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**DIPLOMATIC CONFERENCE TO ADOPT A CONVENTION ON SUBSTANTIVE RULES REGARDING INTERMEDIATED SECURITIES**
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**MEMORANDUM**

**regarding suggestions for revision of the text of the draft Convention**

**(submitted by the Editors of the draft Official Commentary)**

This memorandum is to express some views of the Editors of the draft Official Commentary about the need for some revisions to the text of the Convention. The draft Official Commentary makes reference to these suggestions in footnotes.

## 1. Article 4

Section 4-11 of the draft Official Commentary points out that the regulation requirement must exist in respect of the activity of maintaining securities accounts ("in respect of that activity"). It is not sufficient that an entity is authorised for other parts of its business, for example, as an insurance broker or for the business of extending credit. Footnote 1 to that section also suggests that the reference to "that activity" in Article 4(a) may not be sufficiently clear. We suggest a clarification of paragraph 4(a) as follows:

> (a) intermediaries falling within such categories as may be described in the declaration, which are subject to authorisation, regulation, supervision or oversight by a government or public authority in respect of the activity of maintaining securities accounts ~~that activity~~; or

## 2. Articles 7, 14 and 21

In the course of writing the draft Official Commentary on Articles 7, 14 and 21, we encountered some difficulties in interpreting Article 7. Article 7 simply states that our Convention does not encroach on the applicable insolvency law "unless otherwise provided." If Article 7 is read literally, any given provision of the Convention is subject to the applicable insolvency law, unless the provision embraces an explicit statement to mean "otherwise provided." However, we believe that this is not what is intended in Article 7, and indeed, just for example, it is intended that rights and interests of an account holder that have become effective against third parties under Article 11 or Article 12 are effective in an insolvency proceeding under Article 14 or Article 21. What Article 7 tries to obtain should be to preserve "insolvency specific rules" such as avoidance rules and

procedural rules in insolvency. Article 7 also may be intended to dictate that priority or ranking among interests as provided in Article 19 should be preserved in insolvency proceedings, but if the applicable insolvency law sets out an additional or different rule, that rule might control. From this perspective, we believe that the second session of the diplomatic Conference might wish to revisit Article 7 for clarification. We might note that if the substance of what is intended is written in Articles 14 and 21, then Article 7 would become unnecessary.

We acknowledge that Article 14 is the result reached through the negotiations at the first session of the diplomatic Conference. However, as noted in the draft Official Commentary, the meaning of "comparable interests" is not necessarily easy to obtain, in particular where the non-Convention law offers different treatments to different interests. What is intended in Article 14 might be better addressed if Article 14 were written in a different and clearer way.

Thus, we believe that the second session of the diplomatic Conference also should revisit Article 14 for clarification. We might note that as a policy, one solution would be to introduce a declaration mechanism as an alternative to current Article 14. Following are proposed revisions that would provide for such a declaration mechanism.

*Article 1*
*Definitions*

[…]

(q) "insolvency power" means a privilege, priority or power of avoidance applicable in an insolvency proceeding, other than the rules of law described in Article 21(3)(a), under the law of a Contracting State which has made a declaration under Article Y.

* * *

[Delete Articles 7 and 14]

* * *

*Article X (merged Articles 14 and 21)*
*Effectiveness in insolvency proceedings*

1. Rights and interests that become effective against third parties under Article 11 or Article 12 are effective against the insolvency administrator and creditors in any insolvency proceeding.

2. This Article does not apply to interests granted under Article 12 by an account holder to the relevant intermediary or any other person responsible for the performance of a function of the relevant intermediary under Article 6 in any insolvency proceeding of such intermediary or such person.

3. Paragraph 1 does not affect:

(a) any rules of law applicable in the insolvency proceeding 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 the insolvency administrator.

4. Nothing in this Article impairs the effectiveness of an interest in intermediated securities against the insolvency administrator and creditors in any insolvency proceeding, where that interest has become effective by any method referred to in Article 13.

* * *

*Article Y*
*Insolvency powers*

1. A Contracting State may at any time declare, generally or specifically, those categories of insolvency powers which under that State's law (i) shall have priority over an interest that has become effective against third parties under Article 11, Article 12, or both or (ii) to which such an interest is subject.

2. A declaration made under the preceding paragraph may be expressed to cover categories that are created after the deposit of that declaration.

3. This Article applies only in an insolvency proceeding but does not apply in an insolvency proceeding of the relevant intermediary.

4. Subject to Article 19(5), an insolvency power has priority over an interest that has become effective against third parties under Article 11 or Article 12 and such an interest is subject to an insolvency power only if the insolvency power is of a category covered by a declaration made prior to the effectiveness of such interest.

5. Notwithstanding the preceding paragraph, a Contracting State may, at the time of ratification, acceptance, approval of, or accession to the Convention, declare that an insolvency power of a category covered by a declaration made under paragraph 1 shall have priority over an interest that became effective under Article 11 or 12 prior to the date of such ratification, acceptance, approval or accession and that such an interest is subject to the insolvency power.

* * *

*Explanatory note*

1. Article Y relates to an "insolvency power", which is defined broadly to include priorities, privileges and avoidance powers in an insolvency proceeding. (However, the definition excludes the avoidance powers mentioned in Article X(3)(a) – preferences and fraudulent transfers.) Also, it applies only in an insolvency proceeding but not in an insolvency proceeding of a relevant intermediary (i.e., no change is proposed to Convention interests in a relevant intermediary's insolvency proceeding). Thus, it is a targeted approach to treatment of Convention interests in insolvency proceedings.

2. Article Y is made subject to Article 19(5). A "non-consensual security interest" as used in Article 19(5) would be included within the definition of "insolvency power". The "subject to" approach means that a priority under the non-Convention law would apply without any declaration and also could apply outside of an insolvency proceeding (if the non-Convention law so provides). So this approach makes no change in substance to the current version of Article 19(5) on priorities.

3. The approach of this draft would not compel any Contracting State to adopt an approach that would differ from the substance of the current Article 14 approach. Any Contracting State that wishes to give Convention interests comparable treatment to comparable interests could do so by making an appropriate declaration under Article Y. But the Article Y approach has the advantage of eliminating the ambiguity inherent in Article 14 and would provide transparency and public notice. Moreover, it would provide a mechanism for a Contracting State to provide Convention interests with better treatment than "comparable" interests, consistent with recent developments in national, regional, and international law reforms.

4. Parts of Article Y might better be placed among the Final Provisions of the Convention.

## 3. Article 9

Section 9-17 of the draft Official Commentary explains that the words "by instructions to the relevant intermediary" apply properly to credits and debits made under Article 11, which must generally rely on the authorised instructions by the account holder (see Articles 15 and 23). They also apply to designating entries provided under Article 12(3)(b). However, they do not apply to agreements granting an interest to the relevant intermediary (Article 12(1) and (3)(a)) or to control agreements in favour of other persons (Articles 1(k), 12(1) and 12(3)(a)). Such agreements are not "instructions to the relevant intermediary" in the strict sense. Viewed this way, the reference to instructions by the account holder is not sufficient in Article 9(1)(b). Section 9-17 (in footnote 4) notes that the diplomatic Conference may wish to consider an appropriate revision of the text. We suggest the following revision of Article 9(1)(b):

> (b) the right, by instructions to the relevant intermediary <u>or in accordance with an agreement to grant an interest in intermediated securities or control agreement</u>, to effect a disposition under Article 11 or grant an interest under Article 12.

## 4. Article 15

Section 15-18 of the draft Official Commentary explains that an erroneous change was made to Article 15(1)(a) during the first session of the diplomatic Conference. We propose to rectify that unwanted change by revising Article 15(1)(a) as follows:

> (a) in respect of a debit, by the account holder and, if applicable, the person ~~in whose favour a designating entry has been made~~ to whom an interest in the relevant intermediated securities has been granted under Article 12;

## 5. Articles 18(1) and 18(2)

Section 18-5 of the draft Official Commentary notes the narrowness of the third protection provided for an innocent acquirer in Article 18(1)(c). There is a variety of grounds on which the acquisition might be held invalid or liable to be reversed as a result of the violation of the rights of another person. But the third protection identifies only one specific ground and provides no protection against invalidation or reversal based on other grounds arising out of the violation of rights. Accordingly, paragraph 1(c) should be revised to read as follows (together with some further technical and conforming revisions in paragraphs 1 and 2):

> 1. Unless an acquirer actually knows or ought to know, at the relevant time, that another person has an interest in securities or intermediated securities and that the credit to the securities account of the acquirer, designating entry or the interest granted to the acquirer violates the rights of that other person with respect to the interest of that other person:
>
> (a) [...]
>
> (b) [...]
>
> (c) the credit, designating entry or the interest granted is not rendered invalid, ineffective against third parties or liable to be reversed on the ground that the credit, designating entry or the interest granted violates the rights of that other person ~~right or interest of that other person invalidate any previous debit or credit made to another securities account~~.
>
> 2. Unless an acquirer actually knows or ought to know, at the relevant time, of an earlier defective entry:
>
> (a) the credit, designating entry or interest is not rendered invalid, ineffective against third parties or liable to be reversed as a result of that defective entry [...]

This change would recognise that when an acquirer meets the Convention's test of innocence, it should not suffer any loss or detriment as a result of a violation of the other person's rights.

**6. Article 18(6)**

Example 20-3 of the draft Official Commentary notes that the more specific priority rule under Article 20(2) is controlling over the general rule under Article 18(1) but that the current text may not be sufficiently clear in this respect. We suggest the following clarification be added to Article 18(6):

> 6. This Article does not modify the priorities determined by Article 19 or Article 20(2).

**7. Article 35**

Footnote 10 to section 35-1 of the draft Official Commentary notes that the reference to Article 32 is no longer correct since the reference to close-out netting provisions and their operation has been moved to Article 33 during the first session of the diplomatic Conference. We suggest the following clarification of Article 35:

> "Articles ~~32,~~ 33 and 34 do not affect…"

**8. Article 39**

Article 39(3) defines pre-existing interests by reference to "the relevant date", i.e., the date when the declaration made under Article 39(2) becomes effective. Under that definition, a preexisting interest may be created after the Convention enters into force for the relevant Contracting State, but before the relevant date. In the context of Article 39(2), this could be taken as suggesting that an interest granted after the Convention enters into force for a Contracting State but before the relevant date may retain some other priority than the priority assigned by the Convention in Article 19. But that interpretation would be inconsistent with the rule of Article 39(1). The only pre-existing interests relevant to Article 39(2) should be the interests granted before the Convention has entered into force for the relevant Contracting State. To avoid this contradiction between paragraphs 1 and 2 on one hand and the definition of pre-existing interest in paragraph 3(a) on the other, we suggest the following modification of the definition in Article 39(3)(a):

> (a) "pre-existing interest" means any interest, other than a non-consensual security interest, that has been granted before the ~~relevant~~ date on which this Convention has entered into force in respect of a Contracting State other than by a credit to a securities account;

**9. Note**

The Editors also contemplate that they may offer some additional drafting suggestions for minor changes in the Convention text. These changes would be of a technical, drafting nature and would not involve any material change in substance.