capable, at present, of dealing with securities held cross-border. The general rule appeared to be that they do so, because investors' interests were derivative interests. The English analysis would be that those interests held abroad would have whatever character the law of that country assigned to them at the higher tier but would be treated as a matter of English law as to the interest deriving from the trust at the lower-tier.

2.1.2 France

Four meetings with 2 to 3 experts from the private financial sector, two academics and a representative of the French regulatory authority took place.

The first point that was discussed was the notion of securities. There was agreement that there should be as a definition broad as possible that refers to financial instruments held indirectly through a chain of intermediaries.

Another problem discussed in Paris was the nature of the investor's interest, whether it is a right *in rem* or a right *in personam*. Most French experts tend to characterise it as a property right but there is support for the view that the focus should be on the relationship between the investor and the intermediary.

As to the question of the bankruptcy of an intermediary, the French legal experts agreed that the French system provides for a clear answer: the assets of the investors represented by book entries become isolated.

In case an intermediary does not have enough securities to satisfy all customer claims, the loss is shared *pro rata*.

There was discussion between academics as to the question when the transfer of securities occur. There was support for the view that the transfer of securities would occur in the moment there exists a clear contract between the seller and the buyer. However, others said that, additionally, the object of the transfer

should be clearly identified which lead to the opinion that the changing of the books marked the point of the transfer of the assets. In France, there is no clear opinion expressed on the matter which book entry is relevant for this question.

As to priorities between competing interests Article 2279 of the French Civil Code protects a *bona fide* acquirer. But this rule cannot be applied to dematerialised securities represented by book entries.

As to upper-tier attachment, the experts agreed that it was impossible under French law. The law is particularly clear because the only place where securities can be attached is the place where those securities are maintained, i.e. at the level of the intermediary which maintains the account.

2.2 Presentation on Chinese securities holding

The description of the English and French systems were followed by a presentation entitled *Securities Holding System and Pledge in China* by Mr Li Ruiqiang, the written summary of which is attached hereto as Appendix 4.

2.3 Nature of the right and functional approach

The members of the Study Group agreed that the issue of the nature of the right of the account holder seemed crucial and conceptually the most difficult one but disagreed on the question to which extent this fact should be addressed in the future instrument.

The wording "transfer of the right to the transferee" comprised different situations that needed to be addressed separately, namely:

- Dispositions in form of a liquidation, which are not directly beneficial to a transferee. Multi-tiered systems manage this issue by using the process of netting, i.e. at the end of a trading period there will be one group that has liquidated interests and another group that has acquired interests. In this scenario, tracing would be impossible.
- In a different scenario the transferee knows exactly who the transferor is, e.g. in the case of secured lending.
- Very large institutional investors acquiring or disposing of a block of securities usually do not wish to make transactions in the anonymity of the market, in which case, on the contrary, there is a direct exchange between the parties of a disposition.

Others agreed that this item was most important and proposed to come to a solution by a functional approach which should provide practical answers to the following questions:

- Whether the investor's interest is protected in case of insolvency. It was immaterial if this is achieved by way of conferring a proprietary right or another type of claim.
- Whether creation, transfer or pledge of an interest in securities are linked to physical book entries.

- What happens in case of a transfer to the relationship between issuer and investor.
- What are the rules as to competing interests, *bona fide* purchase, upper-tier attachment and the relationship between book entries and legal/equitable interests.
- Whether netting is possible, whether there is a right of use and other more policy oriented issues.

One member pointed out that Article 2 (I) (a) and (b) of the Hague Convention on indirectly held securities referred to "legal nature and effects". There was no uniformity as to the legal nature but there should absolutely be uniformity as to effects of crediting securities to an account. "Effects" was the place where the line between conceptual approach and functional approach was to be drawn. It would be imperative for compatibility that the effects were identical.

Other members advocated a middle position: in terms of procedural approach it was helpful to start with a functional approach to identify the relevant features a modern system should deliver. One had to bear in mind the differences of the two ways by which legal certainty could be achieved. The first one was pure conceptual thinking, i.e. resolving a problem by a proper definition of the investor's interest, as it had been done for example in the case of U.C.C. Article 8. However, such an approach would be very difficult to pursue and would take much time. Moreover it would be difficult to "sell" this approach to countries because in most cases it entailed changes regarding the notion of property. One should avoid this confrontation by using a functional approach compatible with the most important legal systems.

Some speakers were concerned that a purely functional approach would still leave outstanding huge systemic risk implications. Therefore, the work should be open to reassessing this point.

Furthermore it was made clear that a functional approach should also cover cross border operations and that at this stage it was impossible to prejudge how much uniformity was necessary to achieve compatibility. While there might be an approach that did not interfere with existing solutions in many jurisdictions, it was not to be excluded that one discovered that, when different systems were added together, a non-interfering approach was not possible.

There was support for the assumption that a functional approach was capable of resolving compatibility issues as well. E.g., even if the nature of the investor's interest was defined in different ways, in all jurisdictions investors were protected when an intermediary fell insolvent. The question was whether two national systems were connectible, even though the characterisation of an investor's interest was different, the functional approach might provide the answer that it depended on the private international law rules or on the cross border insolvency rules.

The Group concluded that functional approach meant an approach which looked to the practical result whatever the legal rule was. If the result was delivered, the method had not to be the same. On a cross border basis one might find that

rules had to be more uniform than expected. Taking the proposition that the investor's interest should be protected in case of insolvency of the intermediary, there were several ways in which a given jurisdiction could deliver that result. The two main variants were

- a separate property rule under which the investor's interest is treated as property distinct from the property of the intermediary and which is therefore not available to the intermediary's creditors,
- a special insolvency rule under which, within the scope of the insolvency rules, certain assets which are treated as assets of the intermediary are nevertheless subject to a special regime.

In isolation either of those rules can deliver the required result. But combined in a cross border situation, they might not do so.

Assuming an intermediary operates in jurisdiction A (its home jurisdiction) where the insolvency rule is merely property based, and also in jurisdiction B where the rule is that there is no separate property but there is a special insolvency rule saying that an intermediary in jurisdiction B has to be liquidated in such a way as to create a separate insolvency estate for account holders. The problem is that when the insolvency happens in jurisdiction A, the liquidator is going to apply the home insolvency rules. The investors in jurisdiction B will claim to have protected accounts while the liquidator's position will be that there is protection only by way of having property in the assets but not otherwise. As the predominant rule of international insolvency law is universality, it is quite possible that one would have the rules of jurisdiction A being applied on a world wide basis.

Therefore, it was not possible to say that either of those two models could simply be left to face the practical test whether it works internationally. One might come to the conclusion that this moved the discussion to the property model because there was a fairly general recognition that only property of the insolvent institution itself is available for the creditors whereas there was no special insolvency regime for splitting property of the insolvent intermediary institution. The option not to suggest any uniform rule as to the nature of the investor's interest, would consequently require international uniformity of insolvency law.

2.4 Preliminary outline of the scope

The Study Group agreed that it would be appropriate to choose three to five basic items to begin with. The following three documents served as a basis for the discussion:

- a list of 14 problem areas for consideration with a view to defining the scope of the project drawn up by the Secretariat (UNIDROIT 2002, Study LXXVIII Document 1),
- a Working paper entitled *Indirectly held Securities: Key Characteristics* and relative to the scope of the work presented by Mr Guy Morton (reproduced in Appendix 5),
- the list of issues in Art. 2 (I) of the *Convention on the Law applicable to certain Rights in respect to Securities held with an Intermediary*, recently adopted under the auspices of the Hague Conference on Private Interna-

tional Law describing the scope of this instrument (reproduced as an extract in *Appendix X*). Generally, there was broad agreement that the issues could give guidance on where harmonised rules are needed, at least in the sense that the Study Group could not leave aside issues mentioned in Article 2 (I) without indicating the reason for this. Both instruments, the Hague Convention and the future UNIDROIT instrument, should be compatible. The Convention's definitions should be used whenever possible.

After having discussed several issues comprised in Document 1, in the working paper presented by Mr Guy Morton and in Art. 2 (I) of the Hague Convention, a consolidated list of 17 issues probably falling within the scope of the project was compiled by the Vice-Chairman of the Group. It is reproduced in *Appendix 6*.

As to the sequence to be followed it was suggested that the logical order would be to deal first with requirements for dispositions and *bona fide* purchase and adverse claims and later on with the creation and perfection of security interests.

The Study Group continued to work in three sub-groups, each one dealing with a separate set of issues. The task was to assess whether there was a need for a uniform or harmonised law regarding the 17 issues and how any such rules could look like. As to the question whether a uniform rule was needed, the issues were tested against the criteria of internal legal soundness and cross border compatibility with special emphasis on avoidance of legal and systemic risk and enhancement of market efficiency. The sub-groups presented their findings as follows.

2.5 Sub-group 1: Trading issues

The sub-group addressed questions regarding the transfer of securities as defined by points 2 and 3 of the consolidated list. The findings of the sub-group were recorded in a working paper, which is literally reproduced here.

"...

(1) Necessity of book entries

Should there be a rule that a book entry in a securities account is a necessary precondition of any effective disposition – that is, a rule that a purported disposition not recorded by a book entry in a securities account is ineffective for all purposes?

The sub-group agreed that as a minimum the priority rule should be that an interest recorded by book entry prevails over an interest not so recorded. It is for further discussion whether a more extensive rule invalidating informal [non-book entry] dispositions is required on grounds of legal certainty, market efficiency or systemic risk. Our suspicion was probably not – that is, that the priority rule would provide sufficient protection.

(2) Sufficiency of book entries

Should there be a rule that a book entry in a securities account is sufficient for an effective disposition – that is, that no additional condition should be required?

The sub-group thought that the book entry ought to be sufficient, on the ground that any additional condition would introduce uncertainty because such conditions would not be apparent from the information available to participants in the system. This needs to be a uniform rule, because the uncertainties that could arise from conditions not apparent from book entries would affect not only the immediate parties to the transaction but parties to other transactions at other levels in the chain of indirect holdings.

(3) Timing of when property rights arise

Should there be a uniform rule that property rights arising from a book entry take effect when and only when the book entry is made?

The sub-group concluded that there should be such a rule because any additional timing factor would give rise to additional risk and/or uncertainty without any identifiable, compensating benefit. This needs to be a uniform rule because the uncertainties that could arise from conditions not apparent from book entries would affect not only the immediate parties to the transaction but parties to other transactions at other levels in the chain of indirect holdings.

(4) Overcrediting of a securities account

Should a credit to a securities account be effective to create a property interest even if it is made at a time before a matching entry on which it is, or ought to be, dependent, has been made?

The sub-group's provisional view was that such a credit ought to be effective. This is because otherwise the possibility of reversal would create uncertainty, which could affect not only the immediate parties to the transaction but parties to other transactions at other levels in the chain of indirect holdings. The sub-group acknowledged that such a rule would permit a mismatch between the aggregate balances on securities accounts maintained by an intermediary and the securities or rights to securities available to the intermediary. However, the sub-group thought that this should be dealt with in other ways. First, the agreement between the intermediary and the account holder whose account was mistakenly credited could entitle the intermediary to redebit the account in defined circumstances. Secondly, there could be a requirement that in any case where redebiting was not possible, the intermediary should be obliged to redress the imbalance from its own resources. Thirdly, any imbalance not redressed in this way would bring into play the rule about allocation of shortfalls. (The sub-group assumed that the last two points would be considered by the other sub-group dealing with shortfalls.)

Notes

- (a) The sub-group did not regard cases involving securities lending programmes, for example by Euroclear Bank, under which accounts of other account holders would be temporarily debited to permit the matching early credit, as constituting overcrediting. Clearly such programmes do raise potential systemic issues. The group may wish to consider in another context whether those issues justify or require a uniform rule.

(b) The above discussion assumes that the overcrediting is the result of computer or human error at the intermediary of which the account holder is unaware. Different considerations clearly might apply in a case where the account holder colluded with the intermediary.

(5) Irrevocability of book entries

The sub-group discussed whether there should be a uniform rule dealing with the possibility of revocation of credits to securities accounts by transferors or intermediaries. Possible rules would be (a) a rule precluding revocation under any circumstances, (b) a rule permitting revocation but only in defined circumstances, for example, failure of a matching payment or delivery or absence of any action taken in reliance on the revoked credit or (c) a rule permitting revocation generally.

The sub-group ruled out option (c) given the unacceptable risk and uncertainty but concluded that further discussion is needed on (a) and (b).

(6) Form of instruction for book entry

Should there be a uniform rule as to the form of the authority or instruction or other preconditions for a book entry transfer?

The sub-group concluded that such a rule was not necessary – the matter should be left to the PRIMA law and/or the agreement between the intermediary and its account holders.

(7) Adverse claims

Should a credit of securities to a securities account be effective to create a property interest that prevails over competing interests (a) of which the account holder has no knowledge at the time of the credit (or thereafter), (b) of which the account holder has no knowledge at the time of the credit but acquires knowledge thereafter or (c) of which the account holder has knowledge at the time of the credit?

Where the account holder is itself acting in the capacity of a lower tier intermediary, the sub-group thought that on the grounds of systemic risk and market efficiency, it was strongly arguable that the property interest should prevail over the competing interest in all of (a), (b) and (c) above, thus providing absolute protection irrespective of knowledge – that is, the intermediary should be able to follow the instructions of its account holder and to ignore any adverse claim. However, this issue requires further discussion.

Where the account holder is not itself an intermediary, the sub-group questioned whether a uniform rule was required on any of the grounds of legal risk, systemic risk or market efficiency. In any event, the sub-group doubted whether protection extending to case (c) could be justified."

2.6 Sub-group 2: Security interests in indirectly held securities

This sub-group dealt with lending and pledging transactions and identified four main issues that should be taken into consideration. The sub group came to the following conclusions:

(1) Creation of the security interest

As to the creation of the security interest in indirectly held securities the general rule was that this question had to be integrated in the secured transactions regime of the relevant jurisdiction. The following points were of special interest:

- In the case of a security interest in a securities account, the legal regime in place should provide for the creation of a security interest in a pool of assets as opposed to a regime, which requires that security can only be established over assets specifically identified. So the regime should recognize security interests in floating assets without any need for a specific description. It should be possible to create a security interest over a class of assets.
- As to the question whether there should be formal requirements for security interests to be valid or effective as between the debtor and the creditor, there are different approaches. In particular, the question is if a book entry should be a prerequisite for a security interest to be effective as between the immediate parties (debtor and secured party).
- In the case of a security interest granted to someone else than the intermediary, it is doubtful if the intermediary's consent to the creation of the security interest should be required.

(2) Perfection of the security interest

As to the perfection of a security interest the sub-group drew the attention to the following points:

- Perfection should be defined in the same way as under the Hague Convention ("completion of any steps necessary to render a disposition effective against third persons who are not parties to that disposition").
- It has to be considered whether there should be one single method or different methods of perfection, for instance perfection by filing or registration in a public registry, perfection by possession or control or, lastly, automatic perfection as e.g. provided for in UCC Article 8.
- Another crucial point is the link between different methods of perfection and the question of priorities among competing interests.

(3) Priorities

As to priorities among competing claimants the sub-group suggested to consider a number of different scenarios:

- Priority contest between an account holder and the insolvency administrator of the intermediary. The question is whether the account holder should prevail or not.
- Priority contest between an account holder and a lender to which the intermediary has re-pledged the securities. Should re-pledging be permitted?
- Priority contest between two different secured parties to which the account holder may have granted a security interest.

- Possibility of a *bona fide* purchase having an impact on the rank of competing claims?

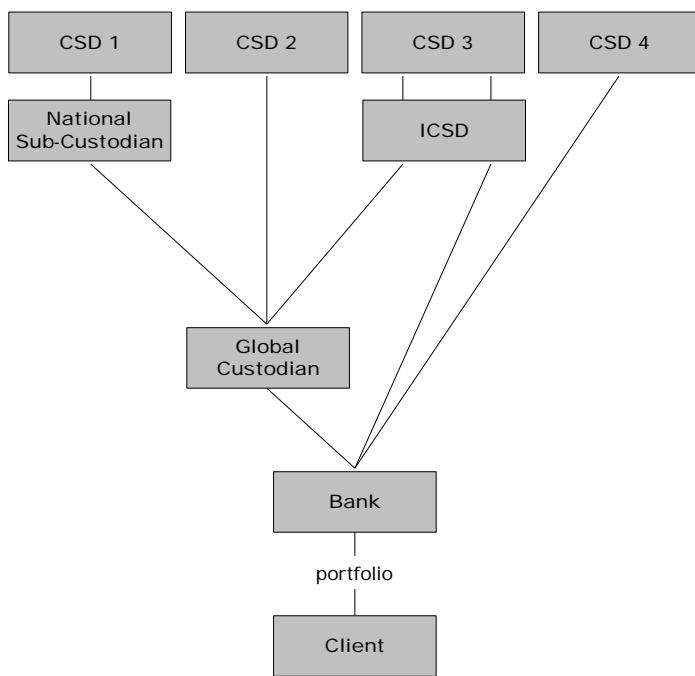
(4) Enforcement

Lastly, the sub-group suggested to take into consideration harmonised rules relating to the enforcement of a security interest.

2.7 Sub-group 3: Shortfall, segregation and right of use

(1) Shortfall

As to the question of allocation of shortfalls within an indirect holding system, the sub-group divided its considerations in two distinct sets of scenarios.



(a) Static Scenarios

Example: A Client holds a portfolio with a bank. That bank has sub-deposited securities partly with a CSD (CSD 4), partly with an ICSD, partly with a global custodian. The global custodian itself holds part of the securities through an ICSD (not necessarily the same), part of the securities with a CSD. In another country it does not have direct access to a CSD (CSD 2) which is typically the case in eastern countries that do only allow access to a CSD through a local bank as sub-custodian.

- *First scenario:*

The global custodian has not sufficient securities (without falling insolvent) to satisfy all interest of all its clients. In this case, where the bank has chosen its global custodian, the bank should make up this shortfall.

- *Second scenario:*

Same as above, but the global custodian falls insolvent. Again, the risk should be born by the bank. The additional question is if the Bank could contractually pass this risk on to the client.

- *Third scenario:*

The client has securities in his portfolio, that unavoidably are held through one specific sub-custodian who represents the ultimate level before the issuer (e.g. Italian government bonds must be held through *Monte Titoli S.A.*, the Italian CSD). Who should bear the risk when this sub-custodian falls insolvent? There are three principles:

- Everything should be done to avoid a risk of insolvency at this level. The companies typically on the top of the chain, must be set up in a way that they are insolvency-resistant.
- A restriction of their field of activity should be possible.
- They must have among their members a risk sharing system to mitigate consequences of a possible insolvency.
- In case there are, nevertheless, not sufficient securities, should again the bank bear the risk although it did not have a choice but to hold the securities in question through this sub-custodian?

- *Fourth scenario:*

What happens if the reason why the global custodian does not have enough securities relate to the fact that the CSD with which it is obliged to hold the securities falls insolvent? Should this scenario be assimilated to the situation where the global custodian falls insolvent or should it be assimilated to an insolvency of a CSD in a direct holding?

- *Fifth scenario:*

The global custodian holds through an ICSD. An ICSD can have two functions; it can be just another supplementary intermediary that again holds through a CSD; but very often ICSDs are the upper level (e.g. for Eurobonds), in which case there is hardly another choice than to hold through this ICSD. In case there are more ICSDs, the custodian has again the choice.

- *Conclusions from first to fifth scenario:*

- Who should bear the shortfall: Client, Bank (lead-intermediary) or global custodian?
- Should the answer depend on whether or not the Bank had a choice in the selection of the sub-custodian?
- In which scenario can the risk be passed on to the client by the bank? Should this depend on the question if there was a choice as to the sub-custodian?

- *Sixth scenario:*

The (lead-) intermediary, that is the bank with which the client holds his account, falls insolvent. The rule should be a pro-rata sharing between the clients of this bank. In case the bank has not sufficient securities of the issue in question in the client-, but in its own account, the question is if it should add them up to the client portfolio.

(b) Dynamic scenario:

Example: Client 1 of Bank A sells securities to Client 2 of Bank B. Bank A will immediately debit the securities account of Client 1, Bank B will immediately debit the purchase price from Client's 2 cash account. In case the two banks have the same global custodian and this custodian falls insolvent the question is, who should bear the risk of the shortfall. Client 1 does not have the securities in his account, Client 2 does not have the money any more. One possible answer

could be that, as long as the securities remain credited to Bank A's account the risk is with Client 1. At the time they pass to Bank B's account the risk is with Client 2. It becomes more difficult to define the decisive moment in case the securities are held through another layer.

(2) Segregation and right of use

The sub-group drew the attention to the fact that in the UK and the USA intermediaries used securities that they had in custody or that they received as collateral. This was done on an industrial basis ("margin-lending"). In other countries banks were very much in favour to introduce the right of use.

However, the right of use introduced an element of uncertainty in every system. A model for providing certainty in this respect would comprise (a) segregation at all levels, (b) absence of right of use and, (c) that the beneficial owner is identifiable from the first up to the last tier. The question was whether this system is compatible with the requirements of modern securities markets and whether it was worth to discuss the abolishment of the right of use or rather try to promote as secure a legal framework regarding the right of use as possible.

The minimum prerequisites were

- that investors are sufficiently informed; that they give their consent to the use; that the consent should depend on the level of understanding the investor has;
- prudential rules applicable to use and re-use of securities. These could e.g. consist of
 - o limitations as far as the volume of securities that can be used is concerned, e.g. a certain percentage could be fixed;
 - o limitations as far as the duration of the use is concerned (only short-term transactions?);
 - o requirements as to the quality of the counterparty of a use (e.g. transactions only with counterparties that have a good rating);
- segregation of assets (to which degree?);
- perfect match system, that is banks having (in securities or at least in value?) enough securities to satisfy their clients claims.

2.8 Additional example regarding shortfall, segregation and right of use

In addition to the presentation by sub-group 3 the Study Group discussed the following example, which was introduced by Mr Hideki Kanda:

An account holder holds 100 ABC securities with his Intermediary. He pledges 30 of them to his Lender-1.

The first question was, what happened to the book entry with his Intermediary.

For example, under the US system, there are four different possibilities of perfection:

- Arrange that the control of this account is shared with the lender, while the account remains unchanged. This way is primarily used in the US.

- Permit a lender to perfect security by filing a notice to a public registry. The intermediary has no notice of this. This is a relatively weak protection.
- Earmark the book entry, i.e. some kind of notation of the pledge is made in the books.
- Make the lender account holder, entailing a change of the book entry, i.e. debit the account of the borrower and to credit a separate account. This is the safest way but rarely used in the US because of practical difficulties.

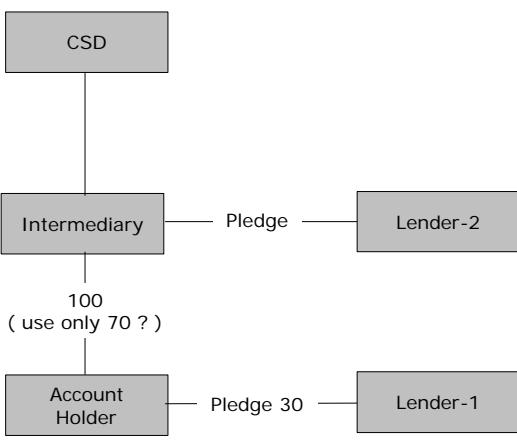
Consequently, in the US, the provision of securities collateral, in most cases, has no influence on the book entry.

By contrast, in Japan, provision of securities collateral always entails some kind of book entry: either the transfer into another account or at least an "earmarking".

The next question was whether the intermediary could use (with the account holder's consent) the 100 securities including the encumbered part or whether

the intermediary could only use the 70 unencumbered units. Supposing the rule was that the intermediary could only use the unencumbered part: what happened if the intermediary pledged 100 (including the 30 encumbered) units to its own Lender-2, violating its obligation?

There was support for the opinion that Lender-2 should win this conflict following the logic of the book entry system.



The question raised was if Lender-1 should be bound or not by any agreements between the account holder and the intermediary regarding a right of use. In case the account holder had already agreed to a right of use beforehand, the general principle would say that Lender-1 could not receive more than the account holder had. That in turn would suggest that Lender-1 should be likewise be bound. Some members were of the opinion that nevertheless Lender-1 should not be bound. If the account holder agreed to the right of use after the pledge was in place the question would be different and especially difficult to answer in case the intermediary was not aware of the pledge.

In order to highlight a significant difference between systems based on the property model (e.g. in Japan, Germany) and those based on the model of an entitlement (e.g. in the US), the above described example was modified:

In case Lender-1 was not (yet) account holder with respect to the pledged assets, the intermediary had the right to pledge all securities that the account holder had in his portfolio. If the intermediary had in its own account 200 securities of the same issue, then the intermediary was entitled to use the entire 300 including the encumbered portion. If the 30 securities provided as collateral were moved into another account (as for example in Japan), the intermediary could only pledge 270 to Lender-2. However it could have happened, by mistake, that

Lender-2 obtains a security interest of 300. In this situation, e.g. under Japanese Law, Lender-2 is favoured in the case of a shortfall in the sense that the loss will be shared amongst the parties at the level of the account holder. In an entitlement system (e.g. in the US), there is no relationship between the 300 or 270 units pledged by the intermediary to Lender-2 and the account holder's level of the holding system. The system under the UCC, for example, connected both levels by an obligation of the intermediary, namely to maintain financial assets correspondingly to what its account holders had in their accounts. By contrast in the traditional civil law countries, e.g. Germany or Japan, there were always the same securities pledged at the different levels. As in case of a shortfall there would be somebody who wins, the question was against whom. Consequently, in these systems, there were competing interests between claimants at the same but also at different tiers, who were claiming the same asset on the basis of their security interest.

3 Proceedings on the possible type of the future instrument

The Study Group found it useful to discuss the type of instrument at this early stage, because the question of the appropriate instrument had an impact on the content of the work.

The group felt that the aim of its work could probably not be achieved by employing principles or a model law. Principles are by definition a kind of restatement of generally accepted basic rules. However, in the area of indirectly held securities there were no such rules. As to a model law, the problem was that it was already clear that there were, at present, five or six fundamentally different legal structures in place around the world. A model law would be incompatible with most of them. The necessary radical changes in some of those systems were unlikely to be achieved in a reasonable timeframe.

Therefore, the Study Group assumed that a minimum set of rules in form of a convention that could be applied in a greater number of different jurisdictions would be the appropriate instrument. This appeared to be the only way to efficiently address problems of compatibility.

As such a minimalist convention would mainly deal with compatibility issues, it would have to leave aside the internal soundness of systems to a large extent. Therefore, an additional instrument (i.e. setting forth benchmark principles) could be drawn up against which countries could measure the quality of their own legislation.

4 Proceedings as to future work

4.1 Amendment of the title of the project

11. The Study Group emphasised that the scope as reflected in the original title of this Study ("Harmonised Substantive Rules for the Use of Securities held with an Intermediary as Collateral") was too narrow because the treatment of providing collateral unavoidably entailed that all questions of creation and trans-

fer of indirectly held securities had to be addressed. Therefore the Study Group decided to modify the title accordingly into "Harmonised Substantive Rules regarding Securities held with an Intermediary".

4.2 Promotion of the project

As to the promotion of the project, the Group agreed to prepare a presentation by the summer of 2003. This presentation is supposed to explain the need for harmonised substantive rules regarding indirectly held securities, to present the work of UNIDROIT on this project and to set forth first ideas as to possible solutions. The Group decided to draft this paper as part of the informal working process between its sessions.

The Group authorised the Secretariat to co-ordinate the work with other international public and private bodies which are active in the field of harmonisation of securities law. It was emphasised that the UNIDROIT project responded the call for action by other organisations.

4.3 Fact Finding Missions

As to fact finding missions, it was decided to carry out other such missions in a number of States, resources permitting. It was emphasised that these informative exercises which, at the same time contributed to promoting the awareness for the need of a harmonised framework for indirectly held securities should encourage public and private bodies to contribute to the funding.

As to the choice of the countries to aim at the Study Group, in addition to the points set out in Doc. 6 sect. 3 para. 2⁴, emphasised that (1) With a view of fully reflecting the global reach of the project it was desirable to carry out at least one fact finding mission in Asia and/or Africa; (2) countries which are at present considering to amend their respective legislation should be addressed first in order to co-ordinate work; (3) there should be informative exchange with international bodies such as the ECB; (4) contacts with the authors of the *Giovannini* and *G30* reports should be established as well.

The Secretariat in concertation with the Vice Chairman of the Study Group was to work out further details.

4.4 Industry observers

The Group agreed that the project needed the interest and the support from the private financial sector but at the same time expressed the concern that any further enlargement of the group could slow down the working process. Furthermore, it was emphasised that the private financial sector is invited to create a parallel body co-operating with UNIDROIT in this project (*Capital Markets Working Group*).

⁴ UNIDROIT 2003, Study LXXVIII, Doc. 6.

4.5 Next meeting

The next meeting will be held from 13 - 15 November 2003. A seminar or any other forum involving the private financial sector, could be planned for the 12 November 2003. Any such additional meeting would not require the presence of all members of the Study Group.

APPENDIX 1

LIST OF PARTICIPANTS

Chairman

- Mr B. SEN, Senior Advocate at the Supreme Court of India, New Delhi, India

Members of the Restricted Study Group

- Mr J. Michel DESCHAMPS, Partner, McCarthy Tétrault, Montreal, Canada
- Mr Philippe DUPONT, Partner, Arendt & Medernach, Luxembourg, Luxembourg
- Ms Dorothee EINSELE, Professor of Law, Christian-Albrechts-Universität zu Kiel, Kiel, Germany
- Mr Edgar I. JELONCHE, Attorney-at-Law, Professor of Commercial Law, Buenos Aires University School of Law, Buenos Aires, Argentina
- Mr Hideki KANDA, Professor of Law, University of Tokyo, Tokyo, Japan
- MR LI Rui Qiang, Law Manager, China Securities Depository and Clearing Co. Ltd., Beijing, P. R. China
- Mr Guy MORTON, Partner, Freshfields Bruckhaus Deringer, London, United Kingdom
- Mr Frédéric NIZARD, Direction juridique, Crédit Agricole SA, Paris, France
- Mr Richard POTOK, Principal, Potok & Co., Darlinghurst, NSW, Australia
- Mr Curtis R. REITZ, Professor of Law, University of Pennsylvania Law School, Pennsylvania, USA
- Mr Luc THÉVENOZ (*Vice Chairman*), Professor of Law, Centre for European Legal Studies, University of Geneva, Faculty of Law, Switzerland
- Mr WU Zhipan, Professor of Law, Vice-President of the Peking University, Beijing, P. R. China

Observers to the Study Group

- Mr Christophe BERNASCONI, First Secretary, Hague Conference on Private International Law, Permanent Bureau, The Hague, The Netherlands
- Mr. Spiros BAZINAS, Senior Legal Officer, UNCITRAL Secretariat, Vienna, Austria
- Mr Antoine MAFFEI, (Co-ordinator, Capital Markets Working Group), Partner, De Pardieu Brocas Maffei & Leygonie, Paris, France

UNIDROIT

- Mr Herbert KRONKE, Secretary-General
- Mr Philipp PAECH, Research Officer (*Secretary to the Study Group*)
- Ms Marina SCHNEIDER, Research Officer

APPENDIX 2

MATERIALS DISTRIBUTED TO THE STUDY GROUP

- *Securities Holding System and Pledge in China*, March 2003 (submitted by Mr LI Rui Qiang), reproduced in Appendix 4
- *Indirectly held Securities: Key Characteristics*, March 2003 (submitted by Mr Guy Morton), reproduced in Appendix 5
- *Convention on the law applicable to certain rights in respect of securities held with an intermediary*, (Hague Conference on Private International Law, Text of the convention #36), not reproduced
- *The Rome Project: Status as of 12 March 2003* (working paper compiled by the chair), not reproduced
- *The Rome Project: Updated Status as of 13 March 2003* (working paper compiled by the chair), reproduced in Appendix 6
- *Trading issues* (working paper submitted by Sub-group 1), reproduced in sect. 2.5
- *Lending and Pledging Transactions* (working paper submitted by sub-group 2), not reproduced
- *Second Report on EU Clearing and Settlement Arrangements, Draft – 20 February 2003* (The Giovannini Group), not reproduced
- *Consultation Meetings with Legal Experts – Presentation and Questionnaire* (prepared by the Secretariat), not reproduced

APPENDIX 3

DRAFT AGENDA

DAY 1

1. Adoption of the Agenda
2. Adoption of the Summary Report on the First Meeting
3. Presentation/evaluation of the fact finding missions

DAY 1/2

4. Discussion/decision on the scope of the project
- 4a Identification of key features

DAY 2/3

5. Decision on the approach to be adopted/
Development of the outlines of a future instrument
 - basic definitions (e.g. "securities")
 - functional core principles, to the extent possible at this stage
 - definition of criteria for commissioning an economic impact study

DAY 3

6. Decision on further fact finding
7. Decision on other future inter-sessional work
8. Decision on Industry Observers

APPENDIX 4

CHINA SECURITIES DEPOSITORY AND
CLEARING CORPORATION LIMITED

**SECURITIES HOLDING SYSTEM AND PLEDGE
IN CHINA**

CHINA, MARCH 2003

CONTENTS

I. FOREWORD**II. THE MEANING OF SECUTITIES HELD WITH INTERMEDIARIES****III. SECURITIES HOLDING SYSTEM IN CHINA****IV. THE LEGISLATION ON SECURITIES PLEDGE IN SECURITIES HOLDING SYSTEM IN CHINA**

1. The meaning of the share pledge
2. The conditions to establish share pledge
3. State-owned shares pledge
4. The scope of shares that can be pledged
5. The relationship between pledger and pledgee in share pledge system
6. Status of registration and the problems in the process of establishing share pledge
7. Pledgee's right to pledge the pledged assets
8. The procedure of execution by courts
9. The special legislation in the course of carrying out the pledge right
10. carrying out the pledge rights of the state-owned share or society legal person share

SECURITIES HOLDING SYSTEM AND PLEDGE IN CHINA

I. FOREWORD

The Hague Conference's project on "the law applicable to certain rights in respect of securities held with an intermediary" provides a uniform rule on the application of conflict laws applicable to the rights of securities held with intermediaries. However, the substantive rules in many countries are different and the difference brought much inconvenience to cross-border transactions. Because of this situation, International Institute for the Unification of Private Law aims at constituting uniform substantive rules by soliciting expertise and finding out the difference of laws and the facts in different countries. The project of the conference is on Harmonized Rules for the Use of Securities Held with an Intermediary. My report's purpose is to introduce and discuss the securities holding system and share pledge in China.

4.6 II. THE MEANING OF SECUTITIES HELD WITH INTERMEDIARIES

The report of Hague conference the Law Applicable to Dispositions of Securities Held through Indirect Holding Systems defined that "...direct holding system in which owners of securities had a direct relationship with the issuer, the investors would either be recorded on the issuer's register or be in physical possession of bearer securities."

In a physical environment, this traditional holding system posed many problems. Transfers of securities had to be settled through the physical delivery of paper certificates and instruments of transfer, making such transactions not only labor-intensive, time-consuming but also risky and expensive.

To avoid these shortcomings, some modus operandi of the indirect holding system comes into being gradually. Under the indirect holding system, the relationship between the investor and the issuer company is not direct. The investor's securities interest is recorded on an intermediary's book entry and the intermediary's interest is recorded another intermediary's book entry. There are one or more intermediaries between the investors and the issuers. The securities interest is recorded at different administrative levels in the intermediaries' chain.

Because securities is recorded in the omnibus account and the higher tier intermediary cannot offer interest information to the investors, the investors are unable to claim rights against the issuer directly but only against the direct intermediary according to the contract signed between them.

III. SECURITIES HOLDING SYSTEM IN CHINA

The Securities Law of the People's Republic of China stipulates that a securities registration and clearing institution shall perform the following functions: (1) establishment of securities accounts and clearing accounts; (2) custody and transfer of ownership of securities; (3) registration of the names of the holders of securities; (4) clearing and delivery of listed securities traded on the stock exchange; (5) allotment of securities rights and interests upon entrustment by the issuer; (6) handling of inquiries concerning the above-mentioned business; and (7) other business approved by the securities regulatory authority under the State Council. Article 150 stipulates that before trading listed securities, a holder shall place all such securities in the custody of a securities registration and clearing institution. A securities registration and clearing institution may not use its clients' securities as collateral or lend them to others.

In China, investor's name and interest are registered in their accounts which the securities registration and clearing institution (CSD) keeps for them.

According to the law mentioned above, the securities holding system in China might be described as follows. The investor's names are recorded on the register directly, and only a small number of investors have their securities held by intermediaries indirectly. The shares in China are mainly divided into A-share and B-share. A-share is listed and traded in China's local currency. B-share is listed and traded in foreign currencies. For all A share holders, their names and holdings are recorded the book entry of the securities registration and clearing institution (SD&C). For B share holders, all the domestic investors have their names registered directly; some foreign investors can choose not to appear their names in the book entry of the registration institution directly but on only the book entry of the securities companies (intermediaries).

IV. THE LEGISLATION ON SECURITIES PLEDGE IN SECURITIES HOLDING SYSTEM IN CHINA

In China, the securities eligible for pledge is currently limited to the shares of the listed companies.

1. The meaning of the share pledge

The meaning of the share pledge refers to the acts of a debtor or a third party to transfer right of share thereof to the creditor as guarantee of the creditor's rights. When the debtor fails to pay off the debts, the creditor has the right, according to the procedures of law, to convert the right of share into money, or auction, or sell off the share to get paid off preferentially with the proceeds. The Guarantee Law of The People's Republic of China stipulates that the shares and the share certificates that can be transferred according to law can be used in pledge.

2. The conditions to establish share pledge

The Guarantee Law stipulates that if the share certificates that can be transferred according to law are pledged, the pledger and the pledgee shall enter into a written pledge contract and register at securities registration departments. The pledge contract goes into effect as of the date of the registration.

According to the law mentioned above, three conditions shall be met to establish share pledge: (i) the share being pledged can be transferred according to law; (ii) the pledger and the pledgee shall enter into a written pledge contract; (iii) the pledge contract shall be registered at securities registration institution.

3. State-owned shares pledge

Provisional Regulations on the Administration of the Issuing and Trading of Stocks stipulates that the transfer of state-owned shares shall be approved by the government department concerned. The government department concerned is usually the Ministry of Finance in China. The state-owned share pledge shall be registered at the securities registration and clearing institution (SD&C) after acquiring the approval from the Ministry of Finance.

4. The scope of shares that can be pledged

The category of shares in China mainly divided as A share, B share, H share, ADRs, GDRs and so on. According to the laws, the share that can be pledged are A share held by comprehensive securities companies in their proprietary accounts and the securities invested fund. A share held by the natural persons and other legal persons is forbidden to be pledged.

5. The relationship between pledger and pledgee in share pledge system

The Securities Law of the People's Republic of China stipulates that the securities registration and clearing institution is in charge of setting up securities accounts and clearing accounts, providing custody and securities ownership transfer service.

The Guarantee Law stipulates that a pledgee has the obligation to properly take care of the pledged assets. The pledgee shall assume civil liabilities for the damage or evanescence of the hypothecated assets resulted from improper care. If the pledgee fails to properly take care of the pledged assets, which could lead to the damage or evanescence of the pledged assets, the pledger can request the pledgee to withdraw and deposit the hypothecated assets in advance, or request to pay off the debts and have the pledged assets returned. Because of securities dematerialisation, centralized registration and custody in China the duty of taking care of pledged collateral shifts from the pledger to the securities registration and clearing institution (SD&C).

6. Status of Registration and the problems in the process of establishing share pledge

According to the Guarantee Law, the pledger should not transfer the possession of share to the pledgee but register the shares at the securities registration and clearing institution in the process of establishing the share pledge. But according to the basic

rules of the civil law, the possession of the pledged collateral should be transferred to the pledgee. There is an important difference between the Guarantee law and the civil law. We will discuss the special situation in the process of share pledge.

(i) Saving the right of pledge from damage

The Guarantee Law stipulates that if it is possibly to damage or reduce the value of the pledged assets, the pledgee can request the pledger to provide corresponding guarantee. If the pledger refuses to provide guarantee, the pledgee can auction or sell off the pledged assets and use the proceeds, with the agreement of the pledger, to clear off the guaranteed creditor's rights or have the proceeds deposited to a third party agreed upon by the pledgee.

(ii) Carrying out the pledge right

The pledgee can carry out the pledge right as the following three models: a. to get the securities interest by converting the pledged assets into cash according to the agreement with the pledger, b. to auction the pledged assets and c. to sell off the pledge assets and use the proceeds according to law.

(iii) Transfer of the possession of the shares

The problems from the share pledge registration can be resolved by transferring the share from the pledger's account to that of the pledgee. In China, the relevant law stipulates that the lender (commercial banks) shall apply for a special seat in the stock exchange. The seat is used to deposit and dispose the securities as collateral. Meanwhile, it has to open a special fund settlement account with the securities registration and clearing institution (SD&C). The securities registration and clearing institution shall transfer the pledged share to the special seat of the lender.

7. Pledgee's right to pledge the pledged assets

To pledge the pledged assets means that the pledgee pledges the pledged assets to another new pledgee for himself or other person. The new pledged asset is still the original pledged asset. The new pledge right is prior to the original pledge right in case of interest claim.

The Supreme Court decides that the pledgee can re-pledge the pledged assets to guarantee his debt with the consent from the original pledger in the period of the existence of pledge. But the guaranteed creditors' rights shall not exceed the scope of the original creditor's rights. The part which exceeds the original creditor's does not have the priority to the original pledged rights. The original pledgee cannot pledge the original pledged asset without the consent of the original pledger or he should compensate the losses if his action causes damages.

8. The procedure of the courts execution

According to the Supreme Court's decision that if the pledged assets are frozen by courts, the court can seal up or detain the pledged assets which the person subjected to execution

have the pledge rights; if the person subject to execution fails to pay the debts before the agreed deadline, the court has the power to convert it into money, or auction or sell off the property, the pledgee should be paid off preferentially with the proceeds, and the person who has applied for execution can be paid off with the rest of the proceeds.

9. The special legislation in the course of carrying out the pledge right

The business segregation between commercial banking and securities industry is strictly enforced in China. The Commercial Banking Law of the People's Republic of China stipulates that the commercial bank can neither deal in the business of trust investment and stock trade, nor invest in real estate except for its own use, or invest in the non-bank finance institutes and enterprises. The commercial bank should dispose the real estate or stock as a result of carrying out the pledge right within one year of its acquisition. The disposition should be supervised by the Central Bank of China and China Securities Regulatory Commission. The stock exchange and the securities registration and clearing institution shall assist the bank in disposing of the estate and the stock.

10. If the pledged assets are state-owned share or society legal person share, the pledgee should carry out the pledge rights according to the special law.

* * *

INDIRECTLY HELD SECURITIES: KEY CHARACTERISTICS

1. INTRODUCTION

- 1.1 This note considers –
 - (a) the key features which a law on indirectly held securities must have in order to attain the standard of "internal soundness" suggested in the study group's first meeting;
 - (b) the extent to which there needs to be uniformity among the laws of different states if the objective of "compatibility" suggested in the first meeting is also to be achieved.

A. Key characteristics

2. INVESTORS' INTEREST

2.1 The interests of investors represented by the credit of securities to their accounts with an intermediary should be protected from the insolvency of the intermediary, in the sense that it should not be available for realization for the benefit of the general creditors of the intermediary.

2.2 There should be a clear rule about the effect of any failure by the intermediary to maintain underlying securities or rights (e.g. rights with a higher-tier intermediary) corresponding to the rights of its own account holders.

Note: probably the rule should be that the rights of account holders should abate pro rata, so that the deficit would be borne by them all equally, but this is for discussion.

2.3 There should be a clear rule about the means by which securities held with an intermediary can be transferred.

Notes:

- (a) A transfer by book entry to another securities account should be sufficient. Should it also be necessary – that is, should any disposition not recorded on securities account with the intermediary be recognized? If so, on what conditions?
- (b) A rule about security of transfer (i.e. the sufficiency of a transfer by book entry) implies a rule against "upper-tier attachment" – since a pledgee by book entry will not have a secure title if his interest can be undermined by a competing creditor attaching the pledgor's interest in effectively the same property at a higher level.

2.4 There should be a clear rule on priorities between competing dispositions.

Notes:

- (a) *If the rule under 2.3(a) above were that only a transfer actually recorded on an account with the intermediary would be recognized as an effective disposition, such a rule would seem unnecessary, since competing dispositions could not arise. Otherwise, the desirability of ex ante certainty suggests that a good faith recipient of securities by a book entry transfer across accounts with an intermediary should have priority over any competing interest unless the transferee (or, perhaps, the intermediary?) had actual notice of a prior competing interest.*
- (b) *As between two interests not constituted by book entry on the relevant account, should priority be determined by reference to the order in which the interests are notified to the intermediary? If not, what should the rule be?*

3. POSITION OF ISSUER

3.1 The issuer should not be bound to act in accordance with the instructions[, or to recognize any interest,] of anyone but the immediate holder of a security (that is, the person recorded in its own records as the holder of the security or, in the case of a bearer security, the person in actual or legal possession of the certificate or other document representing the security).

Note: The phrase in square brackets is linked with the exclusion of "upper-tier attachment".

3.2 It is for discussion whether the interest of an account holder with an intermediary should be required or permitted to be recognized by the issuer in any (and if so, what) circumstances.

Notes:

- (a) *Provisions entitling indirect holders to vote need not be incompatible with the rule in 3.1 above if they operate by making the indirect holder the proxy or representative of the direct holder for the limited purpose of voting.*
- (b) *Questions of voting and enforcement of rights in insolvency or reorganization proceedings (including for this purpose the right to initiate such proceedings against the issuer to the same extent as a direct holder) arise from considerations both of expense and practicality (intermediaries may impose substantial charges for exercising such rights, or may be unwilling to do so at all) and of control.*
- (c) *Recognition can also be relevant to the availability of set-off. Prior to insolvency, the point is unlikely to be material because the terms of issue of debt securities will almost invariably exclude set-off. In an insolvency any such exclusion will be overridden by applicable mandatory rules of insolvency law; but a mandatory rule generally favourable to set-off may itself be defeated by an indirect holding pattern, for example if it applies only to mutual claims between the same parties and under the relevant law the indirect holding pattern is regarded as destroying mutuality. Should such a concern about mutuality be dealt with as*

a matter of the general law of indirectly held securities or as a special rule of insolvency law?

4. POSITION OF INTERMEDIARY

4.1 The intermediary should not be bound to act in accordance with the instructions[, or to recognize any interest,] of anyone but its immediate account holder.

Note: see the comment at 3.1 above on the phrase in square brackets.

B. Minimum level of uniformity required for compatibility

5. CHARACTERIZATION

5.1 The rights constituted by the credit of securities to a securities account could in principle be (and are at present) characterized in a number of ways –

- (a) they could constitute a special, *sui generis*, proprietary interest with defined characteristics and conferring defined rights (the UCC Article 8 approach);
- (b) they could constitute rights in the underlying securities or be regarded as conferring title to them (the current German law approach, at least as understood, perhaps wrongly, by the writer of this note);
- (c) they could constitute or be deemed to constitute rights in securities deemed to be deposited with or held by the relevant intermediary (the current French law approach, again as understood by the writer; possibly also the approach under applicable Belgian Royal and Luxembourg Grand Ducal decrees?);
- (d) they could constitute co-ownership rights in or in respect of underlying property, whether actual securities or rights arising from the credit of securities to accounts with a higher tier intermediary (the current English law approach);
- (e) they could constitute merely contractual or other merely personal rights to the delivery of securities of a specified amount and description.

5.2 The last of these approaches avoids any difficulties of combination with other conceptual approaches, but fails to address the basic objective in 2.1 above and requires investors holding securities accounts to incur a credit exposure to the intermediary.

5.3 The second approach, and possibly the third, raise issues of compatibility which could be resolved only if it were generally adopted. If it were, accounts with intermediaries other than the lowest tier intermediary would, it seems, have a status different from that of the account of the lowest tier intermediary, since they would not constitute or evidence a property right.

5.4 The objective set out in 3.1 and 4.1 above appear to sit most comfortably with a characterization of an account holder's interest as something other than a property right in the underlying securities or in the rights held by any upper-tier intermediary – Arguably they do not rule out completely a framework under which (as under some laws at present) the investor's interest is a property interest in the underlying securities – the objectives in 3.1 and 4.1 and the linked concern to avoid "upper-tier attachment" could be addressed by procedural rules

preventing attachment and similar claims and protecting the issuer and intermediaries against personal claims for ignoring alleged proprietary claims competing with those of their immediate account holders. However, if this were the rule, it would have to be the universal rule.

* * *

APPENDIX 6

THE ROME PROJECT: UPDATED STATUS AS OF 13 MARCH 2003

Scope : uniform substantive rules / principles for holding and disposition over securities in indirect holding systems, whether international or domestic.

Need for uniform rules to be tested against legal soundness and cross-border compatibility, in particular: avoidance of legal risk (in particular investor protection), of systemic risk, desire for market efficiency.

Type of instrument not yet discussed.

Terminology: definitions consistent as far as possible with the Hague Convention. Differences require motivation.

	List of key features	Uniformity test	Contents of the rule
1	Protection of investor in intermediary's insolvency	Accepted	Implicit
2	Requirements for disposition*: <u>is book-entry necessary / sufficient to perfect a disposition? may need differentiation between sale and collateral transactions</u>	Accepted	Discussed in the trading and lending groups.
3	<u>Finality of disposition: can a book-entry be reversed?</u>	Accepted	t.b.d.
4	Requirements for realisation by secured party	Accepted	t.b.d.
5	Priorities, <u>adverse claims (same tier / different tiers), bona fide purchase</u>	Accepted	t.b.d.
6	Position of intermediary	t.b.d.	t.b.d.
7	Upper-tier attachment	Accepted	Implicit
8	In / out option	t.b.d.	t.b.d.
9	Shortfalls / <u>overcrediting</u> ; requirement to maintain enough holdings	Accepted	t.b.d.
10	Segregation of intermediary's and clients' holdings	t.b.d.	t.b.d.

* In line with the Hague Convention, "disposition" includes creation and extinction of an interest in securities.

11	Use of clients' securities**	t.b.d.	t.b.d.
12	DvP in intermediary-accountholder relationship	t.b.d.	t.b.d.
13	Recognition of <u>settlement netting / close-out netting</u>	t.b.d.	t.b.d.
14	Effects of disposition on rights and actions derived from the securities (voting rights, dividends and interest, set off in bankruptcy, derivative action, etc.)	t.b.d.	t.b.d.
15	Position of issuer	t.b.d.	t.b.d.
16	Disposition over restricted-transfer / -ownership securities	t.b.d.	t.b.d.
17	Cross-Border Bridge (recognition of securities held in another jurisdiction, notwithstanding definition, nature of interest, etc.)	Accepted	t.b.d.

* * *

** May need distinction between uses for liquidity purpose in settlement systems; for financing purpose by intermediary; for revenue purpose by way of securities lending, etc.)