



**UNIDROIT COMMITTEE OF GOVERNMENTAL EXPERTS FOR
THE PREPARATION OF A DRAFT CONVENTION ON
SUBSTANTIVE RULES REGARDING INTERMEDIATED
SECURITIES
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REPORT

Introductory Matters

1. From 6 to 15 November 2006, 36 Member States, 1 non-Member State and 17 observers with a total of 127 delegates (cf. Appendix 3) convened in Rome for the second session of the UNIDROIT Committee of Governmental Experts for the Preparation draft Convention on Substantive Rules regarding Intermediated Securities (hereinafter the "Committee" or the "CGE"). The basic working documents were

- the Preliminary draft Convention on Substantive Rules regarding Intermediated Securities, as adopted by the Committee at its second session, held in Rome, on 6-14 March 2006 (UNIDROIT 2006 Study LXXVIII Doc. 42; hereinafter the "draft", the "draft text" or the "draft instrument");
- the Working paper regarding on so called "Transparent Systems", prepared by the UNIDROIT Secretariat on the basis of contributions submitted by Delegations to the CGE (UNIDROIT 2006, Study LCCVIII Doc. 44); and,
- comments on the draft instrument submitted by the Government of the United States of America (UNIDROIT 2006, Study LXXVIII Doc. 45); the Government of Germany (UNIDROIT 2006, Study LXXVIII Doc. 46); the International Swaps and Derivatives Association Inc. (UNIDROIT 2006, Study LXXVIII Doc. 47); CCP 12 Securities Clearing Houses' Association (UNIDROIT 2006, Study LXXVIII Doc. 48); the Government of Switzerland (UNIDROIT 2006, Study LXXVIII Doc. 49); the Government of Latvia (UNIDROIT 2006, Study LXXVIII Doc. 50); the Association of Global Custodians (UNIDROIT 2006, Study LXXVIII Doc. 51); the Government of the Russian Federation (UNIDROIT 2006, Study LXXVIII Doc. 52); the Government of the Republic of Korea (UNIDROIT 2006, Study LXXVIII Doc. 53); the Government of France (UNIDROIT 2006, Study LXXVIII Doc. 54); the Government of Poland ((UNIDROIT 2006, Study LXXVIII Doc. 55); the Government of the Federative Republic of Brazil (UNIDROIT 2006, Study LXXVIII Doc. 56[a-f]); and,
- various working and informal papers that were submitted during the session (cf. table in Appendix 1 and Appendices 4 to 17.

2. The Chairman of the Committee, Mr Hans Kuhn (Switzerland) opened the session at 10 a.m and welcomed all delegates. He expressed his satisfaction with respect to the great number of countries and organisations interested in carrying this project further and thanked all delegates personally for their remarkable dedication. He pointed out that, at the second session, the Committee had made considerable progress regarding the accommodation of different legal concepts and that readability had greatly improved. In his personal view, there was the possibility that the level of agreement on the draft would rise to a point where a Diplomatic Conference could be convened. He urged delegations to concentrate on resolving remaining fundamental issues as the discussion of last details could be left to the Diplomatic Conference. He underlined the importance of examining the specific situation of so called transparent systems.

3. The Secretary-General also welcomed delegates and observers on behalf of UNIDROIT from Romania, the Asia-Pacific CSD Group (ACG) and the International Organization of Securities Commissions (IOSCO) which had not participated before. Responding to a question from the Chairman, he elaborated on UNIDROIT's practice regarding the degree to which a draft had to be mature before being transmitted to a Diplomatic Conference.

4. The Secretary summarised the proposed draft agenda. He highlighted that it was basically shaped along the issues included in the comments submitted by Governments and observers before the session and generally followed a chronological order. Issues in connection with so called transparent systems (cf. Doc. 44) first emerged in the context of the definitions of "intermediary", "relevant intermediary" and "account holder" in Article 1 of the draft text but would certainly come up in various contexts. Moreover, he proposed to address the definition of "securities settlement [or clearing] system" briefly during the first day of the session and to continue discussion in an informal working group throughout the first week in order to present results to the Plenary by Friday, 10 November. On that basis, the Plenary adopted the draft agenda as set out in Appendix 2.

5. The CGE was reminded of the composition of the Drafting Committee, chaired by Mr Hideki Kanda (Japan), co-chaired by Mr Guy Morton (UK) and Mr Michel Deschamps (Canada), and including representatives from Belgium, Chile, France Germany, Luxemburg, a "Nordic" Country, Switzerland, the United States of America as well as any observer invited to attend by the Chairman of the Drafting Committee.

Consideration of the text of the preliminary draft Convention

General Statements

6. One delegation proposed that all provisions of the draft text be accompanied by a set of explanations which are developed by the CGE itself at the same time as the rules themselves, in order to avoid differing interpretation of the rules. Others were of the opinion that such effect would exactly be achieved by the explanatory notes that would be laid before the Diplomatic Conference and the official explanatory report which would accompany the future instrument.

Article 1(a) – "Securities"

7. The first issue was whether the definition should be an open one or rather refer to the domestic non-Convention law which could provide for a list of financial instruments regarded as securities (cf. Doc. 53§2-1). The Committee took the view that it should not be left to the domestic non-Convention law, as far the application of the future Convention was concerned. Such approach would contravene the uniform application of the future instrument and trigger the need for extensive due diligence procedures. Furthermore, an open definition would not disturb non-Convention law definitions for other purposes.

8. A related question was whether States were obliged, under the future Convention, to recognise as intermediated securities what had been credited to an account in a different country, i.e. the question of the law of which State decided the criterion stated in the last part of the definition (“capable of being credited to a securities account”) was met. Example: the first credit of a financial instrument, in country A, is unlawful because under the domestic law this financial instrument was not capable of being credited to a securities account. The assets were then transferred by credit and debit to a foreign jurisdiction, where the credit of such financial instrument to an account was possible. Some questioned whether the future Convention would be applicable to the credit and debit. Others were of the opinion that the instrument would clearly apply and that the matter could be subject to the rules on ineffectiveness and reversal (Article 8).

9. As regards the call for clarification with respect to certain derivative products, *cf.* Doc. 45(g), the Committee agreed that contracts with substantial obligations on both sides were excluded from the scope of the Convention because such contracts cannot be transferred through debits and credits to an account.

10. There was some support for including the criterion of transferability in the definition of securities. However, other delegations cautioned as “transferable” could be understood as “freely transferable” which would exclude certain types of securities from the scope of the future instrument. Furthermore, the definition contained in the Hague Securities Convention¹ did not contain such criterion – to the extent possible, definitions in the draft instrument should stay in line with the definitions used in the Hague Securities Convention.

11. On the issue that the definitions of “securities” and “account holder” were circular, a majority of delegations thought that this was true but that the rest of the draft text gave sufficient content to these “open ended” definitions which were unavoidable to a certain extent.

Article 1(f) – “intermediated securities”

12. The CGE considered the comments and proposals submitted in Documents 45(a); 46§1; 50 and 54 on the definition of “intermediated securities”. The issues were (a) whether the definition should be given any content that went beyond re-iterating Article 9 and (b) whether proposals that did so complied with the principle of functionality and neutrality. No agreement could be reached at this point. The Committee decided that informal consultations throughout the first week should prepare a common position of the interested delegations.

Article 1(e) – “account agreement”

13. The Committee did not elaborate on the drafting proposal contained in Doc. 54. The matter was deferred to the Drafting Committee.

Article 1(n) – “designating entry”

14. The CGE postponed the issue contained in Doc. 54 to the discussion on Article 5.

Article 1(c), (d), (g) – “intermediary”, “account holder”, “relevant intermediary” and so called transparent systems

15. The CGE stated that, from the logic of the draft instrument, the definitions of intermediary, account holder and relevant intermediary were unambiguous. However, it recognised the need for clarification of the role of entities which form part of certain holding systems, which were termed “transparent”. The issue had been identified earlier, and the Secretariat had, on the basis of submissions from various delegations, in between the second and the third session of the

¹ Convention of 5 July 2006 on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary, hereinafter “Hague Securities Convention”.

Committee, prepared a working paper on this issue (Doc. 44). The Secretary outlined the findings of the intersessional work as set out in Doc. 44.

16. The CGE concurred that there are at least three types of so called transparent systems (as set out on Doc. 44 fig.4). A fourth type, similar to e.g. the *CREST* system in England, should be equally included. There was equally agreement that, depending on the type of a given system, the necessary steps to accommodate it within the logic of the future Convention might differ considerably from the technique which is required to include other types.

17. There was no agreement as to the concrete steps to be taken with a view to accommodating transparent systems of one type or another within the draft instrument. In particular, there was strong opposition against breaking up some of the basic principles of the draft that build on the primacy of the relationship, for purposes of acquisition and disposition, between the account holder and its relevant intermediary. For example, as to the extent upper-tier attachment could be permitted under transparent systems, some delegations cautioned against allowing such exemptions except where absolutely necessary and provided that exemption did not create uncertainty. Others thought that it would be worth while to take the work of the Committee as an opportunity to rethink some concepts applied in transparent systems, in particular the possibility of upper-tier attachment. Some delegations were of the opinion that adapting the draft text to the idea of transparent systems without further conceptual safeguards could deprive the future instrument of much of its positive effect.

18. The Chairman concluded that an informal working group on transparent systems should present a comprehensive solution to the Plenary of Member States as early as possible. Particular emphasis had to be given to the different solutions that seemed to be necessary for different types of transparent systems. To this end, the Secretariat was tasked with organising the work of this informal group. Ms Marjut Jokela (alternate: Ms Marja Tuokila, both Finland) and Mr Juan Camilo Ramirez Ruiz (Colombia) kindly accepted to co-chair the intersessional work.

Article 1(c) - "Intermediary"

19. The Committee discussed whether the words "and is acting in this capacity" in the definition of "intermediary" should be deleted but came to the conclusion that they should stay for the time being. The Drafting Committee might give some further consideration to this point.

20. Furthermore, the Committee came to the conclusion that the domestic non-Convention law should not have impact on the applicability of the future Convention to intermediaries. Intermediaries should enter the scope of the future instrument as soon as they fell under the definition of Article 1(c) without any possibility of exemption by virtue of domestic non-Convention law.

Article 1(o) - "domestic non-Convention law"

21. One delegation raised the issue of multi-unit States in the context of Article 1(o). In a territorial unit of such State not only "the domestic provisions of the State" applied but possibly also the law of the federal State. Therefore, the formula "provisions in force in the State" would be preferable. Acknowledging that this was an issue for further consideration, the CGE decided to deal with it in the context of Article 2.

22. As regards the scope of the notion "domestic non-Convention law" the CGE felt that "domestic" was capable of limiting the intended meaning. Therefore, it should be deleted. Another question was whether *renvoi* provisions would be covered by the formula "non-Convention law". The CGE concluded that this was not the intention of the provision.

23. A third question was whether the formula included procedural rules. The Committee was of the opinion that this was the case.

Article 1(q) – “securities settlement [or clearing] system”

24. The Committee set up an *ad hoc* working group which was asked to develop solutions regarding (a) the definition of SSCS; (b) the mechanism for the designation of SSCS; (c) the extent and nature of exemptions from the provisions of the draft text granted to SSCS. Ms Joyce Hansen (United States) kindly accepted to chair this group with Mr Konstantinos Tomaras (European Commission) acting as Secretary to the group.

Article 1 – “Central Securities Depository” (proposed new definition)

25. The proposal to include, in Article 1, a definition of “Central Securities Depository” (*cf.* Doc. 54) was controversial, as many delegations thought that this would cause uncertainty regarding the logic of the relationships between the different parts of the holding chain. It was agreed that the reasoning behind this proposal, i.e. to exclude certain activities which were typically conducted by central securities depositories and which included making entries to accounts, could better be reflected in a separate Article. A definition of the term “Central Securities Depository” would not be needed for a functional solution of this issue.

Article 2 – Scope of application

26. The question was raised whether the future Convention would only apply to situations involving a cross-border element. The CGE agreed that this was not the case and that the sphere of application covered both purely domestic and cross border transactions. However, it agreed that the current drafting was capable of being misunderstood in this regard, *cf.* Doc. 52§2, and should be clarified.

27. The Committee agreed that the specific situation of multi-unit States needed to be reflected in the wording by replacing “the law of a Contracting State” by “the law in force in a Contracting State”.

28. The general reasoning behind the idea of a “corporate clause”, *cf.* Doc. 46§2 and Doc. 54, was supported by the Plenary. However, a general corporate clause as proposed in the comments did not appear to be appropriate as the distinction between “corporate” and “non-corporate” law was not necessarily clear. Furthermore, in some exceptional cases (*cf.* for example Article 13) the draft text was expressly intended to have influence on what was, at least in some jurisdictions, regarded as corporate law. Therefore, specific concerns as the example described in Doc. 46§2 needed to be dealt with on a case by case and article by article basis. The Chair asked the Drafting Committee to take this issue into account.

29. The CGE came to a similar result with respect to a parallel issue which was termed “regulatory clause”, as proposed earlier on the occasion of the second session of the Committee (*cf.* Doc. 43 Appendix 11). There was clear support for the idea to leave regulatory powers to the Contracting States. However, as far as regulatory powers operated within the scope of the future Convention, they should be limited to the framework set by the latter. This was in particular necessary as in many jurisdictions the “enforcement” of regulatory measures entails the nullity of the disposition in question. Therefore, a general regulatory clause as had been proposed at the occasion of the second session appeared to be too broad. Rather, an article by article examination of the text regarding the extent to which regulatory powers are limited would be necessary. The Chair asked the Drafting Committee to submit a proposal in this regard.

Article 3 – Principles of interpretation

30. The CGE discussed whether the future instrument should expressly set out the general principles it is based on, *cf.* Doc. 52§3 and Doc. 54. It agreed that there was a clear need for guidelines of interpretation which ensure the uniform application of the instrument. Therefore, the instrument would be accompanied by a set of general principles as it is practice in modern commercial law international treaties and which could be included in the preamble of the future Convention. An informal working group was set up with a view to developing a text proposal. Ms Alexandra Makowskaya (Russian Federation) and Ms Sharmini Mahendran (USA) kindly agreed to co-chair this exercise. Furthermore, the Chairman asked the Drafting Committee to bring the necessary changes to Article 3.

31. Additionally, explanatory material could briefly set out the aims of the provisions of the future text. However, this explanatory material could not be subject of future negotiations on the draft Convention. The delegations from France and the USA volunteered to develop such set of aims.

Proposed new Article 3bis – Applicability of Declarations

32. The Committee agreed with the proposal as set out in Doc. 48(b). However, the proposed Article should figure amongst the final clauses of the future Convention.

Chapter II

33. One delegation proposed to transfer the provision defining “intermediated securities”, Article 9, to precede the rules dealing with transactions, priorities, etc., Articles 4 to 8, as it was conceptually difficult to present rules to the reader of the text that dealt with transactions over intermediated securities without having said what intermediated securities actually were. Putting current Article 9 in front of what was currently Chapter II would in so far restore the original order of the draft. Although some other delegations were in favour of keeping the current order, the CGE decided to follow the proposal and change the order of the Articles. The Chairman instructed the Drafting Committee accordingly.

Article 4 Paragraph 1- Paragraph 3

34. There was substantial discussion on the notions of “credit”, “effective against third parties”, “ineffectiveness” and “reversal”.

35. One delegation proposed that “credit” should be defined in a way that made it possible for the non-Convention law to determine what a credit actually was. It should be possible for the non-Convention law to require additional elements that went beyond a pure scriptural act or electronic booking to an account. Others interpreted the rules of Article 4 as self-explaining without further need for clarification and not being open to additional requirements. A third group of delegations was of the opinion, that the “validity” (in the broadest possible meaning) was dealt with under Article 8 and therefore the question of what a “valid” credit was would be open to additional requirements by the non-Convention law.

36. A majority of delegations concurred with the view that the non-Convention law could require additional elements for a “valid” credit. However, the effectiveness *against third parties* depended on the credit alone and no additional requirements could be added (*cf.* Article 4 Paragraph 2). This was necessary to guarantee that innocent acquisition on the part of both the transferee and any onward transferee was possible.

37. The Committee came to the conclusion that some reformulating was necessary in order to clarify the delimitation between “effective against third parties” in Article and “effective”. The Drafting Committee was instructed to realign Article 4 with Article 8 Paragraph 2.

Article 4 Paragraph 4

38. The Committee discussed a proposal on clarification of Article 4 Paragraph 4 and its relocation to Article 8, *cf.* Doc. 45(c).

39. There was general agreement with the idea of restructuring the text along the lines of this proposal, though several delegations doubted that proposed paragraph 3bis(c) should be included. However, there was broad support for the protection of any onward transferee (currently Article 7 Paragraph 5) as a central element of this draft whereas the Plenary was still inconclusive regarding the more general effect of a credit without a corresponding debit, i.e whether there was an initial “something” between the intermediary and the account holder that could not be denied by the domestic non-Convention law, even if the credit could (in a second step) be ineffective or liable to be reversed under Article 8 Paragraph 2. The Chair decided that these issues would be discussed further in the context of Article 8.

Article 4 Paragraph 5

40. The Committee discussed a proposal regarding Article 4 Paragraph 5, *cf.* Doc. 56(b).

41. The Secretary recalled the discussion at the second session of the Committee. On that occasion, the CGE had come to the result that the only purpose of Article 4 Paragraph 5 was to allow book entries on an aggregate basis. That is, in case there were two or more transactions regarding the securities of the same description between an account holder and its intermediary during the same settlement cycle, only the net difference between all acquisitions and dispositions would be booked to the account. Article 4 Paragraph 5 was important to clarify that Article 4 Paragraph 1 and Paragraph 3 did not require every single transaction out of a multitude of transactions of securities of the same description be reflected by a separate scriptural act.

42. Some delegations thought that the concerns set out in Doc. 57(b) regarded rather the “validity” (in the broadest possible sense) of a contract and were therefore a matter to be dealt with in the context of Article 8.

43. The Chairman reminded that the concerns regarding clearing and settlement systems might be addressed in specific rules regarding such systems, which were still to be addressed by the Committee. For the time being, no changes would be made to Article 4 Paragraph 5.

Article 4 Paragraph 6

44. Several delegations wondered why there was a reference to the rules on priority included in Article 5 Paragraph 8 whereas such reference was missing in Article 4 Paragraph 6.

45. The Secretary explained that initially both provisions had exactly the same wording. However, during the second session of the CGE, the relationship between innocent acquisition and priorities had been clarified. According to this concept, there was room for innocent acquisition only in the context of acquisitions under Article 4, whereas the rules on priority applied exclusively to the creation of security interests under Article 5. A situation of two conflicting dispositions that would need to be resolved by a priority regime could, from a logical point of view, not occur. An asset that had been debited to an account could not be debited a second time because after the first debit, it simply figured no longer in the account of the transferor. Against this background, the reference to the priorities regime in the context of disposition was extraneous.

46. The Chair asked this to be included in the future explanatory notes.

Article 5

47. The Plenary discussed the proposal submitted in Doc. 45(c) regarding a simplification of the structure of Article 5. There was broad support for this proposal. Some uncertainty existed regarding the question which alternatives of “delivery” applied in case a Contracting State did not make a declaration under Article 5. The prevailing view was that one or more alternatives actually needed to be included in a declaration in order to be available under Article 5. The Chairman instructed the Drafting Committee to reshape Article 5 along the lines of the proposal contained in Doc. 45(c) taking into account this last aspect.

48. The Committee discussed the proposal submitted in Doc. 49(b). After detailed discussion, the Plenary was convinced that “limited interests” in intermediated securities should be included and enjoy equal status with acquisition and creation of security interests. However, it remained unclear by which means this result could be achieved. It was stressed that special consideration needed to be given to the phrasing under the functional approach and to whether the proposal could be included in current Article 6 or whether a free standing Article would enhance readability of the text. The Chairman asked the Drafting Committee to develop a proposal which would be laid before the Plenary before the end of the session.

49. The Plenary discussed a proposal aiming at re-inserting in the draft the concepts of positive and negative control in an express manner, similar to former draft Articles 1(m) and (n). The Chairman concluded that the Drafting Committee should look into the matter whether a Contracting State had an implicit choice in this regard when making declarations under Article 5 or whether both categories needed to be re-established in the draft.

50. The Plenary discussed a proposal aiming at defining “designating entry” by reference to the non-Convention law, in particular with a view to allowing the designating entry to be made not at the level of the relevant intermediary but at the level of the CSD. After discussion, the Chairman concluded that the issue that was the basis of this proposal would probably be covered by the rules contained in Article 8 Paragraph 2 and that neither Article 5 nor the definition of designating entry should be altered in this respect. He asked the Drafting Committee to examine to what extent the rationale underlying the proposal could be accommodated.

Article 6

51. The Committee discussed a proposal submitted in Doc. 52§2.3 regarding priorities between a title transfer security interest and other security interests. The prevailing view was that Paragraph 2 applied only to securities credited to the same account, i.e. the above described “conflict” would not be governed by the rules on priorities but by those on good-faith acquisition. The Chairman asked the Drafting Committee to consider slight changes to the wording in order to make this clearer whereas the structure as such should remain unchanged.

52. The Plenary discussed a proposal on the necessity of transition rules, submitted in Doc. 49. Several delegations agreed that it was difficult to say whether transition rules were to be included in the future Convention, or in the non-Convention law or whether and to what extent interconnecting rules in both the future Convention and the non-Convention law were appropriate. The Plenary agreed to look into this important matter before the Diplomatic Conference and proposed to undertake intersessional work in this regard. One delegation drew the Committee’s attention to the fact that there were precedents in recently adopted international instruments, in particular the 2001 Cape Town Convention, where transition rules had to be carefully considered. Mr Luc Thévenoz (Switzerland) kindly accepted to chair the effort of developing a first proposal for a set of transition rules.

53. The Plenary discussed a simplification of the structure of Article 6 along the lines suggested in Doc. 54. After a short discussion, this proposal was sent to the Drafting Committee for consideration.

54. The Plenary discussed a proposal to introduce a “purchase money security interest”, as submitted in Doc. 51. Some delegations pointed to the fact that this type of an “automatic super-priority interest” was already recognised by the draft in the context of the priority rules. Others added that the insertion of a uniform regime for the automatic creation of a security interest would heavily encroach upon policy decisions and should therefore be left to national legislators. Another delegation added that though the use of such a rule was generally recognised, its inclusion in the draft was unnecessary to achieve the aims of the future Convention. The Chairman concluded that the proposal would not be included.

Article 7

55. The Plenary discussed a proposal to delete Paragraphs 3 to 6, as submitted in Document 54. Other delegations disagreed with the substance of this proposal as Paragraphs 3 to 6 served important purposes. Two delegations however thought that the structure needed to be improved in order to achieve better readability. In particular, there was a close connection between the content of Paragraph 3 and Article 18 on the one hand, and on the other hand the content of Paragraphs 5, 6 and Article 8.

56. As regards the standard of “innocence” contained in Article 7 Paragraph 4, the proposal to shorten it considerably was dismissed. Most delegations considered this standard as widely compatible with domestic practice; furthermore, its formulation was capable of helping a more uniform interpretation of this rule.

Article 8

57. The discussion on Article 8 was centred on the issues identified earlier in the context of Article 4 (*cf. supra* and Doc. 45c). Article 8 Paragraph 1 seemed to be generally acceptable.

58. The principle stated in Article 8 Paragraphs 2 and 3, i.e. that most issues of “validity” should be left to the non-Convention law, seemed equally widely supported. The element that would consequently exclusively be addressed by the draft – and not be left to the non-Convention law – would be the protection of the innocent acquirer and the onward transferee. However, other delegations cautioned that extending the scope of Article 8 Paragraphs 2 and 3 to all aspects of validity would considerably water down the harmonising effect of the future Convention.

59. There was broad support for the principle to protect the onward transferee, as currently dealt with in Article 7 Paragraphs 5 and 6. However, several delegations insisted that these rules were far too complicated. There was only little support for the proposal to transfer the content of Article 7 Paragraphs 5 and 6 to Article 8 Paragraph 2.

60. On a different note, other Delegations drew the Committee’s attention to the confusion which might arise from the use of the terms “effective” in Article 8 Paragraph 1 and “effective against third parties” in Article 4 Paragraph 2. A different terminology would be needed, all the more since the French version of the text employed perfectly distinguishable terminology in this regard. The Committee agreed unanimously.

61. One delegation urged the Committee to re-introduce specific rules on so called “conditional credits”, stating that the legal effect of such credits was left to the non-Convention law, *cf. Doc. 46§4*. There was wide support for this view.

62. The Chair concluded that Article 8 Paragraph 1 would remain unchanged and that the wording of Paragraphs 2 and 3 should be revised. Furthermore, a specific reference to the legal effect of so called conditional credits should be re-introduced in the context of Article 8 Paragraph 2.

Article 9

63. The Committee supported the proposal on Article 9 Paragraph 1(d) as set out in Doc. 45(a) and Doc. 46 §5.

64. There was only little support to change the title along the lines of the proposal in Doc. 54.

65. The proposal to extend the wording of Paragraph 1(a) as set out in Doc. 46§5 was not supported.

Article 10

66. There were no observations on the substance of Article 10.

Article 11

67. There were no observations on the substance of Article 11.

Article 12

68. There was agreement on the proposal to refer in the title of this provision to the insolvency of an intermediary, *cf.* Doc. 52§5.

69. There were no observations on the substance of Article 12.

Article 13

70. One Delegation proposed to fundamentally reconsider the entire Article as it conferred voting rights upon intermediaries which was under many legal systems impossible. Others clarified that Paragraph 1 was absolutely neutral in this regard and did not address the question whether an intermediary should be permitted to vote on securities that are legally or economically attributed to its account holders.

71. However, most delegations agreed that Paragraph 2 in its current wording had such effect of establishing a voting right for entities that act in their own name but on behalf of others. There was clear opposition in so far as Contracting States would be obliged to enable investors to hold securities in this way. The drafting should make clear that this was not the case.

72. Others however stressed that the main purpose of the Article, which was to enable splitvoting where an entity holds in its own name for others, needed to be maintained. This Article did not change existing concepts, but ensured compatibility, since it made sure that systems where the intermediary had the right to exercise corporate rights were recognised by systems where this was impossible from a conceptual point of view. In other words, voting rights could be "extinguished" in the event an intermediary from a system which belonged to the first group if it was not allowed to exercise them in a system based on the direct link between investor and issuer. A vast majority supported this view.

73. One delegation wondered whether it was necessary to mention the concept of "nominee" in order to illustrate clearly the subject matter of Paragraph 2, *cf.* Doc. 50, Doc. 54. It would be sufficient to use the formula "a person acting in his own name on behalf of another person" without referring to a concept like "nominee" which was alien to many jurisdictions. Others agreed.

74. Another issue related to the potential encroachment upon aspects of corporate law, notably whether the rule of Paragraph 1 obliged issuers to make a securities issue eligible for holding through intermediaries. This was unacceptable in particular regarding family owned companies, partnerships or similar organisations where there were natural limits to the circle of holders. This concern was supported by the Plenary. Another such issue was the question whether Article 13 could alter the corporate law link between the issuer and the investor, notably in case of registered shares. Most delegations were of the opinion that this was not the case. It was stressed, however, that the drafting was not sufficiently clear on this point.

75. There was unanimity that the rules of Article 13 could not alter the framework regarding the exercise of rights flowing from the securities as set forth in Article 9. This needed to be clarified in the drafting.

76. The EU Commission had to reserve its position as the EU Directive on shareholders' voting rights was close to its finalisation but not yet adopted.

77. The Chairman concluded that the basic architecture of this Article should be maintained and the issues described above be addressed as pure drafting matters.

Article 14

78. One delegation proposed to delete the Article entirely, as it affected the relationship between issuer and investor which was clearly outside the scope of the future Convention, *cf.* Doc. 54. Several other delegations replied that this was not the case as the Article did not create a right to set-off but rather ensured that an existing one could be exercised. Furthermore, it created cross-border compatibility since it made sure that different concepts of holding did not affect a generally existing possibility to set off. Within systems where there was a direct link between issuer and investor the rule had probably no practical scope of application.

79. Another delegation proposed to extend the scope of Article 14, which was at present limited to the event of insolvency of the issuer, to other situations, e.g. the failure of the issuer to perform its obligations. Others cautioned that such an extension would encroach heavily on domestic corporate law and was not justified by the purposes of the future Convention. At any rate, the Convention would not preclude Contracting States from maintaining similar rules with a broader scope.

80. The Chair concluded that the Article would be maintained in its current form.

Article 15

81. There were no observations on the substance of Article 15.

Article 16

82. One delegation proposed to delete the Article entirely as it considered its substance mainly covered by Article 8, *cf.* Doc. 54. After a short discussion in the plenary, the proposal was withdrawn. The Chairman concluded that no changes to the substance of Article 16 were necessary.

Article 17

83. Two delegations proposed that the content of the square brackets within the first paragraph of Article 17 Paragraph 1 should be deleted. A qualification of the intermediary's duty to hold sufficient cover assets only for those securities credited to securities account holders would, in theory, mean that the intermediary could continue to credit more securities to itself than it actually held. It remained unclear what happened if the intermediary were to credit securities to accounts which it maintained for itself. Additionally, the words "at least" were pointless and could be deleted, *cf.* Doc. 46§6, Doc. 54. There was support from several delegations for these proposals.

84. The proposal to include a reference to central securities depositories in Paragraph 1, *cf.* Doc. 54, was withdrawn.

85. There was an intense discussion on the alternatives in square brackets in the second paragraph. Despite the fact that opinions were and remained divided on how quickly an imbalance should be removed by the intermediary, all delegations admitted that in practice the choice between “immediately”, “promptly” and similar words would not lead to a clear result as they were always and necessarily subject to interpretation. Furthermore, the time objectively necessary to eliminate the imbalance from a practical point of view depended very much on the concrete event, e.g. settlement cycles, the type of the asset and other factors. Therefore it was obvious that the draft Convention was not in a position to propose a meaningful solution. Rather, the issue should be left to the non-Convention law.

86. Similarly, a vast majority of Delegations supported the idea that Paragraph 3 should not only relate the cost of ensuring compliance with Paragraphs 1 and 2 but should include a complete referral of the issue to the domestic law, the rules of a securities settlement system or even the account agreement, to the extent permitted.

87. The Chairman concluded that in Paragraph 1 the words “at least” and “[for account holders]” would be deleted. Furthermore, he asked the Drafting Committee to align Paragraphs 2 and 3 with the principle that the methods of maintaining the balance in the sense of Paragraph 1 were entirely left to the non-Convention law.

Article 18

88. One delegation proposed to move the substance of Article 7 Paragraph 3 to Article 18. This proposal was widely supported as both dealt with liabilities of an intermediary and Article 7 Paragraph 3 was out of place.

89. The Chair of the *ad hoc* Working Group on Securities Settlement Systems (“SSS”) drew the attention of the Plenary to the fact that the outcome of the work of that group would include proposals regarding the obligations and liabilities of SSS which would probably best suited in the context of Article 18.

90. The Chairman concluded that the substance of Article 7 Paragraph 3 would be moved to Article 18 and that issues regarding the obligations and liabilities of SSS would be postponed to a later point in time.

Article 19

91. One delegation proposed to insert the words “for account holders other than itself” at the very end of Paragraph 1 in order to highlight the rationale behind this article. There was broad support for this proposal.

92. The EU Commission drew the attention of the CGE to the fact that the EU Directive on *Markets in Financial Instruments* (“MiFID”) imposed segregation for client assets. This was an important policy choice with a view to protecting account holders. Therefore, also Paragraph 1 should make explicit reference to segregation. Additionally, the importance of segregation could be highlighted in the future preamble of the instrument. Other delegations, although recognising the importance of segregation and concurring with the rationale behind this proposal, disagreed since it had been decided during earlier sessions of the Committee that the details of how to allocate securities to account holders should be left to national policy. Segregation was only one out of several techniques to achieve the purpose of Article 19. Other systems, in particular those that are based on a property concept, did not need segregation for the protection of the account holders from a conceptual perspective. However, the future Convention would in no way limit the EU or any Contracting State to impose segregation. In order to give some prominence to the technique of

segregation, the text of the instrument could highlight it as one suitable alternative measure to effect allocation in the sense of Paragraph 1.

93. Another delegation pointed to the fact that the current wording of Paragraph 2 took a position on an issue which should be better left to national policy: the inclusion of the word “unsecured” in Paragraph 2 precluded the national rules under which assets allocated to account holders were available to neither unsecured nor secured creditors of the intermediary. The delegation was of the opinion that, for the purposes of the future Convention, it was unnecessary to take a position on this issue in the text. Many delegations shared this concern, others were in favour of maintaining the current wording.

94. One observer raised the concern that the drafting of Paragraph 4 could be understood as cancelling the rule of Paragraph 1 and that it seemed pointless to a wide extent and should therefore be revisited. Other delegation acknowledged that the drafting was not sufficiently clear but insisted on basically maintaining the substance of Paragraph 4. The rationale behind this rule was to recognise that Contracting States have a choice regarding whether assets which are clearly segregated as the relevant intermediary’s own holdings with another intermediary would be available to the general creditors of the relevant intermediary or to its account holders.

95. Another observer pointed to a segregation scenario which was not dealt with by Article 19 but needed to be included: in some systems it was possible to segregate assets with a higher tier in the sense that (a) the relevant intermediary’s assets were kept separate from its clients’ assets and, additionally (b) there were assets belonging to specific account holders which were equally separated from both other categories (“full segregation”). In case such full segregation applied it needed to be recognised in the allocation of securities amongst account holders. Other delegations agreed.

96. The Chair concluded that (a) the principle of the current draft not to encroach upon policy decisions regarding segregation would remain unchanged; (b) there was no support for highlighting the principle of segregation in the future preamble, however, however it could be mentioned as one of several alternatives in Article 19; (c) Article 19 Paragraph 2 raised ambiguities regarding the inclusion of the work “unsecured”, and that the Drafting Committee was asked to prepare a proposal in this regard; (d) the drafting of Art. 19 Paragraph 4 should be made clearer.

Excursus: Preamble

97. Ms Sharmini Mahendran (USA) who had chaired, together with Ms Alexandra Makowskaya (Russian Federation), an effort to produce a first proposal for a future preamble to the instrument introduced a draft text to the Plenary, *cf.* Appendix 10. The Committee endorsed this proposal and the Chairman decided to forward this proposal to the future Diplomatic Conference as a working basis.

Excursus: Specific rules on SS[C]S

98. The SS[C]S Working Group, which had met under the Chairmanship of Ms Joyce Hansen (USA), with Mr Konstantinos Tomaras (European Commission) acting as Secretary, presented its findings in WP 9, *cf.* Appendix 8. The Group’s proposal included clarifications regarding (a) the definition of SS[C]S (b) the provisions in the draft text where an exemption for SS[C]S might be needed; (c) whether the deferral to arrangements made under the account agreement, which appears in various places of the draft text, should regularly be paralleled by a deferral to the rules of an SS[C]S; and, (d) the identification of any other provision which might be relevant in relation to SS[C]S. The Chairman and various delegations thanked the Working Group for its work and expressed their general support for the main thoughts of the Working Group as expressed in the working paper.

99. Regarding the definition of SSS, the findings were basically as follows (*cf.* WP 9 section 2)
- The fundamental proposal was to distinguish, first, a definition of *securities settlement systems* (“SSS”) and, second, a definition of *central counter party clearing systems* (“CCPCS”).
 - The Group proposed further to base both definitions on the feature of “system” instead of “entity”.
 - The Members of the Group had agreed that, in order to benefit from the exemption from the rules of the future Convention, the rules of SSS and CCPCS should be uniform for its participants or classes of participants. Two delegations raised a question regarding different types of arrangements that apply to SSS, notably uniform rules on the one hand and individual arrangements on the other hand. There was uncertainty why the exemptions for SSS should not only apply to the former but also to the latter. Other delegations replied that SSS which are based on private arrangements between service provider and settlement client were outside the scope of this discussions. The SSS relevant in the present context were providers of standard settlement services to a greater number of clients. Other commentators questioned further whether private rules that were agreed upon in addition to uniform rules would benefit from the exemption from the rules of the future Convention.
 - Regarding the criterion of public oversight, the Group regarded appropriate the formula “operated by one or more central banks or subject to regulation, supervision or oversight in respect of its rules”,
 - Regarding the notification, the Group proposed it to be based on the ground of the reduction of risk to the stability of the financial system. A declaration in this regard should be made by the Contracting State whose law governed the rules of the system. One delegation raised the question of which authority would be competent for receiving declarations under the future Convention. Though admitting that this question was for a future Diplomatic Conference to decide, there was the general feeling that the depositary of the Convention could at the same time be responsible regarding the declarations. Others noted that the role of the competent authority might go well beyond receiving and publicising declarations, as an additional benefit of the declaration mechanism could only materialise in case the authority had the relevant expertise to assess the content of declaration.
 - Regarding the proposed definition of CCPCS, one delegation raised the question whether the clear reference to central counter parties was intended to exclude clearing systems that did not operate under a central counter party mechanism. Others were of the opinion that in fact the definition should only cover clearing mechanisms functioning as central counter party. A third Group of commentators was of the opinion that the present text should not attempt to define central counter party, given the great variety of operational and legal arrangements applied in such systems.
100. Furthermore, the Working Group had examined whether references to rules of an SSS which were currently included in the draft text were actually justified (*cf.* WP 9 section 3). The references to Articles 8(2), 16(2)(e), 17(3) and 20(1)(b) were endorsed. Article 21 should be deleted entirely in order to follow the proposed article-by-article approach. However, Article 22 was considered helpful and important; therefore it should be retained subject to adapting the drafting.
101. As a next step, the Working Group had looked into the issue whether deferrals, in the draft text, to the non-domestic Convention law should regularly be paralleled by a deferral to the rules of an SSS (*cf.* WP 9 section 4), following which Articles 1(n) and 9(1)(c) should clearly contain such reference, and Articles 18 and 7(3), (5) should be examined further in this regard.
102. The assessment regarding the inclusion of deferrals to the rules of SSS was completed by a test whether any other provision of the draft Convention should contain such deferral (*cf.* WP 9 section 5). The Working Group did not make a concrete proposal but highlighted this issue for further discussion with respect to Article 4(5) of the draft text.

103. With respect to a deferral to the rules of a CCPCS, the Working Group proposed to include such deferral only in Articles 7(3) and 22(1)(b) of the draft text.

104. The Chairman noted a great support for the Working Paper and asked the Drafting Committee to address the issue of SSS and CCPCS following the proposals contained in the Working Paper.

Article 20

105. With respect to Article 20, one Delegation (*cf.* Doc. 46§7) insisted that under specific circumstances the *pro rata* rule should not apply. Therefore, the derogation contained in Article 20 Paragraph 2 should be retained while removing the square brackets. As an alternative, another delegation proposed to make Paragraph 3 clearer with respect to the primacy of domestic law regarding loss sharing. Others were not sure which solution would be preferable. One delegation cautioned against the rule contained in Paragraph 3: the operations of an intermediary could be subject to more than one insolvency law; this could lead to a situation where the protection intended by Article 20 was not ensured. Another delegation questioned altogether whether Article 20 was useful or not.

106. It was proposed to include an element of timing in Article 20 Paragraph 1, in the sense that it should be made clear that the point of reference for the determination of the basis of the loss sharing was the commencement of the insolvency proceedings. However, there was concern that this could interfere unnecessarily with basic concepts of domestic insolvency law in this respect.

107. One delegation drew the attention of the Plenary to the fact that under the current wording, in case of insolvency, even fully segregated holdings would be included in the basis of the *pro rata* sharing. Hence, there should be the possibility for Contracting States to declare that under the non-Convention law such segregated accounts do not participate in the *pro rata* sharing. Another delegation advocated that clients whose holdings are held in a fully segregated form should be satisfied first in any event.

108. Several delegations proposed to regroup all articles dealing with insolvency issues together in one place in the text, in order to make their interaction with each other clearer.

109. The Chairman concluded that the proposal to include an element of timing in Paragraph 1 of Article 20 was not supported. As regards the bracketed language in Paragraph 2, he summarised that the prevailing view was to delete the language in the first set of brackets, provided that Paragraph 3 was maintained. Furthermore, the Drafting Committee should look into the possibility of regrouping provisions dealing with insolvency. On the treatment of segregated accounts, he saw clear support that the issue should be reflected in the wording but deferred to the Drafting Committee for details.

Article 21

110. The Plenary decided to delete Article 21, following the proposal by the SS[C]S Working Group.

Article 22

111. The Plenary sent Article 22 to the drafting Committee, together with the recommendations given by the SS[C]S Working Group (*cf.* WP 9 section 3-f).

Chapter V – General comments

112. The EU Commission expressed its strong support for this chapter as it was vital to the global financial market. EU countries were already familiar with its content since it basically reflected the relevant EU legislation.

113. The Plenary agreed with a proposal to concentrate all definitions that were specific to Chapter V in one place, notably Article 23 Paragraph 2, in order to streamline the text.

Article 23

114. Commenting on Article 23 Paragraph 2(a), one delegation suggested to include a clear reference to default as triggering enforcement. Other delegations agreed. The Chairman referred this issue as a drafting matter to the Drafting Committee.

Article 24

115. One delegation made the remark that the conceptual relationship between enforcement measures included in Paragraph 1 and the possibility of operating a close out netting provision following Paragraph 3 was not clear. In particular, the present drafting did not reveal whether Paragraph 2 related only to Paragraph 1 or equally to Paragraph 3. Others agreed.

116. On a similar note, there was the proposal to extend the scope of application of the rule currently included in Article 24 Paragraph 2 to the entire chapter since as it stood it related exclusively to Article 24. Several delegations agreed.

117. The Chairman referred both issues as drafting matters to the Drafting Committee.

Article 25

118. One delegation proposed to delete the language in brackets in Article 25 Paragraph 1. Several delegations supported that proposal. The Chair concluded that, in Paragraph 1, the language contained in the brackets would be deleted.

119. With respect to Paragraph 2, the suggestion was made to either delete the language between square brackets or maintain it and make it subject to an opt-out provision, *cf.* Doc. 46§10. There was some discussion on this point but no conclusion could be reached. The Chairman postponed the decision until a later point in time.

120. Equally on Paragraph 2, a proposal had been submitted in Doc. 46§9, notably to replace the words "securities of the same issuer or debtor, forming part of the same issue or class and of the same nominal amount, currency and description" by the definition of "securities of the same description" (Article 1 *lit.* (I)). Others agreed in principle felt that "securities of the same description" would not express adequately the reasoning of this rule and preferred as a solution "equivalent collateral" which would then refer to "securities of the same description". The Chairman referred this matter as a drafting point to the Drafting Committee.

Article 26

121. One observer raised the issue that the language contained in the square brackets in Alternative (a) might trigger the obligation to deliver additional collateral in the event of a deterioration of the credit rating of the collateral provider. Since in this unspecified form this part of the rule was unacceptable, an opt-out relating to this element should be included. There was some support for this position. Other delegations stated that they would rather stick to the wording as it stood, that the brackets should be deleted while keeping the language; to this group of delegations, an opt-out seemed unreasonable. One delegation suggested keeping the wording while narrowing its application by adding objective criteria. The delegations agreed to consult informally and to postpone a decision.

Article 27

122. There were no remarks on the substance of Article 27. No decision was taken in respect of the proposal contained in Doc. 46§11.

Proposal for a new Chapter VI

123. An observer introduced to the Plenary the proposal to include in the draft a new separate Chapter VI, *cf.* Doc. 47. Two delegations expressed their support, other delegations expressed their general sympathy towards the proposal.

124. The proposed new Chapter VI contained two main features: (a) the recognition, by Contracting States, of so called title transfer collateral arrangements and, (b) the general recognition, by Contracting States, of so called close-out netting arrangements. The Plenary discussed whether both elements were linked in substance in a way which required *pari passu* insertion of both of them. There was broad agreement that this was not the case and that the question of whether and by which means they should be included could be discussed separately for both elements.

125. As regards the insertion of the first element of the proposal – recognition of title transfer collateral arrangements – there was agreement that this aspect alone would not require a separate new chapter since it could be dealt with in Chapter V. Some delegations expressed the opinion that important parts of a regime regarding title transfer collateral arrangements were even already inherent in Chapter V since Article 23 Paragraph 1 made express reference to Article 5 Paragraph 2; consequently, the substantive changes with regard to title transfer collateral arrangements brought by the proposal would be limited. Others agreed in principle but stressed that enforcement methods for title transfer collateral might differ from enforcement of security which does not entail full transfer of ownership; as the distinction between both types of collateral was not clearly made in Chapter V, there was a risk of false analogy regarding the enforcement methods. Most Delegations agreed with this point. Some stressed that, provided that a clear distinction between both types of collateral agreement were to be adopted, Article 25 and possibly others needed to be adapted in order to reflect the different legal concepts of both types, e.g., that a right of use is always inherent in a title transfer collateral arrangement and therefore Article 25 made only sense with respect to non-title transfer arrangements. In the end, there was a broad basis amongst delegation for the insertion of express provisions on title transfer collateral arrangements in the draft text.

126. As regards the inclusion of new rules introducing a regime regarding close-out netting, proposed Article 31 of Doc. 47, the Committee recognised that Article 24 Paragraph 3 already provided for some rules regarding this technique. However, their function was solely to protect such mechanism in connection with a collateral agreement, whereas the proposed rule would introduce a free standing and general introduction of close-out netting in Contracting States. Many delegations cautioned against going any further than what was already included in the draft at present. Although close-out netting was regarded an important instrument in modern financial markets, its conceptual realisation in the different jurisdictions caused considerable difficulties to some countries. The commentators feared that the finalisation of the draft text would be retarded as any going further in the direction of general recognition of close-out netting would require extensive consultations at the national level. Consequently, there was no sufficient support for dealing with close-out netting provisions in the future Convention.

127. The Chairman concluded that title transfer collateral arrangements should be given a clearer profile in Chapter V. This should be done by expressly elaborating on this technique as an alternative to security interests which do not entail a transfer of full ownership. The Drafting Committee was instructed to equally examine whether this entailed changes to any other provision

of Chapter V, as for example Article 25. Close-out netting, however, would not be dealt with in this Convention to an extent which went beyond current Article 24 Paragraph 3. Consequently, the creation of a new Chapter VI, as proposed in Doc. 47, was not required.

Excursus: Specific functions of CSDs

128. The Finnish Delegation presented, in the name of 19 Delegations and 2 Observers, a proposal regarding the special function of CSDs, *cf.* Appendix 7. Several Delegations endorsed the importance of a specific rule in this regards. There was some concern that too wide a rule would exclude parts of the holding chain in so called transparent systems. There was however broad consensus that “issuer facing” functions should be excluded from the application of the future Convention. On this basis, the Chairman asked the Drafting Committee to consider the proposal and identify the best location within the draft text to include it.

First report of the Drafting Committee on Chapters I-IV

129. The Chairman invited the Chairman of the Drafting Committee to present the amended draft text to the Plenary. The Chairman of the Drafting Committee stressed that the Drafting Committee considered the text only from Article 1 to Article 21 and that he was not sure whether there was sufficient instruction from the Plenary regarding Article 22. Second, the Drafting Committee, on the basis of the deliberations, had tried to re-order the sequence of articles. However, to avoid confusion and facilitate discussion for the time being, the original numbers had been kept². However, the order as presented to the Plenary was already the proposed new structure.

130. On the definitions in Article 1:

(a) *securities*: the words "or any interest therein" had been deleted; instead, "and or being acquired and disposed of in accordance with the provisions of this Convention" had been added. This was done in order to reflect the discussion in the Plenary on exchange-traded futures as well as swap transactions and other OTC derivatives, which were not securities for the purpose of the future Convention. On the additional point, raised in Doc. 53, notably whether the Contracting State might designate categories of securities that fell within the scope of the future Convention, the Drafting Committee had decided to do nothing but it recommended instead to refer the matter to the future explanatory report.

(New b) *intermediated securities*: the content was not yet changed but the Drafting Committee considered it important to move the most important definition of the future Convention to the top of the list.

(New f) *account agreement*: this change was motivated by linguistic considerations.

(Former h) *disposition*: the definition had been deleted as the term was only rarely used.

(Former i) *adverse claim*: the Drafting Committee had reached the tentative conclusion that a definition was helpful but that, rather than locating it in Article 1, it should be spelled out in the relevant Article what was meant.

(New k) *control agreement*: the word "collateral taker" had been changed to "another person" in order to broaden the scope and descriptions of both alternatives of control – positive and negative – (i) and (ii) – had been re-inserted from a previous draft.

(New l) *designating entry*: similar changes had been made to this definition for the same purposes.

(New m) *domestic non-Convention law*: had been changed to “non-Convention law” in order to reflect the fact that also the law of a different jurisdiction might apply due to the applicable conflict of laws rules; additionally, the new formula “in force in the State” reflected the specific situation of multi-unit States.

² Note of the Secretariat: the numbering of articles in this part of the report still refers to the numbering as in Doc. 42, but new references of Articles appear in this Report between brace brackets: {}.

(*New n*) *securities settlement system*: minor changes were made to this definition following the work of the SSS Working Group and the decisions taken in the Plenary.

(*Former p*) *non-consensual security interest*: had been deleted as unnecessary.

(*new o*) [*central counterparty*] [*securities*] *clearing system*: the Drafting Committee followed the proposals by the SSS Working Group. However, it thought that these two alternatives should be proposed to the Plenary, as the suggestion had been made not to use the words "central counterparty" but rather "securities clearing system". However, this decision was beyond the powers of the Drafting Committee. The Drafting Committee thought it justified to add in sub-paragraph (i) the words "clears but does not settle".

(*new p*) *uniform rules*: this definition referred to rules, on the basis of the report of the SSS Working Group, that are permitted to depart from the default rules of the future Convention, therefore a definition was needed.

131. On Article 2 the Chairman of the Drafting Committee reported that the title had been changed in order to better reflect the character of the rule, which was however only necessary in the English version of the draft text. The rule itself had been amended following the proposals by the Secretariat of the Hague Conference on Private International Law and the deliberations of the Plenary.

132. In Article 3 {new Article 4}, Paragraphs 1 and 2 had been collapsed.

133. The order of Chapters II and III had been switched in order to make the draft text more readable ("intermediated securities" being the most important notion in the draft), as discussed in the Plenary.

134. In substance, the very few changes which had been made to Article 9 {new Article 5} were due to the new concept of acquisition/disposition and granting of an interest to the proposals of the SSS Working Group. The small changes in Paragraph 1d) "including rights and interests in securities" reflected the discussions in the Plenary.

135. On Article 4 {new Article 7}, the Chairman of the Drafting Committee reported that its title now clearly stated "by debit and credit" to make clear that Article 4 {new Article 7} provided for the method of acquisition and disposition. Furthermore, a clear caveat regarding issues of "validity" etc. was included in Paragraphs 1 and 3. The new Paragraph 4 corresponded to former Article 5 Paragraph 2. The wording of Paragraph 5 had not been changed despite some suggestions for amendments. The issues raised in the Plenary should be better dealt with in the future explanatory notes. The substance of former Paragraph 6 had been moved to a separate Article.

136. Further, he explained that the title of Article 5 {new Article 8} had been modified with a view to reflecting its new content. Also the structure of Article 5 {new Article 8} had been revised to take account of its expansion to "interests", i.e. to the fact that in its new shape it covered not only security interests but also other interests. In substance, there were no changes though the Drafting Committee considerably straightened the wording. The word "delivery" had been removed for lack of neutrality. Paragraphs 5b) and 8 were moved to separate articles.

137. The insertion of a separate Article on "non-Convention methods", Article 5*bis* {new Article 9} appeared useful because it allowed, in the future, a simple reference to "Article 4 and 5 rights" as opposed to "Article 5*bis* rights". The insertion entailed no change as regards substance.

138. With respect to Article 8 {new Article 11}, the Chairman of the Drafting Committee explained that in the English title "invalidity" had been chosen to replace "ineffectiveness". As regards the "perfection" or "*opposabilité*", the original notion of "effectiveness against third parties", and in the French text "*opposabilité*" would be kept. Paragraph 1a) needed to be adjusted

to the new structure of Articles 4 and 5 {new Articles 7 and 8}. Paragraph 2 had been significantly amended. This was due to the incorporation of, first, the new concept regarding SSS and, second, an express rule regarding conditional credits, which had triggered a restructuring of Paragraphs 2 and 3.

139. The Chairman of the Drafting Committee drew the attention of the Plenary to a set of diagrams he had prepared in order to better illustrate the conceptual changes.

140. Diagrams 1 and 2 related to the legal effect of acquisition (leaving out for a moment creation of security interests). Traditionally, especially in civil law countries, such “property law transactions” required various factual and/or legal elements. E.g. debit and credit to an account, plus other factual and/or legal elements, in particular a valid underlying agreement. Only the cumulative existence of those factual and/or legal elements produced a legal effect. However, this was not the concept followed by the present draft text since in modern securities transactions debit and credit became the by far most important elements of a transaction. The draft text fundamentally changed the analysis by attributing immediate legal effect to debit and credit without requiring the existence of further elements, e.g. a valid underlying contract. This was important for the stability of the financial system. The legal effect could be challenged only in a second step, under the rules of Article 8 {new Article 11} (although there were exceptions where a debit had from the outset no effect).

141. Diagram 3 illustrated the logic of Article 8 {new Article 11} with respect to a credit entry. Under Article 8 {new Article 11}, a credit entry might be invalid from the outset or even if it was valid it might be reversible. This was entirely determined by the non-Convention law (*cf.* Article 8 Paragraph 2(a) and (b)). However, in order to guarantee stability of the financial system, some legal effect with a view to protecting third parties had to be harmonised: this was the function of the innocent purchaser rule of Article 7 {new Article 12} and consequently, Article 8 Paragraph 2 had to be made subject to this rule.

142. Diagram 4 related to the analogous issue regarding a debit or designating entry. Here, there were three scenarios: it was unauthorised and therefore invalid from the outset (Article 8 Paragraph 1 {new Article 11}); even if it was authorised, it might be invalid for other reasons (Paragraph 2(a)); and even though it was valid, it might be reversible for other reasons (Paragraph 2(b)).

143. Diagrams 5 and 6 dealt with the relationship between Articles 4 and 5 {new Articles 7 and 8} which had undergone a considerable structural change during this session of the CGE. The concept of the old draft was depicted in diagram 5: Article 4 {new Article 7} covered debit and credit transactions, whereas Article 5 {new Article 8} provided for the complete “laundry list” of different types of collateral transactions. Therefore, a collateral transaction on the basis of a credit entry fell within both Article 4 and Article 5 (*cf.* old Article 5 Paragraph 2). In addition, non-Convention methods were also recognised in Articles 4 and 5 {new Articles 7 and 8}.

144. Having introduced limited interests in securities other than security interests, this concept had become unsuitable. The new concept was illustrated in diagram 6: from now on, Articles 4 and 5 {new Articles 7 and 8} did not overlap any more. Article 4 {new Article 7} dealt with debit and credit transactions, whereas Article 5 {new Article 8} addressed non-debit and credit transactions. Article 5 {new Article 8} did not provide for a list of security collateral transactions but for a list that covered methods of granting a collateral interest or any other limited interest, as for example a usufruct. The future Convention would not attempt to characterise any of the interests created under Articles 4 or 5 {new Articles 7 and 8}, it rather provided the “factual” methods for creating them. Consequently, under the new scheme, collateral interests could be created using either the

methods of Article 4 {new Article 7} or the methods of Article 5 {new Article 8}. Non-Convention methods were eliminated from Articles 4 and 5 and put in the new Article 5*bis* {new Article 9}.

145. Moving on to diagram 7, the Chairman of the Drafting Committee took so called repurchase transactions as an example: it did not matter for the application of Articles 4 or 5 {new Articles 7 and 8} whether, under the agreement, the full ownership was to be transferred as Articles 4 and 5 {new Articles 7 and 8} did not characterise the type of transactions which fall within their scope. The line between Articles 4 and 5 {new Articles 7 and 8} transactions was not the line between full interests and limited interests. Article 4 {new Article 7} covered both full and limited, and Article 5 {new Article 8} as well. Though, in his view, there was an important difference: conflicts regarding transactions under Article 4 {new Article 7} gave rise to the implications of the innocent purchaser rule (Article 7 {new Article 12}), whereas conflicts relating to Article 5 {new Article 8} transactions triggered the application of the rules on priority (Article 6 {new Article 13}).

146. Diagram 8 depicted the relation between Articles 7 and 8 {new Articles 12 and 11}. The new draft brought no change in substance with respect to the former draft. What remained harmonised was exclusively the legal effects on the side of the acquirer of intermediated securities: that was the bona fide purchaser rule, Article 7 {new Article 12}. In the example, in case of a defective transaction, A's side was not harmonised, and the non-Convention law determined invalidity or reversal, including all legal consequences. However, B's side would be harmonised under the rules of the future Convention, as B was an innocent purchaser. For those jurisdictions that required matching debit and credit entries, as B was protected as innocent purchaser, A had to be the loser. In other jurisdictions there might be no possibility to identify the loser but this question, once again, was not covered by the draft instrument but rather determined by the non-Convention law.

147. Diagram 9 related to the phenomenon of the so called "onward transferee". The revised version of the draft dealt with this issue in Article 7 {new Article 12} Paragraph 2 (former Paragraph 5). In the event of two transactions, one from A to B and then from B to C, the question was what happened if the credit entry to B's account was invalid or reversible, e.g. because it was not matched with a debit in a jurisdiction which required matching debit and credit entries. In this scenario, a harmonised rule should protect C under condition that he was innocent.

148. In detail, Article 7 {new Article 12} Paragraph 1 contained the general innocent purchaser rule, the substance did not change. Paragraph 2 protected the onward transferee. Its substance remained the same with respect to the old Article 7 {new Article 12} Paragraph 5, the introduction of the notion of "defective entry" was for drafting purposes only. The former Paragraph 3 about protection and immunity of an intermediary had been moved to Article 18 {new Article 20} Paragraph 2. Paragraph 4 now contained all definitions specific to Article 7 {new Article 12}, notably "defective entry" and "knowledge". As said before, the Drafting Committee had decided to eliminate the notion of "adverse claim" as this was capable of being misunderstood. The square brackets around Paragraph 5 would probably be removed.

149. Article 6 {new Article 13} had been streamlined as regards its structure and the title had been adapted to the new concept of Article 5 {new Article 8}. No change had been made with respect to the question whether collateral interests that are granted on the basis of a book entry were covered by Article 6 {new Article 13} or not. The draft used to be silent on this question and was still silent. Consequently, non-Convention law applied to this issue. Paragraph 2 applied the first-in-time rule to interest granted under Article 5 {new Article 8}.

150. The Chairman of the Drafting Committee proposed to comment on new Article 14 in conjunction with Article 19 {new Article 21} Paragraph 2.

151. No changes had been made to the substance of Articles 11 and 12 {new Articles 15 and 16}. With respect to Article 12 {new Article 16}, he noted that one delegation had expressed the need for more clarity regarding the questions whose insolvency was at issue here. The Drafting Committee was not sure whether this issue was capable of being resolved in the text but considered it worth being dealt with in the future explanatory report.

152. No changes had been made to Article 15 {new Article 17} and only minor adjustments to Article 16 {new Article 18}.

153. In Article 17 {new Article 19} Paragraph 1 the Drafting Committee had removed the word "at least" and the square brackets including text as well as the footnote, according to the instructions from the Plenary. Regarding the square brackets in Paragraph 2 the Drafting Committee had been tasked with submitting a proposal: it removed both alternatives and instead inserted "within the time required by the non-Convention law" and "as is necessary". As regards Paragraph 3, only minor changes had been made.

154. Some small adjustments had been made to Article 18 {new Article 20} Paragraph 1, in particular the work "duties" had been removed in the English text. Paragraph 2 related to the protection of intermediaries and their immunity. Previously it was Paragraph 3 of Article 7 {new Article 12}. As regards old Article 7 {new Article 12}, Paragraph 3 was at the basis of it. Proposals by the US delegation and the SSS Working Group had been incorporated. The Drafting Committee had not been in a position to reach a conclusion on the issues within square brackets.

155. Article 18*bis* {new Article 3} corresponded to the proposal made in W.P. 6 regarding central securities depositories (*cf. Appendix 7*). For the time being, as there was not yet enough time to discuss, the Drafting Committee had put it into square brackets.

156. As regards Article 19 {new Article 21}, there had been agreement in the Plenary that the future Convention was not to require a particular segregation scheme but to remain neutral on this issue. Therefore, the notion of segregation was only used in Paragraph 4. As regards the relationship with the insolvency context, Article 19 {new Article 21} remained silent, i.e. allocation applied inside and outside the insolvency scenario (whereas, in contrast, Article 20 {new Article 22} relates specifically to the insolvency of the intermediary). The title had been shortened and Paragraphs 1 and 3 slightly changed. The amendment of Paragraph 2 had proved relatively complicated as it had been impossible to simply remove the word "unsecured". Instead, the rule is now subject to new Article 14. There was also a new Paragraph 4 which referred to the technique of segregation without requiring it. Paragraph 5 was former Paragraph 5 which had been streamlined for better readability.

157. Article 20 {new Article 22} had been restructured with a view to improving readability. Former Paragraph 3 became new Paragraph 1. There was now in Paragraph 2 a clear reference to Article 19 {new Article 21}. Furthermore, Paragraph 2 now combined old Paragraphs 1 and 2 and was therefore the central loss-sharing rule. The new Paragraph 3 was a result of the proposals of the SSS Working Group.

158. Article 21 had been deleted as a result of the work of the SSS Working Group. Article 22 {new Article 23} had been streamlined though there had been no discussion on its substance in the Plenary.

159. A new separate Chapter now embraced Articles 13 and 14 {new Articles 24 and 25}. The Drafting Committee did not amend Article 14 {new Article 25}. Issues raised in the Plenary should be included in the future explanatory report), although Article 13 {new Article 24} underwent considerable changes. In its Paragraph 1, a specific reference to Article 9 {new Article 5} was

added. Furthermore, the last sentence was deleted. In Paragraph 2, the reference to the legal concept of nominee was deleted by the Drafting Committee, however the future explanatory report should give further explanation in this regard. New Paragraph 3 flowed directly from the discussion on a “corporate clause”, as the Drafting Committee had been requested to examine on an article-by-article basis where an explicit rule ensuring protection of national corporate law was necessary.

160. The Chairman of the Drafting Committee came back to the set of diagrams. Diagram 10 related to the concept of Article 9 {new Article 5} and illustrated its neutrality vis-à-vis both the direct and indirect system, with respect to the rights of the account holder. In the direct system, like France, Germany, Japan, the shareholder is only the account holder at the bottom of the chain (“ultimate account holder”), whereas an intermediary was under no circumstances a shareholder. The ultimate account holder could exercise his shareholder rights against the issuer, i.e. voting, receiving dividends, etc. directly. In other jurisdictions, corporate rights should be recognised to the ultimate investor through intermediaries. This was indirect exercise of corporate rights. Article 9 {new Article 5} had to recognise both systems.

161. Diagram 11 depicted the relation between Articles 13 and 9 {new Articles 24 and 21} . In the event that the issuer kept a shareholder record, in common law countries (typically) the CSD or CSD's nominee is recorded as the shareholder, not the “bottom person” A, whereas in civil law countries, the “bottom person” or “ultimate investor” is registered. With respect to a transfer of the assets from A to B, Article 9 {new Article 5} basically said that the bottom person (now B) had to be recognised as the recipient of the fruits of the ownership that was to say either that B could exercise its rights to vote and to receive dividends directly or indirectly. This did not mean, however, that the issuer had to recognise B as a shareholder before B was not recorded in the shareholders register, *cf.* Article 13 {new Article 24} Paragraph 3, as this was a typical corporate law matter which this Convention should not encroach upon. This goal was difficult to achieve as soon as a nominee had to be fitted in: in those civil law jurisdictions, where only the bottom person A or B could be the shareholder, “a person acting in his own name on behalf of another person” had to be recognised only at this level under Article 13 {new Article 24} Paragraph 2. There was no obligation to recognise such person at the intermediary level. This was why the word “person” was used instead of “intermediary”.

162. Diagram 12 depicted the context of Articles 19 {new Article 21} Paragraph 2 and 14. The intermediary used the assets of the account holder, without the consent of the latter, for a pledge to its own creditor, the collateral taker. In the event of the insolvency of the intermediary, a race between the account holder and the collateral taker would get underway. The account holder and the collateral taker would both claim precedence. The latter would point out that he had a perfected security interest under Article 5 {new Article 8}. The former rule in Article 19 {new Article 21} Paragraph 2 did not include the right of this collateral taker, because it made reference to “unsecured” creditors. This had now been removed and the draft takes no position on who would prevail in this situation. That was why the Drafting Committee proposed Article 14, which basically said that the race between an account holder and a collateral taker in such a case was to be delegated to non-Convention law. There might be room for some harmonisation which went further but for the time being this was what the Drafting Committee could do on the basis of the instructions of the Plenary.

163. The Chairman of the Committee expressed his gratitude to the Chairman of the Drafting Committee for this excellent presentation and for the great job which the Drafting Committee had done.

Consideration of the proposed amendments

164. Several delegations noted that the Drafting Committee had managed to streamline the text so that it was more readable and easier accessible now.

165. Several delegations noted that the wording of Article 18 {new Article 20} Paragraph 2 did not reflect precisely the discussion in the Plenary. Members of the Drafting Committee agreed that this was in fact the case as they had found during the discussion in the Drafting Committee additional difficulties which they had tried to accommodate in the text. The drafting of Article 18 {new Article 20} Paragraph 2 would, in any event raise difficult policy decisions: investor protection, avoidance of systemic risk and market efficiency opposed each other. For example, a wide immunity for the intermediary would raise concerns regarding investor protection. However, it was also clear that not all intermediaries were systemically important so that they did not necessarily deserve a high degree of immunity. As a good harmonised rule was probably impossible to draft, the matter should be left to the non-Convention law. Delegations agreed that the Drafting Committee should reconsider the amendment.

166. One delegation raised queries with respect to the new concept under Articles 4 and 5 {new Articles 7 and 8}. Under which Article would for example a traditional pledge be dealt with where possession was given to the security taker but the ownership remained with the security provider. Another delegation replied that a pledge could, depending on the details, either enter Article 4 {new Article 7} or Article 5 {new Article 8}, as the legal characterisation was irrelevant to the classification; what counted was exclusively whether a book entry was made (Article 4) or not (Article 5).

167. Another commentator felt that the inclusion of clearing systems in Article 22 {new Article 23} was incorrect as far as the rule referred to the making of book entries to securities accounts, as clearing organisations were not involved in debiting and crediting of securities accounts. Others agreed.

168. The same delegation expressed its hesitance towards Article 13 {new Article 24} Paragraph 2: it might be still unclear to what extent issuers had to recognise nominees. Others shared this concern.

169. One delegation found the delimitation between security collateral interests and other limited interests unclear. Others replied that the draft text did not attempt to characterise any transaction but that the inclusion of limited interests amongst the legal effects that can be obtained by employing one of the methods included in Article 5 {new Article 8} or Article 5*bis* guaranteed absolute neutrality: any kind of interest could be created, the future Convention would just provide a range of methods to achieve this result.

170. One delegation congratulated the Drafting Committee on its work but still felt that the great majority of rules contained in the draft applied to non-transparent systems exclusively. The approach chosen did mostly not work for transparent systems. In order to enhance predictability also with respect to the legal effect of cross-border transactions involving a transparent system, the instrument needed some further thought on how these systems could be included.

171. Another delegation wondered whether the rule on evidential requirements, Article 5 {new Article 8} (Paragraph 5b) should not apply to both Article 4 {new Article 7} and Article 5 {new Article 8}.

172. The Chairman concluded the discussion in order to give more time to the Drafting Committee to finish its work.

Second report of the Drafting Committee

173. The Chairman of the Drafting Committee introduced his second report by drawing the attention of the Plenary to the amended draft text in the English and French languages, W.P. DC 5 (*cf.* Appendix 14).

174. Article 1(j)(ii) had been changed having in mind the situation of several subsequent issues of, e.g., bonds which however were regarded under corporate law as belonging to one single issue. Article 1(k) and (l) had been made consistent with each other. In the definition of SSS, Article 1(n)(i), the words "or clears and settles" had been introduced in order to cover a situation where an SSS had a clearing function as well as settlement functions; in this event, the clearing function had to be equally covered. In the definition of securities clearing system, Article 1(o), a broader language had been adopted and the square brackets had been taken out. In order to make sure that this system could include central counterparty mechanisms, the words "through a central counterparty or otherwise" had been added. Finally, the definitions q), r) and s) of Article 1 had been moved to Chapter V.

175. New Article 3 corresponded to former Article 18*bis*. The square brackets had been removed, no other changes had been brought to the substance.

176. In Article 4 {new Article 7}, the title had been changed to "acquisition and disposition by debit and credit".

177. The structure of Article 5 {new Article 8} had been changed on the basis of an intervention during the discussion of the previous version of the draft. Only the content of subparagraph a) was retained here. Subparagraph b) had been transformed in a separate Article 5*ter* which now applied to both Articles 4 and 5 {new Articles 7 and 8}. In Article 5*bis*{new Article 9} the words "and or for making such an interest effective against third parties" had been added for purposes of clarity.

178. In Article 8 {new Article 11} Paragraph 2 the reference to Article 6 {new Article 13} had been put in square brackets, as the Drafting Committee had not been entirely sure whether such reference would be needed at all. In Article 7 {new Article 12}, the Drafting Committee had added the words "or of the account agreement" at the end of Paragraph 5.

179. In Article 14, the words "and interests granted by that intermediary" had been added which did not entail any change in substance.

180. Article 18 {new Article 20} had been redrafted on the basis of the concerns raised in the Plenary, including its title. There were three main changes with Paragraph 1 remaining unchanged: (A) motivated by the discussion in the Plenary, the square brackets around "securities settlement system" had been removed and instead square brackets had been set around the word "intermediary"; (B) a new Paragraph 3 had been added, dealing with the liability of the intermediary in case Paragraph 2 applied. The situation addressed in Article 18 {new Article 20} Paragraph 2 did not cover the scenario where the intermediary was liable to the account holder but rather spoke of the relationship between the intermediary and third parties. It addressed for example the issue of what happened if third parties sued the intermediary; (C) Paragraph 4 was equally added and provided for a special reference to securities settlement systems and in particular securities clearing systems.

181. Three amendments had been made to Article 22 {new Article 23}: (A) Paragraph 1 *lit.* (a) and (b) had been switched and, from now on, for securities clearing systems only *lit.* (a) is relevant; (B) in what was now *lit.*(b), in the last line, the English text had used the word "final" which had been changed to "irrevocable" following a suggestion from the Plenary; (C) a small change had been made to Paragraph 2 for purposes of clear drafting only.

182. Article 13 {new Article 24} Paragraph 2 had been amended following a proposal from the Plenary: it had been made clear that the person acted in his own name on behalf of one person or more than one person. Further, addressing concerns raised from the perspective of applicable corporate law, the Drafting Committee included a new sentence in Paragraph 2 saying "but this Convention does not determine the conditions under which such a person is authorised to exercise such rights". Lastly, Paragraph 3 had been amended, against the background that the former version, which had attempted to refer specifically to the situation of registered shares, had remained unclear. The new language was broader and not capable of being misunderstood.

183. A very minor drafting change had been brought to Article 14 {new Article 25}.

184. On Chapter V, the Chairman of the Drafting Committee reported that all definitions had been regrouped. In conformity with the European Collateral Directive, the Drafting Committee had decided to use the word "full ownership" in Article 23 {new Article 26} Paragraph 2(b) and (c). *Lit.* (d) introduced the notion of "relevant obligations" for what had been "secured obligations" before. The latter did not fit any more since the Chapter now equally covered title transfer. *Lit.* (h) now included a suggestion from the Plenary.

185. Article 27 was entirely based on the proposed Article 26 {new Article 31} in Document 47.

186. The Drafting Committee made several changes to Article 24 {new Article 28}: in order to include, as agreed by the Plenary, title transfer collateral arrangements, many changes to the drafting had been necessary, in particular to include close-out netting arrangements in title transfer transactions. In the opinion of the Drafting Committee, the current text was compatible with the EU Collateral Directive.

187. In Article 25 {new Article 29} Paragraph 1 the sentence within the brackets had been deleted. Paragraph 2 had undergone some technical changes entailed by the insertion of title transfer collateral arrangements. The square brackets had been maintained since the Drafting Committee had not been sufficiently instructed on this point.

188. New Article 26 was based on the proposed Article 23 of Document 47. The Drafting Committee had felt that this provision should be set out in a separate article.

189. The amendment of Article 26 {new Article 31} had been substantial and complicated. The Drafting Committee had tried to accommodate the views expressed by delegations. The text in square brackets had been deleted and replaced by an objective criterion in Paragraph 1a)ii) – "as determined by reference to objective criteria relating to the creditworthiness" – without mentioning specific rating. New Paragraph 2 now expressly permitted opt-out from Paragraph 1a)ii).

190. The Drafting Committee had decided to create a provisional Chapter VI on final clauses in order to keep track of the discussions and decisions of the Plenary; however, this was, at the moment, only a fragment.

191. The Chairman of the Drafting Committee asked the Swiss Delegation to comment specifically on the French draft text, where necessary. The Swiss Delegation explained that a terminological issue regarding the word "*garantie*" had been solved. Throughout the text this word was used in a more general sense. In Chapter V, however, the distinction between "*garantie avec constitution d'une sûreté*" and "*garanties avec transfert de propriété*" had been introduced. However, the wording in Article 23 {new Article 26} Paragraph 1 needed not to be aligned as it had differed from the English version and had been already correct.

192. The Swiss delegation also explained that, concerning the declaration that a Contracting State can make under Article 26 {new Article 31}, if Paragraph 2 of the French text was reflecting the English version and corresponded to the Committee's intention, Paragraph 1 of this Article had to be shortened.

193. The Chairman expressed again his admiration for the Drafting Committees work and thanked all its members and the Secretariat for spending long nights over the text. He opened the floor for comments.

194. All Speakers expressed their satisfaction with the progress which had been made during this session and thanked the Drafting Committee for the good work. One delegation stressed that the final clauses had still to be drafted and that there might be the need for reconsidering the declaration mechanism.

195. The Chairman noted broad agreement with the text of the preliminary draft Convention.

Future work

196. He turned to the issue of future work and the question whether the draft should be transmitted to a Diplomatic Conference immediately or whether a fourth session of this Committee would be needed.

197. Three delegations expressed their hope that, at a fourth session of the CGE, the issue of how to include transparent systems would be resolved.

198. The EU Commission congratulated the CGE for its achievements so far. It recalled that the EU was currently undertaking a similar initiative and its Member States' discussions were, at this time, not sufficiently advanced. This situation made it difficult to take any definitive views on the UNIDROIT draft text. Therefore, a fourth session would be welcome with a view to permitting the EU Member States to refine their position on both projects and to guarantee the success of both projects. However, the EU Commission would urge the CGE, in case a fourth session should be held, to immediately set a timeframe for the holding of the Diplomatic Conference in order to avoid any slowing down of the overall process.

199. Several other delegations expressed their support for a fourth session. Others were of the opinion that the draft text could be transferred to the Diplomatic Conference immediately but confirmed that they would not oppose a fourth session of this committee in the event other delegations deemed it necessary for the success of the work.

200. The Swiss delegation took note of the excellent progress of the work and informed the CGE that Switzerland was actively considering hosting the Diplomatic Conference in Geneva, Switzerland.

201. The Chairman thanked all commentators and concluded that a fourth session should be held. The prospective dates would be communicated shortly.

202. The delegation of Columbia, at the request of the Chairman, outlined the future intersessional work of the Working Group on Transparent Systems. An invitation to participate and a working document would be sent to all interested delegations shortly.

Conclusion

203. Delegations expressed their satisfaction with the session and thanked the Chairman and the UNIDROIT Secretariat.

204. The Chairman requested the Secretariat to organise a fourth session of this Committee in early 2007 and concluded the session.

**LIST OF DISTRIBUTED DOCUMENTS
AND INDEX OF ANNEXES**

References: UNIDROIT Study LXXVIII (not reproduced in this report; available on <http://www.unidroit.org/english/workprogramme/study078/item1/main.htm>)

- Doc. 42, Preliminary draft Convention on substantive rules regarding intermediated securities as adopted by the Committee of Governmental Experts at its second session, Rome, March 2006
- Doc. 43, Report on the second session of the UNIDROIT Committee of governmental experts for the preparation of a draft Convention on substantive rules regarding intermediated securities, Rome, May 2006
- Doc. 44, Working paper on special provisions regarding so called "Transparent Systems", (prepared by the Secretariat), Rome, October 2006
- Doc. 45 [a, b, c, d. rev., e, f, g and h], Comments by the Government of the United States of America, Rome, October 2006
- Doc. 46, Comments by the Government of Germany, Rome, October 2006
- Doc. 47, Comments by the International Swaps and Derivatives Association, Inc. – ISDA, Rome, October 2006
- Doc. 48, Comments by the CCP12, Rome, October 2006
- Doc. 49 and Doc. 49 b), Comments by the Government of Switzerland, Rome, October 2006
- Doc. 50, Comments by the Government of the Republic of Latvia, Rome, October 2006
- Doc. 51, Comments by the Association of Global Custodians - AGC, Rome, October 2006
- Doc. 52, Comments by the Government of the Russian Federation, Rome, October 2006
- Doc. 53, Comments by the Government of the Republic of Korea, Rome, October 2006
- Doc. 54, Comments by the Government of France, Rome, October 2006
- Doc. 55, Comments by the Government of Poland, Rome, November 2006
- Doc. 56 [a-f], Comments by the Government of the Federative Republic of Brazil, Rome, November 2006

References: CGE/Securities/3

- W.P.1, *Agenda* (reproduced as [Appendix 2](#))
- W.P.2, *Proposal on Article 2 – Scope of Application*, submitted by the Hague Conference of Private International Law (reproduced as [Appendix 4](#))
- W.P.3, *Daily Report*, Plenary session, 6 November 2006 (not reproduced)
- W.P.4, *Proposal on Article [X], Neutrality of Convention with respect to characterization of intermediated*, submitted by the Government of the United Kingdom (reproduced as [Appendix 5](#))
- W.P.5, *Comment on article 8(3bis) as proposed in document 45 c) and discussed in the plenary session*, submitted by the government of the united kingdom (reproduced as [Appendix 6](#))

- W.P.6, *Comments on the preliminary draft Convention on harmonised substantive rules regarding intermediated securities*, submitted by Belgium, Czech Republic, Denmark, Germany, Greece, Spain, France, Italy, Latvia, Hungary, Luxembourg, Malta, the Netherlands, Austria, Poland, Portugal, Finland, Sweden, United Kingdom, the European Commission and the European Central Bank (reproduced as [Appendix 7](#))
- W.P.7, *Daily Report*, Plenary session, 7 November 2006 (not reproduced)
- W.P.8, *Daily Report*, Plenary session, 8 November 2006 (not reproduced)
- W.P.9, *Report of the SS[C]S Working Group* (reproduced as [Appendix 8](#))
- W.P.10, *Comments on the preliminary draft Convention on harmonised substantive rules regarding intermediated securities*, submitted by the International Swaps & Derivatives Association, Inc., ISDA (reproduced as [Appendix 9](#))
- W.P.11 rev., *Proposal on the Preamble of the preliminary draft Convention on substantive rules regarding intermediated securities*, submitted by the Government of the United States of America (reproduced as [Appendix 10](#))
- DC/W.P.1, *Drafting Proposals for consideration by the Drafting Committee*, submitted by the Government of the United States (reproduced as [Appendix 11](#)) (English only)
- DC/W.P.2, *Drafting Proposals for consideration by the Drafting Committee*, Governments of France, Germany and United States (reproduced as [Appendix 12](#))
- DC/W.P.3, *Text of the preliminary draft Convention*, submitted by the Drafting Committee (not reproduced)
- DC/W.P.4, *Proposal on Article 1*, submitted by the Government of the United States of America (not reproduced as [Appendix 13](#)) (English only)
- DC/W.P.5, *Text of the preliminary draft Convention*, submitted by the Drafting Committee (reproduced as [Appendix 14](#), now edited by the Secretariat and released as Doc. 57)
- INF. 1, *List of participants* (reproduced as [Appendix 3](#))
- INF. 2, *FAO facilities* (not reproduced)
- INF. 3, *Comments submitted by Zentraler Kreditausschuss* (reproduced as [Appendix 15](#)) (English only)
- INF. 4, *Comments submitted by the Singapore Exchange* (reproduced as [Appendix 16](#)) (English only)
- INF. 5, *Comments on the preliminary draft Convention on harmonised substantive rules regarding intermediated securities*, submitted by the Federative Republic of Brazil (not reproduced, now Doc. 56[a-f])
- INF. 6, *Presentation of diagrams*, prepared by the Chairman of the Drafting Committee (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.

PROVISIONAL DRAFT AGENDA (rev. 2)
(prepared by the Secretariat)

Monday, 6 November

- 8:30 a.m. Registration at FAO; Security-Badges
- 10 a.m. *Morning Session (Plenary)*
Opening Address
Adoption of the agenda
Organisation of work
Report on inter-sessional work
- 11 a.m. Consideration of the text of the preliminary draft Convention
- General statements
 - Article 1 – Definitions*
(*as far as not discussed in the context of the relevant Articles)
 - "Securities"¹; *cf.* in particular Doc. 45(g); Doc. 50 p. 2; Doc. 53 §II-1; Doc. 54.
 - "Securities account"; *cf.* in particular Doc. 52 §1.
 - "Intermediated securities"²; *cf.* in particular Doc. 45(a); Doc. 46 §1; Doc. 50 p. 2; Doc. 54.
 - "Account agreement"; *cf.* in particular Doc. 54.
 - "Designating entry"; *cf.* in particular Doc. 54.
- 2 p.m. *Afternoon session*
- "intermediary"³, "relevant intermediary" and "account holder" , including the issue of so called transparent systems; *cf.* in particular Doc. 44.
 - "domestic non-Convention law"⁴
 - "securities settlement [or clearing] system"; outline of the parameters and set up of a Working Group; *cf.* in particular Doc. 45(h); Doc. 48; Doc. 54 on Art. 1q and Art. 21.
 - Proposed new definitions⁵
 - "Central Securities Depository", entailing change of the definition of account holder; *cf.* Doc. 54 Art. 1(u).

¹ We should not spent too much time.

² U.S. proposal [Doc. 45(a)] based on meeting in Paris and Berlin for a new wording (= plain reference to Art. U.S. proposal basically developed in Paris 9) supported by Gemany in their comments [cf. Doc. 46§1] and by the Secretariat. France tables different proposal [cf. Doc. 54].

³ Several points:

- ♣ Is there a proposal from the Swiss delegation re. non-applicability of the convention to accounts maintained by intermediaries for themselves?
- ♣ U.S proposal for clarification for the drafting committee (no material changes intended). Where is this proposal?

⁴ US proposal for clarification (DC paper)

⁵ U.S.: „Defective Transaction“ context Article 7, cf. US paper for DC.

6 p.m. *Evening session*
(Proposed informal working group on the definition of securities settlement [or clearing] systems)

Tuesday, 7 November

9:30 a.m.

Morning session (Plenary)

- Article 2
 - Exclude corporate law; *cf.* in particular Doc. 46 §2; Doc. 54.
 - Purely internal situations; *cf.* in particular Doc. 52 §2.
- Article 3 “General principles”; *cf.* in particular Doc. 52 §3; Doc. 54.
- New Article 3*bis*; *cf.* in particular Doc. 45(b).
- General mechanisms of Chapter II (Art. 4-8)
- Article 4
 - Deletion of Para. 4; *cf.* in particular Doc. 45(c).

2 p.m.

Afternoon session

- Article 5
 - Simplification; *cf.* in particular Doc. 45(d)rev.⁶; Doc. 54.
 - Scope: limited interests other than security interests; *cf.* in particular Doc. 49(b).
- Article 6⁷
 - Rank of security interest acquired under Art. 5(2); *cf.* in particular Doc. 53 §II-3.
 - Transition rules; *cf.* in particular Doc. 49.
 - Purchase money security interest; *cf.* in particular Doc. 51.
 - Structure; *cf.* in particular Doc. 54.

7 p.m.

Reception at the Residence of the Ambassador of Finland, Mr Pauli Mäkelä, organised in cooperation with the Finnish Central Securities Depository (on invitation).

Wednesday, 8 November

9:30 a.m.

Morning session

- Article 7⁸; *cf.* in particular Doc. 45(e); Doc. 46 §3.
 - Relationship to Art. 8(2)
 - Para. 2 - gratuitous grant; *cf.* in particular Doc. 52 §4-1; Doc. 53 §II-2.
 - Para. 3 - Immunity of Intermediaries (proposed new para. 7*bis*) ; *cf.* in particular Doc. 45(e), or deletion of the paragraph.
 - Para. 4 – standard of innocence; *cf.* in particular Doc. 52 §4-3; Doc. 53 II-2.

⁶ U.S. proposal: little change intended, *cf.* explanation at the end of doc.

⁷ Hideki Kanda: Relationship between Art. 6 and Art. 7: Others believes that this could directly go to the drafting committee as the plenary had agreed that the effect could be left to the DNCL.

⁸ Hideki Kanda will propose to change “adverse claim” into “competing claim”. Furthermore, he thinks the question of “registered securities”, where traditionally good faith rules are not applied, could be discussed.

- Para. 3⁹ to 6 - proposed deletion; *cf.* in particular Doc. 54.

- Article 8; *cf.* in particular Doc. 45(c); Doc. 46 §4; Doc. 54.

2 p.m.

Afternoon session

- General mechanisms of Chapter III (Art. 9-14)
- Article 9
 - Alignment with “intermediated securities”; *cf.* in particular Doc. 45(a); Doc. 46 §5.
 - Change of title, etc.; *cf.* in particular Doc. 54.
- Article 10
- Article 11

Thursday, 9 November

9:30 a.m.

Morning session

- Article 12 – title; *cf.* in particular Doc. 52 §5.
- Article 13
 - Para. 2 – “nominee” etc.; *cf.* in particular Doc. 50; Doc. 54.
- Article 14
 - Extension of scope; *cf.* in particular Doc. 52 §6.
 - Deletion of Article; *cf.* in particular Doc. 54.

2 p.m.

Afternoon session

- General mechanisms of Chapter IV (Art. 15-22) ; *cf.* in particular Doc. 54.
- New Article on CSDs ; *cf.* in particular Doc. 54.
- Article 15 - exemptions; *cf.* in particular Doc. 44.
- Article 16 – deletion of Article; *cf.* in particular Doc. 54.
- Article 17 – text in square brackets; *cf.* in particular Doc. 46 §6; Doc. 54.

7 p.m.

Reception at the Villa Medici – Academy of France in Rome (on invitation)

Friday, 10 November

9:30 a.m.

Morning session

- Article 18
- Article 19
- Report of the proposed informal working group on securities settlement [or clearing] systems

2 p.m.

Afternoon session

- Article 20
 - Para. 1 – pro rata; *cf.* in particular Doc. 46 §7.
 - Para. 1(b) – DNCL; *cf.* in particular Doc. 54.
 - Para. 2 - wording; *cf.* in particular Doc. 45(f).
- Article 21 – rules directed to system stability; *cf.* in particular Doc. 54.
- Article 22

⁹ Relationship with para. 1 (Hideki Kanda)? Could para. 1 be collapsed with para. 5 into one single rule regarding “anti-reversal”?

Saturday, 11 November*No plenary session***Sunday, 12 November***No plenary session***Monday, 13 November**

9:30 a.m.

Morning session

- Chapter V
- Article 23
 - Title transfer collateral; *cf.* in particular Doc. 47; Doc. 42 §152 *et seq.*
- Article 24 – “collateral securities”; *cf.* in particular Doc. 46 §8.
- Article 25 – use of “of the same description”; *cf.* in particular Doc. 46 §9.
- Article 26; *cf.* in particular Doc. 46 §10.
- Article 27
 - Para. 2 – removal or limitation to consumer; *cf.* in particular Doc. 46 §11.
- Proposed new Chapter VI on title transfer collateral agreements and close-out netting; *cf.* Doc. 47 incl. Appendix.

2 p.m.

Afternoon session

- First report of the Drafting Committee on Chapters I-IV
- Consideration of the proposed amendments

Tuesday, 14 November

9:30 a.m.

Morning session

- Discussion of provisions left out so far or provisions that need to be revisited

2 p.m.

Afternoon session

- ... continued

Wednesday, 15 November

9:30 a.m.

Morning session

- Second Report of the Drafting Committee
- Consideration of the proposed amendments
- Future work and adoption of the amended preliminary draft Convention

2 p.m.

Closing

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PROPOSAL

(submitted by the Hague Conference on Private International Law)

Article 2 – Scope of application

This Convention applies where:

- (i) the conflict of laws rules of the forum designate the law in force in a Contracting State as the applicable law, or
- (ii) the case does not involve a choice in favour of any law other than the law in force in the forum and the forum is a Contracting State.

PROPOSAL

(submitted by the Government of the United Kingdom)

Article [X]

Neutrality of Convention with respect to characterization of intermediated securities

The domestic non-Convention law determines –

- (a) whether an account holder to whose securities account intermediated securities are credited holds securities or a right or interest in securities; and
- (b) if the account holder holds a right or interest in securities, the nature of that right or interest.

**COMMENTS BY GOVERNMENTS
AND INTERNATIONAL ORGANISATIONS**

(submitted by the Government of the United Kingdom)

**Comment on Article 8(3bis) as proposed in Document 45 c) and discussed in the
Plenary session**

The key question in relation to the discussion on Art. 8(3bis) arises in the situation where –

- a) the immediate recipient of a credit that is defective because of the absence of a matching debit is an intermediary; and
- b) a credit, or subsequent credit, is made in the system operated by that intermediary.

In other words, in Example 2 in the diagram overleaf, must system A, and the law of Country A which is applicable in Country A, treat a good faith purchaser in System B as a good faith purchaser, thereby validating the original defective credit in System A?

If Country A is required to give special protection to X or Y (or both), this will create major uncertainty in System A, because Intermediary A will not know which of two apparently identical defective credits is reversible unless it can identify whether the recipient of the initial defective credit is an intermediary. Uncertainty of this kind may be regarded as unacceptable as a matter of legal policy in Country A and/or as a matter of operational risk in System A.

If, on the other hand, reversal of the defective entry against the initial recipient is permitted (i.e. if reversal/invalidity is left purely to the domestic non-Convention law), the risk is transferred to System B: Intermediary B takes the risk that it may act on a credit made by Intermediary A which turns out to be defective, in circumstances where Intermediary B is unable to eliminate the risk in its own system. For example, Intermediary B will be obliged, under the law of Country B, to recognise the interest of Y because of the bona fide purchaser rule (Art 7(5)) under the law of Country B.

There is therefore a choice between uncertainty/risk in System A and uncertainty/risk in System B.

Is it acceptable to throw the risk on to System B? Arguably yes, because Intermediary B is better able to assess the risk (e.g. by investigation of the law of Country A and the integrity of the procedures of Intermediary A at the time when it opens its account with Intermediary A) and to mitigate it through the rules of its system (e.g. as to apportionment of loss) than System A.

**COMMENTS BY GOVERNMENTS
AND INTERNATIONAL ORGANISATIONS**

(submitted by Belgium, Czech Republic, Denmark, Germany, Greece, Spain, France, Italy, Latvia, Hungary, Luxembourg, Malta, the Netherlands, Austria, Poland, Portugal, Finland, Sweden, United Kingdom, the European Commission and the European Central Bank)

It seems sensible to ensure that the Convention has no adverse impact on the crucial role played by Central Securities Depositories and other persons in establishing the issue in book-entry form of securities and in ensuring the integrity of the issue during its existence.

It is therefore proposed to include in the Convention a provision that puts it beyond doubt that these activities of CSDs (acting in that capacity) are outside the scope of the Convention, a draft of which is set out below, and which is suggested for inclusion within Article 21 (or elsewhere within the Convention).

The proposed provision uses the phrase “central securities depositories” without suggesting any definition for it. This usage without definition also appears, in a different context, in the Hague Securities Convention (see its article 1(4)), and reflects also the fact that the essential description of the activity to be distinguished is set out in the draft article itself.

“Article 21

This Convention does not apply to the activity of creation, recording or reconciliation of securities conducted by central securities depositories or other persons vis-à-vis the issuer of such securities.”

REPORT OF THE SS[C]S WORKING GROUP

1. Mandate

The task of the group was to examine and report back to the plenary on the following issues:

- (a) the appropriate definition of "Securities Settlement or Clearing Systems,
- (b) the determination of which provisions of the UNIDROIT Convention are affected by the definition and might need to be displaced by the rules of a system; such consideration would also cover the question on whether a global override was preferred to a piece-meal one;
- (c) the provisions of the draft which defer to arrangements made by an account agreement. The group was asked to consider whether the rationale for deferring the rules of an SS[C]S should apply to them as well;
- (d) any other provision which might be relevant in relation to SS[C]Ss.

The group proceeded with the examination of these issues on the basis of the current version of the Convention. It acknowledged however that a number of amendment proposals have been submitted by delegations which would be considered by the plenary in the course of events.

2. Definition of Securities Settlement Systems and Central Counterparty Clearing systems.

The group first considered whether clearing (in the sense of Counterparty Clearing) should be part of the definition of SS[C]S. The members arguing in favor of such inclusion stated that the Convention needs to ensure that for systemic stability reasons CCPs also benefit from the protection offered by the Convention to Securities Settlement Systems.

While all members were sympathetic to these policy concerns, they questioned the method proposed. They argued that the inclusion of "clearing" in the definition of systems would lead to confusion especially in relation to the use of the definition in Articles which are of no relevance, and therefore of no concern, to the CCPs.

The group finally decided to propose the exclusion of "clearing" from the general definition of systems. It also decided to propose that a specific definition of CCP clearing systems parallel to that of SSSs needs to be adopted so as to be used in the Articles of the Convention which are relevant to CCPs in that respect, namely Articles 22 (1) (b) and 7 (3).

The group also decided not to retain the word "clears" in the definition of a "Securities Settlement System" to avoid confusion with CCP clearing.

2.1 Securities Settlement Systems

The group considered each of the parts of the current definition in square brackets.

- (a) System or entity

Both were examined. As regards a definition based on the notion of "entity", it was pointed out that there is a risk that the definition might also cover, at least under certain circumstances, custodians. It was felt that this is undesirable. For this reason, the definition should try to use words that would not include custodians, such as the notion of uniform or standardized rules of the system etc. It was also felt that the word entity might not be broad enough to encompass the notion of participants.

In view of these concerns, the group felt that the definition should be based on the notion of "system". In addition to avoiding the problems and complications identified above, it had the added benefit that it was the basis of existing definitions in a number of States; it is also broad enough in concept to be compatible with the different types of clearing and settlement arrangements in States.

(b) Rules and agreements with its participants that are publicly accessible

The members of the group agreed with the basic premise that in order for the system rules to benefit from the exemption offered by the Convention, their public accessibility was a necessity.

There was however an important debate as to how to arrive at this result.

A number of members would have preferred public accessibility of the rules to be part of the definition. While recognizing the fact that such public accessibility of rules may not be a regulatory requirement in a number of countries around the world, they saw this requirement as an element of international acceptance. It was also mentioned that the CPSS-IOSCO recommendations require transparency.

A different view was that, in order not to increase regulatory burden, public accessibility of rules should not be part of the definition, but a necessary condition for obtaining the exclusion.

A third possibility was to require system rules to be part of the declaration itself, as a mechanism for making sure that they would become public.

Of the three mechanisms for achieving publicity of the rules of the system, the second – that the rules must be public in order for the exemption to take effect – seemed the most likely to find favor. The group suggests that the plenary considers that the Convention should explicitly include that condition in a separate provision.

The group then considered the nature of the rules that need to be accessible to the public. A number of issues were raised. What is meant by "agreements"? Do all the agreements need to be disclosed, even the bilateral ones with each client of the system? Account agreements also need to be disclosed? Would they be all the rules of the system or only the parts that relate to the Convention? The group considered that one should only focus on "uniform" or "standardized" rules with participants or classes of participants.

Also important to take into account is the fact that in some cases rules of a system affecting arrangements with participants are imposed by law. The group considered that it will be sufficient to refer to "uniform rules", which is a term broad enough to cover agreements/arrangements with participants howsoever described within the system and rules whose source is legislation with the understanding that this term does not cover non-uniform bilateral agreements between the system and its participants.

The drafting Committee could consider whether "uniform rules" of the system should be a defined term or whether it could be addressed in the commentary.

(c) Is operated by a central bank or conducts operations that are supervised [by a regulator that has oversight over its rules and agreements]

It was pointed out to the group that the current text failed to capture properly the fact that in a number of countries there is a distinction between regulation, supervision and oversight and the different entities which might conduct them. It would therefore be preferable to have language which did not interfere with this. Systems would be covered if they are subject to regulation, supervision or oversight. There was a general consensus on this.

The group then considered whether the requirement for supervision etc., would need to be subject to the qualification that supervision etc., of a system should be "in such capacity". The

possible interpretation of such qualification was discussed, e.g., supervision or oversight in relation to CSD operations as settlement system. The issue of CSDs which are licensed as banks was raised in that respect.

The group felt that it could achieve the same result without the shortcomings of a referral to the systems "capacity" by referring to supervision etc., "in respect of the system's rules".

The group also agreed to provide that the definition should also cover systems "operated by one or more central banks".

(d) Declaration on the grounds of the reduction of risk to stability

There was agreement that a declaration should be made. The two issues mostly discussed were (i) a possible challenge of such declaration, (ii) the stability element.

As to the challenge possibility (relevant in cases where any Contracting State wants to contest a declaration made by another) it was mentioned that experience in international conventions show that no successful challenge is to be expected. For this reason such a clause expresses the seriousness of the matter for contracting States, it gives guidance but bears, strictly speaking, no legal consequences.

On the stability issue, it was mentioned that there is no agreement world wide as to what falls within stability issues and thus should be left to the judgment of each contracting State.

(e) Designation mechanism

The group mainly considered the appropriateness of a designation mechanism as part of the definition. Such designation would be based on a declaration by the Contracting State the law of which governs the rules of the system. It was generally felt that such a mechanism would provide a good approach for the UNIDROIT convention.

For example, it was stated that a given entity operating two different systems might be designated by two contracting states such as CREST Co. operating both in relation to UK and Irish securities.

2.2 Suggested definitions

On the basis of the conclusions reported in the sections above, the group suggests the use of the following definitions for SSSs and CCPs:

(a) **"Securities settlement system"** means a system which:

- (i) settles securities transactions;
- (ii) has uniform rules with its participants (or classes of participants);
- (iii) is operated by one or more central banks or is subject to regulation, supervision or oversight in respect of its rules;

(iv) has been notified, on the grounds of the reduction of risk to the stability of the financial system, as a securities settlement [or clearing] system in a declaration by the Contracting State the law of which governs the rules of the system."

(b) **"Central Counterparty Clearing System"** means a system which:

- (i) clears securities transactions;
- (ii) has uniform rules with its participants (or classes of participants);
- (iii) is operated by one or more central banks or is subject to regulation, supervision or oversight in respect of its rules;

(iv) has been notified, on the grounds of the reduction of risk to the stability of the financial system, as a CCP clearing system in a declaration by the Contracting State the law of which governs the rules of the system.”

3. Provisions of the draft Convention which make a direct reference to “Securities Settlement Systems”

As a general point, it was mentioned to the group that normally the reason for considering a different approach for SSSs was their systemic stability importance. Throughout the discussion, it was also noted that it might not be necessary in the draft to make express the circumstances under which recourse should be had to the rules of a system. Where the rules apply will be obvious in practice, and accordingly it is enough to say ‘subject to the rules of a system’ without specifying that those rules must, of course, be pertinent and applicable to the matter in hand.”

The group also noted that many of the articles of the Convention that refer to the rules of an SSS also refer to DCNL and account agreements. Where that is the case, a formula was recommended for use throughout the Convention to the effect that “the domestic non-Convention law and, to the extent permitted by the domestic non-Convention law, an account agreement or the uniform rules governing the operation of a SSS”.

The group then considered each provision in turn.

(a) Article 8(2): Lack of authorization, ineffectiveness and reversal.

The reference to the rules of a system in 8(2) was endorsed.

Further, it was felt that the introductory words of article 8(3) should also defer to the rules of a system, 8(3) being an extension of 8(2), and both being within the area of matters that are sometimes covered by and integral to the operating rules of settlement systems.

(b) Article 16(2)(e): Instructions to the intermediary.

The reference in 16 (2) (e) to the rules of a system should be retained. It was noted that the exceptions listed in 16 (2) are intended to be fairly wide-ranging and will in many cases apply cumulatively.

As a matter of drafting it may be enough, subject to the views of the drafting committee, to have simply, “(e) the rules of a” system.

(c) Article 17(3): Requirements to hold sufficient securities.

It was felt that the reference in article 17 (3) to the rules of a system was appropriate and should be retained. There was some discussion about whether the formula needs to be restricted, as currently, to the allocation of the cost of making up a shortfall, or whether it should also include reference to the methods to be used, and this wider formula was preferred. It was noted for the drafting committee that the French version of the draft offers a parallel to be drawn with the expression used in 17 (2) to refer to the methods used to make up the shortfall, and that such parallelism is to be welcomed. Phrasing such as, “... method of compliance or cost of ensuring compliance” were suggested.

(d) Article 20(1)(b): Loss sharing in case of insolvency of the intermediary.

Article 20 establishes a cascade of sources for a loss-sharing rule. Where the insolvent intermediary is itself an SSS, the article provides that the rule for loss sharing should be found in, first, the applicable insolvency law (20(3)). If this has nothing to say on the matter, then, secondly, the rules of the SSS. If these too have nothing to say on the matter, then, thirdly, the pro rata rule set out in 20 (1)(a).

It was felt that recourse to SSS rules for loss sharing in the event of an SSS insolvency was indeed appropriate and that the reference to those rules should stay.

The drafting (of 20 (1)(b)) should however be shortened, partly to avoid reference to the "operator" of a system, this being an undefined term. The following phrasing was suggested, subject to the views of the drafting committee: "20 (1) (b) ... where the rules of an SSS so provide".

(e) Article 21: Overriding effect of certain rules of SSSs.

It was felt that an overarching 'sweep-all' article of this type was inferior to the piece-meal approach whereby the rules of the SSS are mentioned in each other article where relevant. It was therefore recommended that the article be deleted in its entirety.

In any event, the group was of the opinion that the issue of stability in relation to SSS should be dealt with at the definition of an SSS and would be part of the declaration made by the designating authority. On the contrary, the group considered not desirable to include the phrase "[which is directed to the stability of the system or the finality of transactions effected through the system]" as its inclusion implies the need for the courts of one country to assess the validity of judgments about financial stability made by another country. The large majority of the group considered indeed that as there is no international common understanding about the limits and nature of financial stability, to use this phrase would promote legal uncertainty. Nor is it needed as long as the declaration of a system's rules is required to be motivated on the ground of financial stability.

(f) Article 22: Effectiveness of debits, credits, etc. and instructions on insolvency of operator or participants in SSSs.

This article was considered to be helpful and important. Some drafting changes were suggested as follows:

(i) The expression "[which is directed to the stability of the system or the finality of transactions]" should be deleted, as its inclusion implies the need for the courts of one country to assess the validity of judgments about financial stability made by another country. The large majority of the group considered that as there is no international common understanding about the limits and nature of financial stability, to use this phrase would promote legal uncertainty. Nor is it needed as long as the declaration of a system's rules is required to be motivated on the ground of financial stability.

(ii) The reference in the opening paragraph to "[the operator of] the system or any participant in the system" should be modified to avoid any confusion on the insolvency of a system rather than the insolvency of its operator or one of its participants. A phrasing such, "... a participant, including the operator ..." was suggested by the large majority of the group, subject to the views of the drafting committee.

(iii) The preservation of finality rules both for the entry into a system of instructions and for the making of book entries was welcomed. As instructions precede book-entries in time, it might be logical to reverse the order of 22 (1) (a) and 22 (1) (b).

4. Provisions of the draft which defer to arrangements made by an account agreement. The position of "Securities Settlement Systems"

The group then considered the provisions of the draft which defer to arrangements made by an account agreement; it questioned why SSSs rules were not mentioned as well. Was this intentional?

The following Articles were considered

(a) Article 1(n): Definition of "designating entry"

After a short discussion, the group considered that this article should also contain the default SSSs provision.

(b) Article 9 (1) (c): Intermediated securities.

The group discussed at some length this provision. The fear was expressed that a referral to the rules of the system would jeopardise the right of account holders to cause the securities to leave the system since it would naturally tend to prevent the account holder from doing so. It was also considered whether an express reference to the system rules might reduce the effectiveness of the reference to the "account agreements".

Members who were in favour of the inclusion of the default rule for SSSs felt on the contrary that any system rules which would prevent withdrawal would only apply if national law allowed systems to impose such rules. Thus, any curtailing effect on the freedom offered by account agreements would be the of a statutory, policy decision and would therefore be justified.

On balance, the group agreed that this provision should also contain the default provision on SSSs.

(c) Article 18: Application of DNCL and account agreement to obligations of intermediary.

Article 18 is a general provision which applies to all the obligations and duties of the intermediary under the Convention and specifically refers to DCNL and to the extent permitted by DNCL, the account agreement. This also seems an appropriate place to refer to the rules of an SSS which may affect duties and obligations to the extent permitted by DCNL.

This article also provoked extensive discussions which centred on specific problems faced by a particular SSS. That system provides for a split of the functions between the SSS and a number of nominees that also act as intermediaries especially as regards cross-border securities. In essence, such securities are held through a nominee carrying out some of the intermediary functions of the SSS.

It was alleged that the current draft of the Convention and of Article 18 in particular would not allow the SSS and the nominees to organise properly their business since it is not possible under the current draft to distinguish and to apportion responsibilities between the various entities involved.

Examples of the problems were then discussed, e.g., if a nominee was to receive an instruction on behalf of a client and breaches his duties under the Convention (Article 16), the risk might be that it will be the SSS that would be held liable even though the specific function was performed by the nominee. In addition, in cases of control agreements, the question was which entity would be responsible to receive notice.

After careful consideration, it was felt that the inclusion of the words "the rules of the system" in Article 18 would provide an adequate response to this problem. In any event, specific mention of this issue and the solution arrived at should be mentioned in the explanatory memorandum of the Convention.

(d) Article 7 (3) and (5): Acquisition by an innocent person of intermediated securities.

The group recognised the importance of Article 7 (5) and the need to revisit it in relation to the use of the default SSS provision after the plenary decides whether to retain, modify it or not.

A number of group members introduced also the proposal by a delegation to have a different standard of knowledge for intermediaries including SSSs (in Article 7 (3)). It was argued that intermediaries act in a ministerial fashion, perform systemically important functions and needed special immunity. The group acknowledged that this issue would be discussed at the plenary. It expressed nevertheless the view that it would be sympathetic to such a test in relation to SSSs and CCPs for systemic stability reasons.

5. Any other provision which might be relevant in relation to SSSs.

The following Articles were considered:

- (a) *Article 4 (5): Acquisition and disposition of intermediated securities.*

It was suggested that the group should flag the issue of whether this provision should be subject to DNCL and the SSS rules. The group recognised that this paragraph is currently under consideration by the drafting Committee; it accepted to flag this issue recognising its importance.

6. Provisions relevant to CCPs

As is already reported in section 2 above, the group decided to propose a specific definition of CCP clearing systems needs to be used in the Articles of the Convention which are relevant to CCPs on systemic protection reasons.

There was broad agreement that CCP system rules should be mentioned in Articles 22 (1) (b) and 7 (3). On the contrary, the group was divided on the suggestion to refer to CCPs rules in Article 22 (1) (a). A number of group members pointed to the fact that any extension of the protection to CCPs may cause problems to the extent that CCP system rules might diverge from the rules of the relevant Securities Settlement System in which the CCP participates as an account holder. This type of conflict has to be avoided, especially in cross-border operations. Finally, and after extensive discussions, agreement was reached to limit mention of CCPs only to Articles 7.3 and 22 (1) (b).

7. Conclusions

In conclusion, we have reached general consensus on the definition of an SSS, propose a new definition for CCPs, recommend the deletion of Article 21 and recommend that specific Articles should recognize and defer to the rules of an SSS and a CCP.

Appendix 9

COMMENTS BY GOVERNMENTS AND INTERNATIONAL ORGANISATIONS

(Comments by the International Swaps & Derivatives Association, Inc., ISDA)

Thank you for your invitation to us to participate as an observer in the third session of the UNIDROIT Committee of Governmental Experts (**CGE**) to consider the preliminary draft Convention referred to above (the **draft Convention**) and to present our proposed revisions to Article 1 and Chapter V, together with our proposed additional Chapter VI relating to title transfer collateral arrangements and close-out netting.

We understand that it was the consensus of this morning's session of the CGE that the draft Convention should not include provisions dealing with close-out netting generally, as this would extend the draft Convention too far beyond its current scope of dealing with intermediated securities and related issues. Although, of course, we sponsored this proposal, we understand the basis for this decision.

We were pleased to hear confirmed this morning that it is the general consensus that Chapter V should cover title transfer collateral arrangements. As we noted in one of our interventions this morning, we believe some additional changes are strictly necessary and other changes are highly desirable to ensure that Chapter V properly reflects the nature of a title transfer collateral agreement.

We offered this morning, and you kindly accepted our offer, that we would send to you our suggested revisions to Chapter V necessary to include title transfer collateral arrangements fully within the scope of that Chapter. Our suggested revisions are set out in the attached marked copy of Chapter V.

In reviewing these changes, national delegates and observers attending the CGE meeting may find the following comments helpful:

1. We believe that the definition of "collateral agreement" in Article 1 should be amended to limit it to security collateral agreements, partly because the current definition only refers to a grant of a security interest and not the transfer of title and partly also because the only references to "collateral agreement" in the draft Convention outside of Article V appear to relate only to security collateral agreements, for example, in Article 6.
2. We also believe, given the substantive difference between the basic mechanism of security collateral agreements, on the one hand, and title transfer collateral agreements, on the other hand, that it is necessary to deal with certain issues in each case in a somewhat different way, as indicated in our attached proposal and discussed in our comments below. Hence, the need to introduce a separate definition of "title transfer collateral agreement" in Article 23.

3. In framing these proposed amendments, we have had regard to the relevant provisions of the European Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements (the **FCAD**) as we believe that FCAD properly reflects the distinction between security and title transfer, and these provisions already apply under the laws of a significant part of the membership of UNIDROIT. We have, however, attempted to conform our drafting suggestions, of course, to the style and approach of the draft Convention.
4. We discussed this morning that title transfer collateral arrangements are broadly conceived of in at least two different ways in different legal traditions. First, there are those title transfer collateral arrangements established under English law and under a number of other common law jurisdictions, where the transfer is considered to be an outright transfer, and this is the basis on which most cross-border securities sale and repurchase (repo) transactions are effected in the European market. In other countries, for example, Italy and a number of other civil code jurisdictions, a title transfer collateral arrangement is conceived of more as a type of transfer by way of security, often referred to as an irregular pledge, which has some of the characteristics of outright transfer (for example, conferring on the pledgee the ability to transfer full ownership of the collateral received to a third party) and some characteristics of a pledge. (The US approach under the Uniform Commercial Code may represent a third characterisation.) In all of these cases, though, the collateral taker in principle takes ownership for most, if not all, purposes and crucially (a) is able to transfer full title to the relevant assets to a third party, who takes free and clear of any interest of the collateral provider's original ownership interest in those assets and (b) is subject only to an obligation to return fungible equivalent assets to the collateral provider and not the identical assets it originally received from the collateral provider (which would arguably be impossible, in any event, with fungible intermediated securities). We believe that our drafting changes are adequate to cover these different conceptions of the nature of a title transfer collateral arrangement, and that no further distinction needs to be drawn. We believe that this is consistent with the functional approach that the draft Convention takes in relation to other issues.
5. In our proposal, the key provision of Article 24(1) has been amended to expand it to cover title transfer collateral. We have suggested using the concept of a close-out netting provision, which is effectively the approach taken in the FCAD. Hence we have added a definition of "close-out netting provision" to Article 23(2), which tracks fairly closely the prior wording of Article 24(3). Given this change, Article 24(3) is itself no longer necessary.
6. We believe that it is better to change "secured obligations" to "relevant obligations" given that title transfer collateral does not involve the creation of security and therefore to avoid confusion on this point. This is not a strictly necessary change, but in our view it is desirable, given the possibility in some countries that a title transfer collateral agreement might be recharacterized as a security agreement (this risk, though, is intended to be eliminated by our proposed new Article 26).
7. As was discussed this morning, Article 25 which deals with the right to use collateral securities only relates to security collateral agreements, as such a right of use is a modern exception to the normal principle in most countries (virtually all of Europe, for example) that a security taker is either not permitted or is highly restricted in its ability to "deal with" security taken. It is not necessary to deal with the right of use in relation to title transfer collateral agreements as this arises from the nature of the agreement itself.

The transferee's only obligation to the transferor under a title transfer collateral agreement in relation to the collateral originally transferred is the contractual obligation to return fungible equivalent collateral to the transferor if an enforcement event does not occur and

otherwise to account to the transferor by way of close-out netting or contractual set-off against the collateralized obligations. A properly drafted title transfer collateral agreement therefore does not expressly confer a right of use on the transferee, and indeed if it did do so, a question would arise as to whether the agreement was genuinely a title transfer agreement or was in fact intended to create security.

8. Our proposed new Article 26 is intended to eliminate the risk that a title transfer collateral agreement might be recharacterized as a security agreement. It is comparable to Article 6 of the FCAD.
9. In Article 27, we have taken the opportunity to propose some wording in relation to the credit-ratings point discussed during this morning's session. It is not, of course, strictly related to our title transfer collateral drafting suggestions, and it is offered only tentatively as we have not had a chance to consult more widely within the Association. Some ISDA members may, therefore, still favour a broader approach.

**AMENDMENTS proposed by the International Swaps and Derivatives Association, Inc. to
the Preliminary Draft Convention on Substantive Rules Regarding Intermediated
Securities (as adopted by the Committee of Governmental Experts at its second session,
held in Rome, 06-14 March 2006)
(UNIDROIT 2006 – Study LXXVIII – Doc. 42 – March 2006)**

Article 1

[Definitions]

...

(r) "collateral taker" means a person to whom a security interest in intermediated securities is granted;

(s) "collateral provider" means an account holder by whom a security interest in intermediated securities is granted;

(t) "security collateral agreement" means an agreement between a collateral provider and a collateral taker providing (in whatever terms) for the grant of a security interest in intermediated securities.¹

**CHAPTER V – SPECIAL PROVISIONS WITH RESPECT TO
COLLATERAL TRANSACTIONS**

Article 23

[Scope and interpretation in Chapter V]

1. - This Chapter applies to collateral arrangements under which a collateral provider delivers intermediated securities to a collateral taker under Article 5(2) or Article 5(3) in order to secure or otherwise cover the performance of any existing or future obligation of the collateral provider or a third person.

2. - In this Chapter –

(a) "*enforcement event*" means, in relation to a collateral agreement, an event on the occurrence of which, under the terms of that collateral agreement, the collateral taker is entitled to enforce its security or operate a close-out netting provision;

(b) "*close-out netting provision*" means a provision of a collateral agreement, or of a netting agreement of which a collateral agreement forms part, under which, on the occurrence of an enforcement event, whether through the operation of netting or set-off or otherwise, either or both of the following may occur:

(i) the respective obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value, or are terminated and replaced by an obligation to pay such an amount; or

¹ References to "collateral agreement" in Chapters I to IV of the Preliminary Draft Convention should be replaced by "security collateral agreement".

(ii) an account is taken of what is due from each party to the other in respect of such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party;

(c) "collateral agreement" means a security collateral agreement or a title transfer collateral agreement;

(~~b~~d) "collateral securities" means intermediated securities delivered under a collateral agreement;

(e) "equivalent collateral" means, in relation to collateral securities delivered to a collateral taker under a collateral agreement, securities of the same description;

(~~e~~f) "secured-relevant obligations" means the obligations secured by a security collateral agreement or the performance of which is secured or otherwise covered by a title transfer collateral agreement, including, but not limited to, obligations in respect of eligible transactions; and

(g) "title transfer collateral agreement" means an agreement, including an agreement providing for the sale and repurchase of securities, between a collateral provider and a collateral taker providing (in whatever terms) for the transfer of title to intermediated securities by the collateral provider to the collateral taker for the purpose of securing or otherwise covering the performance of relevant obligations by operation of a close-out netting provision.

Article 24

[Enforcement]

1. - On the occurrence of an enforcement event, the collateral taker may:

(a) realise the collateral securities provided under a security collateral agreement:-

(~~a~~)—(i) by selling them and applying the net proceeds of sale in or towards the discharge of the secured-relevant obligations; or

(~~b~~ii) by appropriating the collateral securities as the collateral taker's own property and setting off their value against, or applying their value in or towards the discharge of, the secured-relevant obligations, provided that the security collateral agreement provides for realisation in this manner and specifies the basis on which collateral securities are to be valued for this purpose; or

(b) operate a close-out netting provision relating to a title transfer collateral agreement.

2. - Collateral securities may be realised or a close-out netting provision may be operated under paragraph 1:

(a) subject to any contrary provision of the collateral agreement, without any requirement that:

(i) prior notice of the intention to realise or operate the close-out netting provision shall have been given;

(ii) the terms of the realisation or operation of the close-out netting provision be approved by any court, public officer or other person; or

(iii) the realisation be conducted by public auction or in any other prescribed manner or the close-out netting provision be operated in any prescribed manner; and

(b) notwithstanding the commencement or continuation of an insolvency proceeding in respect of the collateral provider or the collateral taker.

~~3. — A collateral agreement may provide that, if an enforcement event occurs before the secured obligations have been fully discharged, either or both of the following shall occur, or may at the election of the collateral taker occur, whether through the operation of netting or set-off or otherwise:~~

~~(a) — the respective obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value or are terminated and replaced by an obligation to pay such an amount;~~

~~(b) — an account is taken of what is due from each party to the other in respect of such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party.~~

34. - This Article and Articles 25 and 26 are ~~is~~ without prejudice to any requirement of the domestic non-Convention law to the effect that the realisation or valuation of collateral securities or the calculation of any obligations must be conducted in a commercially reasonable manner.

Article 25

[Right to use collateral securities under a security collateral agreement]

1. - If and to the extent that the terms of a security collateral agreement so provide (or, where collateral securities are delivered to the collateral taker under Article 5(2), if and to the extent that the terms of the security collateral agreement do not provide otherwise), the collateral taker shall have the right to use and dispose of the collateral securities as if it were the owner of them (a "*right of use*").

2. - Where a collateral taker exercises a right of use, it thereby incurs an obligation to replace the collateral securities originally transferred (the "*original collateral securities*") by transferring to the collateral provider, not later than the discharge of the ~~secured-relevant~~ obligations, equivalent collateral securities of the same issuer or debtor, forming part of the same issue or class and of the same nominal amount, currency and description or, where the security collateral agreement provides for the transfer of other assets [following the occurrence of any event relating to or affecting any securities provided as collateral], those other assets.

3. - Securities transferred under paragraph 2 before the ~~secured-relevant~~ obligations have been fully discharged:

(a) shall, in the same manner as the original collateral securities, be subject to a security interest under the relevant security collateral agreement, which shall be treated as having been created at the same time as the security interest in respect of the original collateral securities was created; and

(b) shall in all other respects be subject to the terms of the relevant security collateral agreement.

4. - The exercise of a right of use shall not render invalid or unenforceable any right of the collateral taker under the relevant security collateral agreement.

Article 26

[Recognition of title transfer collateral agreements]

1. - The law of a Contracting State shall permit a title transfer collateral agreement to take effect in accordance with its terms.

2. - If an enforcement event occurs while any obligation of the collateral taker to transfer equivalent collateral under a title transfer collateral agreement remains outstanding, the obligation may be the subject of a close-out netting provision.

Article 27~~6~~

[Top-up or substitution of collateral]

1. - Where a collateral agreement includes:

(a) an obligation to deliver collateral securities or additional collateral securities in order to take account of changes in the value of the collateral provided under the collateral agreement or in the amount of the ~~secured-relevant~~ obligations~~],~~ in order to take account of ~~any circumstances giving rise to~~ an increase in the credit risk incurred by the collateral taker as determined by reference to a downgrade by a nationally or internationally recognized credit rating agency of a rating assigned to debt of the collateral provider or other objective criteria of the creditworthiness of the collateral provider, or, to the extent permitted by the applicable law as determined by the private international law rules of the forum, in any other circumstances specified in the collateral agreement; or

(b) a right to withdraw collateral securities or other assets on providing collateral securities or other assets of substantially the same value,

the provision of securities or other assets as described in paragraph (a) and paragraph (b) shall not be treated as invalid, reversed or declared void solely on the basis that they are provided during a prescribed period before, or on the day of but before, the commencement of an insolvency proceeding in respect of the collateral provider, or after the ~~secured-relevant~~ obligations have been incurred.

Article 28~~7~~

[Declarations in respect of Chapter V]

1. - A Contracting State may declare that this Chapter shall not apply under its domestic non-Convention law.

2. - A Contracting State may declare that under its domestic non-Convention law this Chapter shall not apply –

(a) in relation to collateral agreements entered into by natural persons or persons falling within such other categories as may be specified in the declaration;

(b) in relation to intermediated securities which are not permitted to be traded on an exchange or regulated market;

(c) in relation to collateral agreements which provide for ~~secured-relevant~~ obligations falling within such categories as may be specified in the declaration.

PROPOSAL

(submitted by the Government of the United States of America)

CONVENTION ON SUBSTANTIVE RULES REGARDING INTERMEDIATED SECURITIES

[PREAMBLE]

THE STATES SIGNATORY TO THIS CONVENTION,

CONSCIOUS of the growth and development of global capital markets and recognizing the benefits of holding securities, or interests in securities, through intermediaries in increasing the liquidity of modern securities markets,

RECOGNIZING the need to protect persons that acquire or otherwise hold such intermediated securities,

AWARE of the importance of reducing legal risk, systemic risk and associated costs in relation to domestic and cross-border transactions involving intermediated securities so as to facilitate the flow of capital and access to capital markets,

MINDFUL of the need to enhance the international compatibility of legal systems as well as the soundness of domestic and international rules relating to intermediated securities,

DESIRING to establish a common legal framework for the holding and disposition of intermediated securities,

BELIEVING that a functional approach in the formulation of rules to accommodate the various legal traditions involved would best serve the purposes of this Convention,

HAVING due regard for domestic non-Convention law in matters not determined by the Convention,

HAVE AGREED upon the following provisions:

DRAFTING PROPOSALS FOR CONSIDERATION BY THE DRAFTING COMMITTEE

(submitted by the Government of the United States)

Article 1

[Definitions]

(e) “*account agreement*” means, in relation to a securities account, the agreement with the relevant intermediary governing, affecting, or relating to that securities account, including any agreement entered into by the intermediary with the consent of the account holder;

Explanatory Comment: The proposed revision of the definition of “*account agreement*” is intended as a clarification only and not as a change in substance. The definition in the current draft Convention is taken from the corresponding definition in Article 1(e) of the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary (Hague Securities Convention).

The Explanatory Report on the Hague Securities Convention states:

“This is the agreement between the account holder and its intermediary governing their respective rights and duties in relation to securities that are or may become credited to a securities account maintained by that intermediary. The definition does not require that the account agreement fulfil any formal requirements. It may be oral or in writing or partly oral and partly in writing; it may incorporate in whole or in part rules or the procedures of the intermediary; and if in writing may consist of one or more documents.”

The proposed revision merely clarifies and provides certainty concerning this broad reading. The explanatory report on the UNIDROIT Convention should explain that the definition should be given the same meaning as the definition in the Hague Securities Convention (as with the definition of “*intermediated securities*”).

(o) “*domestic non-Convention law*” means the provisions of law of in force in the State whose law is applicable under Article 2, other than those provided in the Convention.

Explanatory Comment: The phrase “*in force*” should be used instead of “*law of*” to conform the terminology of this definition to that used in the Hague Convention. The definition must cover the situation where the State is composed of two or more territorial units and one or more of its units have their own rules of law. The term includes the law of the territorial unit and the law of the State (to the extent applicable under the law of a territorial unit or the law of the State).

(u) “defective transaction” means the credit of securities to the account of an account holder, or a the making of a designating entry in favour of another person under Article 5, in such circumstances that the credit or designating entry is not effective or is liable to be reversed.

Explanatory Comment: See the Explanatory Comment to Article 7, below.

Article 4

[Acquisition and disposition of intermediated securities]

1. - Intermediated securities are acquired by an account holder by the credit of securities to that account holder's securities account.

2. - No further step other than a credit is necessary, or may be required by the domestic non-Convention law, to render the acquisition of intermediated securities effective against third parties.

Explanatory Comment: Article 8 (2) permits the domestic non-Convention law to address the effectiveness and liability for reversal of entries in securities accounts. Article 4(2) could be misread as providing that once made, a credit is automatically and permanently effective. Instead, the point of Article 4(2) is simply that no additional formality is required for effectiveness. The proposed revision would clarify its meaning.

Article 7

[Acquisition by an innocent person of intermediated securities]

5. - Where securities are credited to the account of an account holder under Article 4 or a security interest in favour of a collateral taker becomes effective against third parties under Article 5 and the account holder or collateral taker does not at the time of credit or effectiveness have knowledge of an earlier defective transaction with respect to the securities

(a) the account holder or the collateral taker is not liable to anyone who would benefit from the ineffectiveness or reversal of the defective transaction; and

(b) the credit or effectiveness in favour of the account holder or collateral taker is not rendered ineffective or liable to be reversed as a result of the defective transaction.

6. - For the purposes of paragraph 5 a person has knowledge of a defective transaction if that person:

(a) has actual knowledge of the defective transaction; or

(b) has knowledge of facts sufficient to indicate that there is a significant probability that the defective transaction exists and deliberately avoids information that would establish the existence of the defective transaction; and knowledge received by an organisation is effective for a particular transaction from the time when it is or ought reasonably to have been brought to the attention of the individual conducting that transaction.

~~{5. - Notwithstanding Article 8[(2)], if:-~~

~~(a) securities have been credited to a securities account of an account holder, or have been designated in favour of another person in the manner described in Article 5, in circumstances such that the credit or designating entry is not effective or is liable to be reversed; and~~

~~(b) before that credit or designating entry has been [cancelled or] reversed, the securities are credited to a securities account of a third party, or are designated in the manner described in Article 5 in favour of a third party (such a third party being in either case referred to in this sub-paragraph as "the acquirer"), under a further disposition,~~

~~the fact that the initial credit or designating entry was made in circumstances such that it is not effective or is liable to be reversed does not make the further credit or designating entry~~

~~ineffective, in favour of the acquirer, against the person making the further disposition, the relevant intermediary or third parties unless:~~

~~(i) the further credit or designating entry is made conditionally and the condition has not been satisfied;~~

~~(ii) the acquirer has knowledge, at the time when the further credit or designating entry is made, that it is made as a result of the further disposition and that the further disposition is made in the circumstances referred to in this paragraph; or~~

~~(iii) the further disposition is made by way of gift or otherwise gratuitously.]~~

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~~[6. -- For the purposes of paragraph 5 the acquirer has knowledge that the further credit or designating entry is made as a result of a purported disposition made in the circumstances referred to in that paragraph if the acquirer has actual knowledge that it is so made, or has knowledge of facts sufficient to indicate that there is a significant probability that it is so made and deliberately avoids information that would establish that that is the case.]~~

Explanatory Comment: The suggested revision would reformulate paragraphs (5) and (6) so as to be consistent with the structure and style of paragraphs (1) and (4) on adverse claims. The definition of “defective transaction” would be added to Article 1. The revision is considerably simpler than the current draft text (which was not addressed during the March 2006 meeting of experts). It deletes language that was intended to identify a connection between the protected credit or security interest and the earlier transaction that was ineffective or liable to be reversed. So long as the account holder or collateral taker who does not have knowledge of a defective transaction is protected, that connection need not be made. Note, however, that paragraph (5) does *not* provide affirmatively that an account holder or collateral taker who has knowledge is liable. It contemplates that in those circumstances a beneficiary of a defective transaction would have to make a connection between that transaction and the transaction in favour of the account holder or collateral taker with knowledge (*i.e.*, tracing) and assert liability, ineffectiveness, or reversal under the domestic non-Convention law.

Article 13

[Position of issuers of securities]

1. - The law of a Contracting State shall permit the holding through intermediaries of securities that are permitted to be traded on an exchange or regulated market, and the effective exercise of the rights attached to such securities which are so held, including the rights to receive notices and to vote by proxy. This is without prejudice to the terms of issue of the securities.

Explanatory Comment: We recognize that the more general, result-oriented approach of Article 13 of the current draft Convention generally is an improvement over its predecessor (former Article 19). However, we have two principal concerns. First, the reference to “effective exercise of the rights attached to such securities” is *too* general. We support adding back a reference to notices, proxies, etc., even if only as examples.

¹ ~~Further consideration to be given to whether there should be a more general protection against reversal based on reversal etc. of earlier transactions; paragraphs 4 and 5 reproduce Article 7(6) and (7) of Doc. 24.~~

Article 16

[Instructions to the intermediary]

1. - Subject to paragraph 2 {and Article 8(1)}, an intermediary is neither bound nor entitled to give effect to any instructions with respect to intermediated securities of an account holder given by any person other than that account holder.

2. - Paragraph 1 is subject to:

(a) the provisions of the account agreement, any other agreement between the intermediary and the account holder or any other agreement entered into by the intermediary with the consent of the account holder;

(b) the rights of any person (including the intermediary) who holds a security interest created under Article 5;

(c) subject to Article 15, any judgment, award, order or decision of a court, tribunal or other judicial or administrative authority of competent jurisdiction;

(d) subject to Article 15, any requirement ~~mandatory rule~~ of the domestic non-Convention law; and

(e) where the intermediary is [the operator of] a securities settlement [or clearing] system, the rules of that system.

Explanatory Comment: Deletion of the square brackets in paragraph 1 would recognize that an instruction (authorization) of a collateral taker sometimes may be required under Article 8(1). The proposed revision of paragraph 2(d) would recognize that deference to the domestic non-Convention law would not override the prohibition of upper-tier attachment under Article 15. Also, we question whether “mandatory rule” is the appropriate qualifier. That terminology normally is understood to mean rules of law that cannot be varied by the parties. We suggest that “requirement” is a more felicitous expression of the intent here.

Article 17

[Requirement to hold sufficient securities]

3. - The preceding paragraphs do not affect any provision of the domestic non-Convention law, or, subject to the domestic non-Convention law, any provision of the rules of a securities settlement [or clearing] system or of an account agreement, relating to the allocation of the cost of ensuring compliance with the requirements of those paragraphs or providing any other remedy for noncompliance with those requirements.

Explanatory Comment: The proposed additional text recognizes that under some legal regimes or settlement or clearing systems there may be other appropriate approaches for dealing with an intermediary's noncompliance. For example, it may be impossible to ensure compliance if the relevant securities are not available. Or, compensatory damages may provide an appropriate remedy for dealing with noncompliance.

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 in respect of those obligations and duties are subject to any

applicable provision of the domestic non-Convention law and, to the extent permitted by that law, the account agreement.

Explanatory Comment: The proposed revision is intended to clarify that the relevant liability is the liability in respect of Convention obligations and duties.

Article 19

[Allocation of securities to account holders' rights; securities so allocated not property of the intermediary]

3. - Subject to paragraph 4, the allocation required by paragraph 1 shall be effected by means that are effective under the domestic non-Convention law and, subject to the domestic non-Convention law, by arrangements made by the relevant intermediary.

4. - A Contracting State may declare that under its domestic non-Convention law the allocation required by paragraph 1 applies only to securities that are held by the relevant intermediary with another intermediary under an arrangement for the segregation of securities held by the relevant intermediary for the benefit of its account holders and does not apply to securities held with another intermediary for the relevant intermediary's own account.

4bis. – A Contracting State may declare that under its domestic non-Convention law the allocation required by paragraph 1 shall be effected by arrangements for the segregation of securities held by the relevant intermediary or credited to securities accounts held by the relevant intermediary with another intermediary sufficient to ensure that the securities so segregated are allocated to the rights of the account holders of the relevant intermediary.

Explanatory Comment: Proposed new paragraph *4bis* is similar to Article 17(4) of the May 2005 draft Convention. It was replaced by the current paragraph 4 (set out above, unchanged, for convenience) during the March 2006 meeting of experts. But paragraphs 4 and *4bis* actually address separate issues. This was pointed out by an observer on the final day of the March 2006 meeting of experts.

Article 22

[Effectiveness of debits, credits etc. and instructions on insolvency of operator or participant in securities settlement [or clearing] system]

1. - Any provision of the rules or agreements governing the operation of a securities settlement [or clearing] system [which is directed to the stability of the system or the finality of transactions] shall have effect notwithstanding the commencement of an insolvency proceeding in respect of [the operator of] the system or any participant in the system in so far as that provision:

(a) precludes the invalidation or reversal of a debit or credit of securities to, or a designating entry in, a securities account which forms part of the system after the time at which that debit, credit or designating entry is treated as final under the rules of the system;

(b) precludes the revocation of any instruction given by a participant in the system for making a disposition of securities, or for making a payment relating to an acquisition or disposition of securities, after the time at which that instruction is treated under the rules of the system as having been entered irrevocably into the system.

2. - Paragraph 1 applies notwithstanding that any invalidation, reversal or revocation referred to in that paragraph would otherwise occur by ~~mandatory~~ operation of the insolvency law of a Contracting State.

Explanatory Comment: Paragraph 2 provides that only “mandatory” (*i.e.*, nonvariable) provisions of a Contracting State’s insolvency law are not overridden by paragraph 1. That suggests that other provisions of insolvency law might override paragraph 1. We suggest deletion of the term “mandatory.”

Explanatory Comment: Miscellaneous changes: In several provisions of the Convention one article is made “subject to” another article of the Convention. In most of our drafting submissions we have conformed them to the current drafting style of “subject to Article XX” but that we believe that the “unless otherwise provided in Article XX” formulation is preferable as a drafting matter because it is clearer and recommend that the change in formulation be made throughout the Convention.

DRAFTING PROPOSALS FOR CONSIDERATION BY THE DRAFTING COMMITTEE

(submitted by the Governments of France, Germany and United States)

(a) *securities* means any shares, bonds, or other financial instruments or financial assets (other than cash) [or any right or interest therein]...

(f) *intermediated securities* means securities (or any right or interest therein) credited ~~the rights of an account holder resulting from a credit of securities~~ to a securities account.

Art 9(1)(d):

(d) Unless otherwise provided in ~~subject to~~ this Convention, such other rights, including rights and interests in securities, as may be conferred by the domestic non-Convention law.

Note: The revised definition of “intermediated securities” is intended to make clear that a credit to a securities account may result in the account holder’s acquisition of the securities as such or a more limited right or interest, such as a proportionate or pro rata right or interest, a co-ownership interest, a non-exclusive interest, or the like. The qualification in the definition may make unnecessary the language that appears in square brackets in the definition of “securities.” The additions to Art. 9(1)(d) are for clarity.

References to “rights and interests” and “right or interest” are intended to accommodate an expansive reading.

The Drafting Committee should consider, of course, whether the suggested revisions are sufficient to provide the necessary clarity.

PROPOSAL

(submitted by the Government of the United States of America)

Article 18

2. – An intermediary, including a securities settlement system, who makes a debit, credit or designating entry (an “entry”) to an account maintained by the intermediary for an account holder is not liable to a person who has an interest in intermediated securities and [who claims that the entry violates the rights of that person] [whose rights are violated by the entry] unless –

(a) the intermediary makes the entry after the intermediary has been served with legal process restraining it from doing so, issued by a court of competent jurisdiction, and has had a reasonable opportunity to act on that legal process; or

(b) the intermediary acts wrongfully and in concert with another person to violate the rights of the person whose rights are violated by the entry.

3. – Paragraph 1 does not affect any liability of an intermediary –

(a) to the account holder for the securities account on which an entry is made or a person for whose benefit a designating entry or control agreement applies in respect of that account; or

(b) that arises from an entry which the intermediary is not entitled to make under Article 16.

**PRELIMINARY DRAFT CONVENTION ON SUBSTANTIVE RULES REGARDING
INTERMEDIATED SECURITIES**

CHAPTER I - DEFINITIONS, SCOPE OF APPLICATION AND INTERPRETATION

Article 1
[Definitions]

In this Convention:

(a) *“securities”* means any shares, bonds or other financial instruments or financial assets (other than cash) ~~or any interest therein~~, which are capable of being credited to a securities account and of being acquired and disposed of in accordance with the provisions of this Convention;

(b) *“intermediated securities”* means securities credited to a securities account or rights or interests in securities resulting from the credit of securities to a securities account;

~~(bc)~~ *“securities account”* means an account maintained by an intermediary to which securities may be credited or debited;

~~(ed)~~ *“intermediary”* means a person that in the course of a business or other regular activity maintains securities accounts for others or both for others and for its own account and is acting in that capacity;

~~(de)~~ *“account holder”* means a person in whose name an intermediary maintains a securities account, whether that person is acting for its own account or for others (including in the capacity of intermediary);

(ef) *“account agreement”* means, in relation to a securities account, the agreement ~~with~~ between the account holder and the relevant intermediary governing that securities account;

~~(f)~~ *“intermediated securities”* means the rights of an account holder resulting from a credit of securities to a securities account¹;

(g) *“relevant intermediary”* means, with respect to a securities account, the intermediary that maintains the securities account for the account holder;

~~(h)~~ *“disposition”* means an act of an account holder disposing of intermediated securities and includes a transfer of title, whether outright or by way of security, and a grant of a security interest;

~~(i)~~ *“adverse claim”* means, with respect to any securities, a claim that a person has an interest in those securities that is effective against third parties and that it is a violation of the rights of that person for another person to hold or dispose of those securities;

~~(jh)~~ *“insolvency proceeding”* means a collective judicial or administrative proceeding, including an interim proceeding, in which the assets and affairs of the debtor are subject to control

¹ This definition remains under consideration. Questions have been raised, for example, as to the appropriateness of the particular term “intermediated securities”, as to whether it should be replaced by “intermediated rights”, and as to whether the definition should be expanded so as to include terms that currently form part of Article 4.

or supervision by a court or other competent authority for the purpose of reorganisation or liquidation;

(~~k~~i) “*insolvency administrator*” means a person (including a debtor in possession where applicable) authorised to administer an insolvency proceeding, including one authorised on an interim basis;

(~~j~~t) securities are “*of the same description*” as other securities if they are issued by the same issuer and:

(i) they are of the same class of shares or stock; or

(ii) in the case of securities other than shares or stock, they are of the same currency and denomination and are treated as forming part of the same issue;

(~~k~~m) “*control agreement*” means an agreement between an account holder, the relevant intermediary and another person ~~collateral taker~~, or, if so permitted by the ~~domestic~~ non-Convention law, an agreement between an account holder and ~~a collateral taker~~ another person of which notice is given to the relevant intermediary, which relates to intermediated securities and includes either or both of the following provisions –

(i) that the relevant intermediary is not permitted to comply with any instructions given by the account holder in respect of the intermediated securities to which the agreement relates without having received the consent of that other person;

(ii) that the relevant intermediary is obliged to comply with any instructions given by that other person in respect of the intermediated securities to which the agreement relates in such circumstances and as to such matters as may be provided by the agreement or the non-Convention law, without any further consent of the account holder; ~~provides that, in such circumstances and as to such matters as may be specified in the agreement or provided by the domestic non-Convention law, the relevant intermediary is not permitted to comply with any instruction 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;~~

(~~n~~l) “*designating entry*” means an entry in a securities account made in favour of a ~~collateral~~ a person other than the account holder ~~taker~~ in respect of the ~~securities account or in respect of specified intermediated securities~~ securities credited to the securities account, which, under the account agreement, a control agreement ~~or, the uniform rules of a securities settlement system or the domestic non-Convention law~~ or, the uniform rules of a securities settlement system or the domestic non-Convention law, has ~~the effect that~~ either or both of the following effects –

(i) that the relevant intermediary is not permitted to comply with any instructions given by the account holder in respect of the intermediated securities in relation to which the entry is made without having received the consent of that other person;

(ii) that the relevant intermediary is obliged to comply with any instructions given by that other person in respect of the intermediated securities in respect of which the entry is made in such circumstances and as to such matters as may be provided by the account agreement, a control agreement, the uniform rules of a securities settlement system or the non-Convention law, without any further consent of the account holder; ~~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;~~

(~~m~~e) “*domestic non-Convention law*” means the ~~domestic~~ provisions of law ~~of in force~~ in the State whose law is applicable under Article 2, other than those provided in this Convention;

(~~p~~) “*non-consensual security interest*” ~~[to be defined];~~

(~~qn~~) *“securities settlement ~~for clearing~~ system”* means ~~{a system}~~ ~~{an entity}~~ which ~~:-~~

(i) ~~clears, settles or clears and settles, or clears and settles,~~ securities transactions;

(ii) ~~{has rules and agreements with its participants that are publicly accessible};~~

(iii) is operated by a central bank or central banks or is subject to regulation, supervision or oversight by a governmental or public authority in respect of its rules ~~conducts operations that are supervised {by a regulator that has oversight over its rules and agreements};~~ and

~~(iv)~~ ii) has been notified, on the ground of the reduction of risk to the stability of the financial system, as a securities settlement ~~for clearing~~ system in a declaration by ~~a~~ the Contracting State the law of which governs the rules of the system; ~~, {or falls within a category of {systems} [entities] that have been notified as securities settlement [or clearing] systems in a declaration by a Contracting State and has been specifically identified as falling within that category in a publicly accessible website of its regulator which also specifies the date on which it first was designated as falling within that category};~~

~~provided that a declaration referred to in this sub-paragraph must be made on the grounds of the reduction of risk to the stability of the financial system;~~

(o) *“securities clearing system”* means a system which - _____

(i) clears, but does not settle, securities transactions through a central counterparty or otherwise;

(ii) is operated by a central bank or central banks or is subject to regulation, supervision or oversight by a governmental or public authority in respect of its rules; and

(iii) has been notified, on the ground of the reduction of risk to the stability of the financial system, as a securities clearing system in a declaration by the Contracting State the law of which governs the rules of the system;

(p) *“uniform rules”* means, in relation to a securities settlement system or securities clearing system, rules of that system which are common to the participants or to a class of participants and are publicly accessible.

(r) ~~“collateral taker” means a person to whom a security interest in intermediated securities is granted;~~

(s) ~~“collateral provider” means an account holder by whom a security interest in intermediated securities is granted;~~

(t) ~~“collateral agreement” means an agreement between a collateral provider and a collateral taker providing (in whatever terms) for the grant of a security interest in intermediated securities.~~

Article 2

[Scope Sphere of application]

This Convention applies where =

(a) the conflict of laws rules of private international law of the forum state designate the law in force in ~~of~~ a Contracting State as the applicable law; or

(b) the circumstances do not involve a choice in favour of any law other than the law in force in the forum state and the forum state is a Contracting State.

Article 2bis
[Central Securities Depositories]

This Convention does not apply to the activity of creation, recording or reconciliation of securities conducted by central securities depositories or other persons vis-à-vis the issuer of those securities.

Article 3
[Principles of interpretation]

1.—In the implementation, interpretation and application of this Convention, regard is to be had to its purposes, to the general principles on which it is based, to its international character and to the need to promote uniformity and predictability in its application.

2.—~~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.~~

CHAPTER II – RIGHTS OF THE ACCOUNT HOLDER

Article 9
[Intermediated securities]

1. - The credit of securities to a securities account confers on the account holder:
 - (a) the right to receive and exercise the rights attached to the securities, including in particular dividends, other distributions and voting rights
 - (i) where the account holder is not an intermediary or is an intermediary acting for its own account; and,
 - (ii) in any other case, if the ~~domestic non-Convention law~~ so provides;
 - (b) the right, by instructions to the relevant intermediary, to effect a disposition under Article 4 or grant an interest under Article 5~~dispose of the securities in accordance with Articles 4 and 5;~~
 - (c) the right, by instructions to the relevant intermediary, to cause the securities to be held otherwise than through a securities account, to the extent permitted under the law under which the securities are constituted, the terms of the securities, the non-Convention law and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system and the account agreement;
 - (d) unless otherwise provided in~~subject to~~ this Convention, such other rights, including rights and interests in securities, as may be conferred by the ~~domestic non-Convention law~~.
2. - Unless otherwise provided in this Convention,
 - (a) the rights referred to in paragraph 1 are effective against third parties;
 - (b) the rights referred to in paragraph 1(a) may be exercised against the relevant intermediary or the issuer of the securities, or both, in accordance with this Convention, the terms of the securities and the law under which the securities are constituted;

(c) the rights referred to in paragraph 1(b) and 1(c) may be exercised only against the relevant intermediary.

3. - ~~Where an account holder has acquired a security interest, or a limited interest other than a security interest, by credit of securities to its securities account under Article 4(4) securities are credited to a securities account of an account holder in the capacity of collateral taker under Article 5, the domestic non-Convention law determines any limits on the rights described in paragraph 1.~~

Article 10

[Measures to enable account holders to receive and exercise rights]

1. - An intermediary must take appropriate measures to enable its account holders to receive and exercise the rights specified in Article 9(1), but this obligation does not require the relevant intermediary to take any action that is not within its power or to establish a securities account with another intermediary.

2. - This Article does not affect any right of the account holder against the issuer of the securities.

CHAPTER III – TRANSFER OF INTERMEDIATED SECURITIES

Article 4

[Acquisition and disposition of intermediated securities by debit and credit]

1. - ~~Subject to Article 8, i~~intermediated securities are acquired by an account holder by the credit of securities to that account holder's securities account.

2. - No further step is necessary, or may be required by the domestic non-Convention law, to render the acquisition of intermediated securities effective against third parties.

3. - ~~Subject to Article 8, i~~intermediated securities are disposed of by an account holder by the debit of securities to that account holder's securities account.

4. - A security interest, or a limited interest other than a security interest, in intermediated securities may be acquired and disposed of by debit and credit of securities to securities accounts under this Article.

~~4. - Without prejudice to any rule of the domestic non-Convention law requiring that no credit or debit be made without a corresponding debit or credit, a debit or credit of securities to a securities account is not ineffective because it is not possible to identify a securities account to which a corresponding credit or debit has been made.~~

~~5.~~ - Debits and credits to securities accounts in respect of securities of the same description may be effected on a net basis.

~~6.~~ - This Article does not preclude any other method provided by the domestic non-Convention law for the acquisition or disposition of intermediated securities.

Article 5

[Grant of Security interests in intermediated securities by other methods]

1. - An account holder ~~may grants an interest in intermediated securities, including a security interest or a limited interest other than a security interest, to another person collateral taker a security interest in intermediated securities so as to be effective against third parties, if -~~ by-

(a) ~~the account holder entering into an collateral agreement with the collateral taker that person;~~ and

(b) ~~one of the conditions specified in paragraph 2 applies and the relevant Contracting State has made a declaration in respect of that condition under paragraph 4;~~ and no further step is necessary, or may be required by the non-Convention law, to render the interest effective against third parties.

2. - ~~The conditions referred to in paragraph 1(b) are as follows - delivering the intermediated securities to the collateral taker;~~

~~and no further step is necessary, or may be required by the domestic non-Convention law.~~

2. - ~~Intermediated securities shall be treated as delivered to a collateral taker if they are credited to a securities account of the collateral taker.~~

3. - ~~Intermediated securities shall also be treated as delivered to a collateral taker -~~

(aa) ~~that the person to whom the interest is granted is if the relevant intermediary is itself the collateral taker and the relevant Contracting State has made a declaration under paragraph 4 in respect of this sub-paragraph;~~

(bb) ~~that if a designating entry in favour of that person has been made and the relevant Contracting State has made a declaration under paragraph 4 in respect of this sub-paragraph; or~~

(cc) ~~that if a control agreement in favour of that person applies, and the relevant Contracting State has made a declaration under paragraph 4 in respect of this sub-paragraph~~

3. - An interest in intermediated securities may be granted under this Article so as to be effective against third parties -

(a) in respect of a securities account (and such an interest extends to all intermediated securities from time to time standing to the credit of the relevant securities account);

(b) in respect of a specified category, quantity, proportion or value of the intermediated securities from time to time standing to the credit of a securities account.

4. - ~~A Contracting State may declare that under its domestic non-Convention law =~~

(a) ~~the condition specified in any one or more of sub-paragraphs (a) to (c) of paragraph 23 is sufficient, to render an interest effective against third parties to constitute delivery of intermediated securities to a collateral taker;~~

(b) -

5. - ~~A Contracting State may declare that under its domestic non-Convention law this Article shall not apply in relation to security interests in intermediated securities granted by or to parties falling within such categories as may be specified in the declaration;~~

(c) paragraph 3, or either sub-paragraph of paragraph 3, does not apply;

(d) paragraph 3(b) applies with such modifications as may be specified in the declaration.

~~6. — If the domestic non-Convention law so permits, a security interest may be granted —~~

~~(a) in respect of a securities account (and such a security interest extends to all intermediated securities from time to time standing to the credit of the relevant securities account); or,~~

~~(b) in respect of a specified category, quantity, proportion or value of the intermediated securities from time to time standing to the credit of a securities account.~~

~~57. - The domestic non-Convention law determines:~~

~~(a) in what circumstances a non-consensual security interest in intermediated securities may arise and become effective against third parties; and~~

~~(b) the evidential requirements in respect of a collateral agreement and the delivery of intermediated securities to a collateral taker.~~

~~8. — This Article does not preclude any other method provided by the domestic non-Convention law for the grant of a security interest in intermediated securities, but the priority of a security interest granted by any such other method is subject to the rules in Article 6.~~

Article 5bis

[Other methods under non-Convention law]

This Convention does not preclude any method provided by the non-Convention law –

(a) for the acquisition or disposition of intermediated securities or of an interest in intermediated securities;

(b) for the creation of an interest in intermediated securities and for making such an interest effective against third parties;

other than the methods provided by Articles 4 and 5.

Article 5ter

[Evidential requirements]

The non-Convention law determines the evidential requirements in respect of the matters referred to in Articles 4 and 5.

Article 8

[Lack of authorisation, ineffectiveness, Invalidity and reversal]

1. - A debit of securities to a securities account or a designating entry is ~~not effective~~ invalid if ~~unless~~ the relevant intermediary is not authorised to make that debit 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 an~~ a security an interest arising under Article 5(3), by the person to whom that interest is granted ~~collateral taker~~; or

(b) by the ~~domestic~~ non-Convention law.

2. - ~~Subject to Article[s 6 and] 7, the domestic non-Convention law and, to the extent permitted by the domestic non-Convention law, an account agreement or the uniform rules and agreements governing the operation of a securities settlement [or clearing] system determine –~~

~~(a) the validity of a debit, credit or designating entry;~~

~~(b) whether a debit, credit or designating entry is liable to be reversed;~~

~~(c) where a debit, credit or designating entry is liable to be reversed, its effect (if any) against third parties and the consequences of reversal;~~

~~(d) whether and in what circumstances a debit, credit or designating entry may be made subject to a condition; and~~

~~(e) where a debit, credit or designating entry is made subject to a condition, its effect (if any) against third parties before the condition is fulfilled and the consequences of the fulfilment or non-fulfilment of the condition.~~

~~, may provide that a debit or credit of securities or a designating entry is not effective or is liable to be reversed.~~

~~3. – Subject to Article 7, the domestic non-Convention law determines –~~

~~(a) where a debit or designating entry is not authorised or a debit, credit or designating entry is otherwise ineffective, the consequences of such ineffectiveness;~~

~~(b) where a debit, credit or designating entry is liable to be reversed, its effect (if any) against third parties and the consequences of reversal.~~

Article 7

[Acquisition by an innocent person of intermediated securities]

~~1. – Where securities are credited to a securities account under Article 4 and the account holder does not at the time of the credit have knowledge of an adverse claim with respect to the securities –~~

~~(a) the account holder is not subject to the adverse claim;~~

~~(b) the account holder is not liable to the holder of the adverse claim; and~~

~~(c) the credit is not ineffective or reversible on the ground that the adverse claim² affects any previous debit or credit made to another securities account.~~

1. - Where securities are credited to the securities account of an account holder at a time when the account holder does not know that another person has an interest in securities or intermediated securities and that the credit violates the rights of that other person with respect to that interest -

(a) the account holder is not subject to the interest of that other person;

(b) the account holder is not liable to that other person; and

(c) the credit is not invalid or liable to be reversed on the ground that the interest or rights of that other person invalidate any previous debit or credit made to another securities account.

² Further consideration to be given to whether to deal specifically with adverse claims of the intermediary (e.g. by amending the definition of adverse claim).

2. - Where securities are credited to the securities account of an account holder, or an interest becomes effective against third parties under Article 5, at a time when the account holder or the person to whom the interest is granted does not know of an earlier defective entry –

(a) the credit or interest is not rendered invalid, ineffective against third parties or liable to be reversed as a result of that defective entry; and

(b) the account holder, or the person to whom the interest is granted, is not liable to anyone who would benefit from the invalidity or reversal of that defective entry.

3.2. – Paragraphs 1 and 2 does not apply in respect of an acquisition of securities, other than the grant of a security interest, made by way of gift or otherwise gratuitously.

~~3. – An intermediary who makes a debit, credit, or designating entry to a securities account is not liable to the holder of an adverse claim with respect to intermediated securities unless at the time of such debit, credit or designating entry the intermediary has knowledge of the adverse claim.~~

4. - For the purposes of this Article =

(a) “defective entry” means a credit of securities or designating entry which is invalid or liable to be reversed, including a conditional credit or designating entry which becomes invalid or liable to be reversed by reason of the operation or non-fulfilment of the condition;

(b) a person acts with knowledge knows of an interest or fact –adverse claim– if that person =:

(a) has actual knowledge of the adverse claim, the interest or fact; or

(b) has knowledge of facts sufficient to indicate that there is a significant probability that the interest or fact exists the adverse claim exists and deliberately avoids information that would establish the existence of the adverse claim that this is the case; and

(c) and knowledge received by when the person referred to in (b) is an organisation, it knows of an interest or fact is effective for a particular transaction from the time when it the interest or fact is or ought reasonably to have been brought to the attention of the individual conducting that transaction responsible for the matter to which the interest or fact is relevant.

5. - To the extent permitted by the non-Convention law, paragraph 2 is subject to any provision of the uniform rules of a securities settlement system or of the account agreement.

~~[5. – Notwithstanding Article 8{(2)}, if:–~~

~~(a) securities have been credited to a securities account of an account holder, or have been designated in favour of another person in the manner described in Article 5, in circumstances such that the credit or designating entry is not effective or is liable to be reversed; and–~~

~~(b) before that credit or designating entry has been [cancelled or] reversed, the securities are credited to a securities account of a third party, or are designated in the manner described in Article 5 in favour of a third party (such a third party being in either case referred to in this sub-paragraph as “the acquirer”), under a further disposition,~~

~~the fact that the initial credit or designating entry was made in circumstances such that it is not effective or is liable to be reversed does not make the further credit or designating entry ineffective, in favour of the acquirer, against the person making the further disposition, the relevant intermediary or third parties unless:–~~

~~(i) the further credit or designating entry is made conditionally and the condition has not been satisfied;~~

~~(ii) the acquirer has knowledge, at the time when the further credit or designating entry is made, that it is made as a result of the further disposition and that the further disposition is made in the circumstances referred to in this paragraph; or~~

~~(iii) the further disposition is made by way of gift or otherwise gratuitously.]³~~

~~[6. – For the purposes of paragraph 5 the acquirer has knowledge that the further credit or designating entry is made as a result of a purported disposition made in the circumstances referred to in that paragraph if the acquirer has actual knowledge that it is so made, or has knowledge of facts sufficient to indicate that there is a significant probability that it is so made and deliberately avoids information that would establish that that is the case.]~~

Article 6

[Priority among competing security interests]

1. - This Article determines priority between ~~security~~ interests in the same intermediated securities which become effective against third parties under Article 5.

2. - ~~Security~~ Subject to paragraph 5 and Article 6bis, interests that become effective against third parties under Article 5~~(3)~~:

~~(a) have priority over any security interest that becomes effective against third parties by any other method permitted by the domestic non-Convention law other than those provided by Article 5(2) or (3); and~~

~~(b) 3. - Interests that become effective against third parties under Article 5 rank among themselves according to the time of occurrence of the following events:–~~

~~(a) if the relevant intermediary is itself the holder of the interest, when the collateral agreement granting the interest is entered into; if the relevant intermediary is itself the collateral taker;~~

~~(b) when a designating entry is made;~~

~~(c) when a control agreement is entered into, or, if applicable, a notice is given to the relevant intermediary.~~

~~34. - Where an intermediary has an interest that has become effective against third parties under Article 5 and makes a designation or enters into a control agreement with the consequence that an interest of another person becomes effective against third parties, the interest of that other person has priority over the interest of the intermediary unless that other person and the intermediary expressly agree otherwise. enters into a control agreement with a collateral taker or makes a designating entry in favour of a collateral taker, the security interest of the collateral taker has priority over any security interest of the intermediary that is effective against third parties under Article 5(3).~~

~~54. - A non-consensual security interest in intermediated securities arising or recognised under any rule of the domestic non-Convention law has such priority as is afforded to it by that law.~~

³ Further consideration to be given to whether there should be a more general protection against reversal based on reversal etc. of earlier transactions; paragraphs 4 and 5 reproduce Article 7(6) and (7) of Doc.24.

~~5. — Subject to paragraph 2, the priority of any competing security interests in the same intermediated securities is determined by the domestic non-Convention law.~~

~~6. - As between persons entitled to any security interests referred to in paragraphs 2, paragraph 3 and 4 and, to the extent permitted by the domestic non-Convention law, paragraph 5, the priorities provided by this Article and the preceding paragraphs may be varied by agreement between those persons, but any such agreement does not affect third parties.~~

Article 6bis

[Priority of interests granted by an intermediary]

This Convention does not determine the priority or the relative rights and interests between the rights of account holders of an intermediary and interests granted by that intermediary that have become effective under Article 5.

**CHAPTER IV –
INTEGRITY OF THE INTERMEDIATED HOLDING SYSTEM**

Article 11

[Rights of account holders in case of insolvency of intermediary]

The rights of an account holder under Article 9(1), and an ~~security interest interest~~ that has become effective against third parties under Article ~~5(2) or (3)~~, are effective against the insolvency administrator and creditors in any insolvency proceeding in respect of the relevant intermediary.

Article 12

[Effects of insolvency]

Subject to Article 22 and Article 26, nothing in this Convention affects:

- (a) any rules of law applicable in insolvency proceedings relating to the avoidance of a transaction as a preference or a transfer in fraud of creditors; or
- (b) any rules of procedure relating to the enforcement of rights to property which is under the control or supervision of an insolvency administrator.

Article 15

[Prohibition of upper-tier attachment]

1. - No attachment of or in respect of intermediated securities of an account holder shall be granted or made against the issuer of the relevant securities or against any intermediary other than the relevant intermediary.

2. - In this Article "*attachment*" means any judicial, administrative or other act or process for enforcing or satisfying a judgment, award or other judicial, arbitral, administrative or other decision against or in respect of the account holder or for freezing, restricting or impounding property of the account holder in order to ensure its availability to enforce or satisfy any future such judgment, award or decision.

Article 16
[Instructions to the intermediary]

1. - ~~Subject to paragraph 2 [and Article 8(1)], a~~An intermediary is neither bound nor entitled to give effect to any instructions with respect to intermediated securities of an account holder given by any person other than that account holder.

2. - Paragraph 1 is subject to:

(a) the provisions of the account agreement, any other agreement between the intermediary and the account holder or any other agreement entered into by the intermediary with the consent of the account holder;

(b) the rights of any person (including the intermediary) who holds ~~an~~an ~~security~~ interest ~~that has become effective against third parties~~ ~~created~~ under Article 5;

(c) subject to Article 15, any judgment, award, order or decision of a court, tribunal or other judicial or administrative authority of competent jurisdiction;

(d) any ~~mandatory rule~~applicable rule of the ~~domestic~~ non-Convention law; and

(e) where the intermediary is ~~the operator of~~ a securities settlement ~~for clearing~~ system, the uniform rules of that system.

Article 17
[Requirement to hold sufficient securities]

1. - An intermediary must, for each description of securities, hold securities and intermediated securities of an aggregate number and amount ~~at least~~ equal to the aggregate number and amount of securities of that description credited to securities accounts which it maintains ~~for account holders~~⁴.

2. - If at any time an intermediary does not hold sufficient securities and intermediated securities of any description in accordance with paragraph 1, it must within the time required by the non-Convention law ~~immediately~~ ~~promptly~~ take such action as is required ~~necessary~~ to ensure that it holds sufficient securities and intermediated securities of that description.

3. - The preceding paragraphs do not affect any provision of the ~~domestic~~ non-Convention law, or, to the extent permitted by ~~subject to~~ the ~~domestic~~ non-Convention law, any provision of the uniform rules of a securities settlement ~~for clearing~~ system or of an account agreement, relating to the method of complying with the requirements of those paragraphs or the allocation of the cost of ensuring compliance with those ~~the~~ requirements ~~of those paragraphs~~ or otherwise relating to the consequences of failure to comply with those requirements.

⁴ The square brackets in paragraph 1 reflect the need to ensure that the Convention does not relax more stringent requirements under a ~~domestic~~ non-Convention law that might, for example, require the intermediary to maintain with another intermediary securities sufficient to reflect securities that the intermediary carries on its books for its own account. Consideration may be given to addressing this issue more generally in the convention.

Article 18

~~[Limitations on obligations and liabilities of intermediaries]~~~~Application of domestic non-Convention law and~~
~~account agreement to obligations of intermediary]~~

1. - ~~The obligations and duties of an intermediary under this Convention and the extent of the liability of an intermediary in respect of those obligations and the extent of the liability of an intermediary are subject to any applicable provision of the domestic non-Convention law and, to the extent permitted by that the non-Convention law, the account agreement or the uniform rules of a securities settlement system.~~

2. - ~~[An intermediary, including the] [The] operator of a securities settlement system, who makes a debit, credit, or designating entry (an "entry") to a securities account maintained by the [intermediary] [operator] for an account holder is not liable to a third party who has an interest in intermediated securities and whose rights are violated by the entry unless –~~

~~(a) the [intermediary] [operator] makes the entry after the [intermediary] [operator] has been served with legal process restraining it from doing so, issued by a court of competent jurisdiction, and has had a reasonable opportunity to act on that legal process; or~~

~~(b) the [intermediary] [operator] acts wrongfully and in concert with another person to violate the rights of that third party.~~

3. - ~~Paragraph 2 does not affect any liability of the [intermediary] [operator] -~~

~~(a) to the account holder or a person to whom the account holder has granted an interest that has become effective against third parties under Article 5; or~~

~~(b) that arises from an entry which the [intermediary] [operator] is not entitled to make under Article 16.~~

4. - ~~The operator of a securities settlement system or securities clearing system to whose securities account securities are credited and who authorises a matching debit of those securities to its securities account is not liable to a third party who has an interest in intermediated securities and whose rights are violated by that credit or debit unless –~~

~~(a) the operator receives the credit or authorises the debit after the operator has been served with legal process restraining it from doing so, issued by a court of competent jurisdiction, and has had a reasonable opportunity to act on that legal process; or~~

~~(b) the operator acts wrongfully and in concert with another person to violate the rights of that third party.~~

Article 19

~~[Allocation of securities to account holders' rights-
securities so allocated not property of the intermediary]~~

1. - ~~Securities of each description held by an intermediary or credited to securities accounts held by an intermediary with another intermediary shall be allocated to the rights of the account holders of that the former intermediary to the extent necessary to ensure that the aggregate number or amount of the securities of that description so allocated is equal to the aggregate number or amount of such securities credited to securities accounts maintained by the intermediary for account holders other than itself.~~

2. - ~~Subject to Article 6bis, sSecurities allocated under paragraph 1 shall not form part of the property of the intermediary available for distribution among or realisation for the benefit of its~~

~~unsecured creditors in the event of an insolvency proceeding in respect of the intermediary or be otherwise subject to claims of unsecured creditors of the intermediary.~~

3. - ~~Subject to paragraph 4, t~~The allocation required by paragraph 1 shall be effected by the ~~domestic non-Convention law and, subject to the domestic~~ to the extent required or permitted by the non-Convention law, by arrangements made by the relevant intermediary.

4. - The arrangements referred to in paragraph 3 may include arrangements under which an intermediary holds securities in segregated form –

(a) for the benefit of its account holders generally; or

(b) for the benefit of particular account holders or groups of account holders;

in such manner as to ensure that such securities are allocated in accordance with paragraph 1.

~~4. 5. -~~ A Contracting State may declare that under its ~~domestic non-Convention law~~ the allocation required by paragraph 1 applies only to securities ~~– that are held by the relevant intermediary in segregated form under arrangements such as are referred to in paragraph 4~~ with another intermediary under an arrangement for the segregation of securities held by the relevant intermediary for the benefit of its account holders and does not apply to securities held with another intermediary – by the relevant intermediary for its for the relevant intermediary's own account.

Article 20

[Loss sharing in case of insolvency of the intermediary]

1. ~~— In any insolvency proceeding in respect of an intermediary, if the aggregate number or amount of securities and intermediated securities of any description held by an intermediary is less than the aggregate number or amount of securities of that description credited to securities accounts, the shortfall shall be allocated:~~

(a) ~~— subject to sub-paragraph (b), among the account holders to whose securities accounts securities of the relevant description are credited, in proportion to the respective numbers or amounts of securities so credited; or~~

(b) ~~— where the intermediary is [the operator of] a securities settlement [or clearing] system and the rules or agreements governing the operation of the system make provision for the allocation of the shortfall, in the manner so provided.~~

2. ~~— [Unless otherwise provided by the domestic non-Convention law,] [I]n any allocation required under paragraph 1(a) no account shall be taken of:~~

(a) ~~— the origin of, or any past dealings in, any securities held by the intermediary or credited to securities accounts held by the intermediary with another intermediary; or~~

(b) ~~— the order in which or time at which any securities are credited or debited to the respective securities accounts of account holders.~~

3. ~~— The preceding paragraphs are subject to any conflicting rule applicable in the insolvency proceeding of the intermediary.~~

1. - This article applies in any insolvency proceeding in respect of an intermediary unless otherwise provided by any conflicting rule applicable in that proceeding.

2. - If the aggregate number or amount of securities of any description allocated under Article 19 to an account holder, a group of account holders or the intermediary's account holders generally is less than the aggregate number or amount of securities of that description credited to

the securities accounts of that account holder, that group of account holders or the intermediary's account holders generally (as the case may be), the shortfall shall be borne –

(a) where securities have been allocated to a single account holder, by that account holder;

(b) in any other case, by the account holders to whom the relevant securities have been allocated, in proportion to the respective number or amount of securities of that description credited to their securities accounts.

3. - To the extent permitted by the non-Convention law, where the intermediary is the operator of a securities settlement system and the uniform rules of the system make provision in case of a shortfall, the shortfall shall be borne in the manner so provided.

Article 21

~~[...Overriding effect of certain rules of securities settlement [or clearing] systems]~~

~~Any provision of the rules or agreements governing the operation of a securities settlement [or clearing] system [which is directed to the stability of the system or the finality of transactions effected through the system] shall, to the extent of any inconsistency, prevail over any provision of [Articles 8, X, Y, ...] [this Convention].~~

Article 22

~~[Effectiveness of debits, credits etc. and instructions on insolvency of operator or participant in securities settlement [or clearing] system]~~

1. - To the extent permitted by the non-Convention law, the following provisions ~~Any provision of the rules or agreements governing the operation of a securities settlement [or clearing] system [which is directed to the stability of the system or the finality of transactions] shall have effect notwithstanding the commencement of an insolvency proceeding in respect of [the operator of] the relevant system or any participant in the relevant system in so far as that provision:-~~

~~(a) precludes the invalidation or reversal of a debit or credit of securities to, or a designating entry in, a securities account which forms part of the system after the time at which that debit, credit or designating entry is treated as final under the rules of the system;~~

~~(a) any provision of the uniform rules of a securities settlement system or of a securities clearing system in so far as that provision precludes the revocation of any instruction given by a participant in the system for making a disposition of securities, or for making a payment relating to an acquisition or disposition of securities, after the time at which that instruction is treated under the rules of the system as having been entered irrevocably into the system;-~~

(b) any provision of the uniform rules of a securities settlement system in so far as that provision precludes the invalidation or reversal of a debit or credit of securities to, or a designating entry in, a securities account which forms part of the system after the time at which that debit, credit or designating entry is treated as irrevocable under the rules of the system.

2. - Paragraph 1 applies notwithstanding that any invalidation, reversal or revocation referred to in that paragraph would otherwise occur by under any rule applicable in an insolvency proceeding ~~mandatory operation of the insolvency law of a Contracting State.~~

**CHAPTER IVBIS –
RELATIONSHIP WITH ISSUERS OF SECURITIES**

Article 13

[Position of issuers of securities]

1. - The law of a Contracting State shall permit the holding through intermediaries of securities that are permitted to be traded on an exchange or regulated market, and the effective exercise in accordance with Article 9 of the rights attached to such securities which are so held, but need not require that all such securities be issued on terms that permit them to be held through intermediaries. ~~This is without prejudice to the terms of issue of the securities.~~

2. - In particular, the law of a Contracting State shall recognise the holding of such securities described in paragraph 1 by a person acting in his own name on behalf of another person ~~(including a nominee)~~ or other persons and shall permit such a person to exercise voting or other rights in different ways in respect of different parts of a holding of securities of the same description; but this Convention does not determine the conditions under which such a person is authorised to exercise such rights.-

3. This Convention does not determine whom an issuer is required to recognise as the holder of securities.

Article 14

[Set-off]

1. - As between an account holder who holds intermediated securities for its own account and the issuer of those securities, the fact that the account holder holds the securities throughwith an intermediary or intermediaries shall not of itself, in any insolvency proceeding in respect of the issuer, preclude the existence or prevent the exercise of any rights of set-off which would have existed and been exercisable if the account holder had held the securities otherwise than through an intermediary.

2. - This Article does not affect any express provision of the terms of issue of the securities.

**CHAPTER V – SPECIAL PROVISIONS WITH RESPECT TO
COLLATERAL TRANSACTIONS⁵**

Article 23

[Scope and interpretation in Chapter V]

1. - This Chapter applies to collateral agreements under which a collateral provider ~~delivers~~ grants a security interest in intermediated securities to a collateral taker ~~under Article 5(2) or Article 5(3)~~ in order to secure the performance of any existing or future obligation of the collateral provider or a third person.

⁵ Further consideration will be given to the terminology of this Chapter and its consistency with that of the remainder of the preliminary draft Convention.

2. - In this Chapter –

(a) “collateral agreement” means a security collateral agreement or a title transfer collateral agreement;

(b) “security collateral agreement” means an agreement between a collateral provider and a collateral taker providing (in whatever terms) for the grant of an interest other than full ownership in intermediated securities for the purpose of securing the performance of relevant obligations;

(c) “title transfer collateral agreement” means an agreement, including an agreement providing for the sale and repurchase of securities, between a collateral provider and a collateral taker providing (in whatever terms) for the transfer of full ownership of intermediated securities by the collateral provider to the collateral taker for the purpose of securing or otherwise covering the performance of relevant obligations;

(d) “relevant obligations” means any present or future obligations of a collateral provider or a third person; ~~“enforcement event” means, in relation to a collateral agreement, an event on the occurrence of which, under the terms of that collateral agreement, the collateral taker is entitled to enforce its security;~~

(~~e~~) “collateral securities” means intermediated securities delivered under a collateral agreement;

(~~e~~) “secured obligations” means the obligations secured by a collateral agreement.

(f) “collateral taker” means a person to whom an interest in intermediated securities is granted under a security collateral agreement or to whom full ownership of intermediated securities is transferred under a title transfer collateral agreement;

(g) “collateral provider” means an account holder by whom an interest in intermediated securities is granted under a security collateral agreement or full ownership of intermediated securities is transferred under a title transfer collateral agreement;

(h) “enforcement event” means, in relation to a collateral agreement, an event of default or other event on the occurrence of which, under the terms of that collateral agreement, the collateral taker is entitled to enforce its security or operate a close-out netting provision;

(i) “equivalent collateral” means securities of the same description as collateral securities;

(j) “close-out netting provision” means a provision of a collateral agreement, or of a set of connected agreements of which a collateral agreement forms part, under which, on the occurrence of an enforcement event, either or both of the following shall occur, or may at the election of the collateral taker occur, whether through the operation of netting or set-off or otherwise:

(i) the respective obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value or are terminated and replaced by an obligation to pay such an amount;

(ii) an account is taken of what is due from each party to the other in respect of such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party.

*Article 23bis**[Recognition of title transfer collateral agreements]*

1. - The law of a Contracting State shall permit a title transfer collateral agreement to take effect in accordance with its terms.

2. - If an enforcement event occurs while any obligation of the collateral taker to transfer equivalent collateral under a title transfer collateral agreement remains outstanding, that obligation and the relevant obligations may be the subject of a close-out netting provision.

*Article 24**[Enforcement]*

1. - On the occurrence of an enforcement event, the collateral taker may —

(a) realise the collateral securities provided under a security collateral agreement:

(i) by selling them and applying the net proceeds of sale in or towards the discharge of the secured relevant obligations; or

(ii) by appropriating the collateral securities as the collateral taker's own property and setting off their value against, or applying their value in or towards the discharge of, the relevant secured obligations, provided that the collateral agreement provides for realisation in this manner and specifies the basis on which collateral securities are to be valued for this purpose; or

(b) operate a close-out netting provision. -

2. - Collateral securities may be realised, and a close-out netting provision may be operated, under paragraph 1:

(a) subject to any contrary provision of the collateral agreement, without any requirement that:

(i) prior notice of the intention to realise or operate the close-out netting provision shall have been given;

(ii) the terms of the realisation or the operation of the close-out netting provision be approved by any court, public officer or other person; or

(iii) the realisation be conducted by public auction or in any other prescribed manner or the close-out netting provision be operated in any prescribed manner; and

(b) notwithstanding the commencement or continuation of an insolvency proceeding in respect of the collateral provider or the collateral taker.

~~3. — A collateral agreement may provide that, if an enforcement event occurs before the secured obligations have been fully discharged, either or both of the following shall occur, or may at the election of the collateral taker occur, whether through the operation of netting or set-off or otherwise:~~

~~(a) — the respective obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value or are terminated and replaced by an obligation to pay such an amount;~~

~~(b) an account is taken of what is due from each party to the other in respect of such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party.~~

~~4. This Article is without prejudice to any requirement of the domestic non-Convention law to the effect that the realisation or valuation of collateral securities or the calculation of any obligations must be conducted in a commercially reasonable manner.~~

Article 25

[Right to use collateral securities under security collateral agreement]

1. - If and to the extent that the terms of a security collateral agreement so provide ~~(or, where collateral securities are delivered to the collateral taker under Article 5(2), if and to the extent that the terms of the collateral agreement do not provide otherwise)~~, the collateral taker shall have the right to use and dispose of the collateral securities as if it were the owner of them (a “right of use”).

2. - Where a collateral taker exercises a right of use, it thereby incurs an obligation to replace the collateral securities originally transferred (the “*original collateral securities*”) by transferring to the collateral provider, not later than the discharge of the ~~secured~~ relevant obligations, securities of the same issuer or debtor, forming part of the same issue or class and of the same nominal amount, currency and description equivalent collateral or, where the security collateral agreement provides for the transfer of other assets [following the occurrence of any event relating to or affecting any securities provided as collateral], those other assets.

3. - Securities transferred under paragraph 2 before the ~~secured~~ relevant obligations have been fully discharged:

(a) shall, in the same manner as the original collateral securities, be subject to a security interest under the relevant security collateral agreement, which shall be treated as having been created at the same time as the security interest in respect of the original collateral securities was created; and

(b) shall in all other respects be subject to the terms of the relevant security collateral agreement.

4. - The exercise of a right of use shall not render invalid or unenforceable any right of the collateral taker under the relevant security collateral agreement.

Article 25bis

[Requirements of non-Convention law relating to enforcement]

Articles 23bis, 24 and 25 do not affect any requirement of the non-Convention law to the effect that the realisation or valuation of collateral securities or the calculation of any obligations must be conducted in a commercially reasonable manner.

Article 26

[Top-up or substitution of collateral]

1. - Where a collateral agreement includes:

(a) an obligation to deliver ~~collateral securities or additional collateral securities~~ —

(i) ~~___~~ in order to take account of changes in the value of the collateral provided under the collateral agreement or in the amount of the ~~secured~~relevant obligations;

(ii) ~~___~~, in order to take account of any circumstances giving rise to an increase in the credit risk incurred by the collateral taker, ~~as determined by reference to objective criteria relating to the creditworthiness, financial performance or financial condition of the collateral provider or other person by whom the relevant obligations are owed;~~ ~~or,~~

(iii) ~~___~~ to the extent permitted by the ~~applicable~~ non-Convention law ~~as determined by the private international law rules of the forum~~, in any other circumstances specified in the collateral agreement, ~~or~~

(b) a right to withdraw collateral securities or other assets on providing collateral securities or other assets of substantially the same value,

the provision of securities or other assets as described in paragraph (a) and paragraph (b) shall not be treated as invalid, reversed or declared void solely on the basis that they are provided during a prescribed period before, or on the day of but before, the commencement of an insolvency proceeding in respect of the collateral provider, or after the ~~secured~~relevant obligations have been incurred.

2. - A Contracting State may declare that paragraph 1(a)(ii) does not apply.

Article 27

[Declarations in respect of Chapter V]

1. - A Contracting State may declare that this Chapter shall not apply under its ~~domestic~~ non-Convention law .

2. - A Contracting State may declare that under its ~~domestic~~ non-Convention law this Chapter shall not apply –

(a) in relation to collateral agreements entered into by natural persons or persons falling within such other categories as may be specified in the declaration;

(b) in relation to intermediated securities which are not permitted to be traded on an exchange or regulated market;

(c) in relation to collateral agreements which provide for ~~secured~~relevant obligations falling within such categories as may be specified in the declaration.

CHAPTER VI – FINAL CLAUSES

Article X

[Applicability of Declarations]

A declaration made by a Contracting State under any article of this Convention is applicable only if the law of that Contracting State is the non-Convention law.

**Comments on the UNIDROIT preliminary draft Convention on Substantive
Rules regarding Intermediated Securities**

(prepared by the Zentraler Kreditausschuss)

ZENTRALER KREDITAUSSCHUSS

MITGLIEDER: BUNDESVERBAND DER DEUTSCHEN VOLKSBANKEN UND RAIFFEISENBANKEN E.V. BERLIN ·
BUNDESVERBAND DEUTSCHER BANKEN E.V. BERLIN BUNDESVERBAND ÖFFENTLICHER BANKEN
DEUTSCHLANDS E.V. BERLIN · DEUTSCHER SPARKASSEN- UND GIROVERBAND E.V. BERLIN-BONN
VERBAND DEUTSCHER PFANDBRIEFBANKEN E.V. BERLIN



Comments on the UNIDROIT Preliminary Draft Convention on Harmonised Substantive Rules Regarding Intermediated Securities of March 2006

25. September 2006

The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks financial group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,300 banks.

The BVI was founded in 1970 and has become the central association which represents the interests of the German investment fund industry. Its 80 members (mutual fund companies, institutional fund companies and asset management companies) have more than 1,150 billion (1.15 trillion) euros of aum (assets under management), manage 2,850 retail funds (Publikumsfonds) and 4,688 institutional funds (Spezialfonds) for 15 million investors.

General

In UNIDROIT's third preliminary draft of a Convention on Substantive Rules Regarding Intermediated Securities, the UNIDROIT secretariat and the experts present at the intergovernmental conference have, once more, achieved a further improvement over the predecessor drafts. There are many provisions which have received a clearer and simpler language and – in view of the different national jurisdictions – a more neutral wording.

Yet, we see a certain danger for the realisation of the goals which the UNIDROIT Convention seeks to achieve. These dangers result from the numerous qualifications for the provisions at the level of Member States (hereinafter domestic non-Convention law). By way of example, we would like to mention: Article 4 (4), Article 5, (4), (5) and Article 8 (2). The more exceptions and derogations are possible under national law, the lower will be the degree of harmonisation of substantive law. We suggest that the next intergovernmental conference should see a renewed attempt to replace the currently possible national law waivers from the Convention's provisions for the benefit of a central, final and absolute regulation within the Convention.

The German banking industry, co-operating under the umbrella of the Zentraler Kreditausschuss (ZKA), continues to endorse UNIDROIT's work on this Convention. We see a link between this Convention and The Hague Securities Convention which has recently been signed by the first States and we believe that both Conventions will mutually complement each other. We are confident that, at the next intergovernmental conference scheduled for autumn 2006, UNIDROIT will see further breakthroughs on the road towards a final draft of the Convention and wish it the best of success for this work. Our comments below seek to make a contribution towards this goal.

Definition of "securities" and "intermediated securities" (Article 1 lit. a and f)

We welcome the amendment of the definition of "securities" that has taken place. The present draft has incorporated as an additional requirement that financial instruments or financial assets need to be capable of being credited to a securities account; this meets our demands that the scope of the definition of the term "securities" be narrowed down. The present language would, for instance, exempt from the Convention's regulatory scope those interests which fall under company law; at least in Germany, such interests are generally not assigned by means of crediting to an account.

From the report on the last intergovernmental conference we take it that there are still plans to draft another working paper on the definition of "securities" and "securities held with an intermediary". We would, therefore, also like to submit our comments on the following issue which was discussed at the intergovernmental conference: What is the policy for dealing with scenarios where – under the transferee's jurisdiction — the financial instrument may be credited to a securities account, yet, where this is not an option under the domestic non-Convention law of the transferee's home State? In other words: Which jurisdiction should take priority in deciding whether a financial instrument is "capable of being credited to a securities account"? Apparently, at the intergovernmental conference, suggestions have been made that the collateral taker's State shall treat the financial instrument in the same way as the collateral provider's State (cf. Doc. 43 No. 18 (p. 4)).

We feel that a regulation of this matter within the UNIDROIT Convention would be inappropriate. Instead, this issue belongs to the sphere of international private law. It should, therefore, not be covered by a Convention on the harmonisation of substantive law. It is already regulated through The Hague Securities Convention. Quite rightly, The Hague Securities Convention predicates its solution on the jurisdiction of the State where the transferee resides, not on the State of the transferee. In our view, the authority to decide whether a certain financial instrument is capable of being credited to a securities account should lie with the transferee's State.

Definition of "control agreement" (Article 1 lit. m and lit. n)

The present draft Convention provides a far more intelligible definition of "control agreement" than was the case in previous versions and it has successfully achieved this

without making any substantial changes. We explicitly welcome the fact that the specification of those account-holder instructions which the intermediary must not follow without prior approval of the collateral taker and the specification of those collateral taker instructions which the intermediary must follow, can now be regulated within the control agreement or under domestic non-Convention law

Definition of "securities interest" (Article 1 lit. r through t)

We welcome the fact that — due to the economic significance of the collateral agreements — the Convention now also provides a definition of collateral taker, collateral provider, and collateral agreement. In addition to this, we feel that there should also be a definition of the term "securities interest".

In line with the provisions under the Financial Collateral Directive, the definition under the Convention should, however, distinguish between the transfer of full ownership of the financial collateral and financial collateral arrangements by way of security where the full-ownership remains with the collateral provider. Notwithstanding the foregoing, since the term "security interest" constitutes a legal term under U.S. law (Article 9 Uniform Commercial Code), this term should preferably be avoided. Also the Financial Collateral Directive makes use of a neutral term ("security financial collateral"). The following terminology would be possible: The term "collateral" might serve as a generic concept. Sub-concepts could be "transfer of title collateral" and "security collateral". The major difference would be the transfer of ownership to the collateral taker (transfer of title collateral) or the retention of ownership by the collateral provider (in the case of security collateral). The term "disposition" would have to be rephrased: "...includes a transfer of title, whether outright or by way of collateral, and a grant of securities collateral."

Acquisition and disposition – Effectiveness towards third parties (Article 4 (2)) 2)

The language of Article 4(2) provides that, apart from the requirements under paragraph (1), no further step shall be necessary, or may be required by the domestic non-Convention law, to render the acquisition of intermediated securities effective against third parties. This language has been adopted from the previous draft without any amendments. At this point, we should like to reiterate our comments made concerning the previous draft:

It remains unclear whether the addition "against third parties" seeks to exempt the issue of the effectiveness of the account holder's acquisition towards the intermediary from the scope of application of Article 4 (2). We see no need for this: The credit to the account holder's securities account should rather more be effective towards everyone, i.e. towards both, third parties and the intermediary alike¹. Hence, the words "against third parties" should be removed. At least, however, the Explanatory Notes on Article 4 (2) ought to point out that said provision also includes the effectiveness towards the intermediary.

Disposition of securities by the account holder (Article 4 (3))

The term "disposed" used in Article 4 (3) has not been synchronised with the term "disposition" as defined in Article 1 lit. h. Whilst Article 4 (3) only covers the "title transfer" by means of crediting to a different securities account, the term "disposition" also includes financial collateral arrangements by way of security. Article 4 (3) should therefore read: "The title to intermediated securities is transferred by an account holder ..." Accordingly, Article 4 (1) should read: "The title to intermediated securities is acquired by an account holder..."

Security interests in intermediated securities (Article 5)

Under Article 1 lit. r through lit. t, the terms "collateral taker", "collateral provider" and "collateral agreement" are only used in the context of granting "security interest", concluding a "control agreement" and effecting a "designated entry". If the term "security interest" were to only cover financial collateral arrangements as security interests (such as liens, charges, pledges) (which is currently the case under the provisions of Article 1 lit. h), then the limitation of the terms "control agreement" and "designating entry" to a "securities interest" would make sense: After all (unless the securities are kept in custody by the collateral taker) said financial collateral arrangements as security interests are the only case where the pledged securities will remain credited to the account of the collateral provider and only in such cases will the collateral taker exercise control over the pledged securities via the collateral provider's intermediary who accordingly changes his will to now possess the benefit of the collateral taker.

¹ Again, we would like to refer to the explanatory comments made by UNIDROIT concerning the draft Convention of November 2004 (page 26 on Article 2 (2)): "Most jurisdictions give an account holder's right the status of being generally effective against anybody, i.e. the intermediary and third parties. This is also one of the foremost objectives of the preliminary draft Convention".

However, as regards the terms "collateral taker", "collateral provider" and "collateral agreement", a broad definition which should also include transfer of full ownership of the financial collateral, would be desirable. The fact that the terms "collateral taker", "collateral provider" and "collateral agreement" shall also include title transfer structures, is evidenced by Article 5 (1) which calls for conclusion of a collateral agreement also in the case of a transfer of full ownership of the financial collateral; furthermore, this also becomes evident in Article 9 (3), according to which the domestic non-Convention law may limit the collateral taker's rights of ownership. This finding, too, indicates that the term "security interest" is meant to cover both types of collateralisation. We therefore reiterate our request (under Article 1 lit. r through lit. t) for a definition of "security interest" in a way that this term covers both forms of collateralisation, i.e. financial collateral arrangements by way of security and transfer of full ownership of the financial collateral.

Declaration to be made by the Contracting State (Article 5 (3) and (4))

The fact that the creation of a security interest in intermediated securities through designating entry and through a control agreement requires that the relevant Contracting State has made a declaration, constitutes an unwanted hurdle on the road towards harmonisation and thus towards legal certainty in ascertaining the preconditions for the creation of collateral. Hence, it should be sufficient that the respective domestic non-Convention law regulates the types of collateral arrangements described hereunder.

Hence, we would like to suggest the reverse regulatory approach, namely that a Contracting State needs to declare that, under its jurisdiction, — potentially either through designating entry or through a control agreement — collateral arrangements shall not be an option. Article 5 (4) should be amended accordingly.

Consideration of a Contracting State's non-Convention law when creating and realising collateral (Article 5 (5) and Article 5 (7) lit. b)

Article 5 (5) and Article 5 (7) lit. b allow the domestic non-Convention law to lay down special requirements as regards the creation and realisation of collateral agreements. One lesson learnt in the context of the Financial Collateral Directive, however, is that, more often than not, the provision of choice tends to have a counterproductive effect as regards the overall goal of a comprehensive harmonisation. In view of this, the scope of

paragraphs 5 and 7 lit. b should be narrowed down, i.e. domestic non-Convention law should not stipulate any formal requirements as regards the creation, effectiveness and evidential requirements in court proceedings (e.g. written form, authentication of documents by notaries, registration, data certa). Article 3 of the Financial Collateral Directive can be seen as one example for a regulation that is fit for purpose. Article 5 (5) , (7) should therefore be complemented by a second sentence which should read as follows²:

"Member States shall not require that the creation, validity, perfection, enforceability or admissibility in evidence of a financial collateral arrangement or the provision of financial collateral under a financial collateral arrangement be dependent on the performance of any formal act."

Concerning Article 5 (7) lit. b we should furthermore like to point out that, as far as its regulatory content is concerned, it would rather tie in with Articles 23 ff. and that it may be more appropriate to relocate it thereunder.

Subject matter of collateral interests (Article 5 (6) lit. b)

Article 5 (6) lit. b stipulates that financial collateral arrangements by way of security may also be granted in respect of a quantity, proportion or a value of securities. Yet, there are special case groups where this provision is likely to clash with the principle of clarity and definiteness under Germany's *property law*. The fact that the principle of clarity and definiteness shall also apply under the Convention, can be seen in Article 1 lit. n, pursuant to which a designated entry shall refer to specified securities credited to the securities account. Since the value may vary, a security interest in securities which is only defined in terms of its value, does not allow determining those securities which are encumbered by a security interest.

Priority among competing collateral interests (Article 6 (2) lit. a)

Under the provisions of Article 6(2) lit. a, security interests in intermediated securities which have become effective towards third parties under the provisions of Article 5(3), shall have priority over those security interests which have become effective towards third

² Cf. Article 3(1), Financial Collateral Directive (Directive 2002/47/EC).

parties in a different manner that is permissible under domestic non-Convention law, yet which is unrelated to Article 5 (2) and (3).

First of all, we should like to point out that this provision is not easily understood and that its wording is rather cumbersome. Also in terms of its content, the provision does not appear to be in line with the *ratio legis* behind the definition of a ranking of priorities under Article 6: The goal behind the ranking proposed in the draft Convention consists in promoting the application of the Convention at an international level by ensuring that those collateral takers who comply with the rules of the Convention shall have priority over those collateral takers who ignore the rules of the Convention. Hence, all security interests which have been created in line with the Convention's provision have to take precedence over those security interests which have been created under domestic non-Convention law.

Pursuant to the present draft of Article 6 (2), only those collateral interests shall have priority which have been created in line with the provisions under Article 5 (3). Article 5 (3), however, only regulates those cases where intermediated securities have to be deemed as delivered to the collateral taker. The actual "method" for the creation of collateral under the Unidroit Convention is specified in Article 5 (1): A collateral agreement and a delivery to a collateral taker are required. Paragraphs (2) and (3) contain a concept clarification of the term "delivery". Should the current language under Article 6 (2) be upheld, then this would signify that – whilst nothing would change for all other collateral created under the provisions of the Convention – collateral which become effective through a collateral agreement and crediting to the collateral taker's securities account, would no longer have priority over collateral which becomes effective under the provisions of domestic non-Convention law but would have priority over all other collateral created in line with the Convention (Article 5 (1) in conjunction with Article 5 (3)). Even if this were deliberately intended, it remains unclear, how these securities should be treated in terms of their priority.

More correctly (and linguistically more concise) Article 6 (2) should therefore read:

"Securities interests that become effective against third parties under Article 5:
(a) have priority over any security interest that becomes effective against third parties by any other method permitted by the domestic non-Convention law;
..."

Last but not least, from the expression "*become* effective" used in the introductory sentence we conclude that this prioritisation rule shall not be applicable to legacy cases. An approach where collateral that predates the implementation of the Convention suddenly becomes subordinate in rank to new collateral provided under the terms of the Convention, would be unjustifiable. After all, the earlier collateral was created at a point in time where the possibility to provide collateral under the provisions of Article 5 and therefore to benefit from the provisions of Article 6 (2) lit. a, was not even an option yet. Should our view be incorrect, then we would appreciate the introduction of a "grandfathering clause" in the Convention.

Priority among competing collateral interests (Article 6 (2) lit. b)

The new Draft Convention predicates the rank of such collateral which have been provided under the terms of the Convention on certain events. In the case of a collateral for the benefit of the relevant intermediary, this shall be the point in time where the collateral agreement is made (Article 6(2) lit b (i)) i.e. the point in time where the collateral becomes effective (Article 5(1) lit a). In all other cases only one of the two prerequisites for the coming into effect of the collateral, namely the delivery, is mentioned as decisive for the ranking of the collateral. Yet, to be correct, also in these cases the ranking needs to be predicated on the point in time at which the collateral was created. Hence, Article 6 (2) lit. b should use the same language as in the previous draft (cf: Article 10 (1) lit. b):

"(b) rank among themselves in the order in which they were created"

Agreement on the ranking (Article 6 (6))

Under the provisions of Article 6 (6), the respective collateral takers may agree a derogation from the priorities stipulated by the preceding paragraphs. We welcome the fact that the provision now includes a clear qualification to the effect that any such agreement shall not affect third parties.

**Knowledge of the existence of an "adverse claim"
(Article 7 (4) lit. b and Article 7 (6))**

Article 7 (4) lit. b and Article 7 (6) ("...and deliberately avoids information that would establish the existence of the adverse claim.") must not be construed to mean that the collateral taker has an obligation to conduct investigations. It should therefore be pointed out in an Explanatory Report that the aforementioned phrasing under Article 7 (4) lit. b and Article 7 (6) does not give rise to any such investigation obligation.

The same applies to the last half sentence added under Article 7 (4) lit. b which refers to the attribution of knowledge received by an "organisation". The term organisation can be construed in a very broad sense so that it may even give rise to a group-wide knowledge attribution.

Irrelevance of the ineffectiveness of an earlier disposition (Article 7 (5))

Article 7 (5) is to be welcomed. The person acquiring a security interest should not have to worry whether the collateral provider attained its ownership or the realisation right in the securities in an effective manner. In this regard, again, the Explanatory Report on Article 7 (6) should point out that there is no investigative duty concerning potential, adverse claims.

**Effectiveness of a debit of securities to a securities account subject to authorisation
(Article 8 (1))**

Whilst the same does not apply to the effectiveness of the credit and contrary to the previous draft Convention, the effectiveness of the debit is no longer subject to a corresponding authorisation of the relevant intermediary. Admittedly, in standard securities transactions handled via the stock exchange or a different marketplace, the respective order of the securities account holder to the crediting intermediary to buy securities can invariably be construed as an authorisation; yet, as regards the direct transfer from one account holder to another, such an authorisation is tenuous, at best. Hence, we endorse the foregoing amendment as correct.

Conditional debit or credit (formerly: Article 7 (4))

The provision previously contained in Article 7 (4) under which it was specifically allowed to impose certain conditionalities upon the debit or credit, is no longer contained in the present draft. The Chairman of the Drafting Committee provides the following explanation for this deletion: "[...] *former paragraph (4) had been removed, as conditional debit or credit could be dealt with in former Article 7 (5), now 7 (2).*" As the Chairman of the Drafting Committee pointed out quite rightly, the case group of conditional credit or debit resulting from Article 7 (5) of the previous version is now covered by Article 8 (2). On the grounds of transparency, we feel it is preferable to include this case group by way of example under the Convention. It could, for instance, be modelled on the language of Article 7 (4) of the previous draft. At least, however, there should be a statement of motivation concerning Article 8 (2) which ought to point out that the scope of Article 8 (2) shall also cover the case of conditional debits or credits.

Domestic non-Convention law that may provide that a debit or credit of securities or a designating entry is not effective or is liable to be reversed (Article 8 (2))

Under the provisions of Article 8 (2), the domestic non-Convention law or – if and when this is permissible under the domestic non-Convention law – an account agreement or the rules of a clearing and settlement system may provide that a debit or credit or a designating entry is invalid or liable to be reversed. Should, however, the effectiveness of the debit or credit or the designating entry be regulated by the respective domestic non-Convention law (and, potentially, further rules), then the Convention will not be able to achieve the goal of a legal harmonisation as regards the transfer of intermediated securities. At the end of the day, this would always (also) boil down to the respective national jurisdictions.

We therefore explicitly suggest narrowing down the scope of the provisions under Article 8 (2) by limiting the derogation for non-Convention law to the degree necessary. For the purposes of the Convention's *ratio legis*, i.e. the achievement of a harmonisation of substantive rules on intermediated securities, it will be sufficient to allow a conditional credit or debit. Furthermore, , it should no longer be possible to digress from the provisions of the present Convention in favour of the provisions of non-Convention domestic law as currently contained und Article 8 (2).

Chapter III

Rights of the account holder

Rights that may be exercised against the intermediary (Article 9 (2))

The amendments to Article 9 (2) are a great benefit for the Convention. Through the differentiation concerning the parties against which the account holder's rights may be exercised (particularly Article 9 (2) lit. b), the idiosyncracies of the respective national jurisdictions are taken into account. Pursuant to this, the identification of the person against whom a right may be exercised, is based on Convention's provisions, the terms of issue and the legal jurisdiction under which the securities have been issued.

However, it is not immediately obvious why the term "relevant intermediary" has been removed. This removal has to be reversed again, because the rights under paragraph (1) should also take effect towards the relevant intermediary. At least there should be a statement of motivation concerning Article 9 (2) lit. b where it is being pointed out that this means that the rights acquired through a credit shall also take effect towards the relevant intermediary.

Measures which need to be adopted by the intermediary (Article 10)

The new provision under Article 10 is a great achievement and much clearer than the corresponding provisions contained in the previous draft. We particularly agree to the new Article 10 (2) which clarifies that the rights of the account holder against the issuer shall be independent of the duty of the intermediary to take appropriate measures to enable account holders to receive and exercise the rights specified in Article 9 (1).

Even without explicitly mentioning this under the Convention: it is obvious that the intermediary only has to meet these obligations against an adequate compensation; this is currently also set forth by Article 128. (6) of the German Stock Corporation Act (Aktiengesetz).

Requirement for the intermediary to hold sufficient securities (Article 17)

The first paragraph of Article 17 (1) contains an addition in brackets ("for account holders"). This addition should be maintained. A qualification of the intermediary's duty to hold sufficient cover assets only for those securities credited to securities account holders would, in theory, signify that the intermediary could continue to credit more securities for itself than it actually holds. Whilst this would anyway not incur any legal consequences, it also remains unclear what the point would be if the intermediary were to credit securities to accounts which it maintained for itself.

Loss sharing in case of insolvency of the intermediary (Article 20)

In the event of an insolvency of the intermediary, Article 20 (1) lit. a provides that the loss shall generally have to be borne on a *pro rata* basis by all securities account holders. We feel that this principle is at least inappropriate in those cases where the lack of cover assets resulted from the fact that an individual securities account holder has received a credit for which the intermediary failed to set up the necessary cover assets. In such an event, we feel it would be fairer if the loss given the lack of cover assets were exclusively allocated to the respective securities account holder unless said securities account holder acted in good faith during the acquisition.

Therefore, the addition in brackets under Article 20 (2) which allows derogations from this regulation under domestic non-Convention law, should be maintained.

Chapter V

Special provisions with respect to collateral transactions

In our understanding, the regulatory scope of Chapter V also covers those collateral rights where there is transfer of full ownership of the financial collateral. This results from its reference to Article 5 (2): Pursuant to Article 5 (2) intermediated securities assigned as collateral are deemed as "delivered to a collateral taker" if and when they have been credited to its securities account. Pursuant to Article 4 (1), once these securities have been credited to its account, the collateral taker shall have acquired these securities. Hence, a transfer of full ownership of the financial collateral will have taken place.

"Collateral securities" (Article 23 (2) lit. b)

Actually, the term "collateral securities" introduced under Article 23 2 (b) is redundant. Hence, Article 24 (1) could also read as follows: "... the collateral taker may realise the intermediated securities delivered under the collateral agreement: (a) by selling them ... (b) by appropriating them as the collateral taker's own property ...". Article 24 (2) could then continue: "Intermediated securities may be realised under paragraph 1 ...". Also in Article 25 (1) the renunciation to the new term is unlikely to pose any problems: "(or, where intermediated securities are delivered to the collateral taker...".

Definition "close-out netting" (Article 24)

Article 24 (3) adopts the definition of "close-out netting" contained in Article 2 (1) lit. n of the Financial Collateral Directive and we strongly welcome this approach.

Replacement of "collateral securities of the same description" Article 25 (2)

In Article 25(2), it would be preferable to use the definition "of the same description" (Article 1 (1)). This way, in Article 25 (2) in line 4, the words "of the same issuer or debtor, forming part of the same issue..." will become redundant.

Taking account of any circumstances giving rise to an increase in the credit risk incurred by the collateral taker concerning the insolvency remoteness of agreements on top-ups of collateral (Article 26 lit. a)

The recognition of any circumstances giving rise to an increase in the credit risk incurred by the collateral taker as contemplated by Article 26 lit. a exceeds the provisions under the Financial Collateral Directive. Already now, the limited recognition of borrower related top-up entitlements under the provisions of the Financial Collateral Directive has come under strong criticism. Hence, the initiative of the Unidroit Convention's Drafting Committee reflected in Article 26 lit. a is strongly to be welcomed.

Explanations as regards Chapter V (Article 27 (2) lit. a)

One lesson learnt during the implementation of the Financial Collateral Directive is that the provision of choice poses a lasting threat to the harmonisation of law even at a moderate level. Hence, the right to choose in Article 27 (2) lit. a should be removed or it should be limited to consumers only. This is especially true for the elective rights stipulated under the provisions of Article 27 (2) lit. b and lit. c, where the absence of any real need is particularly conspicuous.

What is missing is a provision (similar to Article 3 of the Financial Collateral Directive) which prevents domestic non-Convention law from perpetuating formal requirements in an exaggerated manner (cf. our earlier comments on Article 5 (5) and Article 5 (7) lit. b).

Comments on the UNIDROIT preliminary draft Convention on Substantive Rules regarding Intermediated Securities

(prepared by the Singapore Exchange)

Chapter 1 – Definitions, Scope of Application and Interpretation

Article 1 - Definitions

“intermediated securities”

Comment: We note that questions have been raised by Unidroit members on the term “intermediated rights”. We prefer “intermediated securities” to be used if the intention is to refer to the rights of an account holder resulting from a credit of securities to a securities account.

Chapter III: Rights of the Account Holder

Article 9: Intermediated Securities

Paragraph 1:

Comment: We suggest that the following underlined words be inserted:

-1. The credit of securities to a securities account confers on the account holder:

1.a. the right to receive and exercise the rights attached to the securities, including in particular dividends, other distributions and voting rights (without prejudice to the right of the intermediary to provide otherwise in its account agreement in respect of securities issued by a foreign issuer)

ei. _____ where the account holder is not an intermediary or is an intermediary acting for its own account; and

eii. _____ in any other case, if the domestic non-Convention law so provides.

Presentation of diagrams

(prepared by the Chairman of the Drafting Committee)









