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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**

**Comments on the Preliminary Draft Convention**

Rome, September 2004

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# ISDA

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## BY POST AND BY E-MAIL

3 September 2004

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Dear Sirs,

### **Draft convention on substantive rules regarding securities held with an intermediary**

We are grateful for the opportunity to comment on the preliminary discussion draft convention on substantive rules regarding securities held with an intermediary, published by UNIDROIT in April 2004. As you know, the International Swaps and Derivatives Association, Inc. (*ISDA*) has taken a close interest in this project since its inception, having commented on the proposed scope of work in our letter of 6 September 2002 and on the position paper prepared by the UNIDROIT Study Group for this project in our letter of 11 November 2003.

ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry, a business which includes interest rate, currency, commodity, credit and equity swaps, options and forwards, as well as related products such as caps, collars, floors and swaptions. ISDA was chartered in 1985 and today numbers over 600 member institutions from 46 countries on six continents.<sup>1</sup>

We note that the draft Convention is marked as a "preliminary discussion draft", with the implication that the text is tentative and significant further work is required. We do not propose at this stage, therefore, to offer detailed drafting comments, which we would be pleased to do when the draft is more developed or at any other time at your request.

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<sup>1</sup> For further information on ISDA and its activities, please consult our website at <http://www.isda.org>.

For present purposes, our first, and perhaps most important, point is that this project needs detailed financial industry input. In our letter of 11 November 2003, we noted that the Hague Securities Convention<sup>2</sup> benefited immeasurably from the regular consultations that were conducted by the Permanent Secretariat of the Hague Conference on Private International Law with a stable group of experienced industry practitioners. This is key to ensuring the future effectiveness, market compatibility and broad acceptance of an eventual Convention on these issues. We note that the Secretariat of UNIDROIT has on more than one occasion acknowledged the importance of this and made it clear that detailed industry input will be organised once the project has reached a certain stage of development, possibly by the Spring of 2005. We understand that the Study Group will be meeting in Budapest later this month. We would be pleased to offer advice and assistance as to how best to ensure effective industry input at the appropriate time.

We are pleased to see that certain issues of importance to the financial markets, and in particular the derivatives markets, and which we highlighted in our earlier letters, have been addressed in the draft convention. For example, in our letter of 6 September 2002 we emphasised the importance of addressing the question of set-off of a holding of securities with an intermediary against claims owed to the issuer of those securities. We are pleased to see this reflected in Article 20 of the draft convention.

While specific reference to enforcement of collateral arrangements was omitted from the original draft scope of work and this absence was commented upon in our letter of 6 September 2002, we are pleased to see that article 21 deals with this, including in article 21(3)(b) mandating a secured party's right to realise its security by appropriation of the relevant collateral and in article 21(4)(b) protecting collateral arrangements from the effect of insolvency proceedings, including by implication from the effect of insolvency stays or freezes.

We are also pleased to see that article 8 addresses the protection of rights of account holders on the insolvency of intermediary, which we believe should remain one of the core principles of any future convention regime. We mention this because we understand that at one stage of this project it was not clear that the Study Group intended to propose this as a core principle but was considering instead including it in less formal guidance or model principles.

We believe, however, that there are at least three important respects in which the draft convention can be, and should be, strengthened if it is to confer an important benefit on the security and integrity of the financial trading markets:

1. Article 21 of the draft convention should clearly cover title transfer collateral arrangements, including the title transfer collateral arrangements that form a key component of securities repurchase (repo) and securities lending transactions. ISDA's own empirical work on collateral management shows that most collateral arrangements established in the European over-the-counter derivatives markets, whether or not done under ISDA documentation, are based on transfer of title rather than on creation of a security interest.<sup>3</sup>

Both the European Financial Collateral Directive<sup>4</sup> and the Hague Securities Convention acknowledge and cover both forms of collateral arrangement. Article 21, however, clearly only covers security ("creates a security interest"). A transfer of title, even for a security purpose, does

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<sup>2</sup> The Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary, concluded at the Hague in December 2002 (not yet in force).

<sup>3</sup> ISDA has conducted an annual survey of collateral management practices over the past few years. The latest Margin Survey ("margin" being a synonym for "collateral" in this context) is available from the ISDA website referred to in footnote 1.

<sup>4</sup> Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.

not involve the creation of a security interest in the common law jurisdictions of the United Kingdom and Ireland. We appreciate that the distinction is perhaps less clearcut in civil law jurisdictions where, as, for example, in Italy, a transfer of title by way of security might be assimilated to an irregular pledge. Article 21 should therefore be revised to ensure that it covers title transfer arrangements.

This would include extending article 21 to deal with, and eliminate, recharacterisation risk relating to title transfer collateral arrangements in a manner comparable to Articles 6 and 7 of the Financial Collateral Directive.

2. The provisions of the draft convention should expand the protection of collateral arrangements from the effect of insolvency rules such as preference, zero hour and similar rules where those would invalidate collateral transfers, for example, pursuant to mark-to-market or collateral substitution provisions on the sole basis that such transfers occurred during a "suspect period" or after a cut-off time.

Clearly, where an arrangement is as a whole offends a preference or similar rule, it should not be protected. But normal operation of market collateral arrangements should not be invalidated. Again, this is consistent with the approach taken in Article 8 of the Financial Collateral Directive, and is a point we raised in our letter of 11 November 2003.

We also believe that the opportunity should be taken specifically to clarify that normal mark-to-market collateral arrangements involving thresholds, minimum transfer amounts and/or other provisions that are linked or vary according to the credit rating of a party should not be invalidated by preference or similar rules. A significant proportion of master netting agreements and collateral arrangements include such provisions, which provide important credit protection for financial market participants and help to do so on a more cost-effective basis (for both parties) than would be the case if such provisions were not included.

3. Close-out netting, broadly defined to include contractual set-off and novation or "flawed asset" approaches to close-out netting, should be reinforced to the extent that close-out netting forms the basis of a collateral arrangement. This point clearly interrelates with our first and second points above. Again, this is consistent with Article 7 of the Financial Collateral Directive.

In many important ways, the draft convention is broader and more ambitious than the Financial Collateral Directive, dealing not only with collateral arrangements but all dealings in securities through intermediaries. We think that this is good, and necessary. The draft Convention should therefore confer at least the degree of legal certainty conferred by the Financial Collateral Directive in those respects mentioned above.

Although we are not offering detailed drafting comments at this stage, we thought that it might be helpful if we made three drafting comments at this stage:

- (a) We think it would be helpful to include a definition of "person" in the draft convention in order to clarify that references to "person" in the convention include both legal and natural persons. Account holders, for example, who are natural persons should be assured of the same protections under the convention as corporate account holders.
- (b) We believe that the Study Group should consider whether article 19(2) should be subject to article 20 as well as to article 19(1).

- (c) Regarding article 22(5) we note that a collateral agreement may not itself provide for those consequences set out in sub-paragraphs (a) and (b), which may instead be provided for in a master netting agreement to which the collateral agreement is attached, as would typically be the case with an ISDA Master Agreement, which establishes the close-out netting of terminated transactions, and a related Credit Support Annex, which includes the relevant security or title transfer provisions that give effect to the collateral arrangement.

We wish to commend the Study Group for the hard work it has done so far on this important project and reiterate our support. We would be delighted to provide any further information or assistance regarding international financial market practice or otherwise that may be helpful to you. ISDA and its members will continue to follow the development of this project with great interest. Please feel free to contact either of the undersigned if you have any questions or desire any further information.

Yours faithfully,

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08 September 2004

**Comments on the UNIDROIT Draft Convention on substantive rules regarding securities held with an intermediary**

Dear Mr Paech,

Thank you for the opportunity to comment on the *UNIDROIT Draft Convention on substantive rules regarding securities held with an intermediary*. The Association of German Banks is following the debate on the harmonisation of rules regarding securities held with an intermediary closely and with great interest. The Association of German Banks represents some 240 private commercial banks and eleven regional associations, as well as the special mortgage bank and ship mortgage bank associations. Measured in terms of business volume, these banks hold a share of around 40% of the banking market as a whole. They have a total of some 180,000 employees.


Given the enormous significance of this matter for our member banks, we welcome the fact that we are invited to comment on the Draft Convention at an early stage. Please find attached our comments dealing with some open questions in the draft. Given the complexity of the issue we cannot in contrast take any final position at this early stage of the consultations and reserve the right to submit further comments, also of a

fundamental nature, in the future. This goes particularly for Art. 3, the key provision of the convention, which needs to be examined closely.

Should you have any questions, please do not hesitate to contact us.

Yours sincerely,

  
Baur

  
Rossbach

Encl.



# **COMMENTS**

**of the Association of German Banks**

**on the**

**UNIDROIT Draft Convention on substantive rules  
regarding securities held with an intermediary**

**(8 September 2004)**

### **Preliminary remarks**

The discussion draft presented by UNIDROIT for a convention harmonising substantive rules regarding securities held with an intermediary aims to leave it to national legal systems as to how the objectives set by the draft are achieved with the means and arrangements established under their different legal traditions. Nevertheless, considerable modification of national legal systems may be required. In particular, the planned Convention (see in particular Article 3) will probably make it necessary to convert the German system of book entry transfer of securities, whose legal basis is property law with direct claims by investors to ownership of the securities held in safe custody, to a system that, as we understand it, only allows investors contractual claims against their intermediary. The loss of ownership rights by existing investors accompanying such conversion raises serious problems under constitutional law. Moreover, the legal position of shareholders with respect to their membership rights is unclear. The same goes for bondholders with respect to their rights to participate in bondholders' meetings.

Given the complexity of the issue and its great importance for the German financial marketplace, we cannot yet therefore take any final position at this early stage of the consultations and reserve the right to submit further comments, also of a fundamental nature, in the future. This goes particularly for Article 3, the key provision of the Convention, which needs to be examined closely. Some open questions in the draft are, however, addressed below.

#### **I. Duties of the intermediary (Article 4)**

Article 4 is designed to ensure the relativity of the rights accruing from securities account entries, i.e. their effect solely in the relationship between account holder and intermediary, vis-à-vis the intermediary and Contracting State courts. Thus, the provisions contained in this Article merely define more precisely the basic decision underlying the draft Convention with regard to the legal nature of the rights accruing from the securities account entries.

However, the proposed wording of Article 4 appears to leave no room for the enforcement of adverse claims, where this remains permissible under the provisions of Chapter V, against the intermediary. The exception provided in paragraph (2) from the recognition in paragraph (1) of account holders' rights by a corresponding credit of securities appears to rule out at least any "extrajudicial" recognition of adverse claims by the intermediary. Paragraph (2) should therefore include a further exemption for sufficiently substantiated adverse claims.

#### **II. Early crediting of securities to an account (Article 5 (3))**

Article 5 (2) stipulates that an intermediary may not credit securities to a securities account if it would as a result hold insufficient securities with respect to account holders' rights. In other words, a bank would have to wait until the date of settlement of its covering transaction before it could credit the securities purchased to its customer's account. This is the consequence of the

principle also reflected at other points in the draft, holding that a securities account holder acquires a legal position with respect to securities when these are credited to his account (see Article 9 (1)).

In Germany, stock exchange transactions are settled under current trading rules on the second trading day. However, banks usually settle transactions to buy or sell securities on behalf of their customers already on the transaction date, so that the buying or selling customers' cash accounts are debited or credited then for value on the settlement date and the securities are also credited or debited to the securities accounts before the settlement date. This practice is recognised under German supervisory law, as evidenced by No. 6.1 of the Minimum Requirements for the Trading Activities of Credit Institutions.

The authors of the UNIDROIT Draft Convention have, as the explanatory notes on Article 5 show, recognised that in practice securities are often credited to accounts early in anticipation of the settlement of execution transactions. For this reason, Article 5 (3) states – albeit still in square brackets – that an intermediary may credit securities to a securities account in anticipation of a related credit of securities if this is permitted by the applicable law for the promotion of liquidity in a system for the settlement of transfers of securities. This means that in such a case crediting securities to an account early does not contravene Article 5 (2) of the Draft Convention.

It is, however, unclear what the legal impact of such early crediting of securities to an account on the basis of Article 5 (3) of the Draft Convention would be. It is conceivable that it becomes effective immediately – in part at any rate – , with other customers' holdings of the same security being reduced accordingly at the same time. If the intermediary receives the expected credit to his account on the settlement date, the deficiency would be balanced out again.

From a German legal standpoint, such an approach would be undesirable. By crediting securities to an account early, the intermediary would inevitably interfere with the legal position of other securities account holders. This must not be allowed, nor could it be tolerated by banking supervisors. The only possible solution can be that – like under applicable German law – the credit of securities to an account only becomes effective on the settlement date on receipt of the credit from the covering transaction. Whether the UNIDROIT Draft convention allows such a solution is, however, doubtful in view of the principle that to acquire a legal position only the credit of securities to an account, and nothing else, is required (see Article 9 (1) and (2)).

Crediting securities to an account early is an essential part of the clearing of customer commission transactions in particular. To allow retention of this approach, which is undoubtedly practised in other countries, the Study Group should reconsider the concept of

the absolute legal effect of a securities account credit and find a solution for crediting securities to an account early without other customers' holdings of the same security being affected. The impact of Article 5 (3) of the Draft Convention should therefore be re-examined closely.

### **III. Cover (Article 6)**

#### ***Requirement for the intermediary to cover credits to customers' accounts***

Article 6 (1) states (as a follow-up to Article 5) that the securities held by the intermediary must be appropriated to the rights of account holders. Appropriation of securities to securities account credits in the book-entry transfer system is only possible in terms of numbers, but not in such a way that individual securities, e.g. securities identifiable by code numbers, are appropriated to specific crediting operations. It would therefore be better to stipulate here that the rights of account holders arising from credit entries must be appropriated to securities held by the intermediary. It is particularly important that every credit in favour of the customer is backed by securities. Wording to this effect would mean, in our view, that the second half of this paragraph, stating that appropriation must take place to the extent necessary to ensure that the aggregate number or amount of the securities so appropriated is equal to the aggregate number or amount of the securities credited by the intermediary, could be dropped.

Any breach by the intermediary of its duties, under Article 6 (1), to hold sufficient securities in respect of account holders' rights and, under Article 5 (2), not to credit securities to an account or to dispose of securities if this would result in a deficiency should not, in our view, lead to the allocation of liability provided for under Article 7 (2). According to Article 7 (2), all investors holding rights in respect of securities of a given description credited to securities accounts with the intermediary are liable for the deficiency in proportion to the respective numbers or amounts of securities so credited. Liability on the part of all investors is only possible if the deficiency does not result from a credit of securities to an individual investor. In such a case, the investor in question must bear the risk of any shortage of cover alone. Liability on the part of all investors must be limited to deficiencies that arise after securities have been credited to accounts (force majeure, insolvency of a higher-tier intermediary, etc.). In the event of a deficiency due to the insolvency of a higher-tier intermediary, Article 5 (5) stipulates that the intermediary must acquire securities of the same description out of its own resources. Perhaps it might be possible for the provisions currently spread over Articles 5, 6 and 7, regulating both the duties of the intermediary to hold sufficient securities in respect of account holders' rights and liability-related questions in the event of any deficiencies, to be reworded and restructured on the basis of the above remarks.

#### ***Applicable law (Article 6 (3))***

Article 6 (3) is unclear: It states that the means by which securities are appropriated (as concerns credits to securities accounts, see Article 6 (1) above) is determined by the applicable law, i.e. not by the Convention. This provision thus probably refers to Article 6 (1). The explanatory note on Article 6, however, then refers to the different techniques adopted in national legal systems for ensuring that securities held for account holders are protected from the insolvency of the intermediary. While the wording of Article 6 (3) thus refers to Article 6 (1), the explanatory remarks refer to Article 6 (2). In our view, Article 6 (3) should refer to Article 6 (2) in particular. Article 6 (1) merely contains a requirement for intermediaries to cover credits in favour of their customers with securities or with such credits of their own with higher-tier intermediaries. Under this requirement, no allowance need be made for particularities of national legal systems. Article 6 (3) should at any rate be made to refer to Article 6 (2).

#### **IV. Insolvency law**

##### ***Protection of holders of “real” security interests***

It is questionable whether holders of security interests over securities credited to a securities account held with the intermediary are adequately protected in the event of the intermediary’s insolvency. Article 8 (1) stipulates that the rules of Chapter III apply notwithstanding the opening of an insolvency proceeding in respect of an intermediary. Only the rights of account holders constituted by the credit of securities to a securities account are then explicitly mentioned. Although, according to the wording of the first half of Article 8 (1), the rights of holders of security interests over securities credited to securities accounts would also probably be adequately protected, the Study Group should look separately again in their consultations at how holders of security interests over securities credited to securities accounts are protected.

#### **V. Creation of security interests over securities**

Article 9 (4) stipulates that an account holder may create a security interest over securities by causing the securities or the account to be delivered into the “control of another person”. When such delivery into the control of another person is to be considered effective is regulated by Article 11: If the account holder’s own intermediary is to be granted a security interest, then the agreement to this effect is sufficient (Article 11 (2)). If a third party is to be granted a security interest, the intermediary must be instructed to carry out any instructions received from this third party for the further disposition or transfer of the securities (Article 11 (3)). It can be concluded from Article 11 (3) that “control” means the third party’s right of disposal over the securities or the securities account. The conditions for creating a security interest are thus excessive in our view – the German lien would not be covered at any rate. While the party granting the security interest should no longer be able to dispose of the

securities provided as collateral without the consent of the party granted the security interest, it should not be a condition that the latter may dispose freely of the securities.

It is unclear whether other ways of creating security interests than those set out in Article 9 are possible. It can be concluded from the wording of Article 9 (4) (“may create ... by ...”) that this is the case. However, because Article 9 (6) refers explicitly to the existence of other methods for the acquisition or disposition of securities, but not to other ways of creating security interests as well, the wording of Article 9 (4) is unclear.

## **VI. Priority (Article 13)**

Article 13 (3)(a) stipulates that dispositions that are “perfected” have priority over dispositions that are not “perfected”. Article 13 (3)(b) then determines the ranking of the “perfected” interests among themselves as follows:

1. Interests created by dispositions perfected by the debit of securities to a securities account on the one hand and their corresponding credit to a securities account on the other hand (Article 13 (3)(b)(i), Article 9 (3));
2. Interests created by dispositions perfected by the delivery of control of the securities or the securities account to the relevant intermediary (Article 13 (3)(b)(ii), Article 9 (4), Article 11 (2));
3. Interests created by dispositions perfected by the delivery of control of the securities or the securities account to a person other than the relevant intermediary (Article 13 (3)(b)(iii), Article 9 (4), Article 11 (3)).

In view of the provision of Article 13 (3)(b), it is unclear what rank a lien held by an intermediary has if the agreement on this lien does not take place until after completion of a pledge in favour of a third party. According to the wording of this provision, interests of the relevant intermediary in securities or in securities accounts always have priority over interests of other persons in respect of these securities. The Study Group should consider here whether interests of the intermediary and interests of other persons should not generally rank equally and differ only in the order in which they were perfected, as stipulated in Article 13 (4) for the ranking of rights of other persons among themselves.

### ***Ranking of “unperfected” security interests***

Article 13 (2) stipulates that “perfected” interests have priority over “unperfected” interests. No distinction is made in German law between “perfected” and “unperfected” interests. It would therefore be helpful if the Convention dropped this term, which stems from Anglo-American law, and made a distinction instead between interests that are only effective between the contracting parties and interests that are effective *inter omnes*. Any interference

with substantive law through a distinction between “perfected” and “unperfected” law should at any rate be avoided.

## **VII. Unencumbered acquisition of rights**

Chapter V (Articles 14 – 18) of the Draft Convention regulates the unencumbered acquisition of rights in respect of securities.

### ***Protection of the intermediary (Article 14)***

Article 14 (1) is open to misunderstanding. It is probably supposed to mean that the *bona fide* intermediary acquires securities on an unencumbered basis if it acquires physical securities in order to meet its obligation under Article 5 to hold cover for credits of securities to its customers’ accounts. Such unencumbered acquisition protects this cover against claims by third parties, which is indirectly protection of this intermediary’s account holders. Article 14 (1) can also be interpreted differently, however, namely that it is precisely not the acquisition of (individual) physical securities but only the book-entry transfer of interests in collective holdings that is protected (irrespective of any higher-tier safe custody).

A clearer wording would be advisable. Should Article 14 (1) be meant as described above, it could read as follows:

“An intermediary which, otherwise than by credit to a securities account held by it with another intermediary, acquires securities in order to comply with his duties arising from Article 5, is not subject to any adverse claim subsisting with respect to those securities at the time of the acquisition if the intermediary does not at that time have notice of the adverse claim.”

### ***Unencumbered acquisition by the account holder (Article 16)***

Under Article 16 (1), an account holder who acquires securities by credit to his securities account, acquires these in good faith and on unencumbered basis if, at the time of the acquisition, he does not have notice of any adverse claim subsisting with respect to those securities. Protection of *bona fide* acquisition is of great importance for the functioning of the system of book entry transfer of securities. The provision of Article 16 (1) must therefore be welcomed.

However, this provision does not say anything about the rights of the former holder: In the field of property law, there is no question that sole ownership can only be held by one person. If someone therefore acquires property (in good faith), the former owner thus automatically loses his right of ownership. Under the approach adopted in the Convention (Article 3), however, crediting securities to an account would probably not transfer ownership

to the account holder but create a contractual claim against the intermediary. This claim could pass from the former holder to the new holder by way of assignment. Under German law, the *bona fide* acquisition of claims is not possible. In view of the requirement that unencumbered acquisition must be possible, a different legal approach (e.g. as in the crediting under German law of securities held abroad), whereby the buyer does not acquire the selling customer's claim against the seller's intermediary but an original claim against his intermediary, is conceivable. Such a legal approach would meet the requirements of Article 16 (1), although the question of what happens with the right of the seller and the interests created by it would remain unsettled.

In our view, clarification on this point should be provided in an additional paragraph (3), stating that unencumbered acquisition by credit to a securities account under Article 16 (1) does not affect the rights of the seller arising from the credit or possible interests created by these rights but that the legal consequences are determined by the applicable law.

***Unencumbered acquisition of security interests over securities (Article 17)***

Under Article 17, the security interest over securities acquired under Article 11 is unencumbered by any adverse claims with respect to those securities if at the time of the acquisition the person granted the security interest did not have notice of such adverse claims.

Article 17 "expropriates" persons previously granted security interests. This cannot be allowed in our view. It should not be a question here of unencumbered acquisition but merely of the *bona fide* acquisition of priority. This would mean that interests of other persons created earlier would remain valid, but would rank lower than the security interest acquired in good faith in accordance with Article 11 in conjunction with Article 17.



# **SOME NOTES ON THE UNIDROIT DRAFT CONVENTION ON SUBSTANTIVE RULES REGARDING SECURITIES HELD WITH AN INTERMEDIARY**

**Study Group - Brazil  
(August 2004)**

## **GENERAL OBSERVATIONS**

- **Definitions and Interpretation (Article 1):**

Most of the suggestions on this matter arose from the discussion of the meaning of all the articles of the proposed Convention that, sometimes, revealed different possible interpretations on the same subject. To avoid any misunderstanding and, thus, legal uncertainties, the proposal is:

a) To clearly define the concept of “relevant intermediary”. The suggestion is to write a definition much more comprehensive considering all the possible indirect holding systems around the world, emphasizing the direct/immediate relationship between the investor and this particular intermediary as the criteria of its identification. If this definition can be satisfactory in the case of indirect holding system with omnibus account (where the only record of the investors is to be found on the books of the investor’s immediate intermediary), the same reasoning is not applicable in other indirect holding systems where the depository also has the record of the beneficial owners only for the purposes of information providing and tracking property rights in the case of insolvency. Like in the other indirect holding systems, the investors have a direct contractual relationship only with the first/immediate intermediary that act on their behalf. Therefore, the definition of the relevant intermediary as proposed in article 1 can be misleading.

b) Also, the concept of “intermediary” should be clarified also to avoid misunderstandings. In fact, this definition (as it is) can be applicable to all the intermediaries in the intermediation chain between the investor and the depository where the securities are safekept, including the “relevant intermediary” also “a person that in the course of business or other regular activity maintains securities accounts for others or both for others ...”; therefore, this concept can be interpreted in two ways: (i) including the relevant intermediary; (ii) excluding the relevant intermediary. Although the meaning can be deduced from the content of the articles, most of the times, perhaps it would be worthwhile to review the wording of the entire Convention taking into account this potential source of legal uncertainty. For example, in Article 3 the term applied is “intermediary” where it should be “relevant intermediary”.

c) We suggest the inclusion of the definition of “security interest” in this chapter; we are assuming that the term “interest” has the same meaning; is it correct? In this case, perhaps it would be useful to use always the term “security interest” or, alternatively, to include both terms (as synonyms) in the same item of chapter 1.

d) The proposal is to introduce a change in the definition (m) “the applicable law”, as follows: “means, in relation to the application of this Convention in a Contracting State, the provisions of the law [and regulation](#) of that Contracting State ... ” Although in Brazil the meaning of “law” involves all the applicable legal framework, in other countries the interpretation can be different.

- **Final Clauses:**

- (1) The provision of Article 23 (that in the draft Convention only applies to Chapter VII as a whole) should be applicable to all the Convention’s chapters and/or clauses in order to accommodate different legal frameworks and market particularities;
- (2) We believe that it should be useful to clarify that any provision of the Convention should not prevent the adoption of more stricter or specific rules by the Contracting States

## **NOTES ON SPECIFIC ARTICLES:**

### **Article 3:**

- 1 (a) (ii) the suggestion is to exclude the expression “voting rights” leading to a wider interpretation.
- 1 (e) general doubt: what would be the rights incompatible (not subject) to this Convention? If the answer is not clear, perhaps it would be better to rewrite it as “[other rights as may be conferred by the applicable law](#)”. The introduction of this change could, perhaps, confer more comprehensiveness to the Convention, due to the strong heterogeneities that can be observed all around the world concerning the institutional and a legal frameworks, as well as market practices.
- 2 (b) Doubt: is this clause supposed to be applicable only to paragraph (1) (a), since other rights and obligations should or could be covered in the account agreement?

### **Article 9:**

- (1) and (2) –perhaps it would be interesting to make further qualification in this article, mentioning that the validity of the credit is bound to its corresponding debit, according to the relevant law. In other words, the credit must have an origin recognized by the legal system.
- (4) and (5) – in the case of Brazil (and, perhaps also in another countries) it is not possible to create a interest simply through the transfer of control of an account for another person, without the specification of the securities. One possible way of solving this kind of constraint could be a little change in paragraph 4, as follows: “An account holder may create a security interest over securities held with an intermediary or, [as permitted by law](#), over a securities account ...”

#### **Article 19:**

- (1) The rights of an account holder referred in this paragraph are specified in article 3(1)(e) and not in article 2(1)(e) as mentioned.

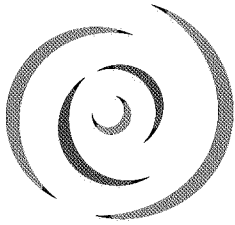
***The following comments are for information only, as changes or questioning are not being proposed.***

#### **Articles 21:**

- (3) (b) - there are restrictions in the Brazilian law on this specific clause; the collateral must not be disposed by the beneficiary (collateral taker).

#### **Article 22:**

- The provisions of this article are incompatible with the local law and regulations



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**Attn. Philipp Paech**

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ITALIE

ph.paech@unidroit.org

Brussels, 3 September 2004

**Subject:** Unidroit draft convention on substantive rules regarding securities held with an intermediary (the "Convention")

Dear Sirs.

We would like to thank you for giving us this opportunity to comment on the above-mentioned Convention. To the benefit of Euroclear participants, the Euroclear System has, since 1967, operated under a modern legal framework for intermediated securities holdings (Belgian Royal Decree no. 62 of 10 November 1967 as coordinated by Royal Decree of 27 January 2004). We therefore have longstanding experience with both the practical and legal issues that may arise in relation to this type of legislation that we would be pleased to share with you.

We welcome Unidroit's initiative to provide a legal framework for intermediated securities holdings which can serve as a reference on a worldwide basis.

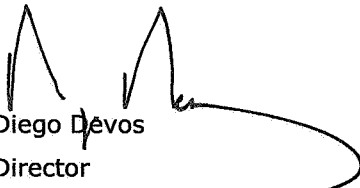
Before making our detailed comments on the individual articles of the Convention, we would like to make three comments of general nature. Firstly, we believe the focus of the Convention should be to clarify the nature of the rights of an account holder against its intermediary. It should *not* be to impose directly or indirectly standards of a regulatory nature on securities intermediaries as this should and is being done by securities regulators in other fora (in particular through the CPSS-IOSCO and ECB -CESR standards applicable to securities settlement systems). Secondly, as the Convention is one initiative amongst others in the area of securities holdings, it will be crucial for the success of the Convention to ensure

consistency with both past and current initiatives such as the EU Settlement Finality Directive, the EU Collateral Directive and the Hague Convention. Thirdly, it must be avoided that the Convention becomes too restrictive in its wording or in its regime and thereby deprives intermediaries of the necessary practical means of conducting their business in an efficient manner corresponding to the market needs of the moment.


In the attached document, we have set out our comments on the individual draft provisions, following the order of the articles as they appear in the Convention.

We stand at your disposal to discuss any of the issues referred to in this correspondence. Could you already take note that Marianne Sandel will be attending the Budapest meeting ?

Yours sincerely,



Diego Devos  
Director  
~~Deputy General Counsel~~



Marianne Sandel  
Director  
Assistant General Counsel



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September 3, 2004.

**EUROCLEAR COMMENTS ON THE UNIDROIT DRAFT CONVENTION ON  
SUBSTANTIVE RULES REGARDING SECURITIES HELD WITH AN  
INTERMEDIARY (APRIL 2004 VERSION).**

**Article 1 Definitions and interpretation**

We believe that the definitions as proposed ( inspired by the Hague Convention ) are accurate for the purposes of this Convention.

For the benefit of doubt, we shall mention that we have assumed that where an intermediary is a client of another intermediary (i.e. in a multi-tier holding chain), it falls within the definition of "account holder".

**Article 2 Scope of the Convention**

The commentary of this article, left blank, is suggesting that the Convention will exclude "pure contractual rights" of the account holder against the intermediary which has some analogy with Article 2.3 a) of the Hague Convention which aims is to exclude from the scope of this last Convention the contractual rights and obligations deriving from the custody relationship (liability, services, etc) beyond what concerns the nature of the rights of the account holder on book-entry securities credited with its intermediary which may be property-based or not ( contractual claim to recover the securities; see paragraph 1 and 2 of Article 2 of the Hague Convention).

Question: In this last situation, is it the intention at this stage to exclude from the Unidroit Convention this type of contractual entitlement which may exist in certain countries (as in Germany where mere contractual claims may only be granted to



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securities investors for foreign securities held by Clearstream Banking Frankfurt with a non-eligible foreign custodian under the meaning of German Securities Deposit Act ("Gutschrift in Wertpapierrechnung"; "WR-Gutschrift") as one could also infer it, apparently, from articles 3 (1) (a) (referring to "ownership") and 6(2) (securities appropriation preventing them from forming part of the general estate of the insolvent intermediary, available for distribution to its creditors)?

### **Article 3 Rights arising from credit of securities to a securities account**

Article 3 specifies that any economic rights to securities deposited with an intermediary on a fungible basis continue to be vested in the account holder (or the person directing him) and are not passed to the intermediary. In this context, it has to be recognised that the right of an account holder to direct the intermediary to exercise the account holder's rights with the issuer will only work in practice, if the laws and articles of incorporation of the issuer recognise nominee holding arrangements. For a full discussion of nominee arrangements, please refer to our comments under Article 19.

In Article 3(1)(d), first line, it should be specified that the right of the account holder is to "an equivalent amount of securities" as opposed to the right to withdraw the very securities deposited with the intermediary.

We very much support Article 3 (3) (b) stating that the rights of the account holder may only be enforced as a rule against the relevant intermediary, in order to allow the latter to hold efficiently intermediated securities abroad, on a fungible basis, protected from upper tier attachments (see also our comments below on Article 4).

### **Article 4 Duties of intermediary with respect to the operation of securities accounts**

We believe Article 4 correctly reflects the principle that every tier in a multi-tier chain must be considered separately and only the relevant account holder (or a



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person authorised by him) is authorised to instruct the intermediary in respect of the account holder's securities account.

As regards the exceptions in Article 4(2)(c), it must be recognised that, in practice, an intermediary will be obliged to give effect not only to court orders but also to other orders or regulations from relevant public authorities, for example in case of an embargo or currency restrictions. To reflect this regulatory reality, we believe the wording of Article 4(2)(c) must be expanded to cover any blockings under any law, decree, regulation order or injunction of any government (court or other instrumentality of government, including a central bank).

The prevention of upper tier attachments is essential for the protection of multi-tier securities holding structures. As currently drafted, we feel that Article 4(3)(c) does not go far enough in stating this principle: We therefore suggest bringing the drafting of Article 4(3)(c) in line with that used in Article 3(3)(b) so that Article 4(3)(c) positively states that any right or claim (as defined in Article 4(3)(c) itself) may only be enforced against the relevant intermediary.

#### **Article 5 -Duty of intermediary to hold securities in respect of account holders' rights.**

1. We clearly support the principle that, as a general rule, an intermediary must maintain sufficient securities in respect of account holders' rights (article 5(1) and (2)). It is indeed a crucial custody practice to make sure that in all times the intermediary is holding with its own intermediaries/sub-custodians enough securities at local level to match the securities holdings of its own clients as recorded in its books in order to avoid as a rule any securities shortfall.

2. However, we believe that this article 5 should not *a contrario* prevent an intermediary from debiting (it is generally a *reversal* of previous credit entries) its client-even if as a result of such debit this would "put the client short" or, in other words, create a securities shortfall (a debit balance)- in certain forced circumstances. For example:





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a) It may happen exceptionally in practice (especially when dealing with international issues and/or in relation to local market practices) that reversals would take place on the local market for reasons beyond the control of the CSD, such as a result of retroactive/backdated record date set by the issuer for corporate actions (e.g. a call from the issuer) in accordance with applicable issuing documentation, obliging a CSD or a custodian to deliver securities to the issuer and to debit accordingly the initial holder (having transferred the securities in the meantime on the local market) even though its account may no longer be sufficiently credited.

b) Lack of harmonisation between domestic markets e.g. with different finality timings and local settlement inefficiencies may also prevent intermediaries to offer to their clients efficient same-day turnaround. For example, in some markets, securities may be transferred to local intermediaries before finality of the cash leg (when for example cash finality with a central bank only happens at the end of the day) which may nevertheless want to already transfer with same day value such securities to other counterparts or clients either in the same domestic market in question or even in other markets or systems.

c) In other markets, finality of the securities transfers may be subject to some clawback rules (which could have a duration period of one year or more) or be subject to possible cancellation of the entire issue according to the contractual conditions of the issue.

In these cases, "unwinding" /reversals of the initial transfers of securities (implying a debit of the positions held by the relevant intermediary with sub-custodians) may have to happen (or even the cancellation of the whole issue) which could lead as a result to securities shortfall/debit balances. In such situations, and this is market practice with most international intermediaries, the client with such a short position will have to cover its debit balance by acquiring (or borrowing) on the market the securities; if he failed to do so, the CSD or custodian will acquire (or lend) the missing securities on behalf and at the participant's expenses ("buy-in" procedure; lending and borrowing arrangements)



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or ultimately apply loss-sharing arrangements between all the clients that have a position in the type of securities in question.

We would therefore suggest to reconsider Article 5 to take into account the above.

3. However, we *do not believe* that the exception granted by **current Paragraph (3)** of this article 5 is justified. We are aware that in a very limited number of countries (if not in only one jurisdiction), legislation is enabling the securities settlement system to credit securities on the accounts of its participants, on the basis of mere unconditional commitments of any (supervised) credit institution established in an OECD country to further deliver such "securities" to the system. We believe that through such facility, it would be possible for the intermediary/CSD to create literally new securities without having any firm guarantee that the relevant securities will be further delivered by the committed credit institution, (the only "guarantee" being that the latter would be a supervised credit institution established within the OECD ...) which obviously creates risks for the ultimate other investors in such "virtual" securities.

4. We are also seriously concerned with the current wording of Article 5 (4) and (5), which suggests that it should always be the personal responsibility of an intermediary to cover **any** insufficient holding of securities and, in optional language in square brackets, suggests to severely limit the possibility for the intermediary to provide otherwise by agreement with its account holders.

In this respect, we would like to make the following points:

- 1) For systemic and other reasons (see above), intermediaries must have the possibility to put in place loss sharing arrangements.
- 2) Loss sharing arrangements should not be limited to the circumstances mentioned in the square brackets of Article 5(5), such as a default of a "compulsory" upper tier intermediary.

As demonstrated above, there are various situations where the rights of account holders as reflected by account entries might exceed the pool of securities held by



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the relevant intermediary, all of such situations being outside of the direct control of the intermediary.

These situations are all distinctly different from the unlikely case where an intermediary holds own and clients assets on a commingled basis and, as a result of negligence or intent uses clients' assets to perform its own obligations. In such circumstances, it goes without saying that the intermediary should be held personally liable for the loss towards account holders and must eliminate the deficiency at its own cost. We do not believe that the Convention needs to contain specific provisions stating this principle, which follows from general principles of law. Our comments therefore relate to insufficiency caused by circumstances outside the control of the intermediary as illustrated above.

*a) The need for an intermediary to have in place loss sharing arrangements*

It seems entirely unjustified to put in place a rule whereby, as a default, an intermediary would be held personally responsible for insufficient securities positions arising out of external event outside of its control. This would, de facto, create a situation where an intermediary acts as insurer/guarantor for its clients which benefited from securities to which they were finally not entitled. There are several reasons why this is not desirable:

- Concentrating risk in one intermediary without giving it the right to pass on this risk to its clients, creates potential systemic risk if the intermediary is systemically important.
- If the intermediary were to bear the risk, it would effectively be acting as a guarantor/insurer for its clients. Consequently, it would be required to set aside capital to cover the potential risks incurred and to insure against this risk, provided such risk is insurable. The costs of these protections would have to be charged to the account holders who were supposed to be isolated from the economic impact of an insufficiency.
- Having instead a loss-sharing arrangement in place does not preclude an account holder from holding the intermediary personally liable for its negligence in, for example, selecting the upper tier intermediary. Loss-



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sharing does therefore not, per se, deprive the account holder of protection against the intermediary's own negligence.

We hope this illustrates that there is more a need for an intermediary to have appropriate loss sharing provisions in place than to hold automatically the intermediary's personal liability for events outside its control.

b) *Loss sharing arrangements should not be limited to "compulsory" intermediation.*

Also, we see no objective justification for limiting the intermediary's right to contractually limit its liability or otherwise determine how to handle an insufficiency in securities to specific circumstances, such as default of a "compulsory" upper tier intermediary (typically a CSD) [ see paragraph (5) square brackets] in the exceptional cases when there is such compulsory intermediary (maybe in the few jurisdictions where it could be mandatory to hold even for individuals the securities account directly with the CSD). Indeed, besides the rarity of this compulsory situation, the need for an intermediary to contractually share an insufficiency of securities amongst its clients potentially exists in any situation.

#### **Article 6 Appropriation of securities to account holders' rights: securities so appropriated not property of the intermediary**

In addition to Article 3, Article 6 introduces another fundamental right of an account holder: its in rem ownership right to the amount of securities deposited and as a result, the key rule laid down in paragraph (2) pursuant to which securities should not form part of the property of the intermediary even in case of its insolvency (see also our comment on article 3) <sup>1</sup>. We are not sure to understand however why the term "appropriated" is used and what it should mean and we wonder whether it would be possible to refer, instead, to "the right of the account holder to the securities" or similar language.

In addition, the Convention raises the issue of segregation in the explanatory note. We do not believe that segregation at an upper tier level is always justified

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<sup>1</sup> As such, we believe Article 6 should follow immediately after Article 3.



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since it may prevent fungibility regime at that level which enhances settlement efficiency and also improves investors protection against upper tier attachments. We think that anyhow the explanatory note should better clarify that such segregation is one possible mean to achieve some form of protection but that “appropriation” or rights of investors on the securities held at upper tier level could also be protected through non-segregated positions at local level as long as the recovery right of the relevant intermediary (on behalf of its clients) against its sub-custodian is legally enforceable against the latter including in case of insolvency.

#### **Article 7 Effect of insufficiency of securities held in respect of account holders’ rights**

We strongly believe that the mechanics of any loss sharing arrangement should be the subject of free contractual arrangements between the intermediary and the account holders and that it is inappropriate to attempt to address or restrain such arrangements by way of legislation.

As currently drafted, Article 7 is at the same time too detailed and not detailed enough and does not take into account that every intermediary operates in a different manner, provides different services and has different clients. For example, there could be reasons why an intermediary would want to exclude certain types of clients from a loss sharing arrangement if this were considered to be in the best interest of the market overall. Also, timing is an important element of loss sharing arrangements because there may be a time gap between the moment when the actual loss occurred and the time when it is discovered. In the meantime, the account holders’ positions may have changed and those impacted by the loss sharing may not be the same. These are issues so detailed and fact-dependant that they are most appropriately addressed in the contract between the intermediary and the account holders.

We therefore propose to replace the current Article 7 with a general requirement that every intermediary must have in place rules that foresee how any deficiency is to be allocated between account holders. Without substituting the actual contractual arrangements, such a provision would ensure that account holders have sufficient information to assess how they could be impacted by a deficiency.



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### **Article 8 Protection of rights of account holders on insolvency of intermediary**

Article 8 further develops the principle in Article 6 (2) in case of bankruptcy of the intermediary. Because of the overlap between the two articles, we suggest to merge Article 8 into Article 6. We are not sure that current article 8 (2) is actually providing for a direct right of the account holder against the intermediary ( sub-custodian) of the insolvent relevant intermediary as described in the explanatory note. Such direct right may be difficult to organise on a cross-border basis to the extent that the jurisdiction of the sub-custodian has to recognise it and the account holder has to know the terms of the sub-custody relationship to exercise it. What in case of conflicts or simultaneous parallel number of independent revindications from the various account holders of a same insolvent intermediary with respect to the exercise of their rights?

### **Chapter IV – Acquisition and disposition of securities held with an intermediary**

We note that Chapter IV states in various places that the Convention does not preclude a Contracting State from imposing formalities in addition to those listed in the Convention. We urge Unidroit to consider adopting the approach taken in the Hague Convention and the EU Collateral Directive, which is to require on the contrary the abolition of such additional requirements.

In the meantime, we acknowledge that it is useful to clarify at least the order of priority between claimants.

### **Article 9 - Acquisition and disposition of securities held with an intermediary**

Chapter IV and more specifically Article 9 uses the term “acquired” to refer to the act whereby an account holder disposes of securities credited to a securities account. In the interest of consistency, and because the term “acquired” is far from neutral because it implies to some extent a sale, we would prefer that the convention use the terminology adopted by the Hague Convention, i.e. “disposition” of securities.



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Paragraph (5) gives the impression, that where a pledge granted over securities represented by an account entry, the entire amount of securities standing to the credit of the account always fall within the scope of the pledge regardless of the terms of the pledge arrangement (e.g. the amount of the claim is less than the amount of securities standing to the credit of the account). We believe any scope for misunderstanding could be avoided by removing the words “with respect to all securities from time to time credited to the relevant account”.

#### **Article 10 Netting and tracing of debits and credits to securities accounts**

As previously mentioned in the forum of the Unidroit Study Group on Harmonised Rules Regarding Indirectly Held Securities, we believe that this provision is superfluous and creates unnecessary confusion.

It is not apparent from the reading of the Article itself that it addressed the right of an intermediary to net account holders’ instructions before instructing an upper tier intermediary. However, based on our reading of the Unidroit Position paper, August 2003, Section 3.6 (Net settlement), we understand this to be the intention.

We question the need for this provision, based on the following reasoning: In the case where securities are held through an intermediary, we do not see how the account holder can maintain a traceable right to specific, identified underlying securities held by its intermediary with an upper-tier intermediary. If this were to be the case, the arrangement between the account holder and the intermediary would not represent in our view a true intermediated holding structure. Rather, the intermediary would have a role of account operator for the account holder who, himself, would be the owner of the account at the level of the upper tier intermediary. As a consequence of this reasoning, and to the extent permitted by the regulatory/supervisory framework applicable to the intermediary, the intermediary should be able to transmit instructions to the upper tier intermediary on a net or a gross basis in accordance with the rules of the upper tier intermediary and market practice.

In our practical experience, an intermediary who does not act as a central counterparty is more likely to send instructions to an upper tier intermediary on a transaction-by-transaction basis because netting of securities positions may create



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reconciliation problems, i.e. problems in identifying which securities have been received or delivered for the account of which account holder.

The right to instruct an upper tier intermediary on either a net or gross basis should be the direct consequence of other provisions of the Convention (e.g. articles 3, 6 and 8) and should not warrant a separate provision. We therefore recommend deleting Article 10.

#### **Article 11 Control**

We are not convinced by the definition of control under current Article 11. We caution against the introduction of the language in square brackets, in particular as regards the annotation of account statements to reflect the giving into control. While the annotation of account statements might be an efficient means of putting the external world on notice of, for example, a pledge of a securities account, intermediaries should not *per se* be precluded from providing this information in another form (e.g. issuing lists of pledged accounts).

#### **Article 12 Perfection of dispositions of securities held with an intermediary**

No comments.

#### **Article 13 Priority among competing dispositions**

To avoid giving the impression that priority of *in rem* rights –which may be part of public policy in most jurisdictions-may be contractually agreed, we suggest to substitute the last part of the first sentence with the following: “without prejudice to the right of a [creditor] [person entitled to the securities] to subordinate its rights by agreement where legally permissible.”

We are not entirely sure how the priorities as listed in Article 13 relate to the general principle that priority amongst perfected security interests is most often determined on the basis of who comes first in time and would be grateful if the study group could elaborate on this. In addition, although it would be to the





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benefit of the Euroclear Operator as intermediary, we do not feel convinced that it would be justified to privilege automatically a pledge to an intermediary over a specific pledge to another person as suggested (in our understanding) in Article 13(3)(b) (ii).

**Article 14** Protection of intermediary

No comments.

**Article 15** Acquisition from intermediary

No comments.

**Article 16** Acquisition by account holder

No comments.

**Article 17** Acquisition from account holder by delivery of control

No comments.

**Article 18** Reversal of debits and credits to securities accounts

Article 18 currently foresees that a movement in a securities account may not be reversed "so as to prejudice an intermediary who, without notice of any defect in or with respect to that debit or credit has effected a further debit or credit which is dependant on it." An identical rule is proposed for movements in securities accounts of an account holder.

In our view, it is important to substantially revisit this disposition to ensure that the application of such a clause is without prejudice to the right of an intermediary to correct operational errors or to reflect a claw-back/reversal effected at the level of an upper tier intermediary. We refer in this respect to our detailed comments on article 5 (since reversals may lead in turn to securities debit balance if the securities so reversed have been transferred in the meantime). As indicated



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above, there are many situations in securities business where an intermediary may be lead to proceed to a reversal of credit entries due to external events beyond its control: e.g.

- Credits of securities to account holders before they are received with finality at an upper tier intermediary as commented on above.
- Reversals due to reversals at an upper tier intermediary including also the default of the upper tier intermediary.
- Reversals due to operational errors (see below a detailed discussion of this situation, often encountered in industry's practice).
- Debits as a result of a retroactive/back dated record date set by the issuer.

Let us consider the example where, mistakenly, an intermediary, acting upon an instruction from Account Holder A, credits Account Holder B rather than A. Upon credit to B's securities account, the securities entitlement is immediately delivered from B to C. This would be possible if B had already submitted a delivery instruction in favour of C to the intermediary before mistakenly receiving the securities or if he entered such an instruction after receiving the securities but before the intermediary discovered the error.

When trying to resolve the situation, which has arisen as a result of a pure operational error, one must take into account the need to protect a good faith acquisition of securities entitlement<sup>2</sup>. We expect there to be general agreement that Account Holder B had no legitimate expectation to receive and no legal basis for acquiring ownership of the securities mistakenly credited to his account. The same is not true for Account Holder C (and any party further down the chain of deliveries) who was legitimately expecting to receive the securities entitlement from B and could not be expected to make separate inquiries about how B acquired his securities entitlement.

Going back to the situation of B, he has received the securities at the expense of A, who was the initial account holder expecting to receive the securities. Based on principles of law generally applied in most countries, B must therefore return the

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<sup>2</sup> Cf. Section 3.5 of the Unidroit 2003 Position Paper on these issues



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securities unduly credited to him and A has a right to receive what was due to him.

We believe this can be done by the intermediary without having to trace back the entitlement from subsequent purchasers and put into question the rights of C as a good faith purchaser: In order to reflect the obligation of B to return the securities, the intermediary can simply make correcting entries in the securities accounts of A and B, i.e. debit B's account and credit A's account. If B had previously delivered to C all securities he had of the securities issue in question, the debit in his account will cause his account to be overdrawn, thus reflecting that he has used more securities than he has. At the overall level of the pool of securities held by the intermediary on behalf of its clients, this means that the total number of securities entitlements exceeds the underlying pool of securities held by the intermediary with the next, upper-tier intermediary. In other words, there is a (temporary) shortfall.

As explained in our comments to Articles 5 and 7, the way in which the shortfall is eliminated should be a matter for the contractual arrangements governing client securities deposits with the intermediary in question (the "rules"). Generally, it would seem reasonable that B, who has had the economic benefit of onwards delivering the securities, be under an obligation to purchase the missing amount of securities (or through the rules authorises the intermediary to effect a buy-in on his behalf), but this should ultimately be a matter for the contractual provision of the agreement with the intermediary to address. In the highly unlikely event that it was impossible to replace the securities through a purchase of the relevant securities, the rules for allocation of shortfalls would ultimately have to foresee an appropriate allocation of the shortfall amongst the intermediary's clients.

While, in our view, reversals is an entirely appropriate tool to correct operational errors, the mechanics of the reversal process will obviously not preclude B from exercising any personal rights B might have against the intermediary for any loss incurred as a result of the intermediary's error. Such a loss could arise if, for example, B had to purchase replacement securities to cover the shortfall in its securities account at a higher price than what he received from C when C acquired them. As such, the rights of B are no different in this case than in case of any other operational error causing a loss to B.



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We hope the above demonstrates the importance of maintaining reversals –which are part of the banking and securities practices since decades- as an appropriate and reasonable way for intermediaries to limit the impacts of operational errors and other external events. Therefore, Article 18 of the draft Convention should not preclude the application of reversals in all circumstances. We wonder whether on balance article 18 should not be deleted altogether.

#### **Article 19 Position of issuers of securities**

We support this provision, which is a partial attempt to protect in particular nominee arrangements. We would like however to have this article further developed to address more comprehensively the protection of such nominee arrangements which are key for the design and the legal soundness of intermediated holding of securities in registered form.

Indeed, there continue to be local requirements that do not recognise or accommodate the fact that settlement normally involves several layers of intermediaries. Such requirements reduce the extent to which cross-border holding and corporate actions can be efficiently processed, thus reducing the value of other market harmonisation efforts. One important example is that laws and regulations do not recognise the concept of nominee holdings ( with distinction between the legal owner holding in its name the securities at local level and the beneficial owners on whose behalf the securities are ultimately held and owned), or otherwise prevent or penalise the holding of securities in fungible form, obliging the intermediary to process at upper tier level as many transfers as it has internal transfers in its books between its clients.

Some countries have requirements to maintain individual records or accounts per owner, which obviously increase cross-border processing costs. This type of security must be held directly in individual accounts, or each intermediary must implement costly, time consuming and error prone internal procedures in order to comply with these local rules. These requirements can be direct, or can be a result of reporting or proxy voting requirements (such as those currently being considered for implementation in the Netherlands). National company law can also



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forbid the exercise of voting rights deriving from registered securities through a nominee.

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We hope that the above comments may help the works of the Unidroit Study Group and we stand ready to further discuss all this during the Budapest meeting or at a separate occasion if necessary.

3 September 2004

MORAIS LEITÃO, GALVÃO TELES, SOARES DA SILVA

ASSOCIADOS  
SOCIEDADE DE  
ADVOGADOS

**COMMENTS ON UNIDROIT'S DRAFT CONVENTION ON SUBSTANTIVE  
RULES REGARDING SECURITIES HELD WITH AN INTERMEDIARY**

MIGUEL GALVÃO TELES

6 September 2004

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## INTRODUCTION

1. This paper purports to be a contribution from the Portuguese law firm, of which the signatory is a partner, Morais Leitão, Galvão Teles, Soares da Silva & Associados, arising from the merger underway between the law firms Miguel Galvão Teles, João Soares da Silva & Associados and Morais Leitão, J. Galvão Teles & Associados. The comments are sent following the invitation made by UNIDROIT on its website.

From now on, the first person of the singular will be used.

2. The comments on the Draft Convention on Substantive Rules Regarding Securities held with an Intermediary (hereinafter, the “*Draft Convention*”) will concentrate basically on the Convention’s scope and the *status* of the securities held with an intermediary, as well as the relationship between the account holders and intermediaries, which relates mainly to some definitions and Articles 2 to 8.
3. Before coming to the discussion of particular provisions of the *Draft Convention*, some reflections on the nature of the so-called “indirect holding of securities” and on the rights and duties involved are advisable. Therefore the text will be divided in two parts, the first one on background aspects. The main issues within such background are:

- a) Should the rights of the account holder be given proprietary effects and to what extent?
- b) What kind of relationship exists between the rights of the account holders and those of the securities holders, as well as between the rights of one account holder and those of a higher-tier and of a lower-tier account holder, and what is the role of the intermediaries' duties?

The second part shall contain comments on specific provisions of the *Draft Convention* and some suggestions.

Since Portuguese law is my main reference and it is not well known, a short summary of its contents may be of convenience. It will form an Appendix, to which references will be made in the text.

I  
**BACKGROUND ASPECTS**

A) **Preliminary remarks**

4. In May this year I gave a lecture in a post-graduation course on securities law organized by the Faculty of Law of the University of Lisbon and the Securities Institute (*Instituto de Valores Mobiliários*). The subject matter was “Custody and sub-custody of dematerialised securities”, but, when preparing the lecture, I changed its title to “Holding of securities on behalf of third parties and reflex securities”. In the lecture, among other things, I made a summary description and analysis of UNIDROIT’s *Draft Convention*.

Afterwards, during some free hours and part of my holidays, I tried to deepen the analysis and this comment is the result thereof.

5. I consider the *Draft Convention* as the fruit of a remarkable work and much of the following text is in support of the adopted solutions. There are, however, points which still deserve to be discussed.
6. The wide use of the “indirect holding of securities” is a contemporary fact, which raises specific legal problems, both substantive and of conflicts of laws, requiring specific answers. This is shown by the issue of substantive legal rules on the matter, starting by the revised (1994) Article 8 of the Uniform Commercial Code, as well as by the adoption of the Hague Convention on the Law Applicable to

Certain Rights in respect of Securities held with an Intermediary (2002) (hereinafter, the “Hague Convention”).

The reasons for the use of the “indirect holding of securities” are in part avoidable, in part unavoidable; in part reasonable and strong, in part not so relevant.

The “paper jam”, by itself, is avoidable by ways other than the “indirect holding of securities”. It suffices to replace, in whole or in part, certificated by dematerialised securities, as has been done, for instance, in France, in Spain and in Portugal. Dematerialised securities may be “directly” held, as, for example, they are in Portugal<sup>1</sup>.

The not so relevant reason for, and the consequence of, the use of “indirect holding” is that it allows “in-house” trading. “In-house” trading reduces costs and, in part, displaces them: instead of paying both the bank and stock exchange fees, the investor just pays bank fees. The latter may become higher than otherwise, but they will be lower than the two kinds of fees together. However, “in-house” trading reduces market transparency. The issue has to be dealt with at the regulatory level<sup>2</sup>.

The unavoidable cause of the “indirect holding of securities” is the expansion of cross-border investment and the reason for such “indirect holding” is practicality. It is impossible to request that proxies and sub-proxies are issued all over the

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<sup>1</sup> See Appendix, paragraph 2.

<sup>2</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments deals already with the issue, regarding MTF (Multilateral Trade Facilities) and internalisation. But the regulatory scope should be enlarged.

world. Furthermore, proxies may be insufficient, if they are too narrow, or dangerous, if too broad. The legality of the “indirect holding of securities” derives from private autonomy. The point is, however, that, since and when the investor does not use the “direct holding” because of impracticability, the protection of his trust requires that he be placed, as much as reasonably possible, in a position similar to the one he would have if he was a “direct” holder. This may imply the granting to the investor of a stronger protection than the one he would have under the general rules of particular legal systems. Such is, in part, the trend of the *Draft Convention*.

Obviously, there are investment-exporting and investment-importing countries and most of the ultimate investors are domiciled in the investment-exporting countries. But the investment-importing countries have an interest that investment made in their companies and financial assets is secure – and, therefore, in the protection of the trust of ultimate investors, as well as of those with whom they deal.

As what is basically at stake is cross-border investment, common rules are welcome.

7. In Portugal, we have had some experience with the legal difficulties raised by the “indirect holding of securities”, fortunately not regarding the insolvency of financial intermediaries<sup>3</sup>, but regarding the fulfilment of voting instructions.

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<sup>3</sup> There has been none of relevance. Furthermore, Portugal being mainly an investment-importing country and taking into account the Portuguese legal regime of securities referred to in the Appendix (paragraph 2), when the Portuguese banks intervene as sub-custodians what they really do is to register the dematerialised securities in the name of the custodian or of a lower-tiered sub-custodian or to have certificated securities in

The Portuguese Companies Code (*Código das Sociedades Comerciais*, of 1986) establishes, for the companies limited by shares (*sociedades anónimas*), the rule of *voting unity* (Article 385). Such rule means that one and the same shareholder cannot vote with some of his shares and to abstain with others or to vote in a sense with some and in another sense with others. The consequence of the breach of the rule of voting unity is the nullity of all the votes which have been split. There are some exceptions provided for to the rule of voting unity, the main one being that relating to representatives of the shareholders.

As referred in the Appendix<sup>4</sup>, in listed companies the shares have to be dematerialised or deposited with a centralised system; and, for the purpose of general meetings, the shareholder is the one in whose name the shares are registered or deposited. If an intermediary has shares registered or deposited in his name, even if he owns the shares on behalf of his clients, he cannot be said to be a representative of them, precisely because he owns the shares in his name. Therefore, how can he split the votes in accordance with the clients' instructions?

The awareness of the question came with the *American Depositary Receipts* (ADRs). During the nineties, some Portuguese companies or one shareholder (the State) of some Portuguese companies issued or sold shares underlying ADR issues. There were complex ways of overcoming the problem of the vote split.

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deposit in the name of one of them. In no sense are the securities held by the Portuguese banks. As Portuguese banks are normally not sub-custodians of one another, the problem of what kind of rights an account holder has under Portuguese law would only arise in the event of insolvency of a lower-tier intermediary, which would normally be a foreign company, if, under the rules on conflict of laws of the *forum*, Portuguese law was considered applicable (as the law of the issuer or the law of the “location” of the securities).

<sup>4</sup> Paragraphs 2 and 3.

But, as the main seller was the State, by privatization, and the Privatization Law (Law 11/90, of 5 April) requires each privatization to be authorized by a decree-law, which has force of law, some privatization decrees, which foresaw ADRs issues, provided that the depositary was to be considered as the representative of the ADRs holders. It was obviously a *fictio juris*, but the provisions solved the difficulty. One may infer, for ADRs, a rule which allows the splitting of vote. But there is no ground to apply such rule outside ADRs.

8. Quite often, financial intermediaries appear as shareholders in the general meetings of Portuguese companies and split their votes. Normally, the number of shares at stake is low and immaterial for the final outcome so that the chairman of the general meeting of shareholders<sup>5</sup> may simply put on the record that he does not determine the question of the validity of the votes because it is irrelevant. But what if the split votes are or may be decisive for the outcome of the voting<sup>6</sup>?

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<sup>5</sup> Portugal has had for a long time a peculiar system according to which the chairman of the general meeting of shareholders is elected separately and does not belong to other corporate bodies. Very often chairpersons of the general meeting of shareholders are lawyers.

<sup>6</sup> In one case I have declared, as chairman of a general meeting of shareholders, the nullity of the split votes of an intermediary, because, although remotely (there were other legal issues), they could be relevant for the outcome. Two shareholders challenged in court the shareholders meeting resolution, on other grounds, but, depending on the decision on the other issues, the court could have to determine on the nullity of the split votes. However, both proceedings were terminated before a judgment was entered and there is no judicial precedent in Portugal on the matter.

**B) Proprietary effects of the account holders' rights**

9. The basic *datum* in an “indirect holding of securities” is that the highest-tier intermediary holds the securities *in his own name*, although *on behalf of third persons* (the beneficiaries).

In English law and, in general, in legal systems which adopt the notion of trust, it does not seem difficult to attribute proprietary nature, as beneficial ownership, to rights of the account holder, even without a specific provision. Although its applicability depends on the terms of the deeds, the rules on trust and sub-trust, if not excluded, will suffice<sup>7</sup>.

In civil law systems the framework is quite different. The situation is one of *fiduciary ownership* (or, at least, quite close to it). In such systems the rights of the beneficiary in fiduciary ownership are, in principle, rights *in personam* (credit rights against the fiduciary owner).

The obstacle can always be overcome by specific provisions, as those contained in the *Draft Convention*. In any event, in order to test the justification and compatibility of the *Draft Convention* with the general principles of civil law systems, one has to ask for what purposes it is necessary or seems to be necessary to grant to account holders rights some kind of proprietary effect.

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<sup>7</sup> Sir Roy Goode, “The Nature and Transfer of Rights in Dematerialised and Immobilised Securities”, in Fidelis Oditah, *The Future of the Global Securities Market*, 1996, pp. 125-126; Joanna Benjamin, *Interests in Securities*, 2000, pp. 303 ff., and (in co-authorship with Madeleine Yates and Gerald Montagu) *The Law of Global Custody*, 2002, pp. 22 ff..



That account holders' rights are effective against third parties or opposable to them, although its contents refer to an intermediary's behaviour, corresponds to the common feature of credit rights ("direitos de crédito" in Portuguese, "droits de créance" in French, "diritti di credito" in Italian, "Schuldrechte" in German). Any civil law system knows the concurrence of credit rights in insolvency, the prevalence of some and the "reduction" *pro rata*.

Therefore, the purposes of attributing proprietary effects to the account holders' rights seem to be twofold: first, to exclude, for the benefit of the account holder and of his creditors, the securities, or the rights of the immediate higher-tier intermediary, from the reach of the intermediary's creditors, at least in the case of insolvency of the latter; and, second, to ensure that, in the event the account holder's rights are provided as collateral, such collateral (more precisely, the rights of the collateral taker) follow the rights provided as collateral.

10. For this last purpose, however, nothing has to be changed in the civil law systems' principles. Civil law systems know very well the *pignus* of credit rights. And the *pignus* of a credit right follows such right. The only supplementary protection needed is that the rights of the intermediary to which the rights of the account holder refer be outside the reach of the intermediary's creditors. But such supplement is involved in the first purpose.
  
11. The main point to be underlined is that to exclude the intermediaries' rights from the reach of its own creditors is justified by the requirement of investors' trust protection. As referred to above, the investor should, as much as reasonably

possible, be placed in a position similar to the one he would have if the securities were “directly” owned. And it is reasonably possible to protect the investor from the intermediaries’ creditors. One could say that also those who deposit cash with a credit institution are not protected. But that money deposits be irregular is of the essence of banking. And the depositor receives a consideration (the interest), whilst, regarding the investor, the intermediary just provides a service.

The reason for excluding the intermediaries’ rights in an “indirect holding of securities” from the reach of their creditors is of the same kind as the one that makes some laws establishing that the ownership of the deposited securities is not transferred to the depositary (“regular” deposit)<sup>8</sup>.

- 12.** It is quite clear that the general rules in force at least in most civil law countries (the qualification derives from limits of knowledge) would not allow that securities held by the highest-tier intermediaries do not respond for his debts or that the rights of higher-tier intermediaries than the account holder do not respond for their debts. However, there are, in civil law systems, precedents of excluding assets held by someone in his name from his creditors reach for the benefit of third persons in whose behalf the assets are held and their creditors. Such precedents relate to the “non-representative mandate”, i.e., the kind of agency, disclosed or undisclosed, where the agent acts in his own name.

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<sup>8</sup> See, for Portuguese law, the Appendix, paragraph 2.

Some laws govern specifically the “non-representative mandate”<sup>9</sup>. It is what happens with the Italian Civil Code, of 1943 (Articles 1705 to 1707), and the Portuguese Civil Code, of 1966 (Articles 1180 to 1184). Our interest is only on the mandate to acquire. In Italy there was and I believe still is strong debate on whether the effects of the acts executed in performance of the mandate produce in the legal sphere of the agent or directly in the legal sphere of the principal, and, in the first hypothesis, on whether the agent has to transfer the rights to the principal or the transfer is automatic<sup>10</sup>. We had the same discussion in Portugal, under the Civil Code of 1867<sup>11</sup>. However, even those who support the thesis of the direct or automatic effect in the principal’s legal sphere have to admit that such effect would not be produced if, a special form *ad substantiam* (notarial deed) or registration being required, the agent executes the act in his own name. In the current Portuguese Civil Code, of 1966, it seems quite clear that, in general, the effects of the act performing the mandate produce effects directly only in the legal sphere of the agent, the latter being under the obligation to transfer them to the principal (Articles 1180 and 1181).

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<sup>9</sup> The “cut” between the quality of being a representative of some other person (*Vertretung*) and the power of attorney (*Vollmacht*), on the one side, and the mandate (*Auftrag*), on the other, has been introduced by the German *Bürgerliches Gesetzbuch* (BGB). The first ones are governed by §§ 164 to 181, inserted in a section on *Rechtsgeschäfte*. The contract of mandate is ruled by §§ 662 to 674, inserted in a section on “particular credit relationships” (particular contracts). The Italian *Codice Civile* followed somehow (just somehow, because it has a title on contracts in general, not on *Rechtsgeschäfte*) the BGB by dealing with “representation” (Articles 1387 to 1400) in the general part of contracts and with the mandate, as a particular contract (Articles 1703 to 1730), within a title on particular contracts. The Portuguese Civil Code is closer to the BGB, “representation” (Articles 258 to 269) being dealt with in a chapter on *Rechtsgeschäft* (“negócio jurídico”) and mandate (Articles 1157 to 1184) in a title on “particular contracts”. § 667 of BGB refers to the agent’s duty to transfer to the principal what he has received from the other party.

<sup>10</sup> See *Commentario al Codice Civile* diretto da Paolo Cendon, vol. IV, 1991, pp. 1273 ff..

<sup>11</sup> The author claiming that the effects were produced directly in the legal sphere of the principal was Pessoa Jorge, *Mandato sem Representação*, 1961, rep. 2001.

Nevertheless, both the Italian *Codice Civile* (Article 1707) and the Portuguese *Código Civil* (Article 1184, based on the Italian provision) exclude from the agent's creditors' reach the assets acquired by the agent in performance of the "non-representative mandate", provided the latter is in written form and prior to the moment when the assets would be apprehended, and provided also that, if the acquisition of the assets is subject to inscription in public registry, such inscription has not yet been carried out.

I brought these examples for comfort. They show that to attribute, in civil law countries, for the purpose of excluding assets from the reach of creditors, some "proprietary" effects to rights which, at their origin, are credit rights, on the basis that the assets are owned on behalf of a third person, is not fully unprecedented.

**C) Relationship between the rights of the account holders and those of the "direct" holders, as well as between the rights of the higher and lower-tier account holders, and linkage with the intermediaries' duties**

- 13.** The "representation" of securities and of each of the account holders' rights is different, in the sense that each security or set of securities and each right or set of rights of account holders has a specific representation. The rights are also different. Those of the "direct" security holder are rights against the issuer: the right to receive dividends or interests from the issuer, the right to vote in the shareholder or bondholder meetings... Those of the account holders are rights against the immediate intermediary: to receive from him the product of the exercise of the rights by the holder of the securities, to direct such exercise...

The account holder's rights being rights against the intermediary with whom he holds the account is not just a matter of *enforceability* of such rights. It is also a matter of their *content*. When the account holder is allowed to exercise rights against intermediaries higher-tier than the one with whom it holds the account (as foreseen in Article 8 (2) of the *Draft Convention*) he is doing so by *subrogatio*, i.e., by exercising the rights of the intermediary<sup>12</sup>.

14. Account holders' rights are *derivative* from the ("direct") security holders' rights and lower-tier account holders' rights are *derivative* from higher-tier account holders' rights<sup>13</sup>.

To the extent that the account holders' rights have a proprietary nature, their derivative character means that "*no holder of an interest can have rights to securities greater than those possessed by the holder of the higher-tier interest from which the former interest is derived*"<sup>14</sup>.

To the extent they are credit rights, their derivative nature means that *the possibility of the satisfaction of such rights by specific performance depends on the ownership and exercise by the intermediary of the "corresponding" rights*. In the event that the intermediary does not have (and does not obtain) such rights or fails to exercise them, the account holder can only claim damages.

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<sup>12</sup> See below, paragraph 32.

<sup>13</sup> Sir Roy Goode, "The Nature and Transfer of Rights in Dematerialised and Immobilised Securities", pp. 120-122.

<sup>14</sup> Sir Roy Goode, *loc. cit.*, p. 122.

This shows the crucial place of the intermediary's duties and, in particular, of his *duty to exercise the rights he owns on the account holder's behalf*. The intermediary's duty to exercise his own rights against his intermediary is the prerequisite for the account holders' rights to be satisfied.

The "chain" in the so-called "indirect holding of securities" does not depend only on the successive rights. It depends also on *each intermediary's duty to exercise his own rights for the benefit of his account holders*.

15. What struck me when for the first time I considered the "indirect holding of securities" was a strong similarity with ADRs. Both the ADR holders and the account holder's rights are rights to receive the economical product of the exercise of the securities rights by a third party (in ADRs, the depositary) and to direct the exercise of such rights. What is peculiar in ADRs is that they are denominated in a currency different from the one of the underlying securities.

ADRs are themselves securities – they are traded in the stock exchange. The underlying assets are also securities. In the ADRs system, at least two levels of securities exist (I say at least because an "indirect holding" of ADRs may also exist).

16. The rights of the account holders being different between themselves and from those of the ("direct") securities holder, are themselves financial instruments and have as their object financial assets. This means that they are or may be (depending on the applicable law) themselves securities, different from the

underlying securities, although connected to them and each connected with the higher and lower-tier ones. They may already be traded on MTF<sup>15</sup>, as well as traded over-the-counter, often “in-house”. If one looks to the *Draft Convention*’s provisions on the “acquisition and disposition of securities held with an intermediary” (Chapter IV), on the “protection from adverse claims” (Chapter V) or on collateral (Chapter VII), those are typically provisions on securities.

I call this kind of securities *reflex securities*, insofar they “reflect” the contents of other securities, by allowing their owner to appropriate the economic product of the *reflected securities*, to direct the exercise of the rights inherent to them and eventually to convert them into basic securities<sup>16</sup>.

As the securities are linked in a chain, the highest-tier securities (the *basic securities*) are just reflected securities and the lowest-tier ones just reflex securities. All the others (owned on behalf of third parties) are both reflex and reflected. The reflex relationship is established through the intermediary’s obligations. The placement of reflex securities implies their issue.

17. The language “indirect holding of securities” is, at least in legal systems which do not adopt the notion of trust, somehow misleading, and that is why I have always used it between brackets. What one holds are reflex securities (or reflex rights) and through them one just has the right to the economic product of other securities, to direct the exercise of the rights inherent to them and eventually to

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<sup>15</sup> Directive 2004/39/EC, Article 4, 15), which refers to buying and selling *interest* in financial instruments.

<sup>16</sup> Regarding ADRs and other financial “products”, Joanna Benjamin speaks of “repackaged securities” and characterizes them as interests in securities – *Interests in Securities*, pp. 251-261. See also, from the author, the 1<sup>st</sup> ed. of *The Law of Global Custody*, 1996, pp. 117 ff.

convert them into basic securities. “Entitlement to securities”, used by Article 8 of the UCC, where the word “securities” refers only to basic securities, shows that the account holder’s rights are different from the ones on the basic securities, although the meaning concentrates too much on the idea of a right to acquire the (basic) securities<sup>17</sup>. The concept of “indirect holding” is economic, rather than legal. Anyway, its use is comfortable and it emphasizes the idea that the investor should be placed, as much as reasonably possible, in a position similar to the one he would have if he owned the basic securities.

The wording “securities held with an intermediary” is equivocal regarding which securities are held (what may be an advantage) and too broad, because it literally covers also the dematerialised basic securities. But it has already been adopted by the Hague Convention and is therefore established. The extension in which the concept is to be employed may be dealt with in the Convention’s provisions.

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<sup>17</sup> Note, however, that Article 8 of the UCC also talks of *direct* and *indirect holding* (§§ 8-108 and 8-109).



## II SPECIFIC PROVISIONS

### A) **The scope of the Convention (Article 2)**

18. Article 2, on the Scope of the Convention, is not yet drafted. A note refers that its purpose is *“to exclude arrangements under which account holder’s rights consist solely of purely contractual or personal rights against the intermediary”*.

The Hague Convention already provides, in Article 2 (3), (a) and (b), that it *“does not determine the rights and duties arising from the credit to a securities account to the extent that such rights or duties are purely contractual or otherwise purely personal”*, nor *“the contractual or other personal rights and duties of parties to a disposition of securities held with an intermediary”*. But paragraph 3 is subject to paragraph 2, which establishes the issues governed by the applicable law determined by the Convention.

Obviously there are matters to be determined by the account agreement, or by the disposition or collateral agreements: for instance, fees, time and prerequisites for instructions and their performance, consideration for a disposition of securities, which debts are collateralised and in which terms...

As for “purely personal rights”<sup>18</sup>, the *Draft Convention* refers to some, as the account holder’s right that the intermediary acts in the manner determined by

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<sup>18</sup> Sir Roy Goode defines *purely personal right* as *“one which does not involve the delivery or transfer to the obligee of an identified asset or funds of assets but is to be satisfied by the obligor’s personal performance in some other way, such as payment of a debt or damages from his general assets”* (*Commercial Law*, 2<sup>nd</sup> ed., 1995, p. 30).

Articles 4 and 5. And, in my view, as referred to below, some “purely personal rights” are of the essence of an “indirect holding of securities”<sup>19</sup>

19. What I believe should be said in Article 2 is that the Convention is *without prejudice of purely contractual or otherwise purely personal rights and duties of the account holders and intermediaries, arising from the account agreements or of other agreements, as well as from the law applicable to them, which are not inconsistent with the mandatory provisions of the Convention*. What will become necessary is to identify which provisions are mandatory.
  
20. Another issue is whether ADRs are or not covered by the *Draft Convention* and whether they should be.

In my view, ARDs are also reflex securities and correspond to a modality of “indirect holding” of the underlying securities, being held with an intermediary. But they are in certificated form (with or without Global Depositary Receipt) and, therefore, the depositary is not an account holder. Account holders will be those to whose accounts ADRs, but not the underlying securities, are credited.

As it is, the *Draft Convention* applies to ARDs account holders, but not to the depositary. And it seems that, ADRs being limited (as far as I know) to one legal system, there is no need to amend the *Draft Convention* on this point.

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<sup>19</sup> See below, II, D).

The situation would change if dematerialised ADRs were adopted. In such case the Convention would apply, unless it was determined that, for its purposes, securities accounts are only those where the securities are credited in the same currency they are issued (basic securities currency). But I do not think it is worthwhile. Whether the Convention will or will not apply to ADRs, and to which extent, is somehow indifferent.

21. In the next section, I shall deal with a remaining point that may be located in Article 2.

B) **The need to exclude the basic securities or entitlements as against the issuer from the Convention's scope (Article 1 (1), (b) and (f), and Article 2)**

22. Article 1 (1) (b) defines securities account as *“an account maintained by an intermediary to which securities may be credited or debited”*. An account maintained by an intermediary to which basic securities are credited or debited and which “represents” dematerialised basic securities falls within the definition. As a consequence, dematerialised basic securities fall within the definition of “securities held with an intermediary”. As referred to above, the definitions are too broad for the purposes of the *Draft Convention*. However, in both cases they are similar to the ones used by the Hague Convention. For the sake of consistency between the two conventions, they should not be changed.

The Hague Convention addresses the point of basic dematerialised securities in Article 1 itself. What is of interest here is paragraph 5, which reads:

*“In relation to securities which are credited to securities accounts maintained by a person in the capacity of operator of a system for the holding and transfer of such securities on records of the issuer or other records which constitute the primary record of entitlement to them as against the issuer, the Contracting State under whose law those securities are constituted may, at any time, make a declaration that the person which operates that system shall not be an intermediary for the purposes of this Convention”.*

I am interpreting the words “operator of a system for the holding and transfer of securities” as including the financial institutions that credit the basic securities to accounts (as happens in Portugal with directly dematerialised securities<sup>20</sup>), provided they are integrated into a system for the holding and transfer of securities.

- 23.** There is an important difference between the way the question of “primary entitlements” presents itself from a conflicts of law point of view and from a substantive one. It is not unreasonable to apply Articles 4 to 6 of the Hague Convention to “directly held” securities, although other conflicts of law rules may be more appropriate. Therefore, Article 1 (5) made the application of the Hague Convention rules to “directly held” securities just optional.

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<sup>20</sup> See Appendix, paragraphs 2 and 3.

Regarding the *Draft Convention*, its intended scope relates only to “indirectly held securities”<sup>21</sup>. And it does not make any sense whatsoever to apply to “directly held securities” for instance Articles 3 (1) (a) (ii), (2), (3) (b), 4 (3), and 5 to 8. Therefore, the exclusion of the “direct holding of securities” from the *Draft Convention*’s scope should be directly determined and not optional.

24. Again for the sake of consistency with the Hague Convention, the same basic wording should be used.

The provision could be included in a new paragraph of Article 1, with reference to the definition of “intermediary”, or in Article 2, as for the determination of the scope of the Convention. The second solution seems to me more appropriate.

In any event, rights which, according to the applicable law, may be exercised directly and without *subrogatio* against the issuer (see, for instance, Articles 9 bis and 10 of the “Arrêté royal” from Belgium, as amended) should also be excluded from the Convention’s scope.

C) **Description of securities (Article 1 (1) (p))**

25. Article 1(1) (p) states that “*securities are “of the same description” as other securities if they are securities of the same issuer, of the same currency and*

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<sup>21</sup> Philipp Paech, “Harmonising substantive Rules for the Use of Securities Held with Intermediaries as Collateral: the UNIDROIT Project”, *Uniform Law Review*, 2002-4, pp. 1142 ff.; “The UNIDROIT’s Study Group on Harmonised Substantive Rules Regarding Indirectly Held Securities”, Position Paper, August 2003.

*denomination, and form part of the same issue, as those other securities, and references to securities of a particular description shall be construed accordingly”.*

The expression “securities of the same description” appears only once in the *Draft Convention* (Article 22 (2)). But there are several references to “description of securities”: “each description” (Article 6 (1)), “a given description” (Article 7 (2)), “that description” (Articles 6 (1) and 7 (2)).

The restriction to “the same issue” in the definition is incompatible with laws, as the Portuguese one, where securities of several issues belong to the same category. In the “individualized” accounts the securities are simply not identified by the issue and they are traded indistinctly. After trading of securities of an issue starts, it is simply impossible to identify securities of one or of another issue. The identification of the appurtenance to an issue is possible only during thirty days as from the issue resolution and, afterwards, if the resolution is challenged in court (Portuguese Securities Code, Article 25). Without reference to the issue, we just have the “same contents” (Article 45 of the Portuguese Securities Code) or, as the Portuguese Companies Code (Article 302, paragraph 2) says, regarding shares, “comprising equal rights”. But, even that, apart from being vague, is insufficient. For an account holder or collateral taker it is obviously not the same thing to have securities subject to one or to another tax regime<sup>22</sup>.

The *Draft Convention* is a Convention on “indirect holding of securities”, not a Convention on securities in general. The only way to define securities “of the

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<sup>22</sup> See Appendix, paragraph 4.

same description” in a manner compatible with the diversity of national laws is to say that:

*“securities are “of the same description” as other securities if, according to the applicable law, they are fungible between themselves...”*

Whether fungibility means, in a particular law, *indifferentiation* or *indifference* or both<sup>23</sup> is irrelevant for the purposes of the Convention.

It will be up to the applicable law to determine the prerequisites of the fungibility of the securities between themselves.

**D) The account holders’ rights and the intermediaries’ obligations (Articles 3 to 6)**

- 26.** A crucial issue for the reliability of the “indirect holding” system is that of the obligations of the intermediary and of their extent. It is the intermediary’s duties that link the chain and the consistency of the account holders’ rights, as well as of the whole “indirect holding” mechanism, depends on them.

The *Draft Convention*’s proposed solutions are basically the following:

- a) The intermediary is bound to give effect to any instructions of an account holder and not to give effect to any instructions of another person, but always subject to the account agreement (Article 4 (1) and (2));

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<sup>23</sup> See Appendix, paragraph 4.

- b) the intermediary is bound to hold (or to acquire and hold) sufficient securities in respect of account holder's rights (Article 5 (1) to (4));
  - c) each intermediary guarantees that the next higher-tier intermediary has enough securities, except as otherwise provided, possibly within certain limits, by the account agreement (Article 5 (5));
  - d) the manner of performance of the obligations of the intermediary in providing assistance to the account holder and the extent of the liability of the intermediary for any failure to perform those obligations are governed by the account agreement (Article 3 (2) (b)), which means the account agreement and the law applicable to it.
27. The point is that the satisfaction of the ultimate investor's interests depends not on one account agreement, but on several, linked in a chain. The higher-tier account agreements are normally agreements between intermediaries, often belonging to a same economical "group". It is to be expected that they shall try to reduce, as much as possible, the extent of their duties and liability. Obviously, the ultimate investor may try to have an account agreement which fully guarantees him. But account agreements are normally standard agreements, prepared by the intermediary.

Since the reliability of the "indirect holding of securities" depends on the extent of the intermediaries' obligations and liability, it seems to me that the Convention



must include more and stronger provisions on the intermediaries' duties than is currently the case in the *Draft Convention*.

28. Regarding the extent of the intermediaries' obligations, two kinds of solutions are possible.

The first one would mean that each intermediary would *guarantee results*, without prejudice of his right of recourse against upper-tier intermediaries, the non fulfilment of their obligations by upper-tier intermediaries not being opposable to the account holder. For a weaker provision, the formula of UCC Article 8 could be used: "*due care in accordance with reasonable commercial standards*" (§ 8-506 (2) and -507 (a) (2)).

Another issue would be whether the rules on the intermediaries' duties should be mandatory or could be superseded by the account agreements and to what extent.

29. Now, let us assume that the intermediary does not guarantee the fulfilment, by the upper-tier intermediaries, of their obligations. And let us imagine that the issuer has paid dividends or interest, but the account holder has not received the corresponding amount; or that he gave instructions to the intermediary for convertible bonds to be converted or bonds to be redeemed and he does not find in his account the result therefrom; or that he gave instructions for shares credited to his account to vote in some sense and no shares have voted in that sense; or that he gave instructions to subscribe a capital increase based on rights, he has even paid for such subscription, but no new shares are found in his account... He asks

his intermediary what happens. This one answers: I have not received the money from my intermediary; or I have transmitted the instructions (and eventually the money) upstream... I have done what I should...

The relevant intermediary has fulfilled his obligations. Perhaps it is the next intermediary who has failed or a higher-tier one. Each intermediary will have some rights against the next one. But such are rights of each intermediary, not of the account holder.

The exercise by the intermediary of his rights against the higher-tier intermediary is a prerequisite for the satisfaction of the account holders' rights by specific performance. The intermediary's duty to exercise his rights against the higher-tier intermediary is a prerequisite for the satisfaction of the account holders' rights by whatever means.

30. The only way to protect the account holder, allowing him to claim even damages, is, first of all, to establish that **the intermediaries have the duty to exercise their rights against higher-tier intermediaries**, to the extent such exercise is required by the account holder's rights.

But it is also necessary that the intermediaries' duties have a minimum content. Otherwise, the intermediaries' duty to exercise their rights could be practically void. Therefore, I suggest that a formula as the UCC's one is used, but, contrary to what happens with UCC's Article 8, as a **mandatory minimum standard**. The steadiness and the reliability of the system depend on it.

Mandatory provisions limiting clauses excluding or limiting intermediaries' liability would also have to be inserted.

**E) Upper-tier attachment, *subrogatio* and insolvency of an intermediary (Articles 4 (3) and 8)**

- 31.** Preclusion of “upper tier attachment”, except in the event of an intermediary’s insolvency, was one of the principles defined as from the *Position Paper*, and it is a sound principle.

The relevant reason is that accounts are not integrated into a system and it is impossible to integrate them into a worldwide system. Without a system, one cannot know whether the lower-tier intermediary has enough securities or whether Article 7 has to apply. Therefore, an upper-tier attachment could grant the account holder more than he would be entitled to as effective in relation to the other account holders, without being possible to know whether such is the case or not. In insolvency proceedings all the claims are brought together so that such risk vanishes.

- 32.** Some countries recognise what could be called a “subrogatory” or “oblique” *actio* (“*action oblique*” in French, “*acção subrogatória*” in Portuguese, “*azione surrogatoria*” in Italian). By it, one person files a claim on the basis of another person’s (claimed) right. If relief is granted, it may produce its effects just on such person’s legal sphere (the subrogatory *actio* will be *indirect*, as is the French

“*action oblique*”) or also in the claimant’s legal sphere (*direct* “subrogatory” *actio*).

Normally, “subrogatory” *actio* is attributed to creditors, to protect them against the debtor’s inaction and the risk of the debtor’s insolvency and is *indirect*. But there are other cases where it is open, as *indirect* or *direct actio*. For instance, the Portuguese Companies Code allows shareholder’s holding, at least, 5% of the company’s equity to claim, by indirect “subrogatory” *actio*, the liability of directors towards the company (Article 77). Article 1181 (2) of the Portuguese and Article 1705 of the Italian Civil Code allow the principal to substitute himself to the agent in claiming the credit rights arising from the performance of the agency agreement. And Article 13 (2) (a) of the UNIDROIT Convention on Agency in the International Sale of Goods allows the undisclosed principal to exercise the rights against a third party, subject to any defences which the third party may set up against the agent, acquired by the agent on the principal’s behalf, where the agent, whether by reason of the third party’s failure of performance or for any other reason, fails to fulfil or is not in a position to fulfil his obligations to the principal (*direct* “subrogatory” *actio*).

Should not a solution of the same kind be adopted regarding claims for intermediaries’ and even issuer’s liability? Since only liability is at stake, the reason against upper-tier attachment does not operate.

It is a matter that, at least, deserves some thought. I note that such a solution would require disclosure duties more complex than the ones foreseen in the Convention on Agency in the International Sale of Goods.

- 33.** The circumstance that the issue regards liability is not, by itself, a ground for excluding the matter from the *Draft Convention*'s scope. In any event, if such was the case, the language of Articles 3 (3) (b) and 4 (3) should be narrower.

## **APPENDIX**

### **SHORT SUMMARY OF PORTUGUESE LAW ON SECURITIES**

1. The main legal basis is the *Código dos Valores Mobiliários*, as amended (Securities Code, hereinafter SC), published on the 13 November 1999 and entered into force the 1<sup>st</sup> March 2000<sup>24</sup>. It has replaced the 1991 *Código do Mercado de Valores Mobiliários* (Securities Market Code), but some of the provisions of the new Code are similar to those of the old one. For instance, the latter already admitted dematerialised securities<sup>25</sup>.
2. The SC distinguishes certificated and dematerialised (*escriturais*) securities (Article 46).

The dematerialised securities are represented solely by a registration. Such a registration may be made through an account with a financial intermediary and integrated into a centralised system, an account with a sole financial intermediary appointed by the issuer or an account with the issuer or a financial intermediary that represents him (Article 61). Only the dematerialised securities integrated into a centralised system may be listed and traded in regulated markets (Article 62).

The account holders with the financial intermediary which registers the securities are the (*direct*) owners of the securities (Article 74). And the transfer of securities is made through the credit to the acquirer's account (Article 68 and 80).

Certificated securities are represented by a certificate. They may be “alive securities” (if the owners keep the certificates) or deposited securities. The deposit

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<sup>24</sup> In this Appendix, provisions mentioned without reference to the source belong to the SC.

<sup>25</sup> As a matter of history, dematerialised securities were introduced in Portugal in 1988 (at the time, just for shares) by Decree-Law nr. 229-D/88, of 4 July.

may be made with a financial intermediary or with a centralised system (Article 99). *The ownership of the deposited securities is not transferred to the depositary* (Article 100).

Only certificated securities deposited with a centralised system may be listed and traded in regulated markets (Article 99, paragraph 2 (a)). Certificated securities deposited with a centralised system are registered into accounts (Article 106, paragraph 1) and subject to the rules applicable to dematerialised securities in centralised systems (Article 105), which means that *the ownership of the securities belongs to those in whose name they are credited into the accounts* (*indirectly* dematerialised securities).

Permanent global certificates are admitted. The global certificate has to be deposited with a financial intermediary or with a centralised system. Securities represented by a permanent global certificate are also subject to the rules applicable to dematerialised securities (Article 99, paragraph 5), which again means that the owners of the rights are those in whose name they are registered in the accounts. Only securities represented by global certificates deposited with a centralised system may be listed and traded in regulated markets (Article 99, paragraph 2 (a)).

The capacity (*locus standi*) for the exercise of the rights inherent to the directly dematerialised or to the deposited securities is evidenced by a certification issued by the financial intermediary with whom they are registered or by the depositary (Articles 78, 83 and 104).



Only financial intermediaries registered with the Portuguese supervisory authority – the *Comissão do Mercado dos Valores Mobiliários* (CMVM) – may provide the services of registration or deposit of securities (Articles 289, 291 and 295).

As a matter of practice, the shares of almost all the listed companies in Portugal are totally directly dematerialised.

3. A centralised system is defined as a set of interconnected accounts (Article 88). Regarding (directly) dematerialised securities, the accounts are the following (Article 91, paragraph 1):
  - (a) Issue accounts, opened with the issuer;
  - (b) Accounts for individualised registration (where the securities that each holder holds are credited and their status annotated), opened with authorized financial intermediaries;
  - (c) Accounts for control of the issues, opened by the issuer with the entity managing the system;
  - (d) Accounts for control of the individualised registration accounts, opened by the financial intermediaries with the entity managing the system.

The accounts of the last type are global accounts per financial intermediary (Article 91, paragraph 4).

The sole existing centralised system is managed by “Interbolsa – Sociedade Gestora de Sistemas de Liquidação e de Sistemas Centralizados de Valores Mobiliários, S.A.” (clearing being now, as a consequence of the integration of the Portuguese stock exchange into Euronext, operated by “Banque Centrale de Compensation, S.A.”, appointed by LCH. Clearnet, S.A.).

4. Article 204, paragraph 2 (a), provides that only *fungible* securities can be traded on a market (regulated or not). Paragraph 3 of the same Article 204 establishes that:

*“For the purposes of trading on a market, the securities which belong to the same category, obey to the same form of representation, are objectively subject to same tax regime and from which different rights have not been detached are considered fungible”<sup>26</sup>.*

According to Article 45 of the SC, *“the securities which are issued by the same entity and present the same contents constitute a category, even though they belong to different issues or series”<sup>27</sup>.*

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<sup>26</sup> The identification of securities according to the tax regime arose in Portuguese practice because of privatizations. Law allowed that tax benefits for the privatized shares were granted. Since there were cases of companies under privatization with part of the shares already privately owned, it became necessary to identify separately, both by the financial intermediaries and the stock exchange, and to trade separately the non-privatized and the privatized ones.

<sup>27</sup> Article 302, paragraph 2, of the Portuguese Companies Code provides that *“the shares comprising equal rights constitute a category”*. According to Article 25 of the SC, shares issued in a capital increase are identified and traded separately, as belonging to an *autonomous category*, for a period of 30 days as from the capital increase resolution (time for challenging it in court) and, if the resolution is challenged, until a court’s final decision.

The concept of fungibility used in paragraph 2 (a) of Article 204 is an *absolute* concept: the securities are fungible or not fungible. The one used in paragraph 3 is a *relative* concept, defining securities which are fungible between themselves.

Fungibility of securities is linked with the irrelevance of the securities order number or the inexistence of any securities order number. In Portugal, directly dematerialised securities do not have a securities order number. Therefore, they are fungible. For certificated securities deposited with a centralised system, the securities order number is irrelevant. They are also fungible.

As an *absolute* concept, fungibility means that the securities have *no individuality* (and are, therefore, not traceable); they are simply *ideal quantities of a class*, they have the nature of *merely categorial rights*. The *relative* concept determines the relevant (complex) classes to which ideal quantities may belong and which characterize them. Both the absolute (which corresponds to a spurious use of the word “fungibility”) and the relative concept of fungibility used by the SC are different from the fungibility concept relating to “things” employed by Article 207 of the Civil Code (see also paragraph 91 of the German BGB), which may also be relevant for some certificated securities. As applied to “things”, fungibility means *indifference*. As applied to ideal quantities, it means *indifferentiation*<sup>28</sup>.

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<sup>28</sup> I have developed these points in an article “Fungibilidade de valores mobiliários e situações jurídicas meramente categoriais” (“Fungibility of securities and merely categorial rights”) published in the *Estudos em Homenagem ao Professor Doutor Inocêncio Galvão Telles*, vol. I, 2002, pp. 579-628 (first publication), and also in *Direito dos Valores Mobiliários*, Instituto dos Valores Mobiliários, vol. IV, 2003, pp. 165-217. My ultimate submission is that “fungible” securities, as merely categorial rights, are *particulars* (as opposed to universals), but not *individuals*.

5. When certificated securities are deposited with a centralised system, a co-ownership by the holders of the securities is established. But such co-ownership refers only to the certificates (being relevant in the event that the deposit terminates), not to the rights represented by them<sup>29</sup>.

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<sup>29</sup> See above my referred study, paragraphs 23 and 24, pp. 594-595 of the first publication. I have called it “divided co-ownership” as opposed to “undivided co-ownership”.