INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW
INSTITUT INTERNATIONAL POUR L'UNIFICATION DU DROIT PRIVE

UNIDROIT COMMITTEE OF GOVERNMENTAL EXPERTS FOR THE PREPARATION OF A DRAFT CONVENTION ON SUBSTANTIVE RULES REGARDING INTERMEDIATED SECURITIES
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COMMENTS BY GOVERNMENTS AND INTERNATIONAL ORGANISATIONS

(submitted by the Government of the United Kingdom)

Proposal for the amendment of the definitions in Article 1 of the Convention

1. Inclusion of definition of "segregation arrangement"

The United Kingdom delegation proposes the insertion of the following definition in Article 1 of the Convention:

(p) "segregation arrangement" means, in relation to securities or intermediated securities held by a relevant intermediary for a particular account holder or group of account holders, an arrangement whereby the relevant intermediary holds such securities so that they are separately identifiable (and which, in the case of intermediated securities held through another intermediary, shall require them to be credited to a separate account with such intermediary).

Explanation

We note that the Convention refers to segregation arrangements in Article 21 but does not specify what steps need to be taken to segregate accounts.

We believe that there is a need to include a definition of "segregation arrangement" in order to ensure that there is no confusion as to what constitutes the effective segregation of accounts.

In order for segregation to be of practical effect, the intermediary must ensure that the securities are separately identifiable. Where an intermediary holds the underlying securities, this could be effected by physical segregation of paper securities, separate entries in the issuer's register of some other equivalent measures. Where the relevant intermediary holds intermediated securities through another intermediary (e.g. a sub-custodian), segregation can only be effected by opening a *separate account* with the issuer or intermediary above it in which to credit the securities that it wishes to segregate. It is not sufficient merely for an intermediary to record the holdings of different account holders as separate accounts entries in its own accounts in order to segregate them.

We believe that the Convention would benefit from an explanation of what constitutes segregation. This would make clear, for example, that an intermediary cannot claim that a loss in a pooled account above it should be borne only by its customer on the grounds that the intermediary has debited its customer's accounts in its own records and not its own house account.

2. Amendment of definition of "uniform rules"

We propose that the definition of "uniform rules" is amended by the insertion of the following words (underlined):

"uniform rules" means, in relation to a securities settlement system or securities clearing system, rules of that system (including system rules constituted by non-Convention law) which are common to the participants or to a class of participants and are publicly accessible.

Explanation

The rules of some settlement systems (including the settlement system in the United Kingdom) have been established by legislation rather than contract and consequently form part of non-Convention law. The proposed wording is intended to make clear that rules created by legislation within the scope of the definition of "uniform rules".

Proposal for amendments to Article 12

3. Knowledge attributed to the purchaser from another person

The Convention currently makes no provision in Article 12(4) for attributing the knowledge of another person to the purchaser. We are concerned that if the possibility of attributing such knowledge in certain circumstances to a purchaser is not recognised by the Convention, then the innocent purchaser defence could be manipulated through the use of an agent or by corporate structuring to give a defence to purchasers where none should exist.

It is commonplace in the securities industry for institutions to operate their trading activities through one or more legal entities but to undertake their custody or registration processes through numerous separate subsidiaries (in particular, in relation to globally-held portfolios) acting as nominees. The nominee subsidiaries into whose accounts the securities are credited will typically have no knowledge of the underlying transaction and, consequently, of any potential violation of a third party's claim.

Fairness requires that where relevant knowledge is obtained by the legal entity responsible for organising a trade of securities, then that knowledge should be attributed to the nominee account holder in whose name or for whose account the securities are ultimately credited. The purchasing account holder should not be able to rely on Article 12 by claiming that it did not know of an interest even though the person having the responsibility for organising the purchase knew of it.

We do not consider that the reference to the knowledge of an 'organisation' in Article 12(4)(c) is sufficient to cover the involvement of such *separate* but connected legal entities or agents.

We therefore propose that the Convention should recognise the possibility of attributing the knowledge of other persons. We accept that the various exceptions and nuances to the concept of 'imputed' or 'attributed' knowledge may mean that it is necessary to make any Convention rule on this kind of knowledge subject to non-Convention law.

Accordingly, we propose the insertion of a new sub-Article 12(4)(b)(iii) as follows:

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 knows of an interest or fact if that person –

(i) has actual knowledge of the interest or fact; or

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

(iii) is deemed under non-Convention law to have the knowledge of another person who knows of an interest or fact; and

4. Clarification that the Innocent Purchaser defence is a minimum protection for purchasers

The protection provided by the Convention to account holders that are innocent purchasers under Article 12 operates as a legal assurance to purchasers within Contracting States that they will be safe from third party claims if they are able satisfy the test set out in the Article. The Article acts as a minimum level of protection in each Contracting State.

As such, the Article is not intended to erase any additional protections that the purchaser may have under the applicable domestic law. We have received feedback from our consultees in the securities industry that this point is not made sufficiently clear in the Article and that the Article would benefit from the insertion of a sub-Article clarifying this position.

We share this view and propose inserting the following Article as Article 12(6)

6. – This Article is without prejudice to any rights or defences available to an account holder or intermediary under non-Convention law or the rules of a Securities Settlement System in relation to the violation of another person's claim to an interest in securities or intermediated securities.

Proposal in relation to article 16 – Effect of insolvency

It has been our understanding through the course of the drafting of the Convention, that the Convention would not seek to encroach upon domestic insolvency rules other than where there is an agreed need to do so, for example, on the grounds of settlement finality.

Accordingly, we believe that Article 16 should be revised so as to make clear that domestic insolvency rules of law and procedure will take precedence save as specifically set out in the Article.

It is implicit in the current formulation of the Article that the precedence of domestic rules of law applicable to insolvency proceedings applies *only* in relation to "the avoidance of transactions for preference or a transfer in fraud of creditors". We do not agree that the rules of insolvency law that fall outside preferences and fraudulent transfer should be excluded from this general override. Furthermore, we believe that the question of what constitutes a rule on preferences or fraud may itself give rise to uncertainty and inconsistent interpretation.

We propose that if there are specific Articles in the Convention (in addition to Article 23 and 31) that should take precedence over rules of insolvency law these should be expressly stated in Article 16. This would have the effect both of making the application of the Convention clearer as well as ensuring that proper consideration is given to determining the interaction of each of the Articles with insolvency rules.

We therefore propose that the Article is amended by deleting the words “relating to the avoidance of a transaction as a preference or a transfer in fraud of creditors” and that further consideration is given to which Articles, if any, should take precedence over insolvency rules of law and procedure.