



**UNIDROIT COMMITTEE OF GOVERNMENTAL EXPERTS FOR
THE PREPARATION OF A DRAFT CONVENTION ON
SUBSTANTIVE RULES REGARDING INTERMEDIATED
SECURITIES
Third session
Rome, 6/15 November 2006**

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***COMMENTS BY GOVERNMENTS
AND INTERNATIONAL ORGANISATIONS***

(Comments by the Government of the Federative Republic of Brazil)

After having analyzed the text of the Convention on Harmonised Substantive Rules Regarding Intermediated Securities, the Government of the Federative Republic of Brazil hereby offers the following comments:

Book Entries: absence of definition of debits and credits and manner of constitution of security interest. Absence of manifestation for credit to securities accounts

The Convention contains a series of references that seem to be book entries but there is no confirmation on how these entries should be made. Supposedly, such absence of explanation is intended to favour the neutrality of the text; however, it seems to us that the omission concerning the manner of making the book entry does not provide the intended neutrality and functionality and may harm the legal certainty that should exist in the transactions that give rise to such book entries.

To such effect, it is also convenient to remind the principles of interpretation and applicability of the Convention that, according to its Article 3, shall take into account its own implementation purposes, predictability and mainly the promotion of uniformity.

Accordingly, depending on the legal system adopted by the several States, the book entry may be defined as the entry made by any intermediary, or the entry made at the CSD level or also the entry made on the issuer's book.

Such a definition is necessary because these book entries – and their requirements – have concrete effects on the characterization of ownership of the securities (both in acquisition and disposal of securities), on the manner of exercise of political rights (right to vote) and property rights (right to dividends or other corporate event), on the constitution of security interests, on solutions to loss allocation problems, among others.

The convention could not affect any of the different requirements of creation and validity of book entries adopted by each State. For such purpose, we understand that a reference to non-Convention law is crucial so as to determine not only what credits and debits are but also what the book entries will consist of.

SITUATION 1 – DEFINITION OF DESIGNATING ENTRY FOR CONSTITUTION OF SECURITY INTEREST

The first situation where it would be important a reference to the Non-Convention Law is the definition of designating entry - Article 1(n).

Such definition is vital, since in the Convention designating entries are considered one of the delivery manners for the purpose of constituting security interests on intermediated securities (Article 5.3(b)).

In such context, though the intermediated securities remain registered in the account holder's name (with no transfer or credit to the collateral taker being made) it is important to note that the account holder/pledgor will lose (or at least be restricted), even momentarily, the rights of disposal of these securities under which a security interest had been validly constituted.

Hence, it is absolutely important that the non-convention law would have the possibility of imposing its own requirements concerning the manner of effecting such book entry:

- in order to avoid fraud to the detriment of third parties, and, moreover
- in order to give assurance to other account holder's creditors about the actual status of its networth and the exact moment in which the security interest has been constituted.

In the current wording, the definition of designating entry only shows the need of an entry in the securities account. Nevertheless, based on the above indicated rationale, in our opinion it is crucial that such entry observes all requirements established in the Non-Convention Law.

Accordingly, for instance, in certain countries it will be required that the entry appears in the books of the relevant intermediary while in other countries it may be additionally required the entry be made in the CSD or the issuer books, all in order to guarantee certainty and uniformity in the structure of constitution of security interests.

To such effect, the proposal consists of the following:

a) To amend the wording of Article 1(n), in order to include a reference to book entry format.

→ **Proposed Wording:**

Article 1(n) "*designating entry*" means an entry in a securities account made in favour of a collateral taker in respect of the securities account or in respect of specified securities credited to the securities account, **in book entry format, according to the domestic non-Convention law**, which, under the account agreement, a control agreement or the domestic non-Convention law, has the effect that, in specified circumstances and as to specified matters, the relevant intermediary is not permitted to comply with any instructions given by the account holder without having received the consent of the collateral taker, or is obliged to comply with any instructions given by the collateral taker without any further consent of the account holder;

b) Should the above proposal not be accepted, we suggest the amendment to Article 1(n), in order to change the alternative conjunction "or" for the additive conjunction "and", so that the account agreement, the control agreement and the domestic non-Convention law may be considered.

→ **Proposed Wording:**

Article 1(n) "*designating entry*" means an entry in a securities account made in favour of a collateral taker in respect of the securities account or in respect of specified securities credited to the securities account, which, under the account agreement, a control agreement **and** the domestic non-Convention law, has the effect that, in specified circumstances and as to specified matters, the relevant intermediary is not permitted to comply with any instructions given by the account holder without

having received the consent of the collateral taker, or is obliged to comply with any instructions given by the collateral taker without any further consent of the account holder;

SITUATION 2 – ACQUISITION AND DISPOSAL OF SECURITIES

In several countries the local law requires more solemnity for transfer of property in securities. This happens by virtue of its economic and social relevance or in order that it may be possible to reach the necessary publicity, so that delivery or transfer of the securities may produce its effects before third parties in a legal certainty environment.

This occurs in Brazil, for instance, with shares of companies, the transfer of which is only perfected upon transcription in the issuer's book or on the depository level. The last one is the only valid manner of registration of property for intermediated securities.

Such requirement is extremely relevant to avoid fraud in securities negotiations and also contributes to the healthiness of the system, since such is the manner to evidence to the market participants the delivery of the negotiated securities.

Thus, in order to permit the conciliation of this sort of requirements, the Convention should necessarily define in which manner such debits and credits should be made (i.e. book entry form) and also establish that the local law will set forth the requirements for debits and credits to effect the transfer of ownership of securities.

a) To change the wording of items 1 and 3 of Article 4 so as to include at the end of each of them a reference to book entry format.

→ **Proposed Wording:**

1. - Intermediated securities are acquired by an account holder by the credit of securities to that account holder's securities account, **in book entry format, according to the domestic non-Convention law.**

3. - Intermediated securities are disposed of by an account holder by the debit of securities to that account holder's securities account, **in book entry format, according to the domestic non-Convention law.**

b) To propose the insertion of an item to Article 1 to deal with the concept of debits and credits, which shall be the one defined by the domestic non-Convention law.

→ **Proposed Wording:**

(x) Credits and debits are those recognized as such by the domestic non-convention law.

SITUATION 3 – EXPRESSION OF WILL IN THE ACQUISITION AND DISPOSAL OF SECURITIES

Pursuant to the Brazilian legal system, legal transactions for acquisition of property are made through:

- the existence of a fair title (legal act by means of which two persons validly express their will of disposing or acquiring an asset/ a security) and
- the observance of a manner (format) recognized by law.

In the acquisition of ownership of a security by means of purchase, for instance:

- the fair title is the sale and purchase agreement, which results in the obligation of transferring the ownership of the security; and
- the manner is the transfer of such securities, that is, its delivery (*traditio*) made by the seller to the buyer with the intent of transferring the ownership thereof, even if the delivery is made in a symbolic way.

In order to be valid and produce its effects the delivery requires: (a) that the transferor be qualified to transfer the ownership of the security to the buyer; (b) that the transferor and buyer be in agreement concerning the transfer of ownership; and (c) that the possession of the disposed security be effectively transferred.

Based on the text of Article 4.1 and 4.3, acquisition of securities would be made by means of the relevant credit to the account of the buyer and disposal of the securities would be made by means of debit to the account of the seller.

Inasmuch as the texts may separately give the idea that the transfer of ownership of securities provided in the Convention complies with the requirement of existence of fair title and intent of delivery, the imposition of such last requirement (mutual intent of delivery) does not seem to be the purpose of these provisions.

Accordingly, based on the above mentioned provisions of the Convention, the securities transfer of ownership would be valid simply upon the mere credit/debit to a securities account, but without need of the expression of will from the acquirer or the seller.

Even if such hypothesis is possible in foreign securities negotiation systems, it is not compatible with the Brazilian legal system, which requires for the valid effectiveness of any legal transaction, mainly sale and purchase, the clear and unequivocal identification of expression of will of the involved parties.

At this moment, it seems important to emphasize that when the Convention deals with the granting of a security interest, it requires concomitance of two requirements, namely:

- expression of will, which occurs, pursuant to Article 5.1(a), by the entering into a collateral agreement, and
- delivery, which occurs, pursuant Article 5.1(b), upon delivery of the securities to the collateral taker.

However, in Article 8.1, the Convention seems to provide a differentiated treatment, requiring the expression of will of the account holder only in the case of debits to be made to a securities account.

For the reasons posted above, we think it would be important to have a clarification why the expression "credit" was deleted from Article 8.1.



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***COMMENTS BY GOVERNMENTS
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(Comments by the Government of the Federative Republic of Brazil)

After having analyzed the text of the Convention on Harmonised Substantive Rules Regarding Intermediated Securities, the Government of the Federative Republic of Brazil hereby offers the following comments:

Netting at the intermediary's level and systems with ultimate investor identification

The clearing and settlement of securities in the manner established in the Convention, as a rule, is based on the assumption that netting may be made at the level of the intermediary. Such an assumption, in our opinion, does not mean that the systems that adopt netting at the level of the ultimate investor are in disagreement with the purposes and rules of the Convention.

This is what occurs, in fact, with the Brazilian stock holding system, which contains a provision of such nature: compulsory netting at the ultimate investor's level, thus prohibiting netting at the level of the intermediary.

In an ideal context, the legal certainty objective should always be observed, meaning that in systems where the netting at the level of the intermediary is accepted and satisfactory, the Convention's rule will apply (which, for the rest, would be compatible with the local rule). But, moreover, in systems where the netting at the intermediary's level is not permitted, but should occur at the ultimate investor's level, the corresponding system rules should prevail.

Hence, there is a perception that if Article 4.5 is maintained in such a wide wording ("may be effected") this provision may lead to an incorrect idea that the netting at the ultimate investor requirement will not necessarily need to be followed, which could bring uncertainty to the system.

Accordingly, we propose the amendment to Article 4.5, in order to add an exception concerning the domestic non-Convention law and the CSD rules.

→ **Proposed Wording:**

4. 5. – **Subject to the domestic non-convention law or any provision of the securities settlement or clearing systems**, debits and credits to securities accounts in respect of securities of the same description may be effected on a net basis.



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After having analyzed the text of the Convention on Harmonised Substantive Rules Regarding Intermediated Securities, the Government of the Federative Republic of Brazil hereby offers the following comments:

Lex societatis (issuer's law) shall prevail concerning corporate rights

There are rights that may only be exercised pursuant to the law of the place of organization of the issuer. However, Article 9.2 (b) and Article 13.1 refer to the corporate law of the place of organization or placement of securities. Hence, it is necessary to establish a solution should such laws be in conflict.



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After having analyzed the text of the Convention on Harmonised Substantive Rules Regarding Intermediated Securities, the Government of the Federative Republic of Brazil hereby offers the following comments:

Systems with identification of the ultimate investor and possibility of exercising rights before third parties other than the relevant intermediary: - Right of withdrawing assets or substituting the intermediary – Judicial constrictions

In some exceptional situations the CSD rules establish that the rights provided in paragraphs 1(b) and 1(c) of Article 9 may be exercised against the CSD itself, inasmuch as it is not the relevant intermediary.

Regarding article 9.2., this rule relates to the exercise of rights against the relevant intermediary. In some exceptional situations, such as when the intermediary does not follow the account holder instructions, the rules of Brazilian CSD state that such rights may be exercised against the CSD, although the CSD is not the relevant intermediary.

This is only possible because the CSD identifies the ultimate investor, i.e., because it is part of a transparent system.

Another situation is the general prohibition of upper-tier attachment, such as established in Article 15, which would generate risks of several natures to Brazil, further to giving rise to a flagrant retrocession in the integrity of the intermediated holding system, which would be contrary to the spirit and finality of the Convention.

This is so since if the CSD may promote the attachment against the relevant intermediary, as provided in the Convention, it will be – as in fact it is – possible to maintain a centralized registry containing all information concerning judicial or administrative constrictions upon intermediated securities, thus avoiding the possibility of attachment of more assets than necessary to comply with the judicial order (that is, with the centralized registry, only the exact quantity of assets as determined in the judicial/administrative order will be object of constriction). Finally, the time required for compliance with the judicial or administrative order will also be optimized, making it more effective.

1st proposal: Maybe it would be possible to confirm, in the text of the Convention, that if an attachment is fully “made against” the relevant intermediary (participant), it would not matter which person is responsible for making the attachment. In this sense, for example, a CSD could make an attachment in its systems but for all purposes there will be an accurate registry that it has been “made against” the relevant intermediary.

2nd proposal: Should the 1st proposal not be feasible, another alternative would be to include an exception such as a new Article 15.3, stating that the provision of Article 15.1 will not apply in transparent systems where there is full knowledge and control of the account holders and the disposition of securities of the securities account.



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After having analyzed the text of the Convention on Harmonised Substantive Rules Regarding Intermediated Securities, the Government of the Federative Republic of Brazil hereby offers the following comments:

Exceptions to the securities settlement [or clearing] systems

In view of its dynamics and complexity, regulation of activities, rights and obligations of the participants of negotiation environment in the modern financial systems is usually made by means of (infra legal) rules enacted by governmental authorities in charge of supervision of such environments and the self-regulation rules established by the settlement systems or clearing houses themselves, to which all participants shall adhere and be subject.

In as much as such rules cannot establish duties, obligations and responsibilities to the participants of such environments in a manner contrary to the law or to the general legal principles, they give specifics to such matters dealt with in a generic manner by the law.

For such reason, it seems proper to make the duties, obligations and scope of responsibility of the intermediaries also subject to the rules of the securities settlement or clearing systems.

Besides, such provision seems to be consistent with the context of implementation of the Convention rules.

From there results the provision of Article 21, when making express reference to such type of rule.

However, the wording of Article 21 and Article 22 maintains, though in brackets, a reference to a requirement that would qualify such local rules as to prevail over the Convention: provision “which is directed to the stability of the system or the finality of transactions effected through the system”.

Such expression gives excessive imprecision to the Convention rule, opening a chance for its content and scope to be submitted to judicial discussion (it would be possible to discuss, in the concrete cases, whether the clearing house rule – in apparent conflict with the Convention – that should be applicable would be effectively connected with the finality of stability of the system and settlement of the transactions in order to eliminate the applicability of the general rules of the Convention).

Besides, such provision seems unnecessary, if one reminds that its applicability should be consistent with the context of implementation of the Convention rules, which aim exactly at the stability of the systems of payment and settlement of transactions effected in the relevant negotiation environments.

Concerning the issue of scope of applicability of the rule of Article 21, in our opinion the rules of the securities settlement [or clearing] system should prevail over all provisions of the Convention whenever such provisions seem in conflict with such rules.

As it is known, in one manner or the other, the intermediated securities are closely related to the negotiation in organized systems, which have rules defined by the supervising authorities for settlement and clearing systems.

Such rules take into account the specificities of each of the systems and try to assure (i) their healthiness, through mitigation of risks to which its participants are subject, mainly the systemic risk, and (ii) their development, by the certainty of settlement and manner of constitution of guarantees.

Thus, the intermediated securities may not be dealt with in a manner segregated from the settlement and clearing systems, under penalty of, in any manner, harming such systems.

For such reason, all Convention rules (and not part of them) shall be subject to the settlement and clearing systems rules, whenever in conflict with them.

→ **Proposed Wording:**

Article 21

Overriding effect of certain rules of securities clearing or settlement systems

Any provision of the rules or agreements governing the operation of a securities clearing or settlement system shall, to the extent of any inconsistency, prevail over any provision of this convention."

If the rule of Article 21 is not be applicable regarding all provisions of the Convention, this fact would give rise for the need of an express reference to Article 4.5; Article 8.2; Article 9.2(c), Article 16.2, Article 17.3, Article 18, Article 20.1(b) and Article 22.1.

Finally, it should be emphasized that in order for the Convention to promote the harmonisation intended in Article 3 and in order to maintain consistency with its other Articles, including Article 21, it is important that the Convention makes use of definitions and institutes known and applicable in all jurisdictions, which cannot lead to different interpretations.

Accordingly, it is proposed:

1) to substitute the current wording of Article 16.2 (e), of Article 20.1 (b) and the Article 22.1, which mentions "the operator of", for a wording already acclaimed in several other provisions of the Convention, making such two provisions subject to the rules of the securities settlement [or clearing] systems.

→ **Proposed wording**

Article 16

[Instructions to the intermediary]

(...)

2. Paragraph 1 is subject to:

(...)

(e) the rules of a securities settlement [or clearing] system.

Article 20

[Loss sharing in case of insolvency of the intermediary]

(b) in accordance with the rules of a securities settlement [or clearing] system.

Article 22.1 - Any provision of the rules or agreements governing the operation of a securities settlement or clearing system shall have effect notwithstanding the commencement of an insolvency proceeding in respect of the system or any participant in the system in so far as that provision:

2) To amend Article 18, including an express reference to the securities settlement [or clearing] systems rules

→ **Proposed wording**

“Article 18

[Application of domestic non-Convention law and account agreement to obligations of intermediary]

The obligations and duties of an intermediary under this Convention and the extent of the liability of an intermediary are subject to any applicable provisions of the domestic non-Convention law and, to the extent permitted by that law, the account agreement, **and the rules of a securities settlement [or clearing] system.**



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After having analyzed the text of the Convention on Harmonised Substantive Rules Regarding Intermediated Securities, the Government of the Federative Republic of Brazil hereby offers the following comments:

Right to use

The right to use allows the collateral taker to use and dispose of assets received as collateral, as if in the capacity of owner. Such possibility will only exist when there is an express provision to such effect in a collateral agreement, providing for the limits to the exercise of such right.

Initially, we understand that such provision may have the effect of increasing the liquidity of the markets to the extent that it permits that the assets given as collateral be reused in other transactions by their collateral taker.

We also understand that a collateral taker, at least in transparent systems, may only exercise the right to use if it receives the assets in its account (Article 5.2 of the Convention). Accordingly, it is necessary to clarify the compatibility with Article 5.3, for the event of collateral created by means of a designating entry, without the effective delivery of the asset to the collateral taker's account. Could there be a right to use in such situation?

Furthermore, it is necessary to clarify whether there is any inconsistency between the provision that establishes the right to use and Article 9.3 of the Convention, which establishes the possibility of the domestic non-Convention law restricting the exercise of rights arising from the securities, pursuant to Article 9.1.