



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

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*Related documents: Doc. 43 and App. 9 and 16, 44, 60 and Appendix, 61-67*

## **Report of the Transparent Systems Working Group**

### **DRAFT**

*(prepared by Chairs of the Working Group)*

#### **1. Task of the Working Group and purpose of the report**

At the third session of the UNIDROIT CGE on Intermediated Securities in March 2006, when discussing the provision on prohibition of upper-tier attachment, questions on the application of this rule in so called “transparent systems” led to a broader discussion on the application and interpretation of the draft Convention in such systems. An informal Working Group was set up for considering, in particular, the rule prohibiting upper-tier attachment. The Working Group could not, however, come to conclusions on how to deal with the specificities of such systems (Doc. 43, App. 9). In the end of the session the plenary agreed to continue the work on transparent systems intersessionally.

The intersessional work concentrated on questions relating to the nature of transparent systems, in particular, which entity is regarded as “intermediary” and “relevant intermediary” in different systems, and to the prohibition of upper-tier attachment. On the basis of contributions by delegations, the UNIDROIT Secretariat prepared a Working Paper (Doc. 44). It was presented at the third session of the CGE in November 2006, but no thorough discussion took place. The plenary agreed on additional intersessional work chaired by Finland and Colombia.

The aim of this new additional work is to deepen the analysis of legal and operational arrangements under transparent systems and to examine by which means such systems could be linked to the mechanisms of the draft Convention (Doc. 57) without disrupting its harmonising effect. The work started by a Working Paper prepared by the Chairs of the group (Doc. 60). Contributions were received by the United Kingdom, People’s Republic of China, the Czech Republic, Sweden, Federative Republic of Brazil, Greece, France, Switzerland and Malta (contributions by Finland and Colombia were included in Doc. 60).

This report, which will be presented and discussed at the fourth session of the CGE in May 2007, is based on the previous work. It consists of two parts. First, it includes a description of different transparent systems based on Doc. 44, which will be complemented by a couple of additional presentations. Second, it concentrates on the specific questions taken up during the work and possible ways to take them into account in the future instrument.

It is important to note that some of the questions discussed in this report are not necessarily specific for transparent systems only, though they have come up during this work due to their relevance in such systems. For instance, questions relating to the application of the draft Convention to the CSD as the highest tier are relevant in non-transparent systems, too.

## 2 Presentations of transparent systems

### 2.1 Definition and categories of transparent systems in Document 44

In Doc. 44 transparent systems are roughly described, in functional terms, as

*“systems, where there are two or more entities involved in the holding chain (between the issuer and the investor) and where at the top level holdings of all lower tier account holder’s interest in intermediated securities are evidenced, in particular by means of maintaining accounts/sub-accounts for each of those lower tier account holders”.*

It is underlined that the definition should not be understood as addressing the question of direct relationship between the investor and the issuer. Likewise, separate mirror registers kept by the issuer or an organisation mandated to do so by the issuer for the purposes of exercising corporate rights are irrelevant for the purposes of the issue of transparency. Such separate registers are not securities accounts in the meaning of the draft Convention and Contracting States can set additional requirements for them.

There are transparent systems throughout the world and different jurisdictions have chosen to base their new legislation on holding securities through such a system. It is also important to note that in some cases holding systems appear to be “mixed systems”, i.e. part of the holding chain, a layer, is transparent while another part is not. Furthermore, there are systems which have both a transparent and non-transparent “branch”, e.g. the former mostly for domestic and the latter for foreign holdings. Non-transparent holding is especially necessary for cross-border securities transactions as well as for foreign investors. Non-transparent branch, though important, is not dealt with separately in this report since the provisions of the draft Convention would be applied to such branches without further modifications.

In Doc. 44 transparent holding patterns are grouped into three categories. In the *first* category, the upper level (the CSD) maintains accounts in the name of the bottom account holder. The “entity in the middle” merely operates these accounts. In fact, this holding model contains one tier only. In the *second* category, the upper level (the CSD) maintains accounts in the name of the “middle entity” but these accounts are divided in sub-accounts for each account holder (client) of the “middle entity” reflecting each client’s holdings. There is a separate set of clients’ accounts maintained by the participant for its clients. The *third* category covers systems where there is an account at the level of the CSD in the name of the “middle entity” reflecting the total amount of securities held by the middle entity on behalf of its clients. The middle entity in turn maintains separate accounts for its account holders (clients). Account information is permanently or regularly consolidated between both levels of accounts which enables the CSD at all times to determine exactly what the client of the middle entity has in its account.

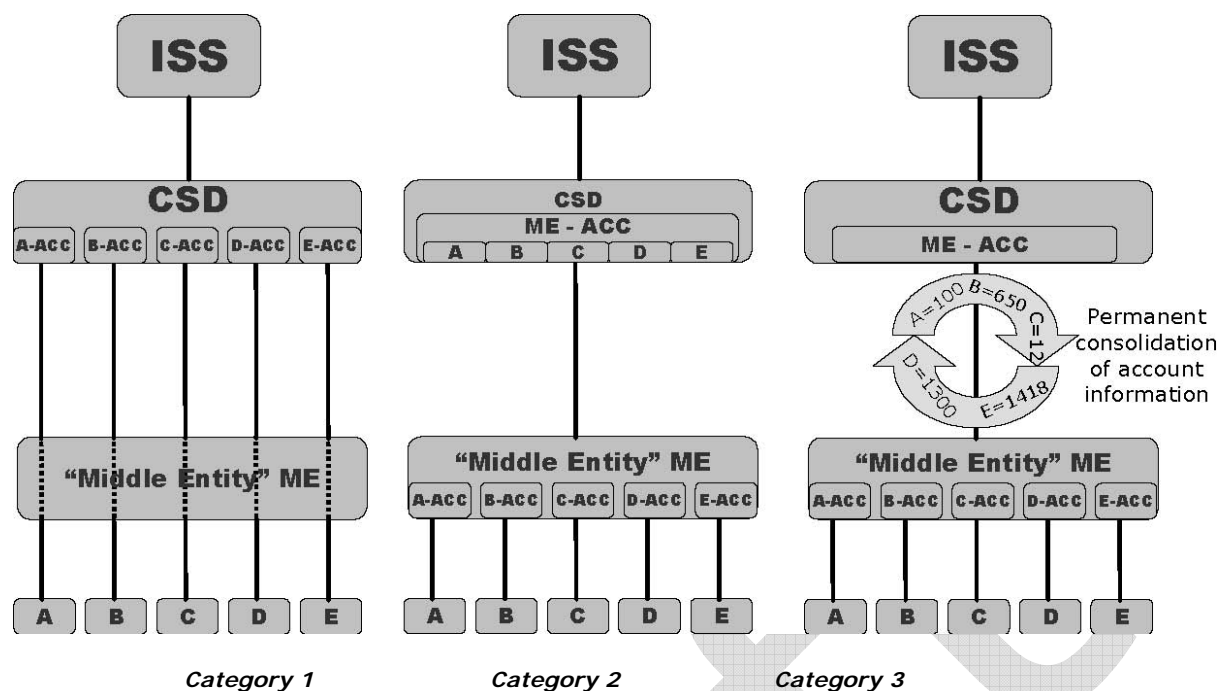


fig. 1

In all categories above the bottom account holder's interest is recognised at the upper (CSD) level.

## 2.2 Descriptions of transparent systems

Doc. 44 contains presentations of transparent systems of Finland, Spain, South Africa, Czech Republic, China, Brazil, Argentina and Sweden.

During the additional work, the holding systems of the UK, Ireland, Colombia, Greece and Malta presented below were brought to the attention of the group. The UK and Irish holding systems can be regarded to form a fourth category, whereas the holding systems of Colombia, Greece and Malta seem to resemble the first category systems.

It is, however, to be emphasised that the four categories are to be seen as mere "working tools". This report does not aim to take any position on whether above categories are correct in detail and which Member State's holding system actually belong to them.

### Fourth category

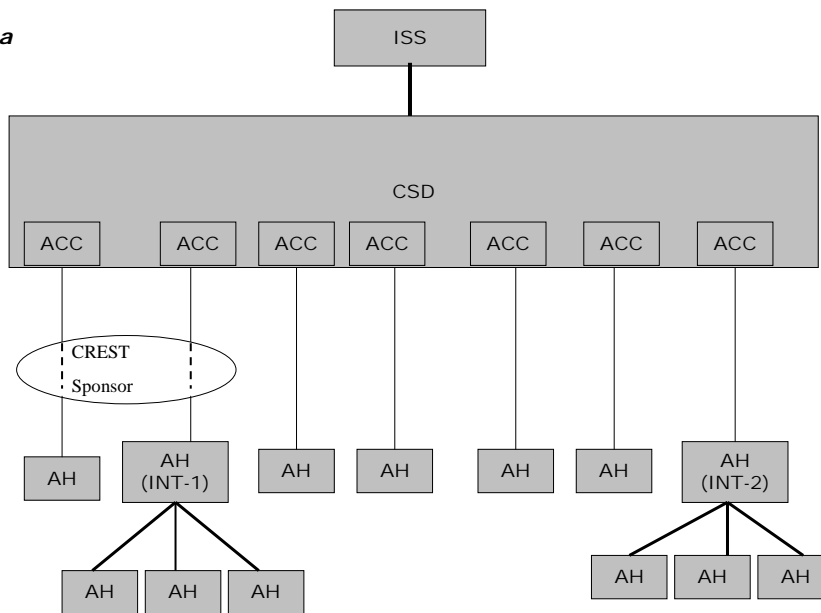
#### *The UK*

The UK holding system differs depending on whether it is a question of holding domestic or international securities.

#### Domestic securities

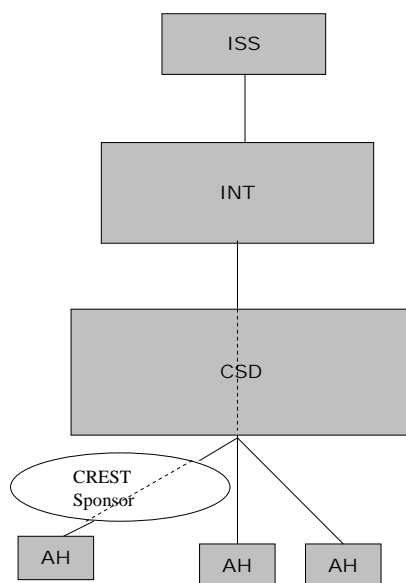
In the UK, the account holder may choose to hold domestic securities directly within the CSD (CREST). The account holder may be the ultimate investor (or an intermediary holding for its clients). The person credited in the records of the CSD as the account holder has legal title to the securities. In addition, the records of the CSD (and not the issuer's register) are the sole legal record of entitlement to the securities as against the issuer. The account holder gives transfer instructions to the CSD either directly or through a regulated CREST sponsor (who does not "maintain" securities accounts in its own books but merely provides an interface with the CSD).

Fig [ ] a



#### International securities

In the UK, an investor is able to hold certain international securities through the CSD, but cannot do so directly. An entity (an intermediary) can hold certain international securities on behalf of the investor (having a securities account with the CSD). This entity, which is entered as holder of the underlying international securities in the issuer's register or in the foreign CSD, issues Depository Instruments under English law to its account holders. These depository instruments are credited to a securities account maintained by the CSD (CREST) in the name of the account holder. The account of the CSD is the sole legal record of entitlement as between the account holder and the entity issuing the depository instruments, which will not maintain any legal records in its own books. Moreover, as in holding of domestic securities, a CREST sponsor can act as a service interface, i.e. an account operator, between the CREST and the account holder.

**Fig [ ] b**

### *Ireland*

#### Domestic securities

The Irish holding system for domestic securities is similar to that of the UK above, except for it is the register maintained by or on behalf of the issuer and not the register of the CSD that is the sole legal record of entitlement to the securities as against the issuer. Upon a transfer of securities at the level of the CSD, securities are credited to the securities account of the transferee in the CSD, but the legal title remains vested in the transferor until the transferee is recorded as holder in the issuer register. In the short period between sending an instruction to update the issuer register and the actual recording of that register, the transferee has a statutory equitable interest in securities under Irish law effective against third parties and enforceable against the transferor.

#### International securities

In Ireland international securities can, in principle, be held as depository interests issued under Irish law under a similar holding pattern to that of the UK above. However, it would be the register of depository interests maintained by or on behalf of the issuing entity and not the records of the Irish CSD that would be the primary record of entitlement of the underlying client.

#### Other holding systems

##### *Colombia*

The beneficial owners are represented directly on the books of the CSDs which constitute the official records of ownership. Participants (Account Operators) in the market operate accounts within the CSDs in the name of each beneficial owner. Securities positions are held within individual segregated accounts in the beneficial owner's name, where participants can provide direct instructions only for their own portfolio or the portfolio operated by them on behalf of their clients.

Securities are represented by both book-entry securities held within the CSDs (in both dematerialized and immobilized form) and a small number of physical securities held outside the CSDs. In each case there is a legal obligation for the CSD acting as a registrar to keep individual accounts segregated at the beneficial owner level, being considered a transparent system.

For book-entry holdings only those debits and credits made in the securities accounts maintained by the CSD are recognized as being legally binding and representative of ownership transfer. For securities deposited with a CSD, only that CSD has the capacity to execute changes in ownership. The issuers' records are considered supplementary to those of the CSD. For attachments, pledges and other encumbrances over securities on deposit with a CSD, the said CSD has the obligation of registering the limitation.

#### *Greece*

In Greece the CSD maintains an account in the name of the investor who has a direct relation to its holdings and towards the issuer. There is only one account per investor in the system. The CSD has an extended notary function.

The investor can interact with the Athens Exchange only through a member of the Exchange. Such members (investment firms) are all account operators. Also custodian banks can become account operators. Account operators execute the orders of investors and are not in any case considered as holders of securities.

The Greek holding system does not provide for an express formal contractual relationship between the investor and the CSD but there is a contractual relationship between the investor and the account operator.

#### *Malta*

In the Maltese holding system the investor can open a securities account directly with the CSD. The securities accounts at the CSD are opened and made out as freely available to the named investors (or intermediaries) and therefore there is no need for a "middle entity", like an account operator, for either opening or the maintenance of a securities account with the CSD.<sup>1</sup>

### **3. Questions under discussion and methods to take them into account in the future instrument**

It became evident during the work that not all questions are relevant in every category of transparent systems. More typically, various categories seem to have differing concerns. The group did not, therefore, aim at reaching a common position in all issues but presents problems and their solutions on behalf of those systems to whom they are of concern. Contrary views, if any, are included as well.

In the end of each issue, views of the Chairs' are presented. These views do not represent the group as a whole. Their purpose is solely to promote discussion and provide for additional reasoning as well as solutions, where appropriate.

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<sup>1</sup> It could be asked whether it is necessary to require involvement of two or more entities in holding in the description of "transparent systems" since this holding model shows that there can be only the top level in the holding, i.e. the CSD, between the issuer and the investor.

### 3.1 Questions relating to intermediary

#### 3.1.1 Defining who is an intermediary and the relevant intermediary

The main difference between the various categories presented earlier lies in the functions of the “middle entity” and the account structure. In other words, the question is whether or not the middle entity is the “relevant intermediary” and between which parties a securities account exists for the purposes of the draft Convention. These issues concern, in particular, definitions in Article 1(c), (d), (e) and (g).

“*Intermediary*” is defined to mean 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 (Article 1.c). “*Relevant intermediary*” means the intermediary that maintains the securities account for the account holder.

In the view of the group, clarity of above questions and common interpretation of the definitions are fundamental for the application of the draft Convention. It is a crucial question in every system for the application of the future Convention who is the relevant intermediary and between which parties the relevant securities account exist. Otherwise there would be uncertainty, which could risk the correct application of many provisions of the future instrument, for instance, Article 17 on prohibition of upper-tier attachment.

It seems that the middle entity does not have the same role in all categories of transparent systems. It is concluded in Doc. 44 that for the second and third category systems the middle entity is the relevant intermediary in relation to the account holder, and thus, as a general rule, there should not be major difficulties to apply the definitions of intermediary and relevant intermediary in these categories.

Yet, for systems where account operators are used (first category systems) or where the CSD maintains accounts but does not also hold securities (for example fourth category systems, see the UK holding system for international securities in section 2.2), clarifying who is the relevant intermediary is most relevant. In these systems securities accounts are directly opened in the name of the ultimate investor at the CSD. Therefore, in these systems the CSD should be the relevant intermediary. The middle entity, an account operator, operates such accounts at the CSD.

In some of these systems account operators may keep their own additional records on investors' securities held in the accounts at the CSD but they do not have legal effects in the meaning of the draft Convention. Therefore, such additional records should not be taken as securities accounts as defined in Article 1. In addition, it is typical of these systems that there is no contract between the CSD and the bottom account holder. Entries with proprietary effects as well as rights and obligations of the CSD (and the account operator) are largely based on specific legislation. However, there usually is a contractual relationship between the account operator and the account holder, but that fact alone does not make the account operator as the relevant intermediary.

#### Possible solutions

According to systems where account operators are used, it would be best if the draft Convention explicitly recognised that a CSD can be regarded as an intermediary. This would confirm the general understanding in these systems and enhance legal certainty, and would not be incompatible with the principles of the Convention. It is also highly important that the draft Convention is consistent with other international conventions in this field (i.e. the Hague Securities Convention, the HSC). In addition, an explicit provision would not only serve transparent systems but would generally clarify the status of the CSD in cross border holdings.

Clarifying the role of the CSD could be done in a similar way as in the HSC by adding clarifying subparagraphs concerning the definition of “intermediary” and “relevant intermediary” to Article 1. Taking into account Article 1.4 of the HSC, such a subparagraph could, for instance, hear as follows:

*A person shall be regarded as an intermediary for the purposes of this Convention in relation to securities which are credited to securities accounts which it maintains in the capacity of a central securities depository or which are otherwise transferable by book entry across securities accounts which it maintains.*

Furthermore, another paragraph could clarify that the fact that a person like account operator keeps additional records of its own on securities credited to securities accounts with the relevant intermediary does not in itself make the person as an intermediary. Neither would such additional records be of relevance for the purposes of credits and debits of securities nor for the prohibition of upper-tier attachment. This issue could be solved by using the corresponding provision of the HSC (Article 1.3.b):

*A person shall not be considered an intermediary for the purposes of this Convention merely because –*

- a) it acts as registrar or transfer agent for an issuer of securities; or*
- b) it records in its own books details of securities credited to securities accounts maintained by an intermediary in the names of other persons for whom it acts as manager or agent or otherwise in a purely administrative capacity*

It seems that the fact that there is no contractual relationship between the CSD and the account holder is not inconsistent with the current definition of “account agreement” (or with the definitions in relation to intermediary). Thus, the draft Convention does not pose an obligation that an account agreement with the relevant intermediary is always necessary. This interpretation should be confirmed in the Explanatory Report.

### **3.1.2 Sharing of tasks of an intermediary with respect to a securities account**

In some of those systems where account operators are used (for example, first category systems) the responsibility for “maintaining” of a securities account is somewhat shared between the CSD and the account operator. Representatives of these systems are concerned that the draft Convention does not recognise the statutory role of account operators. Many provisions are based on the assumption that the account holder directly instructs the relevant intermediary or that the relevant intermediary facilitates the exercise of rights of the account holder, for example.

There may be systems where the account operator merely processes the information flow from account holders to the CSD. However, in other systems the role of an account operator is more significant due to the fact that the account operator makes itself, on the basis of specific legislation, entries in the securities account with the CSD according to the instructions of the account holder. In fact, the account holder is dependent on assistance of the account operator as regards exercising rights under Article 5.1. In addition, the delivery of payments can be entrusted to the account operator, in which case the account holder cannot direct a claim against the CSD, i.e. the relevant intermediary. Furthermore, the account operator is responsible for any errors and omissions in making entries in account holder's securities account. Therefore, it is often the account operator that fulfills the relevant tasks, though the securities accounts are kept in the CSD. Clarifying the role of the account operator would be helpful for interpretation and application of Articles 5, 6, 11, 18 and 20.



It should also be noted that sharing of intermediary functions is not limited to the relationship between the CSD and the account operator but can occur in other situations and relate to other functions, too. For example, in the UK and Ireland the sharing occurs as regards holding of certain international securities between the entity, which holds such securities and issues depositary instruments, and the CSD (CREST) that keeps records for the account holder of depositary instruments representing those securities. In such a case, the holding function is performed by the entity holding securities and issuing depositary instruments while the CREST is responsible for keeping the securities account.

#### Possible solutions

Different solutions can be considered.

First of all, as concerns the difficulty to interpret and apply certain provisions of the draft Convention that make a reference to the account holder's instructions to the relevant intermediary, it is considered as one alternative that the draft Convention could be broadly interpreted so that the account operator is regarded to be acting on behalf of the CSD. However, this suggestion is not seconded by the group, mostly because there is no agency relationship between the CSD and the account operator. The latter bears responsibility of its own errors and omissions.

A second possibility would be to interpret broadly that an account holder is regarded to give instructions to the relevant intermediary (the CSD) through an account operator. This solution would work at least for those systems where the role of an account operator is limited to acting as a service interface.

However, for other such systems where account operators are used, the second solution above does not alone seem sufficient since it does not correspond to nor cover the role of the account operators in their system. Therefore, there has been a third solution in which the role of the account operator would be openly recognised in the draft Convention. This could be done, for instance, by a generally worded provision (for example, as a subparagraph of Article 1, or of Article 3 as suggested later) according to which certain provisions concerning the relevant intermediary may have relevance to account operators or other corresponding persons, if so provided by the non-Convention law. The advantage of this solution would be that it would affect the draft Convention as a whole very little since it would solely direct the application of some provisions to account operators and would not limit the rights of account holders. The question whether and to what extent the application of the instrument is extended to account operators would depend on each holding system and its law. This solution was seconded by several delegations representing the relevant systems.

However, the scope and wording of the third solution above is too limited taking into account the UK system for international securities where the sharing of intermediary functions occurs between the CSD and another entity as well as between the holding and maintaining of the securities accounts functions. This delegation has, therefore, suggested that the draft Convention could recognise that the holding function (allocation of securities, shortfalls, passing on dividends etc.) and the maintaining of records (instructions, entries etc.) can be undertaken by separate entities. This solution would possibly require considering what intermediary tasks belong to "holding" and what to "maintaining of records" as well as making a distinction between these tasks in the draft Convention.

### 3.1.3 Differing views to above solutions

Two delegations do not support the suggestions to clarify the CSD's and account operator's role. The first is not of the view that adding a new "player" – an account operator - into the structure of the Convention would be the best solution. Firstly, because the account operator would also have liabilities and obligations typical of an intermediary. Secondly, because the insertion of this definition in the Convention seems to have the sole purpose of obtaining the qualification of the CSD as a relevant intermediary. Lastly, because both the addition of a new player and the qualifications of the CSD as a relevant intermediary may cause legal uncertainties to all other countries which, having the middle entities, might have to review their own systems and operational arrangements.

Another delegation is not in favour of the proposal to recognise the role of the account operator explicitly because this could lead to legal uncertainties. This delegation would opt for an approach similar to the HSC. Article 3 implies that the CSD is subject to the Convention when they are acting as intermediary which is possible according to the definitions in Article 1. Neither would it be necessary to modify Article 17 because it is clear that the CSD can be regarded as an intermediary or relevant intermediary for the purposes of the draft convention.

However, if such combined reading of Articles 1, 3 and 17 does not offer enough legal certainty and if the "article by article analysis" raises additional issues, the above delegation suggests to confirm this reading in the Explanatory Report and to include a clarified interpretation for the application of each article in transparent systems. An alternative option would be a dedicated interpretative article regarding the application of the Convention to transparent systems. This last option would imply a definition of transparent system in order to specify the scope of such interpretation. Such a definition could be based on the functional term mentioned in Doc 44.

### 3.1.4 Alternative solution: concepts of debit and credit

One delegation has difficulties with the concepts of debit and credit (Article 7) and designating entry (Article 1 and 8). In this system, even though the "middle entity" is regarded to be the relevant intermediary for the investor, the CSD performs central registration activity. Therefore, the transfer of ownership of securities is only perfected upon their registration with the CSD (or with the issuer). The registration with the CSD is the only manner validly accepted for registration of ownership of intermediated securities. In addition, the CSD keeps records of earmarkings which will produce legal effects on intermediated securities. The designating entry in the CSD is the only method sufficient to render effectiveness against third parties. Due to the central registration activity of the CSD, the prohibition of upper-tier attachment also poses problems for this delegation (see 3.2).

This delegation proposes that each Contracting State should define how debits and credits are to be made as well as their specific requirements. Therefore, the draft Convention should include a provision stating that debits and credits, for the acquisition and disposition of securities, shall be those recognised as such by the non-Convention law. Moreover, the designating entry should be made in accordance with the procedures established by the non-Convention law.

### 3.1.5 Views of the Chairs

#### *Concepts relating to intermediary*

It is clear that the concepts of the draft Convention are independent from national concepts and require functional interpretation. Yet, in the view of the Chairs, it can be doubted whether the concepts relating to the intermediary are interpreted in the same way by various systems due to

differing account structures and number of entities engaged. The difficulty seems, in particular, to relate to what is meant with “maintaining” a securities account in the definitions of “intermediary” and “relevant intermediary”. The question is whether “maintaining” refers to a person who provides a securities account where legally binding credits and debits are made (a CSD) or to a person who makes the actual entries that are or may lead to legally binding debits or credits of securities (a middle entity). In other words, which of these functions is considered as “maintaining” a securities account. The first category systems interpret that in their system the person who provides the securities accounts (the CSD) should be the relevant intermediary, even though the middle entity (account operator) makes the actual entries. Yet, it is not certain if this interpretation works for the second category systems.

Consequently, the content and meaning of definitions of intermediary would benefit from discussion in the plenary. In the Chairs’ view, it should be considered if the definition of relevant intermediary ought to be made clearer in order to highlight that it refers to that intermediary who provides the securities account in which legally binding debits and credits are made.

As concerns the role of the CSD and account operators, there seems to be broad support in the group for clarifying that the CSD can be regarded as an intermediary as well as excluding the relevance of records of account operators in the same way as in HSC. Yet, it has been argued that such clarifications are not really necessary because it is clear on the basis of the provisions that the CSD can be an intermediary. Thus, clarifications could be done, for example, in the Explanatory Report.

The Chairs think, however, that there would be great merits if the clarifications regarding the CSD and the account operator were made in the text of the Convention rather than only providing them in the Explanatory Report. There should be only one relevant intermediary for a particular securities account. Furthermore, credits, debits and other entries with legal effects against third parties should solely be made to that account. It is therefore a question of ensuring legal certainty which cannot be undermined. Furthermore, it can be emphasised that these clarifications have already been recognised in the HSC, and account should be taken of the consistency between different international instruments. It has been repeatedly stated by the plenary that – to the extent possible – definitions in the draft Convention should stay in line with the definitions used in the HSC. Not making the clarifications of the HSC in this Convention might even lead one to think that differences between these instruments are intentional, which could create a risk of contrary conclusions.

In addition, it would be important to recognise the current practice according to which maintaining of a securities account can be shared by the CSD and the account operator. Systems, where a huge number of individual securities accounts are at the CSD level, cannot in practice operate without participation of other entities, like investment firms and brokers. Considering the concerns expressed by a couple of delegations, the Chairs would like to give a few additional explanations. It is due to the fact that the account operator has liabilities and obligations typical of intermediary – but not being the relevant intermediary as defined in the draft Convention and the HSC – that recognition of such a player with regard to the relevant securities account is called for. In practice, legal certainty is better ensured by specific rules than just by a broad interpretation of the concepts of the future instrument. Naturally, this does not intend to mean that there is an account operator in every system. In fact, not even all first category systems use account operators. The decision whether to make use of such a provision as well as in which manner, would be left to Contracting States. Neither should suggested clarifications bring uncertainties to other systems be it a transparent or a non-transparent system.

As a whole, it is important to note that above suggestions are very few in number and they are clarifying in nature. They do not disrupt the key concepts or effect of the future Convention. Moreover, the suggestion to recognise the role of an account operator can be restricted to cases where the CSD is the relevant intermediary. In addition, the obligations and responsibilities that can be shared by the non-Convention law, can be specified in the draft Convention. By adopting these suggestions the clarity of the future instrument in the first category systems can be greatly improved.

#### *“Maintaining” and “holding” functions*

Sharing of intermediary functions is not limited to the relationship between the CSD and the account operator. The UK system for holding international securities shows that it can also occur between the holding and maintaining of the securities accounts with another entity. In the UK, an entity holding securities and issuing depositary instruments in respect of them is regarded as “holding” the securities for its account holder and the CSD as “maintaining” the records. This delegation has suggested that the draft Convention could recognise that the holding function (allocation of securities, shortfalls, passing on dividends etc.) and the maintaining of records (instructions, entries etc.) can be undertaken by separate entities. Yet, it may be that in this system the problem with sharing the functions of an intermediary are related to the unclear issue of whether Articles 19, 21 and 22, which require holding of securities, apply at the CSD level in the first place (see 3.3.1). Thus, the need for explicit recognition might depend on the final scope and content of Articles 19, 21 and 22.

If this suggestion is followed, it would possibly require considering what intermediary tasks belong to “holding” and what to “maintaining of records” as well as making a distinction between these tasks in the draft Convention. Moreover, it would seem necessary to study all provisions of the draft Convention Article by Article.

It could also be considered whether the above suggestion worked for sharing the functions between the CSD and the account operator in the first category systems. In such systems, the CSD should be regarded as “holding” securities whereas “maintaining” the records should at least partially be regarded as carried out by the account operator. Whether the UK suggestion is workable more broadly in other systems would depend on how different tasks would be categorised since in some systems account operators may perform both of the above functions, i.e. make entries to securities account as well as pass on dividends. It would also depend on whether it is appropriate to regard the CSD to be “holding” securities since in many first category systems the CSD acts merely as a record-keeper having no rights or interest on issued securities.

Nevertheless, both phenomena of sharing the functions should be acknowledged in the text of the Convention. This could be done, separately or together, in a specific provision which would allow, but not compel, the non-Convention law to permit sharing of the functions of an intermediary. Such a provision could be general or restricted in nature. For example, the tasks that can be shared can be defined explicitly (by wording or references to certain provisions). And, very importantly, since sharing of functions seems to relate only to securities accounts at the CSD level, this could be taken into account in the scope of the provision as well as its location (for example in Article 3).

#### *Concepts of credit and debit*

The suggestion that each Contracting State could define how debits and credits are to be made in order to be effective against third parties would mean that a credit to the relevant securities account in the meaning of Article 7 would not be enough but additional steps, for example, a credit at another intermediary's level might be required. It can be recalled that so far the majority of

delegations in the plenary have been of the opinion that the effectiveness against third parties should depend on the credit to a securities account alone and no additional requirements should be added. It could also be taken into account that requirements for credits and debits as well as the technical procedure for making entries seem to be left to the non-Convention law, and the draft Convention does not deal with issuers' registers for corporate law purposes.

The Chairs would also like to point out that if credits and debits and designating entries in this particular system are solely effective against third parties when made at the CSD level, it is unclear whether the records of the middle entity have independent legal effects in the meaning of the Convention. The interpretation as regards the relevant intermediary may have effect on the next issue of prohibition of upper-tier attachment.

### **3.2. Prohibition of upper-tier attachment (Article 17)**

From the beginning of the work, there has been a question whether upper-tier attachment at the CSD level should be possible, even though the middle entity is regarded as the relevant intermediary as against the account holder. This issue is relevant in the second and third category systems. For systems with only one tier the prohibition is not problematic as long as account operators are not regarded as intermediaries and their records not as securities accounts.

According to Doc. 44, if the middle entity and the account maintained at this level are interpreted to be the relevant intermediary and the relevant securities account respectively in these systems, an attachment against the account maintained by the CSD would not be admitted. However, it is acknowledged that the identity of investors and the details of their holdings are known at the CSD level. Therefore, it could be possible to say that an attachment at the level of the CSD would not cause serious systemic problems compared with an upper-tier attachment under the non-transparent pattern. Attachment of an omnibus account would lead to more severe difficulties.

One second category system gives further explanations for their need for upper-tier attachment. In this system, the CSD performs some activities in a centralized manner that provides the necessary publicity concerning the legal situation of intermediated securities. This system wishes to preserve the current advantages of the centralized attachments made through the CSD. The centralized registry avoids the possibility of attachment of more securities than necessary to comply with the judicial order. When the attachment occurs at the CSD (at the upper level), only the exact quantity of securities would be attached. Moreover, the centralized registry assures an efficient control of the attached securities and optimizes the time required for compliance with the judicial order.

The third category systems work in somewhat different way to second category systems. The account at the CSD reflects only the aggregate amount of securities owned by investors, and details of investors and their holdings are recorded in the accounts at the middle entity level. The central CSD account is permanently and regularly consolidated with the detailed accounts of the middle entities including information on who are the ultimate account holders and what their holdings are. Therefore, the central and detailed registers are by law regarded as a single register. It seems that at least in some cases an attachment has to be made at both levels.

#### Possible solutions

The above second category delegation has suggested that the prohibition of upper-tier attachment would not apply in transparent systems where there is full knowledge and control of the account holders and of the disposition of securities maintained in securities accounts. An alternative solution would be the adoption of an opt-out provision or declaration method for transparent systems.

Article 17 does not pose problems for all transparent systems. For several systems it would be sufficient to clarify the role of the CSD as an intermediary and to exclude the relevance of records of account operators. In that case an exclusion from Article 17 would not be necessary.

#### Views of the Chairs

The prohibition of upper-tier attachment has gained a broad support in the discussions at the plenary. The provision is based on making legally relevant entries and taking actions only at the relevant intermediary level.

Nevertheless, the prohibition of upper-tier attachment is problematic for those transparent systems where the CSD has a specific role, if the middle entity is regarded as the relevant intermediary towards the account holder. Granting a specific exception to the prohibition of upper-tier attachment for these systems, though few in number, would decrease the level of harmonisation. Yet, it could be taken into consideration that the prohibition of upper-tier attachment is mostly aimed at multi-tiered holding systems where the upper-tier intermediary maintains an omnibus account and does not know the identity of account holders at the lower level. The prohibition is perhaps not necessarily as important in the transparent systems above where the upper-tier attachment would only concern the centralised CSD level where the identity of investors and their holdings are known. Even in this case, it should always be guaranteed for the protection of third parties that the attachment is made public at the level of the relevant intermediary, i.e. the middle entity, too. If an exception from Article 17 were allowed, it should be combined with a declaration mechanism so that it would be known which Contracting States make use of it.

However, a middle way solution, i.e. a broad interpretation of Article 17, could perhaps be thought about. If Article 17 provided that an attachment with legal effects can merely be made at the relevant intermediary's level, it would not necessarily prohibit that such legally relevant attachment is reflected at the CSD level. Thus, the CSD records would only provide an additional source of information. Article 17 could also be interpreted as not interfering with the processing of the attachment, i.e. who receives the attachment order etc., as long as it is clear that the legally relevant attachment is made in the accounts at the relevant intermediary level. If this kind of interpretation is seen as possible, it should be thought whether it would require minor clarifications in the provision or whether a clarification in the Explanatory Report would be sufficient.

### **3.3 Questions relating to CSDs (Articles 1, 3, 19, 21, 22)**

#### **3.3.1 Application of certain provisions to the CSD as highest tier (the issuer CSD)**

##### *General*

There have been some concerns in the group about how Articles 19, 21 and 22 relating to sufficient holding, allocation and loss sharing are to be applied, in particular, to the top CSD level. The main purpose of these provisions is to protect account holders against shortfalls and insolvency of an intermediary. Such concerns are most relevant for the first category systems because account holders have their securities accounts directly at the CSD, but they relate generally to all top CSDs.

The difficulty in understanding these provisions is partly related to the assumption that an intermediary itself holds securities for its account holders or holds intermediated securities at an upper-tier level. It is not clear whether and in which way this assumption is to be applied to the issuer CSD (or other corresponding person), in particular in case of dematerialised securities. The role of the issuer CSD is in many ways specific compared to other intermediaries. First of all, intermediated securities are created and recorded at the issuer CSD in the first place, that is to say that securities enter the intermediated holding system through the CSD. This logically affects the

issuer CSD's status as an intermediary since it is the highest tier below the issuer. Thus, there is no upper tier intermediary maintaining a securities account for the CSD, except in cases where the CSD deals internationally. Secondly, it is typical - at least of transparent systems - that the CSD acts merely as a record-keeper having no rights or interest on issued securities. The CSD does not have the right to use such securities for its own purposes and they do not form part of the property of the CSD which could be distributed to its creditors.

It can also be recalled that Article 3 excludes from the scope of the draft Convention, for example, "reconciliation of securities conducted by central securities depositories" but the exclusion is against the issuer only. It gives, thus, an impression that the Convention governs effects of reconciliation of securities by the CSD vis-à-vis the account holders. One delegation wonders if a CSD must revise downwards its account holders' entitlements as a result of a reconciliation of securities, does it have a liability under the Convention to its account holders.

Below, the matter is discussed separately as regards different provisions.

#### *Article 19*

The provision sets up a requirement for the intermediary, for each description of securities, to hold securities and intermediated securities equal to the securities of that description credited to securities accounts which it maintains.

It is not clear whether this provision is intended to be applied to the top CSD, in particular, in case of dematerialised securities. In these systems the literal interpretation of this provision is not possible. Nevertheless, it is general that CSD has to ensure that the amount of securities credited to the securities accounts it maintains for the account holders has to correspond with the amount of issued securities. An issue account is a way to realize this, and therefore, functionally, such an account might correspond to an upper tier holding, even though legally it does not have the same characteristics as a securities account and it serves a different purpose.

Some delegations think that the purpose of the provision could be applied to the top CSD and that the CSD should be required to hold securities in issue accounts or otherwise in the same aggregate number as in securities accounts. Yet, these delegations think that the text of the draft Convention could be improved in this respect.

One delegation is of the view that Article in its current form already covers this aspect because the reference to "an intermediary must...hold securities..." includes the securities recorded in issue accounts, but a clarification in the Explanatory Report might be useful.

However, there seem to be some contrary views. According to one delegation, Article 19 should not apply to the CSD that does not hold securities. The requirement does not make sense in such cases. A couple of other delegations think that the provision should not apply because an issue account does not correspond to a securities account in the meaning of the Convention.

#### *Article 21*

Article 21 deals with allocation of securities between account holders and an intermediary giving two alternative methods, allocation of all securities to account holders (paragraph 1) or segregating securities (paragraphs 4 and 5). Article 21 is closely linked with Article 22 on loss sharing. Article 21 applies where an intermediary holds securities, or intermediated securities are credited to securities accounts held with another intermediary. These requirements are not easily applied at the top CSD level for the above mentioned reasons.

In principle, it seems there are three possibilities to interpret this Article:

1. The provision is not intended to be applied at the top CSD level in the first place.
2. The provision is intended to be applied at the top CSD level, but interpreting that securities accounts at the CSD form the highest tier and the requirements for allocation and segregation would apply to such accounts.
3. The provision is intended to be applied at the top CSD level due to an interpretation that an issue account at the CSD corresponds to the upper tier level.

Should the third interpretation above be correct, an obligation to allocate or segregate securities of account holders could be interpreted to apply to an issue account. Even in systems where such issue accounts are used, such a solution would not be at all feasible or necessary for protecting account holders at the CSD. No rights or interests can be recorded in issue accounts and it is not credited and debited in the meaning of the draft Convention. Thus, segregation of an issue account is not possible to realize in practice. No delegation seconded this interpretation.

Several delegations supported that Article 21 could apply to the CSD along the lines presented in the second interpretation. According to one delegation, Article 21 should not apply to the CSD that does not hold securities.

#### *Article 22*

In systems where matching of corresponding debits and credits is required, and errors and discrepancies relating to entries to securities accounts are traced and corrected, shortfalls should not easily occur. Any situations which could cause discrepancy are solved by traditional property law rules or by compensation. This appears to be compatible with the draft Convention since national ways to deal with errors are permitted. Moreover, an insolvency of the CSD should be unlikely to occur in practice, which is a prerequisite for the application of this Article.

In spite of above, it cannot be said that the CSD is totally immune against shortfalls. Consequently, as the CSD cannot for this reason totally fall out of scope of Article 22, it is necessary to consider its application. Article 22 has to be read together with Article 21 because the method in which the protection of account holders' rights is arranged at the upper level under the latter provision, affects their position in loss sharing.

As these two Articles are closely linked, it is clear that the way in which Article 21 is to be interpreted (see three different possibilities presented earlier) affects the reading of Article 22. Thus, if an issue account were analogically regarded as an upper tier holding in Article 21 (the third interpretation), the requirement for segregation or other arrangement would apply to such account, even though it is impossible to realize in practice. Therefore, lack of segregation would mean that all account holders would share the loss equally under Article 22. Such a result could raise policy problems in different systems.

If, however, Article 21 applied to the top CSD, but in such a way that securities accounts at the CSD would form the highest tier and the requirements for allocation and segregation would apply to such accounts (the second interpretation), the shortfall would only be borne by the relevant account holder (due to individual, segregated accounts at the CSD). This solution would not create problems.

Should Article 21 not apply to the CSD (the third interpretation), neither would Article 22 be applicable. This would mean that shortfalls with respect to the CSD would be left to the non-Convention law.



Irrespective of the fact that the above loss sharing rules generally are subject to any rules applicable in insolvency proceedings as well as rules of a settlement system, many delegations support clarifying the applicability of this provision at the top CSD as well as the role of issue accounts.

#### Possible solutions

It seems to be a rather general view in the group that there is a need to clarify the applicability of Articles 19, 21 and 22 at the top CSD level as well as the position of issue accounts where these are used.

According to one participant, these provisions should not apply to CSDs that do not hold securities. If the CSD does not hold securities in the meaning of these provisions, they do not have any meaning and are consequently confusing. There are also other delegations that think that the draft Convention should not be applicable to issue accounts since they should not be regarded as securities accounts in the meaning of the Convention.

On the above basis, Articles 19, 21 and 22 could be clarified that they do not apply to a CSD which do not hold securities or intermediated securities in securities accounts with another intermediary. That an issue account is not to be regarded as a securities account could be clarified in the Explanatory Report.

However, several delegations would in principle understand the application of Article 19 to the top CSD. This would require modifying the wording in the provision, or clarifications in the Explanatory Report at least.

Moreover, a few delegations think that Article 21 could apply to the top CSD provided that the second interpretation of that provision explained above were adopted. In this case, also Article 22 could apply to the CSD. This solution might require some clarifications at least for Article 21, or the matter should be dealt with in the Explanatory Report. The relevance of an issue account should, nevertheless, be excluded from Article 21 and 22.

#### **3.3.2 Article 3 on CSDs**

Some participants think that Article 3 could be expanded so as to cover all the relevant questions relating to the CSD. For example, the clarification suggested earlier that the CSD can be regarded as an intermediary as well as that the functions of an intermediary can be shared could be dealt with in this provision. Furthermore, as explained earlier, it is not clear if Articles 19, 21 and 22 apply to the top CSD level, and this could be solved in this provision.

There is also a question whether or not it should be allowed in the draft Convention that rules of the CSD may determine some questions if permitted by the non-Convention law. It is to take into account that the CSD, when acting as an operator of a settlement system, can benefit from the specific rules of the draft Convention regarding the rules of a settlement system. It is, therefore, to be considered whether there is a distinct need for recognising the role of the CSD rules which could be applied even though an entry is not made within a settlement process. This question relates at least to Articles 11, 19, 20 and 22 where there is a reference to the rules of a settlement system.

There are differing views on this point in the group. One delegate is somewhat hesitant in recognising the role of the CSD rules. This is because, unlike settlement systems, there are no rules at the EU or at the international level on the CSDs and because the specific provisions on the rules of a settlement system in the draft Convention provides for sufficient protection for the CSDs which almost always are settlement systems. Another delegation wonders how the rules of the CSD

are meant to be distinguished from the rules of a settlement system that it operates.

Several participants, however, consider that there would be no harm in recognising the role of the CSD rules, whether or not in a transparent system, separately from the rules of a settlement system. This is due to the fact that many CSDs operate a settlement system but also provide securities accounts, and rules of a settlement system may be part of the CSD rules. Moreover, because the definition of a securities settlement system (Article 1) covers only systems, it seems that the rules of the settlement system could be used by the CSD only when acting in that capacity. Yet, it would be a benefit if the CSD could make use of the same rules irrespective of whether or not an entry is made during a settlement. Finally, expanding certain references to the CSD rules may become even more relevant in the future if the roles of the CSD and the settlement system will be distinguished.

#### Possible solutions

Article 3 could be expanded so as to cover all questions relating to the CSD. It could clarify that the CSD can be regarded as an intermediary as well as deal with the questions relating to the account operators whose role is linked with the accounts at the CSD. Moreover, the applicability of Articles 19, 21 and 22 at the CSD level could be solved in this provision.

According to some delegations, it could be recognised that the uniform rules of the CSD, in the same way as the rules of the settlement systems, can be applied, if and to the extent permitted by the non-Convention law (a general rule in Article 3 or a reference in different provisions to the CSD rules, where necessary).

#### **3.3.3 Views of the Chairs**

There are different views in the group as to whether Articles 19, 21 and 22 currently apply to the issuer CSD. The wordings in these provisions seem to allow various interpretations, which is not acceptable.

It is possible to think that above provisions do not apply to the issuer CSD because their literal reading does not make sense. If this interpretation is followed, the result should be made clear in the text of the draft Convention. In this case the requirements to hold sufficient securities, allocation of securities as well as shortfall would be left to the non-Convention law. This solution would naturally be possible, but would reduce the overall applicability of the Convention and the level of harmonisation.

Just as well it can be thought that the provisions are applicable to the CSD because it is not clearly excluded from the scope of the provisions. Applying the provisions to the CSD would have the opposite effects to the above carve out. The fewer exceptions from the scope are granted the more often and broadly the future instrument is applied. Yet, this result should also be made clear in the text.

If Articles 19, 21 and 22 were applicable to the top CSD, the relevance of issue accounts should be considered and clarified. The answer is not necessarily the same in all provisions, since Article 19 could functionally be interpreted as covering issue accounts. However, the same broad interpretation in Articles 21 and 22 can lead to undesirable results at the CSD level. The CSDs should have the same possibility than other intermediaries to arrange "full segregation" where securities belonging to specific account holders are separated. Thus, it should be sufficient under Article 21 that the relationship between the CSD and the account holders as well as between account holders is arranged by segregation at the CSD level because there is no upper tier holding where the segregation could be made.

### 3.4 Netting (Article 7.5)

The broad wording in Article 7.5 “may be effected on a net basis” has raised concerns in the group since in many transparent systems netting at the level of the middle entity is not possible. The broad wording can be of concern also to other holding systems, though possibly for other reasons (e.g. traceability).

Moreover, in monist systems where international conventions are directly effective, the right under Article 7.5 could be directly invoked.

#### Possible solution

Many participants support clarifying that the provision is subject to the non-Convention law and the rules of a settlement system.

### 3.5 Article 24

In many transparent systems, there is a transparent and non-transparent “branch”. The former branch is mostly used for domestic and the latter for foreign holdings (usually in the form of omnibus accounts). The draft Convention should regard both these branches as being held through an intermediary in the meaning of the Convention, in particular, in Article 24.1. Thus, the plural form “intermediaries” in paragraph 1 should not be taken as referring to a multi-tiered holding, but also covering one-tier holding systems.

It seems that Article 24.2 is most relevant in multi-tiered holding but does not appear to apply in all transparent systems. This is the case, for example, in systems where securities accounts are directly opened at the CSD level in the name of the ultimate investor (account holder) and where the rights attached to securities are typically conferred only on such account holder and not on the CSD or the account operator. This holding pattern is in line with Article 5, which is referred to in Article 24. In other words, there is no “person acting in his own name on behalf of another person” in the meaning of Article 24.2. Moreover, in these systems the holding does not cross borders since there is only one relevant securities account at the CSD (also with respect to a foreign investor). In the light of above interpretation, Article 24 and Article 5 do not pose problems for these systems.

#### Possible solutions

There is no need to modify the provisions, but the meaning of Article 24 and Article 5 in transparent systems could be explained in the Explanatory Report.