



**UNIDROIT COMMITTEE OF GOVERNMENTAL EXPERTS
FOR THE PREPARATION OF A DRAFT CONVENTION ON
HARMONISED SUBSTANTIVE RULES REGARDING
SECURITIES HELD WITH AN INTERMEDIARY
First session
Rome, 9/20 May 2005**

UNIDROIT 2005
Study LXXVIII – Doc. 23 rev.

Original: English/French
August 2005

FINAL REPORT

General Discussion

1. The Secretary-General welcomed participants (cf. Appendix 3) in this first meeting of the Committee of governmental experts for the preparation of the draft *Convention on Harmonised Substantive Rules regarding Securities Held with an Intermediary* (“the Committee”).
2. He described the exceptional degree of support for this initiative that UNIDROIT had received from stakeholders - evidenced, for example, by the desire expressed in the course of its work on global clearing and settlement by the Group of Thirty, an international non-governmental organisation - for a body of law that is applicable and workable both globally and on a national level (cf. also UNIDROIT LXXVIII – Docs. 20-22 and Appendix 11).
3. Some reforms had already been achieved in this field by two directives of the European Union (“the EU”), namely Directive 98/26/EC on settlement finality in payment and securities settlement systems (“the EU Settlement Finality Directive”) and Directive 2002/47/EC on financial and collateral arrangements (“the EU Collateral Directive”). The Commission of the EU had begun further work intended to address wider issues within the EU regional area. The draft Convention would, by contrast, be global in scope and thus should both complement, and be coordinated with, the work of the EU.
4. Further evidence of the need for an international text had emerged from a “brainstorming” session with regulatory agencies and central banks. This had concluded that there was a vacuum and significant “white spots” in the law governing international transactions in capital markets.
5. The first step towards harmonisation, an appropriate response at the conflict of laws level, was a text adopted under the auspices of the Hague Conference on Private International Law (“the Hague Conference”), the *Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary* (“the Hague Securities Convention”). Whilst the Hague Securities Convention satisfied the need for a clear and consistent conflict of laws rule, the harmonisation of substantive law remained necessary. It was now time, with the encouragement, active participation and support of Governments, international institutions,

practitioners and scholars worldwide, to produce a text having global coverage. This would provide the legal certainty required if high transaction costs and an unacceptable level of systemic risk were to be avoided.

6. The current text of the preliminary draft Convention on Harmonised Substantive Rules regarding Securities Held with an Intermediary ("the preliminary draft Convention") was the result of extensive preparatory work, including consultations and a number of fact-finding events held throughout the world. It had been produced by a Study Group made up of both practitioners and scholars with relevant expertise in emerging and established financial markets. It was hoped that the Committee would complete its work early in 2007, following further meetings.

7. The Committee appointed Mr Hans Kuhn from the Swiss delegation to act as Chairman. Mr Kuhn's appointment was proposed by the delegation from Canada and seconded by the delegations from Luxembourg and the United States of America.

8. After the Committee had adopted the agenda (Appendix 2), the UNIDROIT Secretariat introduced the preliminary draft Convention (cf. Appendix 10), describing its principal objectives. It was intended to increase legal certainty and economic efficiency in the holding and transfer of securities in globalised capital markets. In order to do so, it should address what was seen as the underlying problem – i.e. the divergence of day to day practice from law which has at its heart traditional concepts relating to the possession of physical property and to a direct link between investor and issuer. Such concepts are not relevant to circumstances in which certificates are deposited with a central depository and where investor's rights to securities held through intermediaries are evidenced by book-entries.

9. Though the question of what was the applicable law had been resolved by the Hague Securities Convention, it was now necessary to ensure that applicable law, which might be internally sound, also provided workable solutions whenever it was required to resolve practical problems arising from transactions with a cross border element. Mindful that harmonised substantive law in this field might interact with elements of national corporate, insolvency and tax law, the Study Group had attempted to produce a text which, rather than imposing a legal concept, was functional and neutral. Central to it was the recognition of book-entries to securities accounts as the point of reference for legal effects.

10. In considering the scope and content of the text the Study Group had taken into account the needs of market participants and had drawn up a list of issues that should be covered by the draft Convention. These included the effectiveness of book entries in the event of the insolvency of the relevant intermediary; certainty for the investor in relation to the fruits that flow from the securities; clear rules both on adverse claims and priority; protection for intermediaries from third parties; and the intermediary's power to make net settlements. The Secretariat drew the attention of the participants to the special issue of the Uniform Law Review which contained a series of articles which describe different major holding systems (cf. Appendix 4).

11. The Chairman proceeded to invite delegations to voice their comments, including any they might wish to make on the need they perceived for this project and on the policies to which the preliminary draft Convention was intended to give effect.

12. All delegations that expressed their views strongly supported, in principle, the work undertaken by UNIDROIT and the text of the preliminary draft Convention. They agreed that it would complement the work already undertaken by the Hague Conference. As far as the work on

harmonisation currently being undertaken by the EU was concerned, the need for liaison with UNIDROIT was emphasised.

13. One delegation, supporting the need, in addition to the clear choice of laws rule provided by the Hague Securities Convention, for harmonised substantive law, thought there were a number of options as to the scope of the draft Convention. The right approach was, in its view, to limit the text to the main issues by filling gaps internationally in areas where they exist in national law. Although the text of the preliminary draft Convention was not in all respects satisfactory, particularly in its approach to "the applicable law", it was capable of producing benefits world-wide.

14. Another delegation, whilst welcoming the text as complementary to the Hague Securities Convention (and in particular, new Chapters 6 and 7 which were for some participants the most important in the text), stressed the importance to the future of financial markets of its focus on modern, indirect holding systems rather than on older forms of holding. It was vital to protect the markets against systemic risk. It considered the work undertaken by UNIDROIT as an "extension" of the Hague Securities Convention and would work toward the early implementation of the latter. It had, however, an open mind concerning the final form of the text – whether treaty, model law, or any other form.

15. Another delegation, whilst accepting that the objectives of the draft Convention should be the creation of legal certainty and the promotion of low cost transactions, emphasised the need for it to provide for investor protection. It felt there was the possibility for the text to affect areas of national law designed to protect investors and thus produce a contrary effect. It was particularly concerned that the definition of "securities" was too broad; that nothing should prevent investors from being able to exercise their rights directly against issuers and that the prohibition and prevention of shortfalls should be at the centre of the text instead of focussing on sharing loss in the event of shortfalls.

16. The observer from the EU Commission underscored the need for a global solution regarding cross border clearing and settlement, albeit that the EU itself was currently undertaking preparations for an EU-wide legal framework. In this context the delegation introduced the plenary to the role of the *European Commission's Clearing and Settlement Advisory and Monitoring Expert Group (CESAME)* and the *Legal Certainty Group*. Furthermore, the EU Commission was currently seeking a mandate to negotiate on behalf of its member States in the field of EU legislation already in place. He made the point that the EU Commission considered both the UNIDROIT, and its own, work as complementary.

17. The observer from the Hague Conference endorsed the view the Hague Securities Convention and the future UNIDROIT instrument were complementary and that therefore the terms and definitions used in the preliminary draft Convention should correspond to the greatest possible extent to those used in the Hague Securities Convention.

18. One observer referred the Committee to recent opinions of the European Central Bank (ECB) which gave expression to the role of the ECB in relation to clearing and settlement systems and financial stability within the EU.

19. Several delegations underlined that the future instrument ought to follow, as set out in the Explanatory Notes, the functional approach, i.e. it should accommodate different legal concepts with respect to securities held with an intermediary by building on result-based rules instead of imposing legal concepts.

20. Another group of delegations drew attention to the fact that the peculiarities of the legal structures underlying securities holding through intermediaries in their countries, such as single-tier holding structures or direct holding, were very often not sufficiently reflected in relevant discussions.

21. The Chairman, thanking delegations for the broad general support for the work on a draft Convention, invited delegations to express their views on the scope of the project, in particular on the question of which holding patterns the future Convention should apply to.

22. The keywords underlying this discussion were "direct" and "indirect" "holding". It became clear relatively quickly that these terms were imprecise and that the presumed distinction was not useful in the context of defining the scope of the draft. It was, however, broadly accepted that fact patterns which involved the possession of physical certificates as well as direct registration with the issuer were clearly outside the scope of the draft.

23. Several delegations therefore suggested that the preliminary draft Convention should instead identify precisely the circumstances in which a person acts as an intermediary, although it might be necessary to adopt different definitions from those used in the Hague Securities Convention.

24. Systems such as the "Nordic" systems seemed to be within the scope of the preliminary draft Convention since they were neither based on physical possession of securities nor required the investor to be registered directly with the issuer.

25. It was pointed out that the preliminary draft Convention concentrated on describing the effects that flowed from accounts held with an intermediary. Therefore, a number of delegations pointed to the possible benefit of using the expression "account-providing institution" instead of "intermediary".

26. There was broad agreement that a significant question was which institution should be treated as intermediary in terms of the draft - and that the great variety of fact patterns demanded a flexible and case-by-case approach (cf. for example Appendix 12). In some cases, for example, the entity on the highest level of the holding chain was, according to the legal or contractual arrangements, acting on behalf of the issuer. Another example was entities further down the holding chain that acted as agent for the central securities depository ("CSD"). The criteria that govern the classification as intermediary in terms of the draft were still to be defined.

27. There seemed to be some agreement that some provisions of the text should not apply to certain specific systems, for example, those based on only using one single tier of intermediary and non-fungible accounts.

28. One delegation made the point that it had not yet been demonstrated that it was possible to draft an international instrument which provided the same set of rules for all systems. That delegation hoped, as did other delegations, that the Committee would nevertheless continue to examine all systems although it might be necessary either to limit the scope of the instrument or to draft alternative rules for different systems.

Article 2

29. Following its introduction by the Secretariat, the Chairman invited delegations to comment on Article 2 (cf. also Appendix 5).

30. Several delegations found paragraph (1) (a) of Article 2 unclear, particularly the provision it made for the account holder "acting for its own account". One delegation suggested that the provision was superfluous. Another made the point that, if it were reformulated so as to make explicit provision for ownership, it would not give effect to the functional approach delegations appeared to favour. Another delegation suggested that Article 2 should provide both for the situation in which the investor had ownership of a security and that in which he had a mere contractual relationship with his relevant intermediary. Reinforcing a point it had made earlier, one delegation was concerned that Article 2, in its present wording, was drafted from the perspective of an intermediary. It would have preferred the Article to focus on the rights of the investor and by exception grant the relevant intermediary the power to exercise the investor's rights. That view was not universal. Reference was made to situations in which investor's rights cannot be passed through the chain of intermediaries. One delegation found paragraph (2) (b) of Article 2 too narrow because it did not provide for situations where there was a direct link between ultimate account holder and issuer. It also maintained that the right provided for in paragraph (1) (d) of Article 2 to withdraw securities from the holding system might be not only be disallowed by the applicable law, but also by other rules, such as the rules of the issue. Finally, the meaning of the reference in this Article to "applicable law" was not entirely clear. One delegation, supported by others, suggested to opt for "applicable law as determined by private international law rules".

31. The Chairman summarised the discussion of Article 2 of the preliminary draft Convention. The scope of paragraph (1) (a) of Article 2 was felt by some to be too broad. Article 2 might, however, include provisions to the effect that a credit of a security to a securities account may express the perfection of an underlying transfer.

32. Several delegations thought Article 2 should state expressly that the ultimate account holder is entitled to all rights flowing from securities registered in their name and that any intermediary should pass on these rights to them. Some delegations felt the description of these rights in paragraph (1) (a) of Article 2 was too narrow. Others found it too broad.

33. One delegation did not agree, since, as a matter of principle, an intermediary was not in the position to pass these rights on. It considered that Article 2, on the one hand, referred to the contractual investor-intermediary relationship, and, on the other hand, the investor's rights as entitlement holder and his enjoyment of rights flowing from his securities (whether exercisable against the issuer or against the relevant intermediary).

34. Some delegations agreed with this analysis. One pointed out that, whereas in some systems, rights flowing from securities could be exercised by the beneficial owner, in others they might be exercised only by the ultimate account holder. This view was supported by several delegations. A number of delegations considered both systems should be within the scope of the preliminary draft Convention though not all agreed that, as currently drafted, that was the case.

35. One delegation considered the reference to "ownership" in paragraph (1) (a) of Article 2 to be inconsistent with the functional approach agreed on by the Committee. Furthermore, the enjoyment of rights flowing from securities should be dealt with elsewhere – perhaps in Article 17 - where it should be expressly stated that not only rights but duties flow from securities. This opinion was supported by other delegations, one of them adding that paragraph (1) (a) of Article 2 limited the room for manoeuvre for higher tier intermediaries in that it did not allow them to exercise rights flowing from securities held for account holders. Other delegations supported this view.

36. One observer concluded that the formulation "acting for its own account" in paragraph (1) (a) of Article 2 was ambiguous. It might be deleted all together. Concluding the discussion

on paragraph (1) (a) of Article 2 there was agreement that some redrafting was required though, since this would have implications for other provisions in the preliminary draft Convention, it should be deferred. The Chairman then proposed that the Committee proceed to discuss the remaining sub paragraphs of paragraph (1) of Article 2.

37. Some delegations thought paragraph (1) (d) too narrow, since it referred only to situations where physical certificates might be withdrawn from the holding system and not to withdrawal in dematerialised systems. Withdrawal on the basis of an instruction of the account holder could also be subject to the issuer's terms or those of the account agreement as well as on the instructions of the account holder.

38. Several delegations and observers pointed to the ambiguity of "applicable law" in paragraph (1) (d), following which the Hague Conference's proposed to coordinate a working party to consider this matter. This proposal was welcomed by the Chairman who invited delegations to join the *ad hoc* Working Group on the term "applicable law" informally.

39. As a general comment on the content of paragraph (1) of Article 2, some delegations pointed out that the rights listed did not take into account exceptions to those rights that might derive from contracts, company law and other sources. Other delegations thought the list was sufficient but suggested that the Explanatory Notes could be clearer. Further, several delegations were in favour of the enumeration, in Article 2, of basic rights, albeit not of exceptions to them.

40. One delegation perceived a number of defects in Article 2. For example, Article 2 seemed, inappropriately, to require intermediaries to establish accounts with other intermediaries; to allow withdrawal of securities even where this was not permitted by the applicable law and did not take into consideration the impact of the terms of the relevant account agreement on the rights in question. This delegation also suggested that paragraph 3 of Article 2 be redrafted to clarify the extent and limits of the rights in question. Furthermore in defining the obligations of the intermediary regard should, among other things, be given to the account agreement and reasonable commercial standards, in accordance with the applicable law.

41. Some delegations found it difficult to understand which "third parties" were meant in paragraph (2) (a). The view that, among others, this could refer to the issuer was not contested – though whether it would might depend on national law.

42. Other delegations thought paragraph (2) (b) unsatisfactory because, in some jurisdictions, it encroached on insolvency law and the investor-issuer relationship. This view was not shared by all delegations. One delegation pointed to the clear distinction between paragraphs (2) (a) and (2) (b). The former dealt with the effectiveness of book entries in securities accounts, the latter, with the enforceability of rights flowing from book entries. The view that paragraph (2) (b) should be retained, albeit with some redrafting, was widely shared.

43. As to paragraph (3) (a) of Article 2, more than one delegation thought that the future Convention should provide for the "relevant intermediary" to be strictly liable for the actions of its own upper tier intermediary. A discussion followed on whether the reference to "applicable law" in paragraph (3) (b) should be retained. Several delegations thought it should be, to protect the investor. Others were of the opinion that it was not the business of the future instrument to provide regulatory rules for the protection of the investor against the intermediary.

44. There was a difference of opinion as to whether the reference to the "account agreement" should be retained in paragraph (3) (b).

45. Finally, the Committee elected the first and second Vice-Chairmen. Mr Maxime Paré, member of the Canadian delegation, proposed by the delegation from Brazil and seconded by the delegations from Canada, Spain and Argentina was elected as first Vice-Chairman. Mr R.S. Loona, member of the Indian delegation, proposed by the delegation from Japan and seconded by the delegation from the UK, was elected second Vice-Chairman.

Article 3

46. The Committee then discussed whether the preliminary draft Convention should explicitly state that no credit could be able to be made without a corresponding debit (cf. also Appendix 13).

47. Two delegations were of the opinion that the rule set out in paragraph (4) of Article 3 could cause "over-issue" of securities. Reference was made to the harm that would follow if that were to occur. Several delegations agreed. Moreover, one delegation suggested that inflation itself should be prohibited explicitly in Article 3.

48. As was explained by some delegations, several systems did not even enable a credit of the buyer's securities account without a corresponding debit of the seller's account. In these systems a transfer from one party to another is considered to consist of a transfer of ownership, - i.e., from seller to buyer.

49. A number of delegations made the point that, in other systems, however, it was more common to credit securities accounts without making corresponding debits, since in those systems the settlement of a transaction was analysed as the cancellation of the transferor's rights against his intermediary and the establishment of the transferee's rights against his intermediary.

50. Nonetheless, it was agreed that, even in the former systems, credit without debit was legally possible in some situations, such as netting, the initial deposit of securities into the intermediated system and provisional crediting. As a result, several delegations proposed that any explicit rule prohibiting "over-issue" in this broad and somewhat non-technical sense be left to regulatory rules, whilst the preliminary draft Convention should accommodate both approaches. One delegation expressed the view that the future Convention was not intended to limit any regulatory measures.

51. The view was expressed by some that the distinction between both the systems described was not per se a distinction between a direct and an indirect holding system.

52. One delegation asked how the preliminary draft Convention would treat the debit of a transferor's account whilst the corresponding credit had yet to take place. As delegations pointed out, the draft Convention should apply not only to systems where ownership of the transferred securities rested with the intermediaries concerned, but also other systems where the transferees' accounts would be credited provisionally. The preliminary draft Convention should do so, because of its intention to create internally sound, yet cross-border compatible, systems. One delegation was opposed to this view. It stated that systems enabling provisional credit might not be inter-operable with systems that did not.

53. Some delegations found that the relationship between Articles 3 and paragraph (1) of Article 5 of the preliminary draft Convention needed clarification, since a book entry under Article 3 took effect only once the requirements mentioned in Article 5 have been met. Another

delegation explained that Article 3 should be complemented by Article 5 because Article 5 referred to the validity of a credit, whereas Article 3 refers to technical perfection requirements.

54. There seemed to be a lack of clarity as to whether the various references to “applicable law” in Article 3 referred to the same law. It was the view of the coordinator of the *ad hoc* Working Group on the term “applicable law” that all three references in this Article referred to the same (domestic) law.

55. With reference to the creation of a security interest which was not based on a title transfer, some delegations considered that the creation of such an interest did not necessarily involve a debit of securities. They proposed to modify paragraph (2) of Article 3 accordingly.

56. The Committee went on to discuss the scope of paragraph (4) of Article 3.

57. Some delegations pointed out that it catered both for a system which is based on the identification or tracing of individual transactions throughout the chain of intermediaries and for one based on transactions in securities held in omnibus accounts. Even under the former system, credit would not be ineffective pursuant to paragraph (4) of Article 3, since it imposed no (additional) requirements as to the perfection of a credit. Paragraph (4) of Article 3 would not prohibit the linkage of credit and debit under the domestic legal framework but would provide a solution for a situation where a corresponding book-entry could not be found. This was particularly likely to occur on the lower tiers of a system of indirect holding in a cross border situation. One observer emphasized the need to be sensitive to systems in emerging markets. Different as they might be from familiar ones they needed to be accommodated under the preliminary draft Convention.

58. Another situation specifically included in the scope of paragraph (4) of Article 3 is the so called dynamic situation, i.e. a transfer from a seller to a buyer where neither were participants of a CSD and where, in consequence, the transfer would go through intermediaries on both sides. As not all credits and debits between the numerous intermediaries involved take place simultaneously, there might be a point in time when a corresponding credit to the debit in question could not be identified as it had not yet occurred. If an insolvency event occurred at this point in time, it would be necessary to apply paragraph (4) of Article 3.

59. There was broad agreement that it is often impossible to trace corresponding book entries. Equally, systems under which conditional credits were possible were not dissimilar. Neither system was entirely consistent with one built on corresponding credits and debits.

60. Two delegations did not believe that the preliminary draft Convention followed the functional approach. In their opinion it would favour one system over others.

61. In the course of the Committee’s consideration of paragraph (5) of Article 3, the question was raised whether this provision would require national law to be amended in order to accommodate net settlement. It was explained that the draft would not require systems to operate particular forms of accounts but that national law would not override the legal effect of net settlement, in particular, in a cross-border situation. With reference to paragraph (7) of Article 3, it was pointed out by another delegation that all other systems were to be accommodated by the draft Convention. Not all delegations agreed. They made the point that a contemporary market-place could only work if sound, modern systems were in place.

62. Delegations also proposed that paragraph (5) of Article 3 be clarified so that the distinctions between netting, internalisation and novation were drawn. It was suggested that

internalisation was included in the scope of this paragraph. Some delegations believed that the term "securities of the same description" should be clarified.

63. Discussion on the relationship between the future instrument and regulatory rules followed. One observer pointed out that a clear distinction between regulatory law and transactional law was difficult to make. In any event, the future Convention should not attempt to impose regulatory requirements.

64. One delegation provided an explanation of certain diagrams distributed by the Secretariat on its behalf (Appendix 13). They concerned different systems of transfer, viz. the so-called stage-by-stage system and the system where legally speaking only one disposition took place. That delegation was of the opinion that both systems were catered for by the preliminary draft Convention, since Article 3 focused only on the book-entry into a securities account. This book-entry was both necessary and sufficient for a transfer. The draft Convention should not make detailed provision for its content.

65. One delegation thought paragraph (6) of Article 3 was redundant and proposed its deletion. This delegation felt that this paragraph did not add anything significant to the Article, which regulated the requirements of transfer, either by way of security or otherwise. This view was seconded by several delegations, who proposed that the possible *causa* of a securities transfer be described in either the interpretative first Article of the preliminary draft Convention – now paragraph (h) of Article 1 – or in the Explanatory Notes.

66. Reference was again made to the ambiguity of the term "applicable law" in paragraph (6) of Article 3. One delegation proposed deletion of the term, since it was used here in the context of the characterisation of a transfer, which, as a matter of principle, was already a pure conflict of laws issue. This position was supported by an observer, who referred to paragraph (1) (b) of Article 2 of the Hague Securities Convention.

Article 4

67. Prior to the discussion of Article 4, the Secretariat provided a presentation of the background to the Article (cf. Appendix 14). It related to the creation of a securities interest, either in favour of the account holder's relevant intermediary or in favour of others. The requirements for the perfection of a security interest should be distinguished accordingly, because the intermediary already had power over the secured assets so that the requirement of publicity for the security interest was already met. In the case of the creation of a security interest in securities in favour of parties other than the security provider's relevant intermediary, the requirement of publicity could be met by "earmarking" or "flagging" the securities concerned.

68. It was stressed that the wording "any requirements" in the present Article 4(1)(b) covered also the disposal of the securities concerned by the security taker, and that more explicit reference to traditional pledge could perhaps be made.

69. Finally, it was explained that paragraph (5) of Article 4, which ought to be read in conjunction with paragraph (7) of Article 3 and Article 9, reflected the fact that, in some jurisdictions, it was not possible to take a security interest over a securities account as a whole.

70. The Committee went on to discuss whether Article 4 should (expressly) cover a security interest by way of outright transfer. This was supported by several delegations. One thought it could cause difficulties. It was felt by some delegations that the functional approach on which the draft Convention was to be based required it to provide for most kinds of security interests.

Several delegations thought that those kinds of security interests that were to fall within the scope of the draft Convention should be explicitly listed in Article 4.

71. Some delegations were of the opinion that Article 4 created a new type of security interest, which should not be the purpose of the future Convention. They suggested that Article 4 should regulate perfection issues only. They thought that Article 4 should distinguish between the creation of a security interest by way of a control agreement as a principle of common law jurisdictions on the one hand, and the creation of a security interest by way of deposal or transfer as a principle of civil law jurisdictions on the other. The majority view, however, was that Article 4 as it stood provided perfection requirements only, using the more neutral term "effectiveness". Though one view was for the list of perfection requirements to be extended there was no general agreement as to whether this list should be exhaustive.

72. One delegation was unhappy with the current drafting of paragraph (1) (a) of Article 4, since in its view, it reflected neither market practice nor national statutory law. Under this particular delegation's national law, any actions by the intermediary as to the securities concerned without the express authority of the account holder were considered to constitute a criminal offence.

73. Some delegations were of the opinion that paragraph (1) (a) of Article 4 should explicitly cover statutory liens in favour of the relevant intermediary. This opinion was not shared by all delegations. One of them thought statutory liens were a matter of substantive, non-Convention law and thus covered by Article 9. Some delegations proposed deletion of paragraph (1) (a) because of the contradictory views held by delegations on the matter.

74. One delegation expressed its concern that paragraph (1) (a), read in conjunction with paragraph (5) of Article 4 and Article 9, implied that a security interest granted to the security interest provider's relevant intermediary had priority over a subsequent security interest, granted to a third party. This would be contrary to principles applied in many jurisdictions which prioritise a security interest entailing deposal over a security interest not entailing deposal.

75. Some delegations felt that paragraph (1) (b) of Article 4 should mention that the agreement referred to was a tripartite agreement, although this view was not shared by all. Several delegations thought paragraph (1) (b) should be deleted. One delegation thought paragraph (1) (b) should include a requirement for written consent - either via reference to the "applicable law" or otherwise - for the creation of a security interest. This view was not shared by all delegations.

76. Some delegations pointed to the EU Collateral Directive, which prohibited formal requirements to effect the perfection of a security interest. In their view, paragraph (2) of Article 4 should be deleted. Other delegations proposed the deletion of paragraph (2) since it did not provide creditors with any additional protection or sufficient additional publicity. This view was not shared by all delegations who thought the provision was adequate in relation to insolvency. One delegation thought that the term "annotated" was too vague and that the paragraph should be redrafted so as to make it more explicit.

77. Discussion on the level of control of both the security provider and the security taker followed. One delegation maintained that the security taker should be granted as little control as possible over the securities concerned ("affirmative control") and that the draft Convention should not provide for "negative control" by the security provider. Another delegation proposed an explicit reference to this distinction in paragraph (1) (b) of Article 4.

78. One delegation thought paragraph (3) of Article 4 should be redrafted to include a requirement for an existing security agreement. Other delegations thought it should be clarified. It was not clear to them whether it required Contracting States to enable the creation of a security interest in a securities account. There was no consensus as to whether the provision should require Contracting States to do so. More generally, a provision supporting the possibility of a security interest in a securities account as a whole was welcomed.

79. Some delegations proposed redrafting paragraph (4) of Article 4. It was felt to be too general. As currently drafted, it did not take into account that the simplified perfection of a security interest might not be allowed for all types of parties, in particular consumers. Perhaps an opt-out should be added to the provision.

80. Delegations proposed the deletion of the reference to Article 9 in paragraph (5) of Article 4. One delegation proposed deleting paragraph (5) altogether.

81. As a concluding remark following on the discussion on Article 4, one participant stressed that this provision should not impede the effectiveness of the EU Collateral Directive, which went further than Article 4. This view was supported by several delegations.

82. The Chairman announced that Mr Hideki Kanda, from the Japanese delegation, would chair the Drafting Committee, with Mr Guy Morton (United Kingdom) and Mr Deschamps (Canada) acting as Co-Chairmen. Members of the Committee would comprise representatives of the delegations from Belgium, Chile, Denmark (or another "Nordic" system), France, Germany, Luxembourg, Switzerland and the United States of America. The Chairman would be free to invite observers and make all other arrangements regarding the organisation of work.

Article 5

83. The Secretariat proceeded to provide a general introduction to Article 5. Its paragraph (1) referred to the need for the authority of the account holder in order for a securities transfer to be effective. Taking debits and credits made by the relevant intermediaries as a starting point, such a requirement was felt necessary for investor protection. Paragraph (2) of Article 5 provided for conditional credit. Although conditional crediting might raise questions regarding systemic certainty, market participants thought, as a starting point, that such a provision was necessary. Paragraph (3) of Article 5 referred to the effect of a reversal of a credit on any ground provided by the applicable law. Paragraph (4), on the other hand, referred to reversal in the case of a third party acquirer. A former member of the Study Group added that the present draft Article was the outcome of the dilemma whether certainty as to book-entries into securities accounts should be prioritised over the non-effectiveness of defective credits and debits. The Study Group felt that this should not be the case.

84. One delegation thought that the term "authority" should be redrafted to include such standard authorisation as may be granted to the intermediary in the account agreement. Another delegation pointed out that it was possible in some systems for a debit to be made without prior authority being granted by the account holder – for instance in the case of a statutory lien. Other delegations thought these matters should be left to domestic non-Convention law. Another thought that reference to an agent acting without the necessary authority should be made in this Article.

85. Several delegations were of the opinion that "against third parties" should be deleted, since it implied that the credit or debit might not be effective against the relevant intermediary.

86. Two delegations suggested that paragraphs (2) and (3) could be combined.

87. The Committee's discussion of paragraph (1) of Article 5 (cf. also Appendix 7) concluded with general support for the retention of the paragraph. The preliminary draft Convention should make explicit reference to the need for an intermediary to have authority to make entries. Not all delegations, however, agreed as to what was meant by "authority". One described the requirement, in some "civil code States", for the presence of two elements in order for the transfer of property to be effective, i.e. not only transfer but a valid contract. Paragraph (1) appeared to provide for transfer but not for the validity of the underlying contract.

88. Delegations agreed that this issue was important, but the principle to which the preliminary draft Convention tried to give effect was to ensure that book-entries could be relied upon. A departure from tradition might have to be made to protect the legal certainty of book entries irrespective of the underlying contract between delivering and receiving party.

89. As to detail, a number of delegations supported the deletion of the words "[against third parties]" and agreed that the Drafting Committee should give a wider meaning to the reference to "authority".

90. As the Committee went on to discuss paragraph (2) of Article 5, the EU observer delegation made the point that the paragraph contained the first reference in the text to "a securities clearing or settlement system". For its part, the EU was taking a functional approach to defining that system, i.e. one which took into account what the functions of the system were. The approach taken by the EU Settlement Finality Directive was one of national designation. It applied to systems designated by member States as intended to fall within its scope. The delegation expected that the EU and the Committee would bear in mind the need to achieve harmony between both texts.

91. In discussing the text of paragraph (2) of Article 5, one delegation supported the distinction made between "credit or debit" and "designation". "Designation" might give rise to neither credit nor debit. As to the reference to conditionality, if it was only meant to import a reference to conditions of a contractual nature it should be expanded to include "statutory" conditions.

92. The Committee went on to discuss paragraph (3) of Article 5. One delegation asked what was meant by the expression "on any other ground" in the context of grounds for reversing a credit or debit of securities. Others explained that the Study Group had recognized it was not expert in all national systems and had not wished the text unwittingly to make inroads into national law. The expression was intended to ensure legal certainty and the protection of the ultimate investor. The key question was securities account certainty. Beyond that the Convention should not seek to encroach on the substantive law of Contracting States. Delegations generally agreed that paragraph (3) should, however, be drafted specifically so as to refer to the terms of the account agreement, which, in general, provided for the circumstances in which reversal can take place. There was, however, no general agreement as to whether the words "on any other ground" covered matters such as the validity or otherwise of the underlying contract or any prohibition of a public nature, without the need for additional words. Matters such as liability resulting from the relationship between the account holder and the intermediary were for different States to resolve according to their national law. The text should not provide for them. As to the reference to "the applicable law", in this context it meant "the relevant domestic non Convention law" (which might not be the law that governs the contractual relationship between the account holder and the intermediary). The Committee agreed that the Drafting Committee should reconsider the structure of paragraphs (2) and (3). As to final content and structure, one

delegation suggested that the second part of paragraph (3) contained a priority rule, modified by paragraphs (4) and (5). A simple reference to the priority rules of the clearance and settlement system might suffice. Indeed, no special rules might be necessary – a general rule on priority and good faith in acquisition might be all that was needed.

Article 6

93. The Secretariat then introduced Article 6. Its function was to put beyond doubt that there is a moment in time when book entries become effective. Delegations were not convinced of its need and suggested it be incorporated into Article 5. Though its title implied something more, it simply confirmed the obvious.

Article 7

94. The Committee considered briefly the provision made by Article 7. Delegations were generally in favour of the principle to which it was intended to give effect, but matters such as the degree and nature of regulation to which future clearing and settlement systems would be subject were, at the EU and at other levels, still far from clear. Delegations agreed that detailed consideration of its content should be deferred.

Article 8

95. Article 8 was then introduced by the Secretariat. Unlike paragraph (2) (b) of Article 2, which addressed the account holder's rights against the relevant intermediary, Article 8 was concerned with "attachment" against any upper tier intermediary ("attachment" being defined as broadly as possible). An upper tier intermediary could not be expected to have any information regarding the securities a particular investor has. The effect of attempting to freeze securities at the upper tier would have unwarranted consequences for the entire account and indeed, potentially, for the system as a whole.

96. There was broad support for the principle to which the Article was intended to give effect. Omnibus accounts should not be subject to attachment. One delegation described it as a limited, targeted provision which it had never known to be applied in practice. It was, however, accepted that questions of how and whether the Article should be applied to the direct holding system, which might enable identification at the upper tier, required further consideration and possibly some redrafting in consequence. Any exception to the rule made for that system should perhaps not be automatic. Only when accounts were set up systemically so as to ensure transparency should there be an exception. In drafting terms it might be expressed as "Except as otherwise prescribed by law", rather than by reference to a possible identification. However it was pointed out that any redraft must take into consideration the possibility of difficult priority issues which could arise where attachment was permitted at a level other than the relevant intermediary in several scenarios. Further suggestions for re-drafting were made by delegations. These included general matters such as the importance of the cross-border context in which there might be linkages between direct and indirect holding systems and specific matters such as the definition of "attachment".

Article 9

97. The Secretariat then introduced Article 9. There were compelling reasons for including a priority rule in relation to cross-border transactions. There were interests arising under two different regimes to consider - that for which the preliminary draft Convention would provide and the national systems already in existence. For those arising under Articles 3 and 4, the rule was

relatively straightforward. Interests arising from both Articles had priority over all others and ranked amongst themselves on a "first in time" basis. Interests created under transactions governed by domestic non-Convention law ranked amongst themselves according to that law. In relation to Article 9 cf. also Appendix 7.

98. As to scope, as described in paragraph (1), one delegation found it unclear. In its view, it should deal with pledge, lien or security interest but not other dispositions, such as outright transfer. It was accepted that discussion would be easier when "fact patterns" illustrating its intended scope and operation had been provided. These would illustrate the purpose of the rule i.e., the recognition of the priority of the intermediary as against a third party creditor. Any redrafting would also have to bear in mind not only that Articles 9 and 10 applied to transactions covered by Articles 3 and 4, but that these transfers might take place on different levels.

99. In the context of paragraphs (2) and (3) (which made reference to "the applicable law"), the Committee had the benefit of a presentation from the Co-ordinator of the Working Group on the term "applicable law", Mr Christophe Bernasconi (Hague Conference). The Group hoped it had established a clear and sound foundation on the basis of which the preliminary draft Convention could make reference to "the applicable law". The group outlined the results of its discussion in a working paper, which is reproduced as Appendix 6. Coming back to Article 9, in relation to paragraph (2), some delegations preferred the formula "domestic non-Convention law" (although, since it referred to the Hague Securities Convention which excluded statutory liens, the formula "applicable law" would arrive at the same result).

100. Discussion of Article 9 continued with an explanation of agreements which provide for the voluntary subordination of priority, given by delegations in whose national legal systems such agreements are common.

101. One delegation gave a presentation on a number of fact patterns which illustrated various priority issues in relation to Article 9 of the preliminary draft Convention (Appendix 15). These were discussed by the Committee.

102. In the first fact pattern, an account holder grants a security interest to Lender A under domestic non-Convention law. Later, this account holder provides security over the same securities to Lender B under paragraph (1) (b) of Article 4 of the preliminary draft Convention. The question was whether Lender A or Lender B would have priority. The probable answer was Lender B, under Article 9 as it is currently drafted. The prevailing view was that this was the correct solution.

103. The reason for the priority given to Lender B was the primacy of the entry to a securities account, on which this preliminary draft Convention focuses, over interests in securities not expressed by book-entries. This position was supported by several delegations. Another delegation pointed out that, should another means of perfection be included in the "laundry list" of perfection requirements in paragraph (1) of Article 4, a right so perfected would have the same priority as the right of Lender B had under the current version of the preliminary draft Convention.

104. Some delegations reiterated the fact that the publicity measures referred to in Article 4 had yet to be specified, but that they did not add additional protection, since intermediaries did not disclose interests in securities accounts they maintain.

105. In the second fact pattern, an account holder grants a security interest to Lender A under domestic non-Convention law. Later, this account holder grants a security interest to his

relevant intermediary under paragraph (1) (a) of Article 4 in the same securities. Again the question was who would have priority. The prevailing view turned out to be that, under Article 9 of the preliminary draft Convention, the intermediary would "win". This solution was supported by most delegations.

106. In the third fact pattern, an account holder grants a security interest to Lender A under paragraph (1)(b) of Article 4. Later, this account holder grants a security interest to Lender B also under paragraph (1)(b). The account holder's intermediary then becomes insolvent. Which Lender's rights have priority? The prevailing view was that, under the provisions of paragraph(1)(b) of Article 9, Lender A would "win" - , though both Lender A and B were "innocent" to the same extent. This opinion was not universally held and there was some support for a pro rata sharing, which was contradicted by other delegations.

107. One delegation, however, was of the opinion that Lender B should have priority pursuant to paragraph (1) of Article 10. Another delegation replied that Article 10 did not apply here, since it dealt only with situations where there was a priority issue between account holders maintaining accounts with different intermediaries. In these situations, the transferee could not be considered to have any knowledge of prior claims. This position was supported by some delegations, again with reference to the primacy of credits to a securities account.

108. In the fourth fact pattern, an account holder grants a security interest to Lender A under paragraph (1) (b) of Article 4. Later, this account holder grants a security interest in the same securities to his intermediary under paragraph (1) (a) of Article 4. The prevailing view was that Lender A would "win" and that this was the correct solution.

109. In the fifth fact pattern, an account holder grants a security interest to Lender A which is perfected under domestic non-Convention law (for instance by registration). Later, this account holder grants a second security interest in the same securities to Lender B under paragraph (1) (b) Article 4 by designation. A third security interest is then granted to the intermediary and perfected under Article 4 (1) (a). The prevailing view was that Lender B's rights should be prioritised over the relevant intermediary's rights, which should, in their turn, be given priority over Lender A's rights.

110. In the sixth fact pattern, an account holder transfers securities by way of security to Lender A's securities account held with the same intermediary. Later, this account holder grants a security interest to his intermediary under paragraph(1)(a) of Article 4. The prevailing view was that Lender A would "win" since his security rights were granted first in time. Article 10 was not applicable here because the same intermediary was used.

111. In the seventh fact pattern, a credit to an account is made with a provisional statutory lien in favour of the intermediary concerned. Later, the account holder grants a security interest to Lender A under paragraph (1) (b) of Article 4. The Committee felt that pursuant to paragraph (2) of Article 9, the applicable law should determine priorities.

112. In the eighth fact pattern, an account holder grants a security interest to Lender A under paragraph (1) (b) of Article 4. Later, the same securities are transferred to innocent Buyer B under paragraph (1) of Article 3. Then the intermediary becomes insolvent. Possible solutions to the priority issue were: Lender A would "win" under the provisions of Article 9, since he had been granted his interest first in time, or innocent Acquirer B would "win" under the provisions of paragraph (1) of Article 10 or the loss was distributed on *pro rata* between them.

113. No general agreement could be reached on the right answer.

114. One delegation felt that Buyer B should “win” because this situation would be the result of mistake or fraud by the intermediary, upon which the transfer would have been reversed. Another delegation however, expressed the view that priority could only be established in this case if the preliminary draft Convention expressly so stated. Other delegations were of the opinion that the loss should be shared *pro rata* since, if the buyer’s interest was to be given priority, this would lead to inflation of securities. Further, such a priority rule would induce security takers to agree only on a transfer of title by way of security, which would result in higher costs. Other delegations interpreted Article 9 as it stood as treating all security interests within the scope of the Convention in the same manner. That would be consistent with the EU Collateral Directive. This would lead to the priority of the first party granted an interest, i.e. Lender A. One delegation objected that, if this was the case and Buyer B maintained a securities account with the same intermediary as Lender A, he would be less well off than he would be than if he maintained his account with another intermediary. In that case, he would have priority over Lender A because of the good faith rule in Article 10.

115. One delegation pointed out how difficult it was to find satisfactory reasons to give priority to one interest holder over the other. As was mentioned earlier by another delegation, priority could be based on the fact that Buyer B was most likely to be unknown to the account holder, whereas Lender A was by definition not unknown to the account holder. Priority could also be based on whether Lender A had a mere contractual claim against the intermediary or a proprietary claim.

116. In the ninth fact pattern, an account holder acquires securities under paragraphs (1) and (3) of Article 3. Later, the account holder’s intermediary transfers these securities under paragraphs (1) and (6) of Article 3 to Lender A. Then, the intermediary becomes insolvent and a priority issue arises. The view of the Committee was that, under the provisions of paragraph (1) of Article 10, Lender A prevailed on the grounds of his good faith. This was viewed as the best solution, since the mere risk of dealing with a dishonest intermediary should not lead to the absence of lender A’s good faith. One delegation added that Lender A acted in good faith because he might rely on regulatory rules controlling the intermediary.

Article 10

117. The Committee went on to discuss Article 10 (cf. also Appendix 7). One delegation thought that Article 10 should be considered in connection with a general rule or principle regarding the protection of innocent acquirers or acquirers in good faith. In some jurisdictions with civil law traditions such protection applied to gifts and to situations where the acquirer was negligent though not grossly so. Another delegation pointed out that Articles 10 and 5 were inconsistent as regards the lack, in Article 5, of a reference to “knowledge of an organisation”. Furthermore the point was made that market participants should be entitled to presume that intermediaries were acting in accordance with the law and any regulation. This view was not universally held.

118. The term “gratuitously” used in paragraph (2) of Article 10 appeared to one delegation to be unclear. A former member of the Study Group explained that the Group had intended “gratuitously” to be the opposite of “for value”. Although opinions differed, the majority view seemed to be that “gratuitous” acquisitions should be excluded from Article 10.

119. It was the view of several delegations that “knowledge”, as used in paragraph (3) of Article 10, was unclear. One delegation was concerned that a broad interpretation of “knowledge” would impede dealings between intermediaries. Another delegation questioned

whether the “knowledge” consisted of knowing whether such a claim had been made or could be made.

Article 11

120. The Secretariat provided an introduction to Article 11. This provision was described as one of the central provisions of the preliminary draft as it provided for the protection of account holders’ rights in the case of his intermediary’s insolvency. This Article did not prescribe the legal way in which a national jurisdiction should guarantee the account holder’s protection. It was for national legislation to provide that an account holder’s rights should not be available to an insolvency administrator for distribution among the insolvent intermediary’s general creditors.

121. The relationship between the draft Article 11 and national (insolvency) law was discussed next. It was explained that the preliminary draft Convention did not intend to set aside national insolvency law and its provisions on, e.g. fraudulent preferences. This should perhaps be expressly stated. Several delegations supported this view, with reference to the 2001 Cape Town Convention.

Article 12

122. The Secretariat went on to introduce Article 12. It explained that it was intended to protect clearing and settlement systems and their rules. It reflected the view that these rules should apply even in the case of the insolvency of an intermediary. It was stated that similar provisions already existed in the EU and elsewhere.

123. Several delegations and one observer strongly supported the goal of the Article. It directly enhanced system stability. Some delegations felt that the phrase “which is directed to the stability of the system” should be deleted because of its vagueness. Another delegation pointed to the fact that Article 12 should be consistent with relevant national law. One delegation suggested all national jurisdictions took account of the UNCITRAL Model Law on cross-border insolvency which provided for enhanced cooperation between insolvency administrators, authorities and the like.

124. A discussion on the relationship between Article 11 and paragraph (2) of Article 5 followed. It was not clear what the result of a conditional credit under paragraph (2) was if the relevant intermediary became insolvent before the condition had been satisfied. Some delegations were of the opinion that the result depended on the applicable insolvency law.

125. As a matter of principle however, several delegations felt that the satisfaction of a such a condition should have effect as against third parties. They referred to the common market practice of net settlement at the end of a day. Another delegation referred to conditional transfers which were protected against the effect of insolvency by statutory provisions. It consequently proposed to extend the scope of paragraph (2) of Article 5 by deletion of the phrase “the rules of a securities clearing or settlement system”. More generally, paragraph (2) needed to be revisited in light of the discussion of other provisions. The latter proposal was not widely supported, since it was felt that that encroached unnecessarily on national insolvency law.

126. As to the relationship between Article 11 and paragraph (3) of Article 5, several delegations thought that the text should make it clear that in insolvency situations, the effect of unauthorised agency was to be determined by domestic non-Convention law. The Chairman concluded that the relationship between Articles 5, 11 and 12 required further consideration.

Article 13

127. The Secretariat introduced Article 13. It pointed at the close relationship between paragraph (1) of Article 13 and paragraph (2) (b) of Article 2. Both provisions were intended to protect the intermediary against instructions from parties other than the account holder concerned. Paragraph (2) of Article 13 listed exceptions to this rule.

128. In the following discussion, one observer asked whether instructions with respect to non-Convention interests would have effect in relation to the provision made by paragraph (1) of Article 13. A former member of the Study Group replied that this was not the case and that this should be so stated expressly. One delegation thought that paragraph (1) should require instructions to be in writing. Several delegations agreed. Another delegation was of the opinion that in order to be consistent with paragraph (1) of Article 5, paragraph (1) of Article 13 should expressly refer to "apparent authority" as regulated under domestic non-Convention law. Article 13 was a negative provision (referring to instructions the intermediary did not have to follow), whereas paragraph 1 of Article 5 was a positive provision (referring to instructions the intermediary had to accept). The negative form of the current provision was questioned by one delegation. The importance of consistency of paragraph (1) of Article 13 with paragraph (2)(b) of Article 2 was stressed by some delegations.

129. One delegation proposed the deletion of paragraph (2) (c) of Article 13. This view was not shared by all. Another delegation thought that paragraph (2) (b) of Article 13 should cover domestic types of security interests also. This met with general approval. Although it could be argued that paragraph (2) (b) of Article 13 covered rules of a clearing and settlement system (as creating obligations which an intermediary has to observe without account holder's instructions) several delegations supported the proposal that the text should state so explicitly. Another delegation was of the opinion that Article 7 already did so, provided that the second phrase between brackets was retained.

Articles 14-16 (general discussion)

130. The Secretariat provided an introduction to Articles 14 to 16, which were intended to protect the account holder's rights against the creditors of the intermediary at three stages (cf. Appendix 17).

131. First, Article 14 dealt with the relationship between securities issued and securities credited. The central notion was that there should always be "sufficient securities" and that no inflation should occur. Inflation occurred when more securities were credited to account holders of an intermediary in the intermediary's books than the intermediary had on account on the books of his higher-tier intermediary. In this context, paragraph (1) of Article 14 stated that a conditional credit was only taken into account at the moment it becomes effective. Paragraph (2) of Article 14 dealt of with the situation where inflation did occur. Its solution was that either the intermediary's account with its higher-tier intermediary was increased, or the accounts of this intermediary's clients were decreased.

132. Second, Article 15 provided for the account holder's protection against the creditors of the intermediary. Paragraph (1) catered both for systems with segregated accounts and for systems where the accounts of account holders and the intermediary maintaining these accounts were not segregated. In paragraph (3), the way in which the account holder was protected against the creditors of the intermediary was explicitly left to domestic non-Convention law.

133. Thirdly, Article 16 prescribed a *pro rata* sharing of the loss amongst account holders in the case of a shortfall. As a policy decision, a *pro rata* distribution had been chosen because it would be nearly impossible to trace the responsible actor throughout the chain of intermediaries.

134. Several delegations found paragraphs (4), (5) and (6) of Article 14 too detailed. Others found them too rigid. One delegation gave illustrations of cases where the general rule regarding the intermediary's duty needed to be formulated and interpreted in a flexible manner as a matter of practicability.

135. Some delegations held that the segregation of accounts should be referred to as a fundamental principle. A former member of the Study Group responded that paragraph (3) (a) of Article 15 already referred to segregation.

136. Some delegations requested that the *pro rata* rule should not be mandatory, since in their systems, tracing was possible. They felt that the draft Convention should cater for such systems. Another delegation maintained that the future Convention should not do so. The proposal of one delegation to refer explicitly to the possible criminal liability of an intermediary in the case of a shortfall was not supported. Sanctions against an intermediary should be left entirely to the domestic non-Convention law.

137. The EU observer delegation, referring to Articles 14, 15 and 16 as a whole, emphasized their significance to the regulatory framework. The EU had adopted the Directive 2004/39/EC on Markets in Financial Instruments. This gave effect to a policy of safeguarding clients' assets by segregating investors' accounts from those of their intermediaries. These three Articles should enable Contracting States to devise their own methods for achieving the results that their policies required. At the same time, they should not compromise methods already adopted.

Article 14

138. Commencing discussion on paragraph (1) of Article 14, some delegations supported the need, for a number of reasons, for the paragraph being retained in the text.

139. Some delegations took a different view. They thought that the three Articles went too far. Paragraph (1) of Article 14, for example, could be dispensed with. Not only did it not prevent book entries from causing deficits, it provided that, once there was a deficit, no further transactions could take place until the deficit was made good. As a general point, these delegations were concerned at the extent to which the Articles appeared to encroach on already existing regulation on issues such as investor protection, distribution in the event of "shortfall" on the insolvency of an intermediary and segregation. It was not necessary to impose provisions such as paragraph (1) on all Contracting States. Those that felt the need for such a provision could enact a similar provision in their national legislation.

140. One of the delegations in favour of deleting paragraph (1) suggested that the test against which mandatory rules in the preliminary draft Convention should be measured was whether they were compatible with the minimum level of regulation contracting States agreed was required for the operation of markets worldwide. Other international bodies were specialised in regulation of the financial market. By contrast, the future Convention should confine itself to basic principles. This approach was supported by those delegations and observers who believed the text should provide, as paragraph (2) did, only for the core duties of intermediaries rather than every conceivable breach.

141. Moving to paragraph (2), one delegation suggested that "promptly" should be substituted for "immediately". Responding to a request for clarification a former member of the Study Group explained that the "required" number of securities included both the balance on an intermediary's own account and balances on his client's accounts. Indeed if this was not so, another delegation pointed out that Article 15 would be ineffective.

142. The Secretariat introduced paragraphs (3), (4) and (5). Paragraph (4) protected the rules of clearing and settlement systems already subject to a high degree of supervision. In the event of shortfall those systems should follow their own rules. Paragraph (5) protected the intermediary. The underlying thinking was that the first two paragraphs of the Article impose a heavy duty. An intermediary was liable for imbalance even in the event of upper tier insolvency. Paragraph (5) tried to protect an intermediary against this rule in special case.

143. One delegation supported by others doubted the paragraphs passed the test it had described earlier of compatibility with minimal regulation. One observer found them opaque and was concerned at the extent to which they might expose global custodians to new and unreasonable obligations. Paragraph (6) on the other hand appeared to pass the compatibility test.

144. Summing up on Article 14, the Chairman was only able to detect consensus for the deletion of paragraphs (4) and (5). There was as yet no consensus regarding the fate of the remaining paragraphs. A final decision should be taken later.

Article 15

145. One delegation did not find the structure of Article 15 clear. Others had difficulty with its language, in particular, whether "applied" should be substituted for "appropriated".

146. A former member of the Study Group explained that the first reference to an "intermediary" in Article 15 was to the insolvent intermediary. By the reference to "securities" was meant the aggregate of the securities held immediately on the upper tier or with the issuer, i.e. all securities at the level above the intermediary.

147. One delegation pointed out that Article 15 should cover both jurisdictions in which there was segregation and in which there was not and should be more explicit on the issue of whether, in those where there was segregation, non-segregated securities (namely, securities in the own account of the intermediary) should belong to the insolvent estate and should not be available to the account holders. That delegation noted that this was currently the position in law in many civil law jurisdictions.

148. One delegation, supported by others, noted, in relation to paragraph (3) (a) of Article 15, that certain jurisdictions provided for the appropriation rule under mandatory law. This paragraph should therefore state that the appropriation might be effected by the applicable law and, if the applicable law so permitted, by appropriate arrangements made by the relevant intermediary.

149. The Chairman resumed on Article 15 that it should be redrafted so as clearly to apply to both "segregated" and "non-segregated" systems.

Article 16

150. The Secretariat introduced Article 16 (cf. Appendix 17). The principle to which Article 16 (1) (b) was intended to give effect is that where an intermediary holds fewer securities with a higher tier intermediary than were credited to his account holders, the loss was distributed *pro rata* among account holders. Paragraph 1 (a) provided an exception to this rule. Where the intermediary is operating within a clearing and settlement system which had its own rules for the allocation of the shortfall, these rules overrode the general rule in paragraph (1) (b). In relation to Article 16 cf. also Appendices 7 and 8.

151. One delegation was uncertain when the rule should be applied. Another delegation explained that Article 16 was most likely to apply in the case of a shortfall occurring in an intermediary's insolvency, but it could also apply outside insolvency. This explanation found support, albeit not universal.

152. One delegation proposed that conditional entries under Article 5 could be addressed here. More generally, the prevailing view was that more discussion was needed to clarify the relationship between Articles 5, 9 and 10 on the one hand, and Article 16 on the other.

153. One delegation stated that the rule in paragraph (1) (b) of Article 16 and the exception in paragraph (1) (a) should not be mutually exclusive. After a distribution has been made under Article paragraph (1) (a), it might be that securities are left to distribute amongst account holders under paragraph (1) (b). Other delegations agreed.

154. Further, the delegation proposed that the *pro rata* rule should not be subjected to domestic non-Convention law, particularly where this law provided tracing. Another delegation agreed. Several delegations, however, disagreed and subsequently proposed retaining the phrase "unless otherwise provided by the applicable law" in paragraph (2) of Article 16. More generally, no consensus could be reached on the question whether the future Convention should cater for "tracing-systems". Strong views were expressed on both sides.

155. One delegation proposed the application of *pro rata* distribution of loss not only to account holders of securities of the same description, but to all account holders of the intermediary concerned. Several delegations disagreed, because the rule as it stood was easier in practice and because it seemed fairer in some situations. The Chairman summarised indicating that, firstly, tracing solutions should remain possible under the applicable law, secondly, paragraph (1) (a) and (b) were not mutually exclusive, thirdly, a clearer understanding of how domestic rules operated in practice was needed. Consequently these provisions required further discussion at the next session, in particular with respect to the relationship between Articles 5, 9, 10 and 16.

Form of the future instrument

156. Next, the Secretary-General provided an introduction to a discussion on the possible form of the current draft. He distinguished between "soft law" and "hard law" instruments. In his opinion, this instrument called for a "hard law" approach, since many of its rules were effective against third parties. He then asked whether the instrument should be directly applicable or should be left to national jurisdictions to implement. As no pure monistic or pure dualist systems existed, this question was difficult to answer. Moreover, the area of law dealt with here was strongly interconnected with other areas of law. This made implementation even more difficult. He proposed that at the next meeting of the Committee, case studies illustrating the effects implementation of the preliminary draft Convention would have on national law would be

presented by representatives of the jurisdictions concerned. This proposal met with general approval. Italy kindly offered to coordinate an informal working group to take the proposal further. One delegation, while supporting the idea of intra-sessional work in general, indicated that, in its view, more examples and fact patterns were needed for making informed judgments regarding internal soundness, trans-border compatibility and the economic impact of existing and proposed future solutions.

157. One delegation said that it was worth considering different types of instrument although it was of the opinion that the treaty format was more likely to ensure uniformity and certainty. This position was supported by other delegations. One delegation added that it should be clear which articles of the instrument should be directly applicable and which not. The prevailing view however, was that the ultimate form of the current draft should be decided later.

Article 17

158. The Secretariat then introduced Article 17. This Article was intended to ensure that the ultimate account holder would not be deprived of exercising his rights as an investor simply because he held his securities with an intermediary.

159. Several delegations strongly supported the goal of this Article. Some delegations proposed that the draft Convention should cater only for indirect holding systems. Article 17 should include a statement to that effect. Direct holding systems were seen as the source of many problems, particularly in cross border situations. Other delegations were hesitant to encroach on national (corporate) law by including a provision of this nature in the future Convention. Some delegations did not consider that, as currently drafted, Article 17 had more than the most minimal effect on national law. It only prohibited discrimination against investors who hold through intermediaries.

160. It was thought that paragraph (1) of Article 17 needed clarification. The prevailing view of the Committee was that the paragraph should explicitly state that direct holding systems were permitted provided they did not prohibit the holding of securities through an intermediary. However, strong objections were made to this suggestion.

161. Clarification was also needed as to the scope of paragraph (1). A definition of "securities" seemed essential. Issuers should be free to choose between direct and indirect holding and the draft Convention should explicitly cater for that freedom of choice. Several delegations supported this position.

Article 18

162. The Secretariat introduced Article 18. In the case of insolvency of an issuer of bonds, investors should not be deprived of their rights of set-off. In some jurisdictions, investors might be deprived of these rights simply because they hold their securities through an intermediary.

163. Several delegations supported the principle expressed by Article 18. Others however, thought that rights of set-off should be left to domestic law. It was generally thought that under the preliminary draft Convention, set-off could be initiated by the investor as well as by the issuer. Also, set-off under statutory law was provided for. It was not clear, when the Article was applicable. No consensus could be reached as to its scope of application. Some delegations were of the opinion that it only applied in the case of the issuer's bankruptcy, while others thought it should have broader application.

164. One observer pointed to the discrepancy between the functional approach and the wording "held (...) directly" in paragraph (1) of Article 18. It was admitted by a former member of the Study Group that the provision should be redrafted so as to read "held (...) otherwise than through an intermediary". Further, it was thought that this Article should be directly applicable.

Articles 19-23

165. The Committee's consideration of Chapter VII of the preliminary draft Convention was prefaced by an explanation of its provisions by the Secretariat and a presentation given by the observer from the *International Swaps and Derivatives Association* (ISDA).

166. The Secretariat explained that the precise scope and application of the Chapter were matters on which policy decisions were required. The current text left the question of its application to "natural persons" open (hence the use of square brackets in paragraph (1) of Article 20) and enabled Contracting States (under Article 23) to opt out of all the provisions of the Chapter.

167. Article 20 provided a special regime for the realisation of collateral. The remaining provisions were intended to ensure that certain market practices, closely related to securities collateral (notably, *right of use, top-up and substitution*), were given legal recognition.

168. Paragraph (2) of Article 20 described what the nature of the secured obligation underlying the collateral agreement might be. Paragraph (3) provided for two methods of realising collateral when an "enforcement event" (such as insolvency), occurred, i.e. sale or appropriation. Paragraph (4) enabled realisation free from certain restrictions and notwithstanding the commencement of insolvency proceedings. Paragraph (5) required any realisation under paragraph (3) to be effected "in a commercially reasonable manner".

169. The presentation given by the observer from ISDA (cf. Appendix 16) highlighted the need to reform the law relating to netting and collateral. ISDA expected the future Convention to provide the consistency, legal certainty and economic efficiency needed in the light of the ever-increasing volume of transactions in capital markets that were designed to hedge against all types of risk. Consistency, certainty and efficiency would benefit both developed and developing markets. ISDA had supported the Hague Securities Convention because it had promoted certainty in the field of conflict of laws. National insolvency and property laws, however, remained unharmonized in their treatment of netting and collateral issues. Globally, legal reform had not kept up with changes in the market place. There were now diverse products, such as credit default swaps, commodity swaps etc. Accordingly, global reform should, avoiding complexity, encompass broad netting and collateral mechanisms. It should facilitate close-out netting of transactions in the case of default (whether on insolvency or otherwise) without stay or delay and free from avoidance or claw back. Its general objective should be to facilitate market liquidity and capital formation so as to provide opportunities for investment and risk management.

170. The Committee's discussion of Article 20 began with a request from one delegation, later supported by others, for the redrafting of paragraph (2). In their view, a single sentence ("The secured obligation may consist of any present or future obligation of the collateral provider or of another person.") should suffice.

171. Discussion of the likely relationship between the future Convention and the EU Collateral Directive followed. In the context of drafting it was suggested that, where terms were used in the preliminary draft Convention which were also used in the Directive, they should, as far as

possible, be given the same meaning. As far as the scope of Chapter VII was concerned, delegations from member States explained that the EU Collateral Directive itself imposed a minimum level of harmonization. Member States of the EU were free to go further. Some had implemented the Directive so as to include "natural persons" ("non-financial entities") within the scope of their implementing measures. Others had not. The issue was, since it related to consumer protection, highly sensitive. That justified the need for the preliminary draft Convention be sufficiently flexible to allow Contracting States to exclude certain classes of market participants as well as certain classes of borrowers from the application of Chapter VII.

172. As to whether the whole of Chapter VII should be subject to an opt-out, some delegations accepted that it might be. Some (who felt the same misgivings over retaining flexibility in paragraph (1) of Article 20) did so with regret and even though its provisions were compatible with their own national law.

173. With wide global and market coverage in mind one delegation suggested that the scope of Chapter VII should be expanded to include provisions which would support modern netting systems. As currently drafted its scope in relation to netting was somewhat limited. That, in its view, was because the principal subject matter of the text was intermediated securities. It was tempting to go beyond related netting provisions and provide more generally for netting as a tool of financial management. Delegations held differing views. They were only able to agree that the netting arrangements for which Chapter VII should provide should be those that related to collateralised transactions, close out netting and Central Counterparty netting. Widening the scope of Chapter VII would require further discussion.

174. One delegation questioned whether it was appropriate for paragraph (5) of Article 20 to be stated as a positive obligation. National jurisdictions should be left to decide whether to make a provision of this nature. Other delegations suggested that it should either be deleted or redrafted so as to bring it into line with similar provisions in the EU Collateral Directive and the 2001 Cape Town Convention. There was significant support for the suggestion of one delegation that paragraph (5) should be optional. One delegation thought paragraph (5) should refer not only to insolvency but should be widened to include other risk-increasing events.

175. Turning to Article 21, one delegation thought the reference to performance in paragraphs (2) and (5) unclear. A former member of the Study Group, who explained that it was meant to have the same meaning as "discharge" in paragraph (3) of Article 20, agreed that the Article should be redrafted so as to avoid confusion.

176. A proposal made by another delegation, to include a specific provision for "substitution" in paragraph (2), was supported.

177. Discussion followed on paragraph (a) of Article 22. Several delegations thought the broader alternative, expressed by the first phrase in square brackets, should be preferred to the second in order to accommodate market practice. One delegation, though it agreed, cautioned that the broad support for the use of top-up collateral arrangements should not interfere with national insolvency law. It proposed a provision which would enable Contracting States to choose either one of the two alternatives. Another delegation proposed retaining the narrower alternative, expressed by the second phrase in square brackets, together with an explicit reference to non-Convention law so as to provide for stricter rules (or accomplish other objectives). Although this proposal was strongly supported by several delegations no consensus could be reached.

178. Following a request for clarification from one delegation a former member of the Study Group explained that Article 22 was not, as a matter of principle, intended to make provision for

entering into a collateral agreement in the event of insolvency. It merely addressed the retrospective effect of insolvency rules (such as the zero-hour rule) in respect of close-out netting. The way in which the preliminary draft Convention provided for this should perhaps be revisited.

Report of the Drafting Committee

179. The Chairman introduced the three remaining items on the Agenda: consideration of the report of the Drafting Committee (W.P. 5); adoption of the draft Report (W.P. 4 prov.) and discussion of future work.

180. Before the Chairman of the Drafting Committee, Mr Hideki Kanda, delivered his report, the Chairman thanked members of the Committee for their dedication. He recognised the long hours and hard work that had gone into the production of the revised preliminary draft Convention (W.P. 5) that was before the Committee. In expressing his gratitude he spoke not only for himself but for the other members of the Committee.

181. Mr Kanda described some of the amendments for which W.P. 5 made provision.

182. In the **Title**, a shorter, more neutral, formula "Intermediated Securities" had been substituted for the former¹ "Securities Held with an Intermediary".

183. In **Chapter I**, the title had been changed by the addition "Definitions, Scope of Application" to "Interpretation". In paragraph (1) of **Article 1** (not specifically discussed by the Committee) amendments were suggested only where they were the inevitable consequence of the Committee's consideration of other Articles. The definition of "account holder" had been amended so as to reflect the amendment of other Articles. New definitions (m) and (n) ("control agreement" and "designating entry", terms used in Article 4) were added. That of "domestic non-Convention law" in paragraph (o) was substituted for "applicable law". Two Articles had been added as new Articles 2 and 3. **New Article 2**, which provided that "This Convention applies where rules of private international law of the forum state designate the law of a Contracting State" was, together with the new definition of "domestic non-Convention law" – the expression used in substitution for "the applicable law" – the result of conclusions reached by the Working Group on Applicable Law. **New Article 3** made provision for principles of interpretation formerly made by paragraphs (2) and (4) of Article 1.

184. **Chapter II** had also undergone a change of title, "Intermediated Securities" being substituted for "Rights resulting from the Credit of Securities to a Securities Account". Some Articles, principally Articles 4, 5, 6 and 7 (formerly Articles 2, 3, 4 and 5), had undergone extensive amendment (and had occupied so much of the Drafting Committee's time that there had been none left for similar revision of the other Articles of the Chapter). The use of square brackets throughout the text meant either that the Drafting Committee had recognised the need to do further work on those provisions or that there was a lack of consensus in the Committee as to what provision should be made.

185. Mr Kanda explained that, as a result of extensive discussion, the Drafting Group had intended paragraph (1) of **Article 4** to list all the rights conferred on an account holder by the credit of securities to a securities account. The content of paragraphs (1) (a) and (2) was intended to accommodate both so called direct, and indirect (i.e. beneficial) ownership.

¹ Reference to "formerly" or "the former" in the following paragraphs, in relation to the text of the preliminary draft Convention, is a reference to the text as it appeared in UNIDROIT 2004 Study LXXVIII – Doc 18.

Paragraph (3) repeated the provision formerly made by paragraph (2). Paragraphs (4), (5) and (6) - there were now alternative versions of (5) and (6) one of which reflected the proposal of one delegation set out in W. P. 2 - were substituted for the former paragraph (3). A new paragraph (7) was intended to make clear circumstances in which an account holder's rights might be more limited than those enjoyed under paragraph (1).

186. **Article 5** continued to provide for the acquisition and disposition of securities by debits and credits to securities accounts. New paragraph (2) no longer referred to "further step or event", since "event" had no satisfactory French equivalent. Paragraph (4) now made explicit reference to the fact that some jurisdictions require matching debit and credit entries. Former paragraph (6) had been deleted.

187. **Article 6** had been extensively revised to reflect views expressed by members of the Committee on the former Article. Paragraph (1) was a general provision dealing with creating *and* perfecting security interests. It was not intended to make provision in relation to validity. That remained, as in the former text, a matter for Article 7. Paragraph (2) had been revised to provide a full "laundry list" for perfecting security interests in intermediated securities. Sub-paragraphs (a) and (b) described methods of perfection. Paragraph (4) - which should be read with paragraph (2) - provided a declaratory mechanism related to the methods for perfection described in sub-paragraphs (c) to (f). Paragraph (5) conferred further flexibility on Contracting States by providing a declaratory mechanism which they might use to disapply Article 6 to security interests in intermediated securities granted to or by parties of such descriptions as were specified in any declaration which they made. Paragraph (6) (a) of Article 6 left it to domestic non-Convention law to provide for statutory liens. Sub-paragraph (b) left formal requirements for perfection to be decided according to domestic non-Convention law. Paragraph (7) of Article 6 was paragraph (5) of former Article 4.

188. **Article 7** provided for effectiveness in different circumstances. It also contained a "timing" provision in paragraph (2) derived from the former Article 6 (which has been deleted).

189. As to **Article 8 and 9** (formerly Articles 7 and 8), the Drafting Committee had not had the time to propose any amendment to either.

190. Since the plenary had not been able to reach consensus as to their content, the Drafting Committee had not proposed any amendment of **Articles 10, 11, 12 or 13** (formerly Articles 9, 10, 11 and 12).

191. The Drafting Committee had, at the plenary's suggestion, introduced a **new Article 13**, to the preliminary draft Convention. This made provision corresponding to that made by Article 30 (3) of the 2001 Cape Town Convention which preserved the effect, as against the provisions of the draft Convention, of certain rules of insolvency law (relating to the avoidance of preferences and to fraudulent transfers) and of rules of insolvency procedure (relating to the enforcement of property rights).

192. As to **Article 15** (formerly Article 13) the Drafting Committee had made new provision in paragraph (1) - by which the provisions of paragraph (1) were provisionally made subject to Article 5 (1), as well as to paragraph (2). A new provision had been inserted in paragraph (2) as sub-paragraph (e).

193. Mr Kanda prefaced his description of the amendments the Drafting Committee had suggested to **Article 16** (formerly Article 14) by drawing the Committee's attention to the footnote to Article 16. Some minor amendments had been suggested to this Article, e.g.

“promptly” as an alternative to “immediately” in paragraph (2); the former paragraphs (4) and (5) had been deleted; a new paragraph (5) inserted and the former paragraph (6) retained in square brackets as paragraph (5). As to **Article 17** (formerly Article 15), “allocation” had been substituted for “appropriation” in the English version to facilitate translation into French. Paragraphs (1) and (2) were now in placed in square brackets. A new paragraph (4) enabled Contracting States to elect by declaration that the segregation of securities effects the allocation of securities under national law. The Drafting Committee had not been able to complete its work on Article 16, which dealt with shortfalls and involved consideration of difficult issues such as tracing.

194. Having explained how only the most minor changes had been made to **Articles 19, 20 and 21** (formerly Articles 17, 18 and 19), Mr Kanda explained that **Article 22** (formerly Article 20) still retained square brackets round its reference to “a natural person” and that further and greater flexibility regarding the level of protection Contracting States might wish to confer on consumers was made possible by a new provision in paragraph (2) of Article 25 (formerly Article 23). This provision would enable Contracting States to disapply certain provisions of Chapter VII from security interests in intermediated securities granted to or by certain classes of persons. Paragraph (1) had a new reference in square brackets to “any existing or further obligations” (importing language from the Cape Town Convention). Paragraph (2) was in square brackets, indicating that it might be simplified as one delegation had suggested. Paragraph (5) had been expanded so as to make clear a point made in the plenary’s discussion. Former paragraph (5) of Article 22 (formerly Article 20) should be made subject to domestic non-Convention law.

195. Paragraph (2) of **Article 23** (formerly Article 21) had been amended to take account of the EU Collateral Directive. Paragraph (b) of **Article 24** (formerly Article 22) now provided that substitution was to be excluded from the effect of some insolvency law rules.

196. Finally, Mr Kanda drew the Committee’s attention to the fact that the Drafting Committee had agreed that a new draft Article be added to the preliminary draft Convention to include provisions relating to netting, close-out and Central Counterparties. Although the Committee had discussed how extensive the scope of such an Article might be, it had as yet reached no agreement.

197. Individual delegations added their thanks to the Drafting Committee to those that the Chairman had expressed earlier. More than one delegation hoped that the text they had produced would be circulated widely, beyond participants in the plenary, to organisations and individuals who would be interested in the preliminary draft Convention.

198. Reviewing the content of W.P.5, the focus of one delegation’s observations was principally on whether and if so, how far, the preliminary draft Convention should expand its provisions on netting. In the opinion of one delegation this was not a matter on which the Committee had reached any consensus. Others, including the Chairman, recalled consensus on extending Chapter VII to include at least some provision on netting, close-out and Central Counterparties.

Future Work

199. As to how the Committee should take forward the text that the Drafting Committee had produced, delegations had a number of comments and suggestions on which there was general agreement. Though it was for the Committee, when it next met, to discuss the conclusions the Drafting Committee had reached and given effect to in the text, delegations expressed the need

to test its provisions on a variety of fact patterns and in general to continue to work on its subject matter before the next meeting.

200. The Secretary General, introducing the English version of the draft report, described it as intended to focus future work on the preliminary draft Convention. Once the French version was available both versions would be forwarded to participants in the Committee for comment. At the present time the only comments delegations had on the draft report related to whether it should or should not identify delegations and observers. Consensus seemed in favour of anonymity with some very limited exceptions, in particular in the case of an intervention from an observer where identification is required by the context.

201. The Secretary-General considered that the next meeting of the Committee should not take place before necessary inter-sessional work had been undertaken. An appropriate date might be early in 2006. That would be consistent with the wishes of UNIDROIT's Governing Council. Inter-sessional work should take a variety of forms, from informal email exchanges and meetings to regional seminars. It should involve not only participants in the Committee but practitioners in the field who had not attended this session of the Committee. As a starting point for inter-sessional work, the Secretariat would shortly circulate all papers produced during the session in the form of a single document. This would be circulated in paper form through the usual channels and would also be available on the UNIDROIT website.

202. Finally, it was for one delegation to the Committee to propose, and for all participants to second, a vote of thanks to the Chairman, Dr Kuhn, for his exceptional Chairmanship throughout the course of the meeting.

Appendix 1

LIST OF DISTRIBUTED DOCUMENTS AND INDEX OF ANNEXES

- UNIDROIT 2004 - Study LXXVIII - Doc. 18, *preliminary draft Convention on Harmonised Substantive Rules regarding Securities Held with an Intermediary*, Rome, November 2004 (not reproduced in this report)
- UNIDROIT 2004 - Study LXXVIII - Doc. 19, *Explanatory Notes*, Rome, December 2004, (not reproduced in this report)
- UNIDROIT 2005 - Study LXXVIII - Doc. 20, *Comments on the preliminary draft Convention*, submitted by Finland, Spain, ISDA and EBF, Rome, May 2005 (not reproduced in this report)
- UNIDROIT 2005 - Study LXXVIII - Doc. 21, *Comments on the preliminary draft Convention*, submitted by Germany and the United States of America, Rome, May 2005 (not reproduced in this report)
- UNIDROIT 2005 - Study LXXVIII - Doc. 22, *Comments on the preliminary draft Convention*, submitted by Tunisia, Rome, May 2005 (not reproduced in this report)
- Uniform Law Review / Revue de Droit Uniforme, *Enhancing Legal Certainty over Investment Securities Held with an Intermediary*, Special Edition 2005-1/2, Rome, May 2005 (1 copy per delegation, not reproduced in this report, cf. table of contents in [Appendix 4](#))

References: CEG/Securities/1

- W.P.1, *Agenda* (reproduced as [Appendix 2](#))
- W.P.2, *Proposal regarding a revision of Article 2*, submitted by the United States of America (reproduced as [Appendix 5](#))
- W.P.3, "*Applicable law*" – *Report on the Meaning and the Objectives in the preliminary draft UNIDROIT Convention*, submitted by the *ad hoc* Working Group (reproduced as [Appendix 6](#))
- W.P.4, *Draft Report on the session of the CGE*, first part (now incorporated in the present report)
- W.P.5, *Proposed amendments to the preliminary draft Convention*, submitted by the Chairman of the Drafting Committee (not reproduced in this report, incorporated in UNIDROIT 2005 - Study LXXVIII - Doc. 24)
- W.P.6, *Proposal regarding Indicative Formulations on Priority, Good Faith Acquisition and Sharing of Loss*, submitted by the United States of America (reproduced as [Appendix 7](#))
- W.P.7, *Proposal regarding the inclusion of an Article 16bis*, submitted by the United States of America (reproduced as [Appendix 8](#))
- W.P.8, *Proposal regarding an amendment of Article 17*, submitted by the United States of America (reproduced as [Appendix 9](#))

- INF. 1 rev., *Final list of participants* (reproduced as [Appendix 3](#))
- INF.2, *Presentation slides*, prepared by the Secretariat (reproduced as [Appendix 10](#))
- INF.3, *Comments submitted by Euroclear S.A.* (reproduced as [Appendix 11](#))
- INF.4, *Memorandum submitted by Mr Richard Potok to the Government of Australia as part of the Australian response to the June 25, 2004 draft of the explanatory report to the Hague securities Convention* (reproduced as [Appendix 12](#))
- INF.5, *Working slides on "stage by stage" and immediate disposition*, submitted by the Secretariat (reproduced as [Appendix 13](#))
- INF.6, *Working slides on title transfer collateral in Articles 3 and 4*, submitted by the Secretariat (reproduced as [Appendix 14](#))
- INF.7, *Extract from the Cape Town Convention (Articles 1 and 30)*, submitted by the United States of America, (not reproduced in this report)
- INF.8, *Working slides on Article 8*, prepared by the Australian Delegation (reproduced as [Appendix 15](#))
- INF.9, *Presentation slides*, prepared by the observer from ISDA (reproduced as [Appendix 16](#))
- INF.10, *Presentation slides on Articles 14-16*, prepared by the Secretariat (reproduced as [Appendix 17](#))

All papers having the identifier "Doc." or "W.P." are official documents and therefore available in English and French. Papers identified as "INF." are informal and only available in the language in which they were submitted.

Appendix 2

AGENDA

1. Adoption of the agenda
2. Organisation of work
3. Consideration of the preliminary draft Convention on Harmonised Substantive Rules regarding Securities Held with an Intermediary.
4. Future work
5. Any other business.

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UNIFORM LAW REVIEW

REVUE DE DROIT UNIFORME

NS - Vol. X

2005-1/2

ENHANCING LEGAL CERTAINTY OVER INVESTMENT SECURITIES HELD
WITH AN INTERMEDIARY – THE PRELIMINARY DRAFT UNIDROIT CONVENTION,
RELATED INTERNATIONAL INITIATIVES AND NATIONAL PERSPECTIVES

*VERS UNE SECURITE JURIDIQUE ACCRUE POUR LES TITRES FINANCIERS DETENUS
AUPRES D'UN INTERMEDIAIRE – L'AVANT-PROJET DE CONVENTION D'UNIDROIT, AUTRES INITIATIVES
INTERNATIONALES ET PERSPECTIVES NATIONALES*

Table of Contents – *Table des matières*

UNIDROIT – HARMONISING SUBSTANTIVE RULES WORLDWIDE / <i>L'HARMONISATION DES REGLES MATERIELLES NIVEAU UNIVERSEL</i>	AU
Preface / <i>Préface</i> Dr B. SEN	4
Preliminary Draft UNIDROIT Convention on Harmonised Substantive Rules regarding Securities Held with an Intermediary <i>Avant-projet de Convention d'UNIDROIT sur l'harmonisation des règles de droit matériel applicables aux titres détenus auprès d'un intermédiaire</i>	10
Explanatory Notes to the Preliminary Draft UNIDROIT Convention on Harmonised Substantive Rules regarding Securities Held with an Intermediary <i>Notes explicatives sur l'avant-projet de Convention d'UNIDROIT sur l'harmonisation des règles de droit matériel applicables aux titres détenus auprès d'un intermédiaire</i> prepared by the UNIDROIT Secretariat / <i>préparées par le Secrétariat d'UNIDROIT</i>	36

RELATED INTERNATIONAL INITIATIVES / AUTRES INITIATIVES INTERNATIONALES

The Hague Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary (<i>Hague Securities Convention</i>) Christophe BERNASCONI / Harry C. SIGMAN	117
The UNCITRAL Draft Legislative Guide on Secured Transactions Spiros V. BAZINAS	141
The Changing Legal Landscape for Clearing and Settlement in the European Union Klaus M. LÖBER	155

NATIONAL PERSPECTIVES / LES PERSPECTIVES NATIONALES

Canada – Les sûretés sur des titres détenus auprès d'un intermédiaire en droit canadien Michel DESCHAMPS	189
China (People's Republic of) – How Law Reform Enhances Trading on the Chinese Capital Market DONG Ansheng / HAN Liyu	225
France – De la nature juridique des titres dématérialisés intermédiés en droit français Antoine MAFFEI	237
Germany – Modernising German Law : Can the UNIDROIT Project on Intermediated Securities Provide Guidance ? Dorothee EINSELE	251
The Preliminary Draft UNIDROIT Convention and Capital Market Practice in Germany Jürgen THAN	263
Japan – Legal Rules on Indirectly Held Investment Securities : The Japanese Situation, Common Problems, and the UNIDROIT Approach Hideki KANDA	271
Nordic countries – Direct or Indirect Holdings : a Nordic Perspective Lars AFRELL / Karin WALLIN-NORMAN	277
Poland – Is a Reform of the Polish Legal Framework Regarding Intermediated Securities Useful ? Michał ROMANOWSKI	285
Switzerland – New Legal Concepts regarding the Holding of Investment Securities for a Civil Law Jurisdiction : The Swiss Draft Act Luc THÉVENOZ	301
Annex(e) – Draft Federal Act on the Custody and Transfer of Securities Held with an Intermediary / <i>Projet de loi fédérale sur le dépôt et le transfert des titres intermédiés</i>	312

United Kingdom – The FMLC Report on Property Interests in Indirectly Held Investment Securities : an Analysis of the Need for and Nature of Legislation in the United Kingdom Annex – FMLC Principles For Investment Securities Statute	339
United States of America – Reflections on the Drafting of the 1994 Revision of Article 8 of the US Uniform Commercial Code Curtis REITZ	357

TEXTS OF RELATED INTERNATIONAL INSTRUMENTS / TEXTES D'INSTRUMENTS INTERNATIONAUX

Hague Convention on the Law Applicable to Certain Rights in respect of Securities Held with an Intermediary <i>Convention de La Haye sur la loi applicable à certains droits sur des titres détenus auprès d'un intermédiaire</i>	368
Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on Settlement Finality in Payment and Securities Settlement Systems <i>Directive 98/26/CE du Parlement européen et du Conseil du 19 mai 1998 concernant le caractère définitif du règlement dans les systèmes de paiement et de règlement des opérations sur titres</i>	390
Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements <i>Directive 2002/47/CE du Parlement européen et du Conseil du 6 juin 2002 concernant les contrats de garantie financière</i>	406

SELECTED BIBLIOGRAPHY / BIBLIOGRAPHIE SELECTIONNEE	433
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**PROPOSAL
REGARDING A REVISION TO ARTICLE 2**

(submitted by the delegation from the United States of America)

**CHAPTER II – RIGHTS RESULTING FROM THE CREDIT OF SECURITIES
TO A SECURITIES ACCOUNT**

Article 2

[Rights resulting from the credit of securities to a securities account]

1. - The credit of securities to a securities account with an intermediary confers on the account holder the following rights:

(a) ~~where the account holder is acting for its own account with respect to the securities, the rights [attached to] to receive and enjoy the fruits of ownership of the securities, including in particular dividends, and other distributions, and the exercise of voting rights;~~

(b) the right to dispose of the securities in accordance with Articles 3 and 4;

(c) the right, by instructions to the relevant intermediary, to cause the securities to be held by the account holder with a different intermediary; provided that this shall not require the relevant intermediary to establish, directly or indirectly, a securities account with another intermediary;

(d) the right, by instructions to the relevant intermediary, to withdraw the securities so as to be held by the account holder otherwise than with an intermediary, ~~to the extent permitted under the applicable law;~~

(e) subject to this Convention, such other rights as may be conferred by the applicable law.

2. - Without prejudice to Articles 13 and 17, the rights referred to in the preceding paragraph [:

(a)] are effective against the relevant intermediary and third parties[; but

(b) except as otherwise provided by this Convention, by the terms of the relevant account agreement, by the terms of issue of ~~any the relevant securities~~ or by the law under which ~~any the relevant securities~~ are constituted, may be enforced only against the relevant intermediary].

3. - To the extent that the rights referred to in paragraph 1(a) are dependent on the assistance of the relevant intermediary, such rights are not conferred on the account holder by this Convention to the extent that the realization of such rights:

~~(a) — the rights do not entitle the account holder to receive or effect more than can be received or effected through such assistance as is within the power of the relevant intermediary to provide; and~~

~~(b) — the manner of performance of the obligations of the relevant intermediary in providing such assistance and the extent of the liability of the relevant intermediary for any failure to perform those obligations are governed by the account agreement [and the applicable law].~~

~~(a) is not within the power of the relevant intermediary, though in such circumstances such rights may otherwise be conferred on the account holder by [applicable law];~~

~~(b) would require the relevant intermediary to act in a manner that is inconsistent with reasonable commercial standards, or that is not permitted by [applicable law] or the terms of the securities; or~~

~~(c) is waived by the account holder in the relevant account agreement.~~

4. The duty of performance of any obligations of the relevant intermediary shall be satisfied if the relevant intermediary acts with respect to such obligations:

(a) as agreed upon by the account holder and the relevant intermediary in the relevant account agreement or, the absence of an account agreement, in accordance with reasonable commercial standards;

(b) in accordance with an [applicable law] that imposes the substance of the obligation upon the relevant intermediary;

(c) in accordance with an [applicable law] or with rights of the relevant intermediary arising out of a security interest under a security agreement with the account holder that may vary such obligations; or

(d) by placing the account holder in a position to exercise such rights itself.

**"APPLICABLE LAW" – REPORT ON THE MEANING AND THE OBJECTIVES
IN THE PRELIMINARY DRAFT UNIDROIT CONVENTION**

(submitted by the *ad hoc* Working Group on the term 'Applicable Law')

I. Issues to be kept in mind when defining the term "applicable law" or its substitute

1) Situations envisaged

- Convention [nature of instrument left open] applies in purely domestic situations (directly, with no conflict of laws issue being raised)
- Convention applies in international situations, *i.e.*, where the relevant conflict of laws provision points to a State which is a CS of the Convention (Note: the Group deliberately left aside the Multi-unit State issue –but this issue may have to be examined at one stage)
- In terms of drafting, in defining the term "applicable law" or its substitute, one should avoid, if at all possible, making a distinction between *international* and *purely domestic* situations

2) Applied by Contracting State or not

- In internal situations, Convention will be applied by CS only
- In international situations, Convention will be applied when relevant conflict of laws provision points to CS, even if the forum State is not a CS of the Convention (decision left to the FL of the forum, not the Convention)

3) Body of designated rules

- Convention is not a comprehensive code covering all substantive rules relevant to its subject matter –leaves room for "other" rules of the State ("rest of the law," but rules of the instrument have priority)
- References in the Convention to the "applicable law" should always have an identical meaning

II. Current wording

- Current wording of Arts 1(3) and 1(5) slightly defective (expression "applicable law" traditionally used in conflict of laws context; references to "Contracting State" seem to be too limitative)
- Current Explanatory Note re Art 1(5) inadequate as far as it refers to renvoi (this is a conflict of laws issue, not a substantive law issue)

III. Suggested redraft of relevant provisions

Chapter I – Definitions, Scope of Application and Interpretation

Article 1(1)(m):

"**domestic non-Convention law**" of a Contracting State means the domestic provisions of that State, other than those provided in this Convention

Explanatory Note could state that:

- UNIDROIT Convention provides first (core) layer of rules, remaining law of THAT SAME Contracting State constitutes the second layer (which fills the intentional gaps "left by the Convention); the exact scope and limit of each layer is a policy issue that needs to be decided by the Party and which was not discussed by the Group
- A reference to the domestic non-Convention law encompasses the whole body of law of a CS, not just the law of securities"

Article 1 bis:

This Convention applies where the rules of Private International Law of the forum State designate the law of a Contracting State of this Convention.

Explanatory Note could state that:

- Relevant conflict of laws provision contained in Hague Securities Convention or, if the HC is not applicable, in any other relevant rule
- Question of renvoi left to PL of forum (Note: renvoi is excluded under HC)
- Covers also purely domestic situations (at least by analogy)
- Questions concerning matters not governed by this Convention remain of course governed by the law determined by the relevant conflict of laws rules

Article 1 ter:

Questions concerning matters governed by this Convention which are not expressly settled in the Convention are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the domestic non-Convention law.

Explanatory Note could state that:

- Three-tier system: Convention text - General Principles - Applicable Law

Article 1 quater:

In the implementation, interpretation and application of this Convention, regard is to be had to its purposes, to its international character and to the need to promote uniformity and predictability in its application.

IV. Need to examine all references to applicable law in the instrument

- As a first step, all the references to the "applicable law" in the current draft of the Convention should be changed to "domestic non-Convention law" (at least intellectually).
- Secondly, a careful and comprehensive analysis of the Convention ought to be made with a view to assessing whether all the references to the "domestic non-Convention law" are appropriate in light of the definition of the expression.
- The Working Group looked already at a series of references and came to the following intermediate results:

Article 2(1)(d):

Substitute "by the law under which the securities are constituted" for "under the applicable law"

Explanatory Note could state that:

- traditionally, the law under which the securities are constituted is the *lex societatis* for shares, and the *law of the issue* for bonds
- there is no conflict with the Hague Securities Convention as the rights and duties of an issuer are excluded from its scope (not included in Art 2(1), expressly excluded in Art 2(3)(c))
- the law under which the securities are constituted applies whether or not the State whose law applies is a CS of the UNIDROIT instrument
- internationally mandatory rules of the forum or of a third State apply according to RL of the forum State

Article 2(3)(b):

Substitute "by the applicable law as determined by the private international law rules" for "by the account agreement [and the applicable law]"

Explanatory Note could state that:

- the law applicable to liability of an intermediary to perform the obligations envisaged in Art 2(3)(b) may, for example, be the law governing the account agreement (contract) or the law applicable to torts and delicts (depending on the characterisation made by the forum State)
- there is no conflict with the Hague Securities Convention as the obligations envisaged in Art 2(3)(b) of the UNIDROIT instrument are not within the scope of the Hague Securities Convention (not included in Art 2(1), see also Art 2(3)(a))

Article 3(3), (6) [probably deleted] and (7):

No change required [other than substitute domestic non-Convention law for applicable law]

Appendix 7

PROPOSAL

(prepared by the Delegation of the United States of America)

Indicative Formulations of Text and Examples for Discussion: Priority, Good Faith Acquisition, and Sharing

Conflicting claims to securities accounts and the related interests in intermediated securities are among the most important provisions of the draft text. The initial discussion of these issues in the plenary did not result in a consensus. Following are some suggested formulations of convention text that will illustrate the operation of the priority issues that we have been discussing. Further refinement will be needed, of course, but the formulations may be useful for discussion purposes. Some examples then illustrate the operation of the indicative formulations of the basic priority rules.

In general, the approach suggested for discussion would eliminate priority contests based on timing (either first-in-time under Article 9 or last-in-time under Article 10) as between account holders of the same intermediary. Instead, when an intermediary cannot satisfy all account holder claims to a given issue of securities, the pro rata sharing approach of Article 16 would be invoked. When an intermediary can satisfy all claims, of course, no priority contest will arise. Under this approach, Article 9 would resolve, on a first-in-time basis, priority contests between conflicting security interests in a securities account and the related intermediated securities maintained with a given intermediary. Article 10 would provide the residual rule. Inasmuch as the draft currently is silent as to the circumstances in which Articles 9 and 10 would apply, this discussion paper offers a framework for advancing the discussion,

Indicative formulations of draft convention text:

Article 5

1. - A debit or credit of securities to a securities account or a designating entry is not effective unless the relevant intermediary is authorized to make that debit, credit, or designating entry

- (a) by the account holder and, in the case of a debit or designating entry that relates to intermediated securities which are subject to a security interest granted under Article 4 by the collateral taker; or
- (b) by the domestic non-Convention law.

[N.B This formulation of Article 5 is substantially similar to the version being discussed by the drafting group.]

Article 9

1. - This article applies to conflicting security interests arising under Article 4 in the same securities account or intermediated securities related to the account.

[Renumber remaining paragraphs.]

6 This article is subject to Article 16

Article 10

1. - This article applies to interests arising under Articles 3 and 4

- (a) to which Article 9 does not apply; and
- (b) which do not relate to securities accounts or intermediated securities maintained by the same intermediary.

[Renumber remaining paragraphs.]

6 This article is subject to Article 16

Article 16

2. - Where an account holder has granted one or more security interests under Article 4 in a securities account or intermediated securities related to the securities account, the allocation to the account holder under paragraph 1 must be allocated first to the holders of the security interest in the order of their priority.

[Renumber paragraph 2 as 3.]

Examples:1. ~~AH's~~ ~~AH's~~ Priority, Common IM

Most basic concept: Priority and rights should not turn on (i) when AH receives a credit re a particular issue of security or (ii) timing or characteristics of how the IM obtained securities or intermediated securities with another intermediary. The AH cannot know such irrelevant facts in most cases. They have cast their lot with a common IM that is why Art 16(1) calls for pro rata sharing among AH claiming the same issue of a security when their common IM is insolvent and there is a shortfall in that issue. If the IM can satisfy all AH claims, there is no relevant priority contest. Neither Art 9 nor 10 should have any role in resolving priorities among AH with a common IM. This should be so whether or not a particular AH received its credit in circumstances where it holds the account rights by way of security. This is the next example.

2. Secured Party vs. AH; Common IM

This contemplates that AH grants a security interest to SP. Either: (i) the collateral securities are credited to SP (ie, as an AH) or the books of IM in which case AH no longer has rights to

the intermediated securities); or (ii) the IM makes a designation or other step under Art 4 that renders the SI effective against 3B. In each case the initial property involved is AH's securities account or intermediated securities as to IMAs explained above, if IM becomes insolvent and there is a shortfall, then SP (either as a designated SP or as an AH) should share pro rata, as its rights derive from those of AH.

Illustration:

SP obtains an effective security interest under Art 4 in AH's securities account with IM. IM wrongfully (i.e., without SP's authority) debits the account and credits the account of AH2. The credit to AH2 is effective and (we assume) is not subject to reversal (perhaps AH2 paid IM for the intermediated securities.). SP retains its rights because the debit was ineffective under Art 5(1) (revised, as suggested). If IM has sufficient securities or intermediated securities to satisfy AH2 and SP there is no priority contest. If not, Art 1(61) applies and pro rata sharing applies.

3. Buyer or Secured Party vs AH of Original IM

AH of IM grants a security interest to SP, or sells outright to SP some of AH's account rights in securities. AH instructs IM to transfer the relevant securities to SP's account with IM2 (IM2 may or may not be a direct upstream intermediary in which IM holds a security account with respect to the relevant securities). The credit to SP's account with IM2 renders SP's SI effective against third parties under Art 4. Subsequently, IM becomes insolvent and there is a shortfall in the relevant securities. Neither the AH of IM nor IM's insolvency representative should have any claim, much less any superior claim, as to SP's intermediated securities in its account with IM2. SP acquired its intermediated securities free of any adverse claim under Art 10 (assuming requisite good faith, etc.). Art 9 should not apply and the AH of IM should not prevail under the notion of first in time.

4 SP1 vs SP2, Common IM

Now return to the very first example, in which AH grants a security interest to SP in its securities account. Assume that IM makes a designation or other step under Art 4 that renders the SP's security interest effective against 3B. Subsequently, AH grants another security interest in the securities account to the IM itself, which likewise is effective against 3B under Art 4. Now, finally, we see the operation of Art 9's first in time rule. SP having received its effective security interest first, has priority over IM's security interest. That is to say, Art 9 governs priorities over competing security interests in a securities account or intermediated securities maintained with the *same intermediary*.

a. Vary the example by switching the timing. In that case IM would win. However, in the real world, it might be that IM would never agree to the perfection step for SP given IM's interest, even though IM has priority.

b. Vary it further, assume that SP is first in time but its perfection step is the credit to an account with IM so that SP becomes an AH. Could IM even take a security interest from AH in that account inasmuch as AH is no longer an AH as to the relevant securities? Alternatively, could IM make an effective designation under Art 4 in favor of SP2, with AH as debtor, inasmuch as the relevant securities are now credited to the account of SP? And, realistically, would it? The answer probably should be negative to all of these questions. The convention should address these scenarios explicitly.

PROPOSAL

(submitted by the United States of America)

*Article [16 bis]
[Limitations on duties of intermediary]*

1. - An intermediary satisfies any of its duties under this convention if:
 - (a) the intermediary acts with respect to such duty as agreed upon in the account agreement; or
 - (b) in the absence of an account agreement, the intermediary exercises due care in accordance with reasonable commercial standards to satisfy such duty.

2. - If the substance of a duty of an intermediary under this Convention is imposed upon the intermediary by domestic non-Convention law, compliance by the intermediary with such law will satisfy such duty.

3. - This Article is subject to the limitations specified in Article 2(3). *[Article 2 (3) exceptions, as redrafted by the Drafting Committee, should apply to all intermediary duties under this Convention.]*

PROPOSAL

(submitted by the United States of America)

CHAPTER VI – RELATIONS WITH ISSUERS OF SECURITIES INTERMEDIATED SYSTEMS

Article 17

[~~Position of issuers of securities~~ Holdings under intermediated systems]

1. - Any ~~rule of~~ [applicable / domestic non-Convention] law of a Contracting State, and any provision of the terms ~~of issue~~ of securities constituted under the law of a Contracting State, which would prevent the holding of securities with an intermediary or the effective indirect exercise by an account holder through the intermediary of rights in respect of securities held with an intermediary shall be modified to the extent required to make possible the holding of such securities with an intermediary and the effective exercise of such rights¹.

2. - Without limiting the generality of the preceding paragraph, that paragraph applies in particular to any ~~rule~~ law or provision:

(a) which restricts the ability of ~~a holder of securities~~ an intermediary to exercise voting ~~or~~ and other rights in different ways in respect of different parts of a holding of securities of the same description, pursuant to instructions that the intermediary receives from one or more account holders;

(b) ~~[which does not include adequate provision for making available to account holders holding securities with an intermediary, or to intermediaries for transmission in order for the intermediaries to make available to such account holders:~~

(i) ~~copies of notices, accounts statements, circulars and other materials addressed delivered~~ by the issuer to ~~holders~~ registered owners of such securities; and

(ii) ~~means of exercising the rights attaching to such securities either in person, through an intermediary, or through a proxy or other representative;]~~

(c) which prohibits or fails to recognise the holding of securities by a person acting in the capacity of nominee or intermediary;

(d) under which recognition of the holding of securities by an intermediary or the exercise of rights by an account holder holding securities with an intermediary is conditional on the maintenance of securities certificates or of other records in a particular medium²;

(e) which imposes restrictions on the ~~holding~~ custody of securities or the exercise of rights attaching to securities by [reference to the identity, status, residence, nationality, domicile or ~~other characteristics or circumstances of any person acting in the capacity of intermediary~~]³ requiring that the securities be custodied only within the country of issue.

¹ This Article should be modified so as to clarify that: (a) while laws should allow for dematerialized securities, an issuer may alternatively elect to issue securities in certificated form if permitted to do so by non-domestic law; and (b) this Article does not require that any intermediary accept any specific issue or class of securities as being eligible for the intermediary's services.

² This should apply only to laws, and not to terms of securities; perhaps this should be in a separate section.

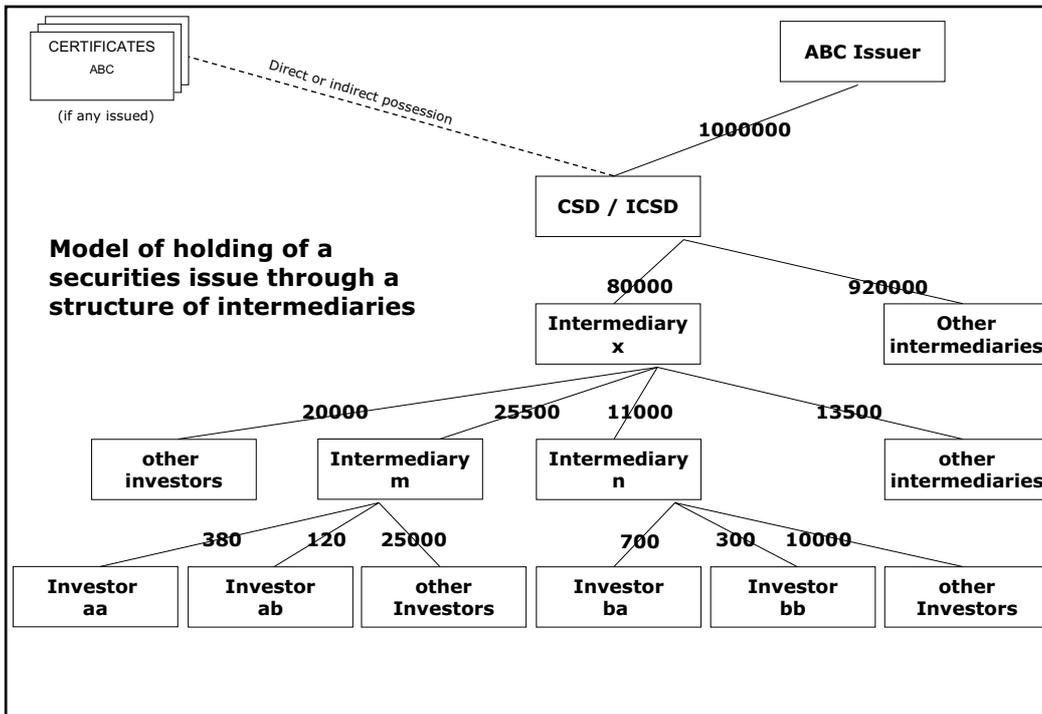
³ The preceding language is over-broad, and should be scaled back if not deleted.

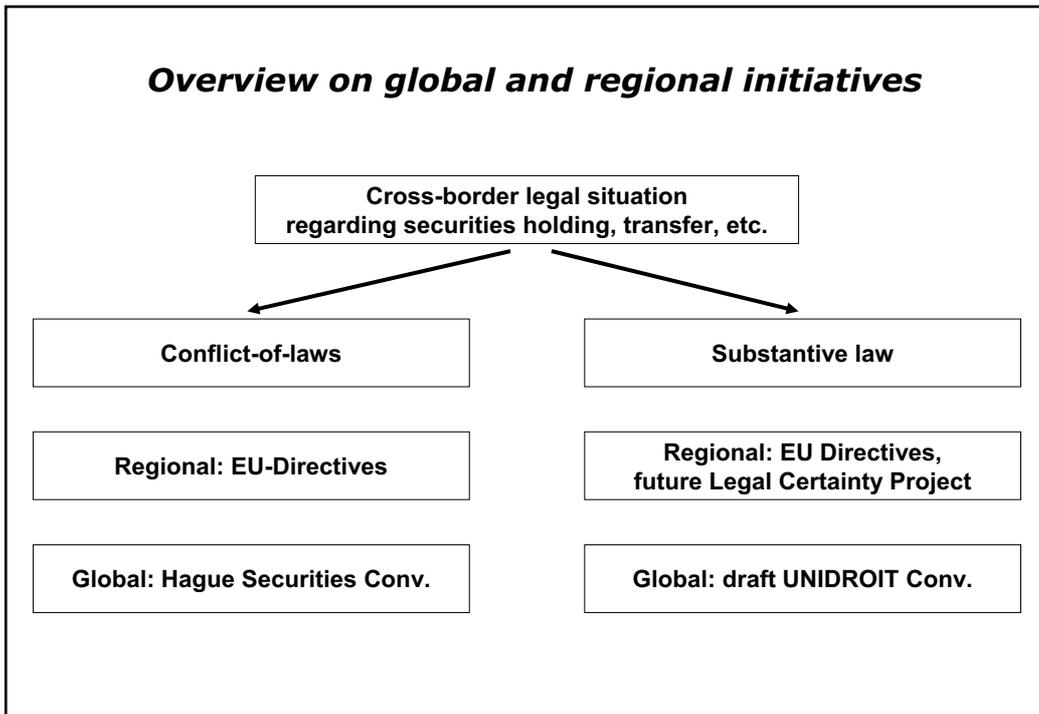
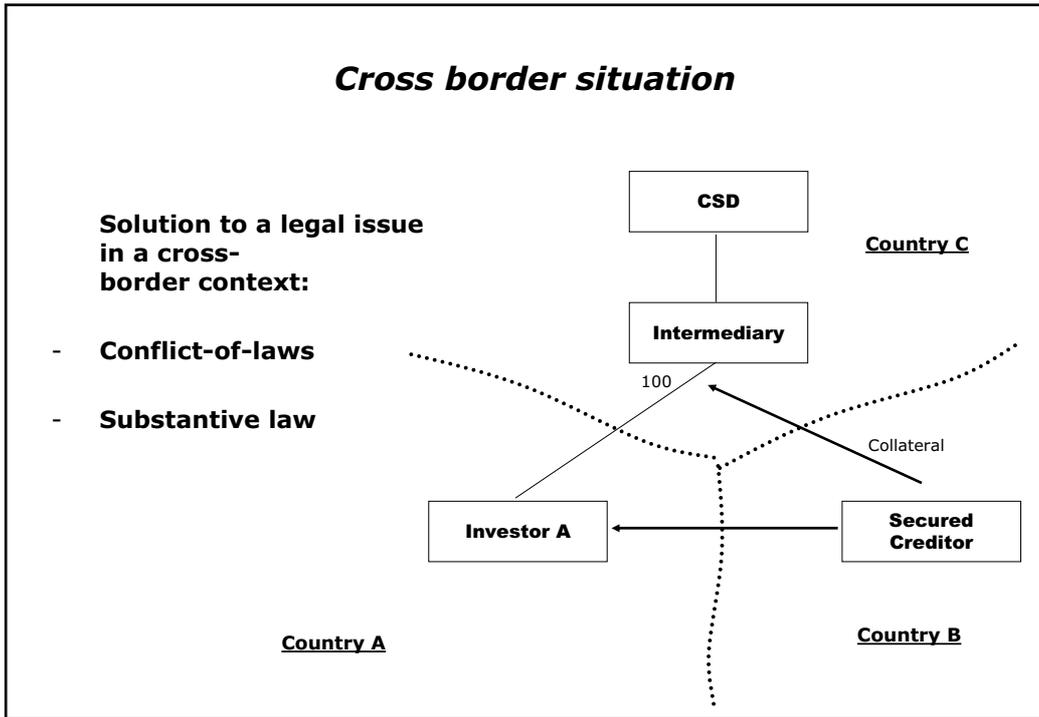
~~[3. - Subject to the preceding paragraphs, nothing in this Convention makes an issuer of securities bound by, or compels such an issuer to recognise, a right or interest of any person in or in respect of such securities if the issuer is not bound by or compelled to recognise that right or interest under the law under which the securities are constituted and the terms of issue of the securities.]~~

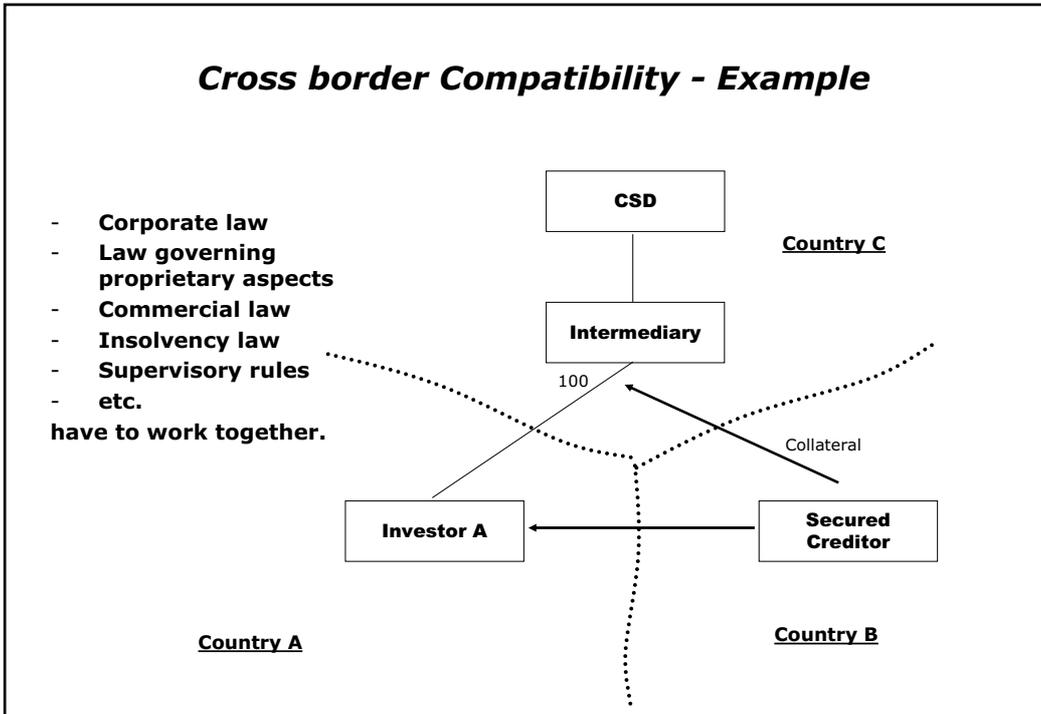
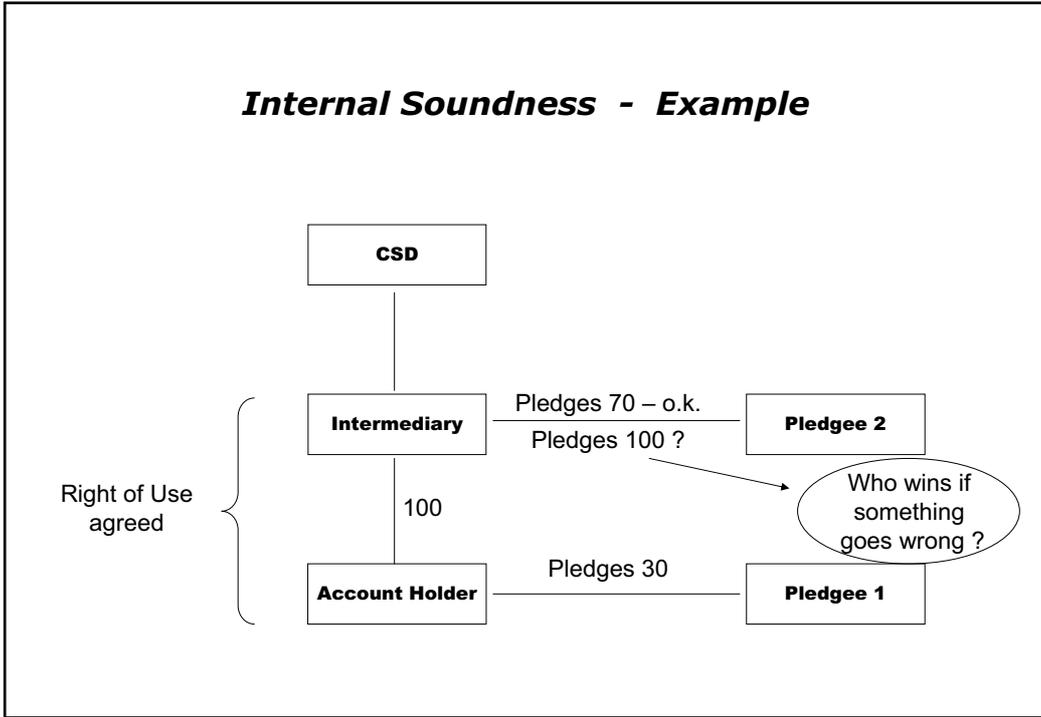
General Background of the Unidroit preliminary draft Convention

First session of the CGE
on intermediated securities

- UNIDROIT Secretariat -







Appendix 11

**International Institute for the Unification of Private
Law (UNIDROIT)**

Via Panisperna, 28
00184 Rome
ITALY

Attn. Dr Philipp Paech

Brussels, 4 April 2005

Subject: Preliminary draft Convention on Harmonised Substantive Rules regarding
Securities Held with an Intermediary (Study LXXVIII – Doc. 18)

Dear Sirs,

The Euroclear Group would like to take the opportunity to submit a few comments on the above-mentioned draft convention. The Euroclear group comprises Euroclear Bank, an (I)CSD based in Brussels, as well as Euroclear France, Euroclear Nederland and CRESTCo, the central securities depositories of France, the Netherlands, and the UK and Ireland, respectively. The CSD of Belgium, CIK, is expected to join the group later in 2005.

As you know, the Euroclear Group has followed this project closely in the past and welcomes UNIDROIT's initiative to provide a legal framework for intermediated securities holdings which can serve as a reference on a worldwide basis. We very much appreciate the work carried out by Unidroit and the relevant Unidroit study group as reflected in the quality of the draft Convention published by Unidroit in December 2004.

At this stage, in view of the forthcoming first session of the Unidroit Committee of governmental experts, we would like to share with you two important concerns on the draft Convention in its current form.

- We believe Article 2(1)(a) needs to clarify that a deposit of securities with an intermediary confers rights on the account holder irrespective of whether it has deposited the securities on its own behalf or on behalf of its clients (e.g. as custodian, trustee or other capacity under the relevant law). The use of the words "for his own account" seems to unduly limit the application of Article 2(1) with the consequence that underlying clients of an account holder would be deprived of their exercise of their rights through the account holder. This is because the account holder, itself, would be unable to exercise the rights through the intermediary.

- Contrary to the spirit of the explanatory memorandum, the wording of Article 14 (paragraph 5 in particular) seems to restrict the possibilities of an intermediary to contractually limit its liability or otherwise determine how to handle an insufficiency of securities. We do not believe it would be objectively justified to limit the possibility for contractual allocation of short falls between the intermediary and its account holders to those situations where the use of the upper-tier intermediary is “compulsory”. Not only would it unduly penalise an intermediary which has been diligent in selecting a “non-compulsory” upper tier intermediary. It would also increase the systemic risk of a knock-on effect of the insolvency of the upper-tier intermediary onto the next, lower-level intermediary because of the latter’s inability to pass on the loss to its account holders. We therefore believe that the inclusion of Article 14(5) needs to be reconsidered.

We thank you for this opportunity to comment.

Yours sincerely,

Marianne Sandel
Director
Assistant General Counsel

Diego Devos
Director
Deputy General Counsel

Appendix 12

**MEMORANDUM SUBMITTED BY MR RICHARD POTOK TO THE
GOVERNMENT OF AUSTRALIA AS PART OF THE AUSTRALIAN
RESPONSE TO THE JUNE 25, 2004 DRAFT OF THE EXPLANATORY
REPORT TO THE HAGUE SECURITIES CONVENTION AND DESCRIBING
THE CHESSE SYSTEM OPERATING IN AUSTRALIA.**

MEMO

To: Ruth Smith (Treasury)
Sumit Parikh (Treasury)
Paul Taylor (Attorney-General's Department)

From: Richard Potok

Date: 22 September 2004

Subject: Application of the Hague Securities Convention to CHESSE

During the recent consultation process in relation to draft explanatory report to the Hague Securities Convention (the "draft ER"), significant concerns were raised by representatives of industry that the current draft ER does not clarify whether the Convention applies to commonly used holding patterns for securities in Australia and, in particular, to the holding pattern for equity securities.

This memorandum considers two hypothetical fact situations in an attempt to analyse the adequacy of the Convention text and the draft ER to issues relating to the application of the Convention to the Australian Clearing House and Electronic Sub-register System ("CHESSE").

We conclude that those undertaking the task of applying the Convention to fact patterns involving CHESSE would benefit greatly from further explanation in the final version of the explanatory report (the "final ER"). There is a need for clarification whether the CHESSE system is "in" or "out" of the Convention. Our expectation is that, like CREST in the UK, it does fall within the scope of the Convention. Once this has been clarified, a full analysis can be undertaken with the final ER in hand to determine whether it is advisable in relation to CHESSE to follow CREST's example and decide to make a declaration under Article 1(5) (opting out of the Convention).

The need for further guidance and clear examples is not limited to the applicability of the Convention to the CHESSE system but would be helpful for other significant types of holding patterns that are at variance with the commonly used "depository" model (as found in DTC, Euroclear or Austraclear).

In particular, further guidance is required in situations where there is an institution that acts both (i) in the capacity of registrar for the issuer and (ii) has a relationship with the account holder. Clarification is required to differentiate between:

- a "mere" registrar, which, if it were the only potential "intermediary" in a holding pattern, would result in the Convention not applying at all (see Article 1(3)(a)); and
- more than a "mere" registrar, which would be considered an intermediary triggering the application of the Convention (pursuant to what is described below as the "Catchall Extension" in Article 1(4)).

A. INTRODUCTION – CHESS AND CREST

In Australia, currently, 74% of equity securities (on the basis of market capitalization) are held through the CHESS system. CHESS is an electronic book-entry register of holdings of approved securities that facilitates the transfer and settlement of market transactions between ASX Settlement and Transfer Corporation Pty Ltd ("ASTC", the operator of the CHESS system) and its participants. Under Australian corporate law, the issuer must maintain registers for owners of securities. Australian issuers have a contractual arrangement with ASTC to maintain the CHESS sub-register as agent for the issuer. The CHESS sub-register is one of a number of sub-registers that together make up the issuer's register.

There are two main issues that arise in relation to CHESS:

- First, will the Convention apply in a situation where a participant in CHESS holds securities for its own account through the CHESS system?
- Secondly, will a participant in CHESS, who acts as a "sponsoring participant" for the owner, be considered an "intermediary"?¹

Although the draft ER does not consider CHESS, the CREST system is considered in some detail. CHESS appears to be similar in many respects to CREST. In para 1-36, it is explained that the CREST system is an electronic system for the transfer of securities that is operated by CRESTCo Limited ("CRESTCo"). CRESTCo maintains records of holdings direct from issuers. Persons acquiring securities through CREST are credited in its records. There are two variants in the UK: one for UK-issued shares; and one for foreign issued shares. In relation to UK-issued shares, the CREST record constitutes the sole register of the issuer and therefore the primary record of entitlement. This appears to have sufficient similarities to the CHESS system to be of assistance.

B. FACT PATTERN 1 – DIRECT PARTICIPANT IN CHESS

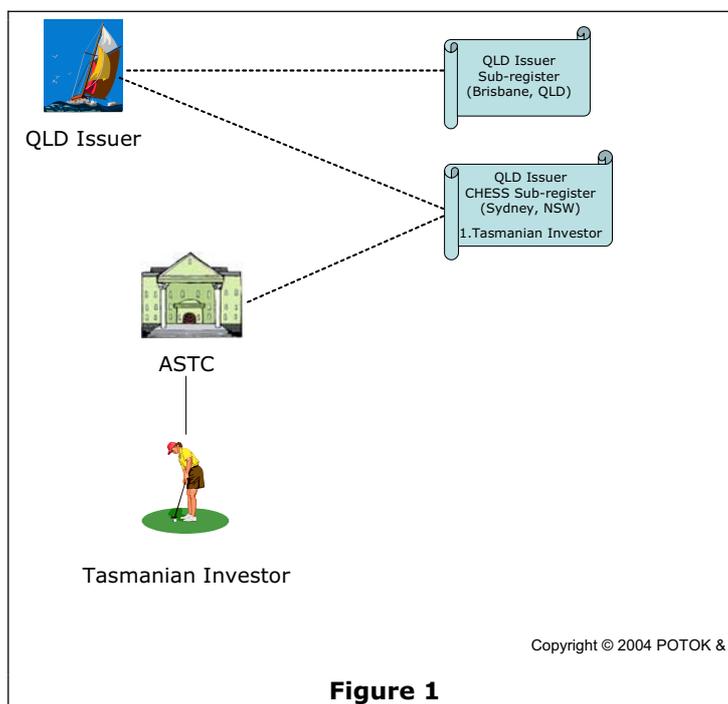
On Day 1, Tasmanian Investor wishes to purchase 100 shares of Queensland Issuer, a company incorporated in Queensland. Queensland Issuer has two sub-registers that together form the Queensland Issuer register:

- *the sub-register that Queensland Issuer maintains in Brisbane, Queensland; and*
- *the CHESS sub-register managed by ASTC and located in Sydney, New South Wales.*

Tasmanian Investor is a CHESS participant and takes a transfer of the Queensland Issuer shares through ASTC. The CHESS sub-register reflects this transfer by recording Tasmanian Investor as an owner of Queensland Issuer shares on its sub-register.

¹ See Fact Pattern 2 in C. below for more details on "sponsoring participants".

Figure 1 below illustrates the above facts.



The issue is: Does the Convention apply to this holding pattern?

1. Applying the definitions in the Convention: "securities held with an intermediary", "securities account" and "intermediary"

Article 2(1) and paras 1-16 and 2-3 of the draft ER make it clear that the Convention only applies to "securities held with an intermediary". Thus, the application of the Convention ultimately depends on whether the fact pattern above constitutes "securities held with an intermediary"?

Article 1(f) indicates that "securities held with an intermediary" means the rights of an account holder resulting from the credit of securities to a "securities account". Consequently, the relevant question becomes: Is the holding record maintained by ASTC a "securities account"?

Article 1(b) indicates that a "securities account" means an account maintained by an "intermediary" to which securities are debited and credited. The CHESS system managed by ASTC arguably involves the debit and credit of securities to an account;² therefore, the question is: Can ASTC be considered an "intermediary"?

Article 1(c) defines an "intermediary" as one that maintains "securities accounts". Thus, here the Convention enters a circular loop, namely:

² There is the question whether the records of CHESS are to be considered "accounts". No definition or explanation of this is provided in the draft ER, and indeed CHESS' counsel queries whether the debits and credits to the "records" in the CHESS system are entries on "accounts" at all (although the CHESS records are part of the CHESS sub-register, which itself is part of the issuer's register; as such the entries on the CHESS sub-register constitute the record of title to the securities). Clarification in the ER that such records would be considered "accounts" for the purposes of the Convention would be helpful.

- Under Article 1(b), "securities accounts" are accounts maintained by "intermediaries".
- Under Article 1(c), "intermediaries" are persons that maintain "securities accounts".

Due to this circularity, one is no closer to understanding whether the CHES example is covered by the Convention. During negotiation process for the Convention, these circular references were noted by delegates, but the drafting committee concluded that some level of circularity was inevitable, and it was decided during the final stages that clarification would be left to the explanatory report.

2. Determining who is an intermediary: applying the General Definition and the Extended Definition

It is important to note that there are three stages to determining whether ASTC is an "intermediary":

- First, there is the definition in Article 1(c) as restricted in Article 1(3) (together, the "General Definition" of "intermediary"). As will be seen below, we would argue that ASTC as operator of the CHES system does not come within the General Definition.
- Secondly, under Article 1(4), certain persons will be "regarded" as "intermediaries" if they satisfy certain criteria (the "Extended Definition"). We would argue that ASTC comes within this Extended Definition and therefore the Convention applies to the CHES system.
- Finally, Article 1(5) allows Australia to make a declaration that ASTC, as the operator of the CHES system, should not be treated as an intermediary.

(a) Does ASTC come under the General Definition of "intermediary"? Additional guidance would be helpful in the paragraphs of the draft ER that explain what constitutes an "intermediary" (paras 1-10 to 1-12). At present this is limited to:

"Any person ... who in the course of business or other regular activity maintains securities accounts for others ... is an intermediary when acting in that capacity" (para 1-10)

"A person is an intermediary only if it maintains securities accounts for others ... and interests in securities are transferred across its books." (para 1-11)

The use of the term "securities accounts" in the explanation of what constitutes an "intermediary" should be avoided because of the circularity in the text (by definition "securities accounts" are held with "intermediaries").

More importantly, what is missing in the explanation of the term "intermediary" is a sentence that explains that the defined term should be understood in its natural sense. In other words, it must include someone standing "in between" – so that an "intermediary" is a person that stands somewhere in the chain between the issuer and the beneficial owner of the securities. This is alluded to in para 1-16 in relation to the definition of "securities held with an intermediary". It would be helpful if it was also identified in the definition of "intermediary".

Moreover, it is only under the definition of "securities account" in para 1-6 that one finds the "essence of the status" of an "intermediary" – that there is some form of continuing contractual or statutory relationship between the account holder and the intermediary in relation to existing or after-acquired securities.³

³ The relationship between the account holder and the intermediary could be of a contractual nature (as explained in para 1-6 of the draft ER) or could be pursuant to some form of statutory regime under which

This need for some form of continuing relationship is alluded to in the explanation of Article 1(3). CHESS would not be an "intermediary" if it *merely* acts as registrar or transfer agent for an issuer.⁴ Clarification is needed in the final ER to indicate the difference between a "mere" registrar, on the one hand, and one who performs additional functions, on the other. This is considered in more detail below under the "Catchall Extension".

Thus, it seems that to be an "intermediary" under the General Definition a person must satisfy **all** of the following:

- it must stand somewhere along the chain of holdings between the issuer and a holder of an interest in securities;
- interests in securities must be transferred across its books;
- it must maintain for others accounts relating to securities; and
- it must have some form of continuing contractual or statutory relationship with the account holder in relation to the securities.

Applying this definition, ASTC does not satisfy the first requirement as the records of CHESS form part of the main register of the issuer, so ASTC does not stand between the issuer and the account holder, but rather acts for the issuer in this regard. Consequently, ASTC is **not** an "intermediary" under the General Definition. Regarding the other three requirements above, see below under the "Catchall Extension".

A further matter is that reference is made in para 1-10 of the draft ER that a "clearing corporation" is an example of "intermediary", without any explanation of what is meant by the term. This needs to be clarified in the final ER as does whether "clearing corporations" may be "intermediaries" under the General Definition or the Extended Definition or both.

(b) Does ASTC come under the Extended Definition of "intermediary"? Article 1(4) has the effect of deeming as "intermediaries" certain persons that would not fit within the General Definition and also possibly not fit within normal parlance of what is an "intermediary". Under Article 1(4), a person will be deemed to be an "intermediary" where **either**:

- the person maintains securities accounts in the capacity of a CSD (the "CSD Extension"); or
- the securities are transferable by book entry across securities accounts which the person maintains (the "Catchall Extension").

The use of the term "securities accounts" is unfortunate in Article 1(4) – once again there is circularity because, by definition, "securities accounts" are accounts maintained by "intermediaries". Putting this to one side, is CHESS a CSD? Or, in our example, are Queensland Issuer securities transferable by book entry across accounts which ASTC maintains in CHESS?

(i) The CSD Extension: Is CHESS a CSD? Any attempt to classify CHESS requires an understanding of the rationale behind the CSD extension. Para 1-35 discusses the Nordic example but should be modified to clarify that when the Nordic account holder opens accounts in relation to

the intermediary acts for the account holder. Note here that this statutory regime is to be distinguished from a regime, such as under Australian corporate law, that requires the issuer to maintain a register in relation to the securities.

⁴ The draft ER in 1-33 states that Article 1(3)(a) is "strictly unnecessary". This is presumably because where the entity in question acts as a registrar for the issuer it is not maintaining securities accounts "for others" – the term "for others" contemplates beneficial owners and not the issuer.

domestic securities directly with a Nordic CSD, the Nordic CSD maintains the register for the issuer and therefore does not “stand between” issuer and account holder. Consequently, the Nordic CSD does not come within the General Definition of “intermediary”. The CSD Extension in Article 1(4) ensures that the Nordic CSDs acting in such a capacity are covered by the Convention.

Unfortunately, no definition is provided in the draft ER as to what constitutes acting in the capacity of a CSD. There is some explanation in para Int-17 to Int-21, but this does not clarify whether CHES is acting in the capacity of a CSD under the Convention. A CSD is described as an entity where large pools of certificates are immobilised or otherwise concentrated (Int-17). Alluding to an uncertificated system (like CHES), para Int-21 indicates that centralisation refers to concentrating the bookkeeping of dematerialized securities. It is arguable that CHES does concentrate the bookkeeping services in relation to dematerialized securities, however, counsel for the CHES system rejects that CHES is a CSD.

It would help if the final ER clarified a little what maintaining accounts “in the capacity of a CSD” means for purposes of the Convention. Some form of further explanation is important for the coherence of the Convention; however the rapporteurs certainly do not wish to enter the difficult debate that exists around the world as to what constitutes a CSD.⁵ Moreover, the meaning of “in the capacity of a CSD” is not crucial because on any definition acting in such capacity appears to be subsumed within the Catchall Extension in Article 1(4) described below.

Perhaps the definition contained in a Bank for International Settlements Glossary could be of guidance:

“a facility (or an institution) for holding securities, which enables securities transactions to be processed by book entry. Physical securities may be immobilised by the depository or securities may be dematerialised (ie so that they exist only as electronic records). In addition to safekeeping, a central securities depository may incorporate comparison, clearing and settlement functions.”⁶

(ii) The Catchall Extension: Are CHES securities “transferable by book entry across” accounts ASTC maintains? This Catchall Extension in Article 1(4) is the step in the analysis that is most in need of clarification. We are told in paragraph 1-35 of the draft ER that the Catchall Extension:

“confirms that a central bank that acts with respect to securities that are transferable by book entry across securities accounts maintained by the central bank is an intermediary with respect to such securities.”

⁵ There is significant controversy as to what entities come within the definition of CSD for regulatory and other purposes. Again, it would be wise for the rapporteurs to avoid entering too deeply into this debate. For example, in the current version of the draft ER, it appears that CREST is to be regarded as an “intermediary” under the Catchall Extension (described below) rather than the CSD Extension. This is not stated explicitly but rather by implication -- after indicating that CRESTCo is an intermediary that can benefit from the declaration mechanism in Article 1(5), para 1-36 concludes, “Article 1(5) also enables a Contracting State to exclude from the definition of intermediary an operator which is a CSD” (my emphasis). Thus, the ER implies that the CREST system is not a CSD – something with which some would strenuously disagree.

⁶ “A glossary of terms used in payments and settlement systems”, Bank for International Settlements, March 2003, available at www.bis.org/publ/cpss00b.pdf. However, some may argue this does not take one much further – for example, a question arises as to what “holding securities” means.

However, what is missing is a real life example of a system where the central bank would not be considered an "intermediary" under the General Definition but would be considered an "intermediary" under the Catchall Extension. The New York Fed is not such an example because in its role as CSD for clearing banks under the TRADES Regulations it meets the General Definition of "intermediary". Providing an appropriate realistic example would both illustrate the need for the Catchall Extension and provide assistance to those attempting to determine whether their systems come within it.

The purpose of the Catchall Extension is to ensure that the Convention covers institutions that act as agent for the issuer, and therefore do not "stand between" but still perform other functions. The problem is that the words of the Catchall Extension are so broad that every type of entity (including most registrars and transfer agents) involved in a chain of holdings has the potential to be included, indeed, including a pure registrar. The language in the Catchall Extension in Article 1(4) covers a person who deals with:

"securities ... which are otherwise⁷ transferable by book entry across securities accounts⁸ which it maintains".

Yet, such an expansive definition arguably conflicts directly with Article 1(3)(a), under which a "mere" registrar is not considered to be an "intermediary".

The intention is that Article 1(3)(a) should trump Article 1(4); however, if that were the case, arguably one would have expected to see at the start of Article 1(4), "*Subject to paragraphs (3) and (5)*". In spite of this, the intention is that the Catchall Extension picks up everyone in the chain between issuer and beneficial holder other than:

- a person who acts "merely" as a registrar or transfer agent (Article 1(3)(a)); and
- a person who acts purely in an administrative capacity for the account holder in respect of an account that is held with a third party intermediary (Article 1(3)(b)).

This must be the correct interpretation of the Convention as otherwise Article 1(3) would lack any meaning.

More guidance is needed as to what is meant by "merely" acting as registrar or transfer agent. Presumably the word "merely" in this context must be understood as meaning "**only**". That results in a relatively narrow category:

1. the person's functions have to be those of a registrar or transfer agent as commonly understood (as described in para 1-32 of the draft ER);⁹ and
2. the person must be acting only on behalf of the issuer and, accordingly:
 - a. if the role of the person in question is exercised independently rather than on behalf of the issuer, it will **not** constitute a "mere" registrar (this may be the case, for example, if the person carries out the function of a registrar as an independent statutory body);
 - or

⁷ The word "otherwise" clarifies that the book entry transfer system does not have to be that of a CSD.

⁸ Again the circularity issue.

⁹ Para 1-32 of the draft ER indicates that the functions of a registrar include the maintenance of the securities register for the issuer and the handling of corporate actions for the issuer. The role of a transfer agent is explained to include handling transfers on behalf of the issuer, and recording the name of the transferee in the register in place of the issuer.

- b. if the person in question also acts under a continuing contractual or statutory relationship with account holders (for example, maintaining accounts on participants' behalf as operator of a settlement system), it will **not** be treated as a "mere" registrar.

However, more guidance is required to flesh out the parameters of this relationship in the case described in 2.b., above. We must bear in mind that, in some jurisdictions, the normal role of a mere transfer agent or registrar may be larger than in other jurisdictions. For example:

- Under the proposed Uniform Securities Transfer Act in Canada and Article 8 of the Uniform Commercial Code in the United States, an issuer of an uncertificated security (in practice, the transfer agent on behalf of that issuer) may enter into one or more control agreements with the registered owner and creditors of the registered owner. That looks like a continuing contractual relationship but, because it is within the normal range of functions, the transfer agent is still acting "merely" as transfer agent for the issuer and would therefore be a "mere" registrar under the Convention.
- Under United States federal securities law, transfer agents have responsibilities to investors in addition to their responsibilities as agents of the issuer. This is why transfer agents must be registered with the Securities and Exchange Commission. Yet, we are clear that United States transfer agents should not be captured by Article 1(4).
- There is an extensive "direct registration system" ("DRS") currently operated in the United States by transfer agents in co-operation with DTC. Among other things, that DRS enables investors who want to be registered directly on the issuer's records to deal more efficiently with such securities through services provided by certain transfer agents, such as electronic movement of positions between the direct and indirect holding systems. The DRS is marketed as an alternative to the indirect holding system. It is used by a relatively small, but significant and growing, number of investors and issuers. There is an organization actively working towards establishing a DRS in Canada, along lines that seem similar but not identical to the DRS now operating in the United States. The final ER should make clear that the activities of transfer agents under systems similar to DRS are not captured by Article 1(4).

Returning to the fact pattern at hand, and applying this test to the CHES system, it is arguable that ASTC has the sufficient continuing contractual relationship with its participant, Tasmanian Investor, to make it more than a "mere" registrar and therefore the Convention would apply to the CHES system. However, more guidance is required in the final ER as to the quality of the relationship that is needed to satisfy the Catchall Extension.

It should be noted that regarding CREST, it is implied in para 1-36 of the draft ER that although CRESTCo is not an intermediary under the General Definition, it is treated as an intermediary under the Extended Definition.

(iii) Avoiding reference to the "direct"/"indirect" split. When determining what constitutes acting "merely" as a registrar, it is important that the focus is on objective facts. The focus should not be on whether the holding pattern would be considered a "direct" holding pattern under local law. Although this emphasis is clearly articulated in para Int-24, there are other parts (such as in para I-35) where the reader may be led in the wrong direction.

For example, para I-35 draws attention to the fact that the credit to the Nordic CSD's accounts results in a direct relationship between the beneficial holder and the issuer and leads to rights enforceable against the issuer. It appears to be a mistake to focus on this relationship when determining whether the Convention applies. One should not focus on the nature, under local Nordic

law, of the relationship between beneficial holder and issuer. The application of the Convention should not be pre-empted by applying Nordic law to determine whether the Convention applies at all. The key issue is the status and role of the intermediary and whether it falls within the Extended Definition under Article 1(4), or is excluded under Article 1(3).^{10 11}

C. FACT PATTERN 2 – HOLDER USING “SPONSORING PARTICIPANT” IN CHESSE

A more complicated but also more likely scenario involves a “sponsoring participant” standing between the investor and the CHESSE system. To illustrate the difficulty, an international fact pattern is analysed.

On Day 1, Hong Kong Investor wishes to purchase 100 shares of New Zealand Issuer. NZ Issuer maintains two sub-registers that together form the NZ Issuer register: (i) the sub-register that NZ Issuer maintains itself and (ii) the CHESSE sub-register, located in NSW, registering ownership of shares purchased through CHESSE. Hong Kong Investor is not a CHESSE participant, and is therefore unable to access the CHESSE system unless it appoints a sponsor.

Hong Kong Investor appoints Singapore Bank, a financial institution incorporated in Singapore and a CHESSE participant, to sponsor its holding of shares in the CHESSE system. Different to the system in the United States with DTC, Hong Kong Investor, and not Singapore Bank, is recorded on the CHESSE sub-register as the registered owner of Queensland Issuer shares. Singapore Bank also maintains records relating to Hong Kong Investor’s securities holdings on its own books.

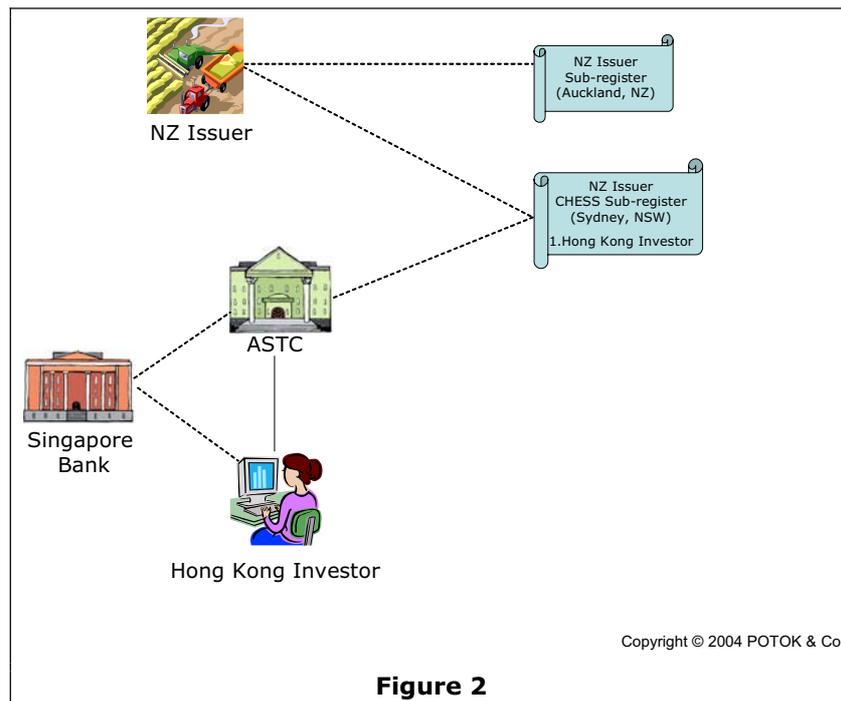
Figure 2 below represents the above facts.

¹⁰ Clarity on this is essential if confusion is to be avoided. For example, in the past, CRESTCo has indicated that the operator of a direct holding system such as CRESTCo is not an intermediary, nor normally should it be deemed to be an intermediary. They reach this conclusion based on the fact that:

- CRESTCo has no proprietary interests whatsoever in the securities held and transferred in its system;
- the interposition of the system operator between the issuer and the beneficial holder does not break the direct relationship;
- only the beneficial holder has full legal title to the securities credited to the CREST account; and
- in respect of Irish securities, for example, the credit on the CREST account reflects an entry on the uncertificated part of the register as maintained by the issuer.

However, the Convention has taken a different approach. The draft ER makes it clear in para 1-36 that CREST **is** deemed to be an “intermediary” under Article 1(4) for the purposes of the Convention. Whether the Convention applies is neither determined by the nature of the interest CREST has under English law in the securities (see Japanese and French law example below) nor by the fact that the account holder has direct rights against the issuer. This discussion reinforces the importance of more explanatory language and examples on this issue.

¹¹ It is worth noting here that at the time of the negotiation of the Convention there were those who argued that the Convention should initially cover those persons that come within the General Definition of “intermediary” with countries needing to make a declaration to come within the Convention in relation to settlement systems that include holding patterns that did not fit within the General Definition. This was rejected after much deliberation. The result is the extensions in Article 1(4) and the “opt out” in Article 1(5). The current difficulties may well have been avoided if we had gone down the other route.



The issue here is whether Singapore Bank will be treated as an “intermediary” under the Convention.

This fact pattern appears to be come directly within Article 1(3)(b). Assuming that ASTC is an intermediary under Article 1(4), then Singapore Bank is “acting as a manager or agent or otherwise in an administrative capacity” when it arranges for the purchase on behalf of Hong Kong Investor. The extent of its involvement is purely as a facilitator and although it may record on its own books that the transaction has taken place, the recording on its own books of the credit of securities for Hong Kong Investor itself has no legal ramifications – the entitlement that Hong Kong Investor has against the issuer occurs upon the recording by ATSC on the register of the issuer (the CHESSE sub-register), not upon the recording at the Singapore Bank level.

This needs to be explicitly contrasted in the final ER with the French and Japanese situations alluded to in para 1-16. With the above fact pattern in mind, the meaning of the following language in para 1-16 is far clearer for the uninitiated:

“In some legal systems, for example those of France and Japan, rights resulting from the credit of securities to a securities account are nevertheless treated as a direct holding of the underlying securities and those maintaining securities accounts and standing between the account holder and the issuer are not themselves regarded as holders of the securities. Nevertheless these rights fall within the scope of the Convention because [it is]¹² the credit of securities to the securities account, not the entry in the issuer’s register or the possession of certificates, that leads to the holder’s right, and it is by entries to the securities account that transfers are effected.”¹³

¹² We believe that there is a typographical error with the words “they result from” needing to be replaced by “it is”.

¹³ It would helpful if the final ER clarified if it is under the General Definition or under the Catchall Extension that such entities in the French and Japanese systems would be classified as “intermediaries” for purposes of the Convention.

Compared in this way, the analysis is easier to follow and the distinction between the position of Singapore Bank in the CHES system and an institution acting as an "intermediary" in the Japanese system can be seen more easily.¹⁴

D. CONCLUSION

This memorandum demonstrates the difficulties in determining whether CHES is covered by the Convention without more guidance in the final ER. Such guidance is crucial.

It is important to note that Australia may not be the only country with this difficulty. The same problem may occur in other countries where the system diverges from the "depository" model that is typified in DTC, Euroclear and, in Australia, for Austraclear. It would be very helpful if the final ER provided examples that look to the applicability of the Convention for the various holding patterns that exist under different systems

* * *

The text of the explanatory report on Article 1(4) was subsequently amended in paragraph 1-36 as follows (new text underlined):

This provision, which operates subject to Article 1(5), confirms explicitly that a person is to be considered an intermediary for purposes of the Convention in relation to (i) securities that are credited to securities accounts that are maintained by that person in the capacity of a CSD, or (ii) securities that are otherwise transferable by book entry across securities accounts maintained by that person in a capacity other than as a CSD, such as a central bank that maintains accounts for book-entry government securities issued by its government or a person that maintains securities accounts under statutory arrangements for the dematerialized holding and transfer of securities. In contrast to the persons described in Article 1(3), those referred to in Article 1(4) are CSDs, central banks and others across whose books transfers may or must be effected and who are not merely acting for the issuer in the capacity of registrar or transfer agent. Thus a CSD or a central bank or other person that maintains records of an investor's holdings qualifies as an intermediary even if the credit of the securities to the securities account maintained by the CSD, central bank or other person establishes a direct relationship between the investor and the issuer and leads to rights that are enforceable against the issuer...As stated in paragraph 1-6, in the context of statutory operator of a securities transfer and settlement system, the reference to securities accounts is to be broadly interpreted to include any form of record of holdings and transfers, whether or not denominated by the operator as an account, and would currently thus include, for example, sub-registers maintained by the Australian CHES system, which in other respects is similar to the United Kingdom CREST system described below."

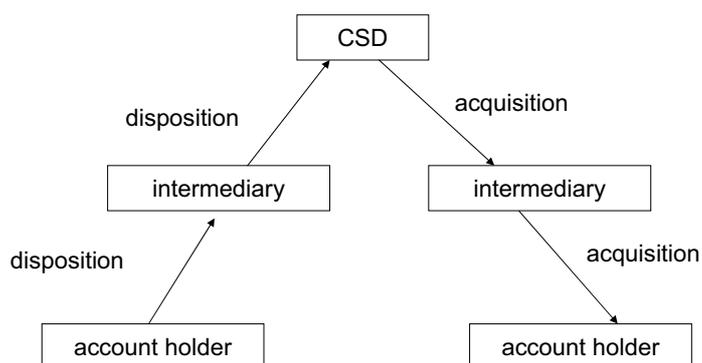
¹⁴ Some have been puzzled by the fact that in determining whether the Nordic CSD is an intermediary, we do not focus on the "direct" nature of the holding pattern – that is, we do not give weight to the fact that the account holder's rights are enforceable directly against the issuer and are not enforceable against the CSD. Some inquire why the analysis is different for Singapore Bank. The difference is that in the cases of the Nordic CSD and the French and Japanese situations, it is the credit of the account holder's interest on the Nordic CSD or French or Japanese intermediary's books that leads to the interest of the holder against the issuer. In the case of Singapore Bank, the recording on its own books of Hong Kong Investor's interest does not lead to the account holder having any rights against ASTC or New Zealand Issuer.

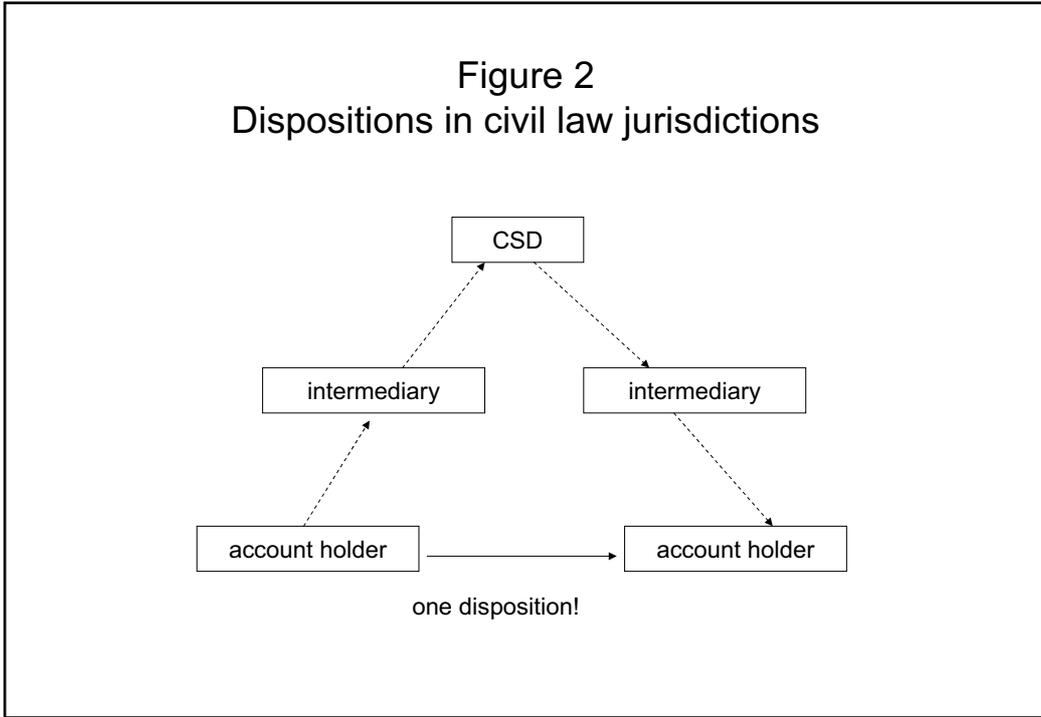
Two Basic Mechanisms of Disposition

First session of the CGE
on intermediated securities

– UNIDROIT Secretariat –

Figure 1
Dispositions in the stage-by-stage jurisdictions





Title Transfer and Collateral Transaction (Art. 3 and 4)

First session of the
UNIDROIT CGE on intermediated securities

– UNIDROIT Secretariat –

Articles 3 and 4

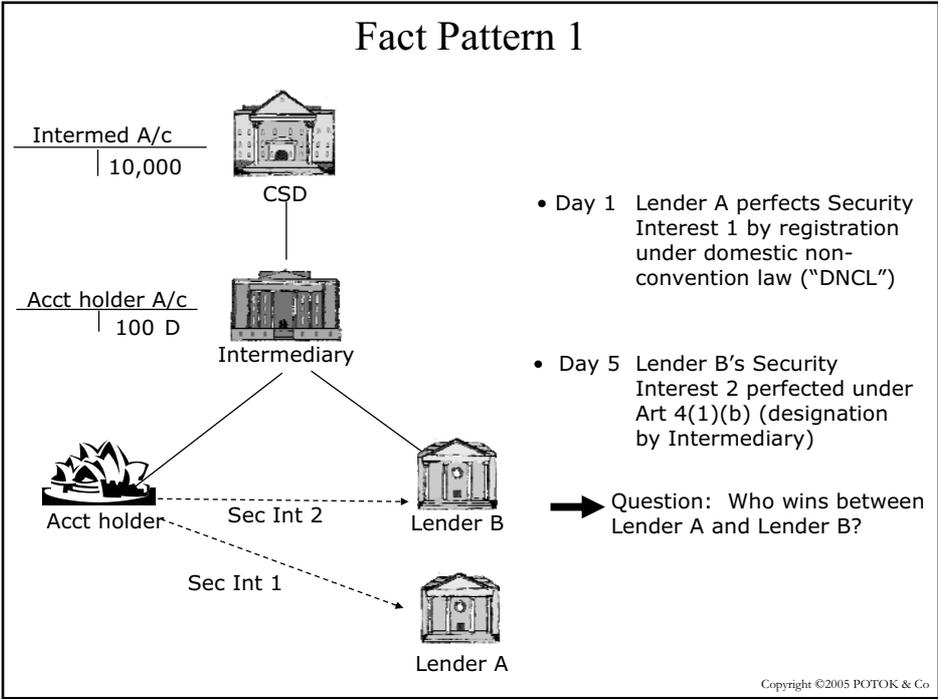
	Title transfer	Collateral Transaction
Substance (Economic function)		
Legal Form		
Current Draft	Article 3	Article 4
Alternative Draft	new Article 3	new Article 4

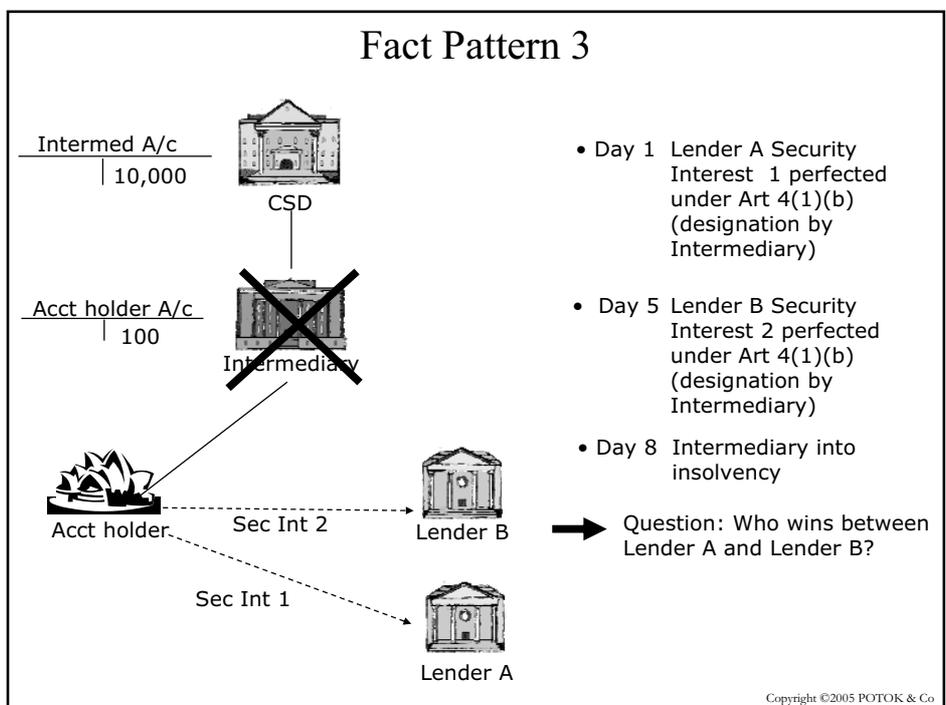
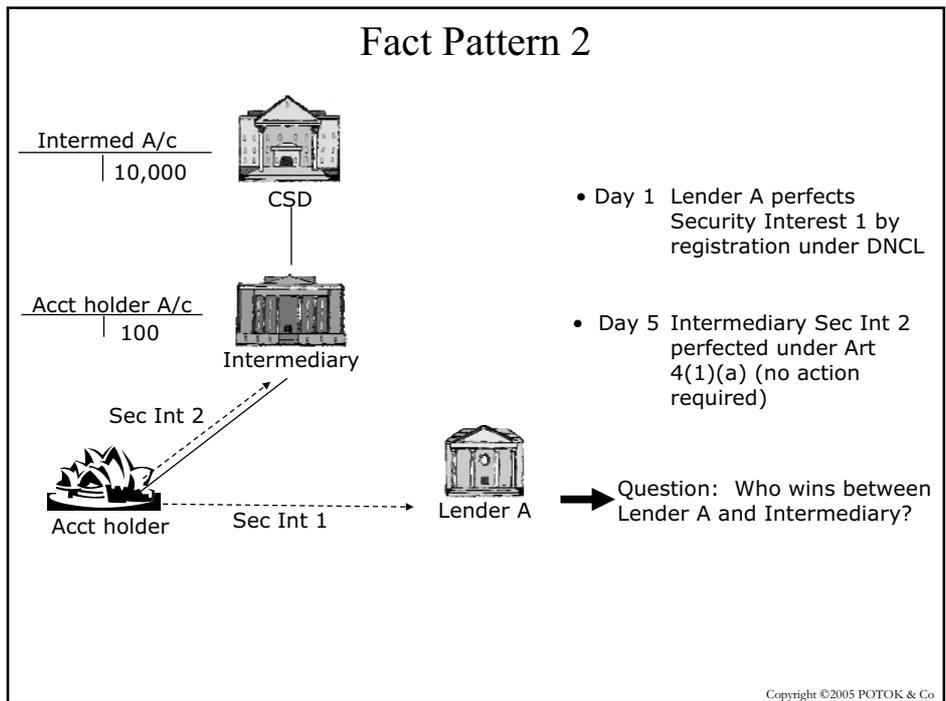
UNIDROIT Securities Convention

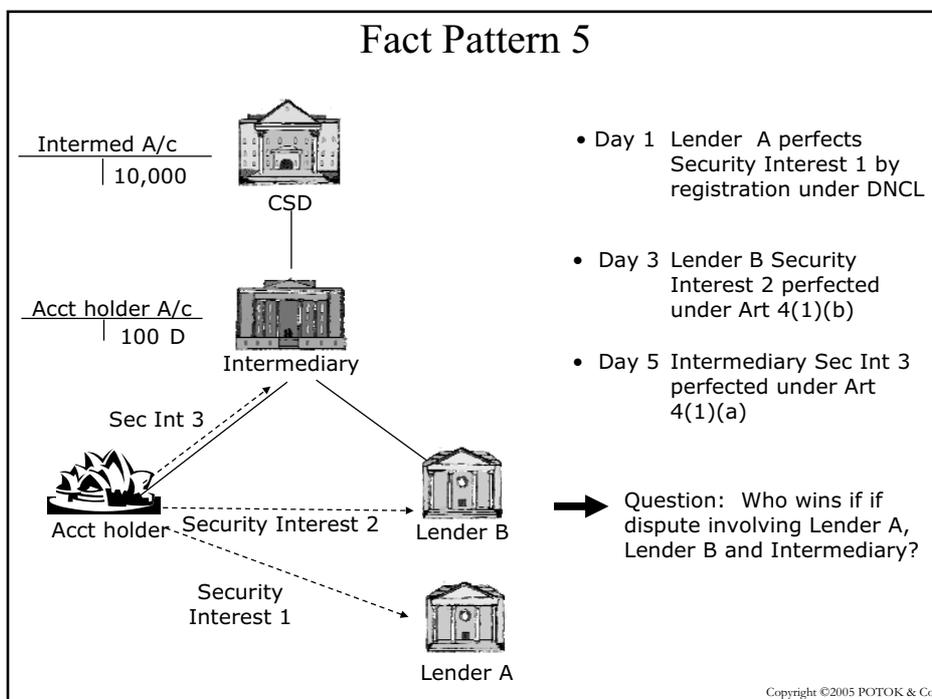
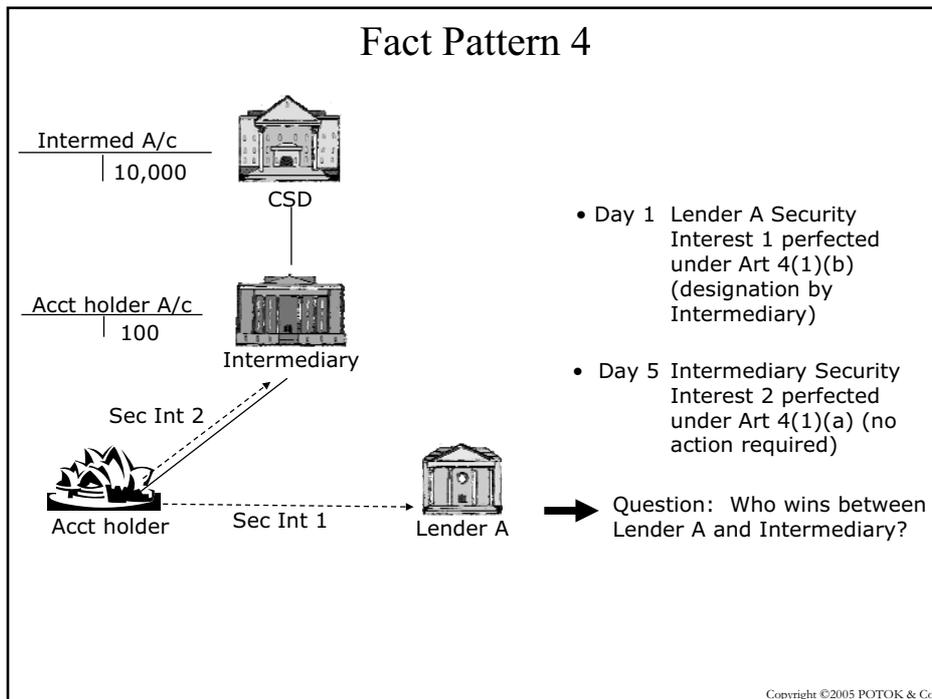
Article 9 and Priorities Discussion

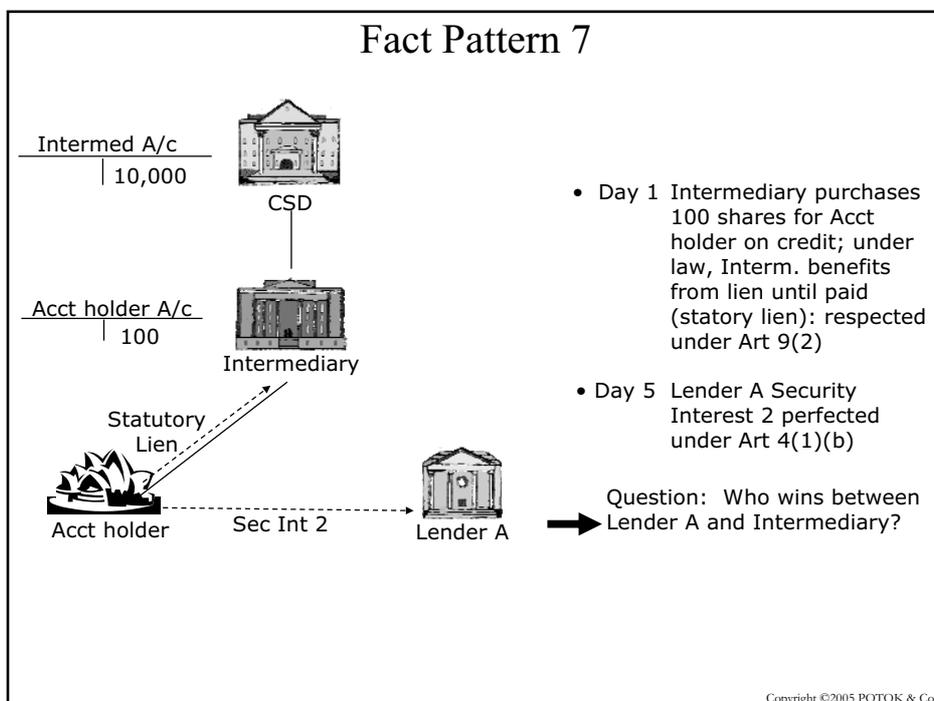
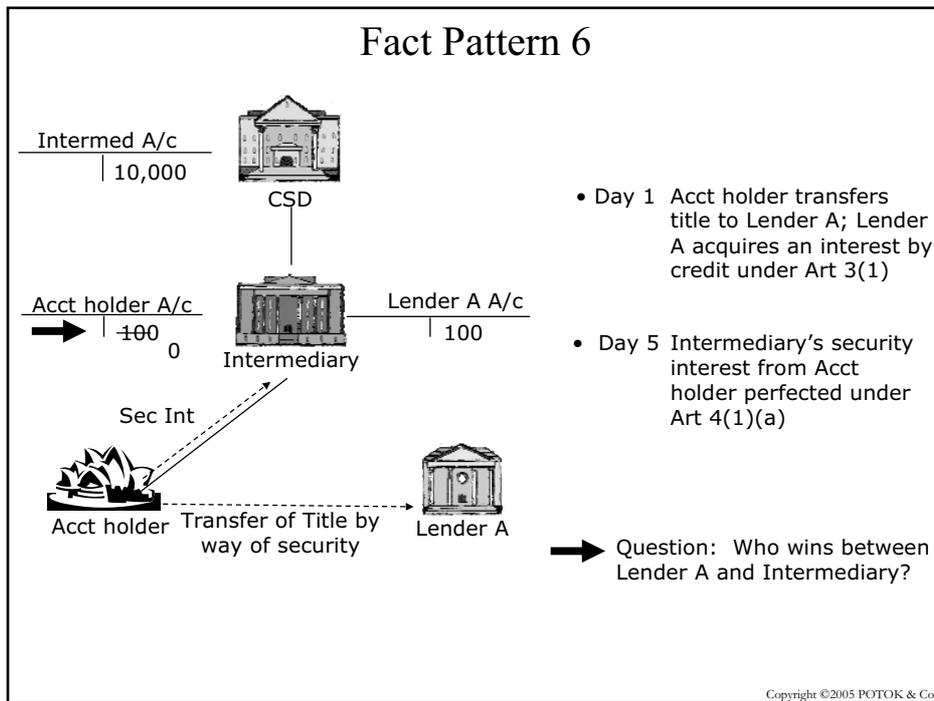
Rome, May 16, 2005

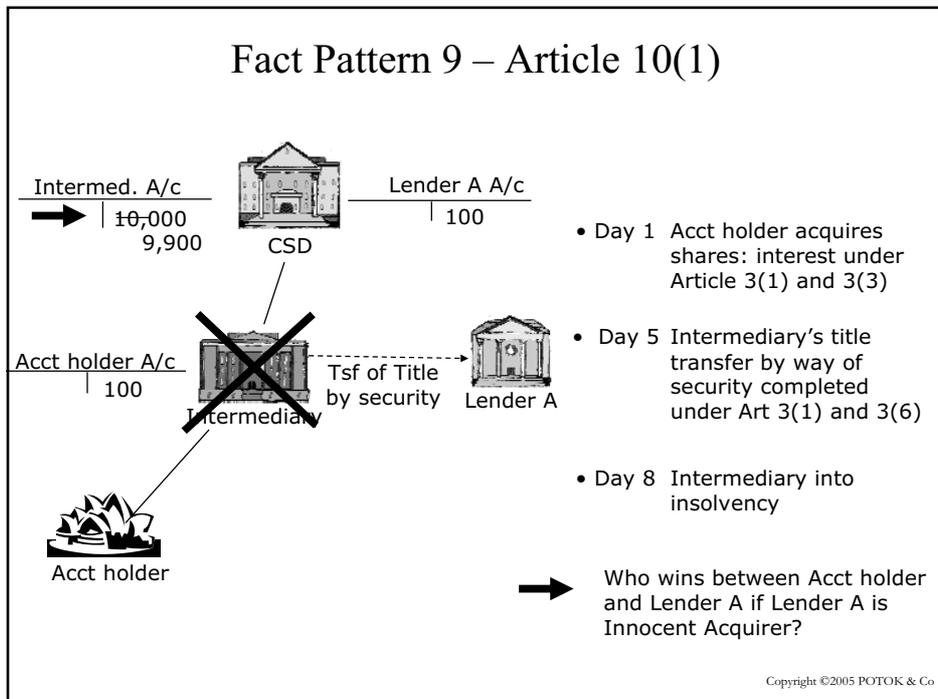
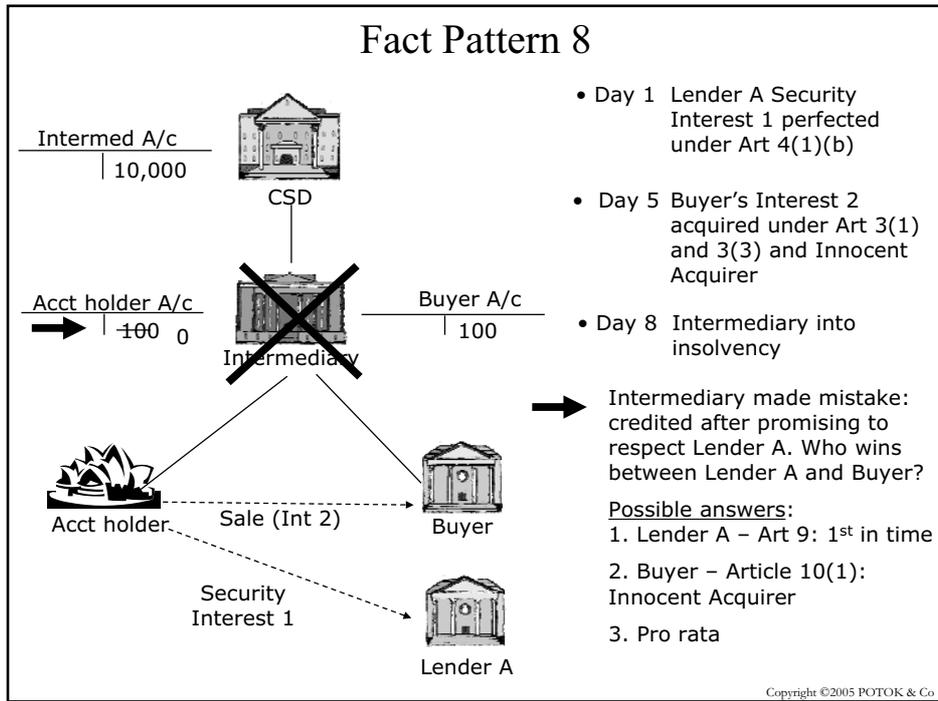
Richard Potok
Australian Delegation











Cross-Border Insolvency – The Future: Law Reform for Netting and Collateral in connection with Financial Market Transactions

ISDA
Lawrence S. Brandman
Goldman, Sachs & Co.

First session of the UNIDROIT CGE
Rome, Italy, May 2005

Financial Market Transactions

- **Local insolvency and property laws throughout the world treat netting and collateral issues in various ways**
- **Pace of global legal reform has not kept up with the**
 - **Paradigm shift in the market place**
 - **Product proliferation**
 - **Technological developments**
- **Current reality**
 - **Products and activities are broad-based**
 - **Market participants are diverse**
 - **Markets are fast-moving**

Financial Market Transactions

- **Effective systemic and credit risk management requires legal certainty, consistency and efficiency**
- **Effective systemic and credit risk management is a foundation for liquidity, capital formation and market efficiency**

3

Netting laws should

- **facilitate the close-out netting**
- **of transactions**
- **in the case of default**
- **whether in or outside the context of insolvency**
- **without stay or delay**
- **free from avoidance, claw-back or “cherry-pick” risk**

4

Netting laws should

- permit single and cross-product netting
- whether pursuant to a single or multiple master agreements (including “master-master” and cross-product master agreements)
- which permit a default under one transaction or agreement to become a close-out event for all transactions and agreements

5

Netting laws should

- avoid cumbersome complexity
- including the elimination of narrow protected classes of:
 - counterparties
 - products
 - specifically approved netting agreements
- as well as unreasonable contractual predicates for netting
- eliminate distinctions between “set-off” and enforceable close-out netting

6

Laws relating to collateral should

- **facilitate the foreclosure and liquidation of collateral**
- **in the case of default**
- **whether in or outside the context of insolvency**
- **without stay or delay**
- **free from avoidance and claw-back**

7

Laws relating to collateral should

- **avoid cumbersome and impractical rules for creating, “perfecting” and maintaining interests in collateral**
- **avoid obstacles for enforcement**
- **eliminate recharacterization concerns as well as distinctions between pledge and title transfer collateral arrangements**
- **permit the use, reuse, rehypothecation and substitution of collateral by the collateral taker**

8

Laws relating to collateral should

- **permit robust collateral arrangements including collateral deliveries based on**
 - **mark-to-market (“top-up”)**
 - **credit ratings and other triggers**
- **all protected from the effect of preference and zero-hour rules**
- **as well as from the action of third parties (including attaching creditors)**
- **providing the collateral taker with a priority position in the collateral**

9

Laws relating to collateral should

- **Eliminate the uncertainty of conflict of laws principles**
- **Adopt approaches like The Hague Securities Convention which facilitate legal certainty and efficiency**

10

Law reform will facilitate market liquidity and capital formation which will result in opportunities for investment and risk management

The Mechanism of Articles 14-16

First session of the CGE
on intermediated securities

– UNIDROIT Secretariat –

