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

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

(submitted by EuropeanIssuers)

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I. INTRODUCTION

EuropeanIssuers reiterates the concerns it expressed on the subject of the UNIDROIT draft Convention on substantive rules regarding intermediated securities (hereinafter the "draft Convention" or the "Convention") in its previous papers dated 3 November 2006, 20 April 2007 and 30 June 2008 respectively[1]. The draft Convention has its merits where it aims to harmonize the framework governing securities credited to a securities account. The rights and obligations derived thereof against the intermediary who provides the account on the one hand and those against third parties who have an interest in the intermediary on the other hand, are to be reconciled. The convention must stick to this clear and well defined purpose. However the draft Convention threatens to affect the relationship between the issuer and the shareholder and overrule the issuer law in some instances. This is suggested by the comments on the relationship between Articles 8 and 9 and again at the level of Article 29 of the draft Convention. It does not recognise the principle that the issuer law should be the only SOURCE when it comes to granting so-called corporate law rights to shareholders. The Convention should refrain from interfering with corporate law regarding securities and the relationship between shareholders and issuers, including the rights granted to shareholders by and to be exercised against issuers. This is all the more so, as the *acquis communautaire* now includes the Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies (14.7.2007), hereinafter the "Shareholder Rights Directive". It is of the utmost importance that the Convention respects the integrity and sovereignty of such EU legal framework.

[1] See our papers on http://www.europeanissuers.eu/en/?inc=page&pageid=positions&keyword=Unidroit.

II. COMMENTS

Article 8 - Relationship with issuers

a) Draft Convention text

"1. Subject to Article 29(2), this Convention does not affect any right of the account holder against the issuer of the securities.

2. This Convention does not determine whom the issuer is required to recognise as the holder of the securities or as the person entitled to receive and exercise the rights attached to the securities or to recognise for any other purpose."

b) Comments

Although the commentary to Article 8 explicitly states that corporate law aspects are excluded from the scope of application, the Convention for sure does not leave the issuer-shareholder relationship unaffected.

Article 8(1)

Article 8(1) makes the exclusion subject to Article 29(2) which requires, as an exception to Article 8, the issuer to recognise the nominee holding structure and the splitting of votes. In its current form (see hereinafter), Article 29 impinges on the content of the applicable corporate law and amounts to entitling every intermediary in the chain to cast votes on behalf of the shareholder/ account holder, which runs counter to generally accepted principles under all Member states corporate law.

Indeed, it all becomes clear when one also reads Article 9 (see hereinafter) and the comments on the relationship between Article 8 and Article 9(1): *"8-13.Where the securities are credited to the securities account, the account holder is given the rights enumerated in Article 9(1)(a). While Article 8(1) uses the phrase "does not affect any right", it is not an exception to Article 9(1)(a). In other words, Article 8(1) is not intended to deny or otherwise limit the right resulting from the credit under Article 9(1)(a). Article 8(1) applies to the matters with respect to the relationship between the account holder and the issuer which are beyond what is spelled out in Article 9(1)(a)."*

We have some difficulties to assess what is there beyond the rights spelled out in Article 9(1)(a) especially as they include the right to corporate actions like distributions and the right to vote at the general meeting!

We must therefore conclude that Article 8 is very misleading. We strongly object to the text of the draft Convention that has gradually evolved into an international legal framework for intermediated securities that will deeply affect the core of the corporate relationship between the issuer and the shareholder, *i.e.* the rights to corporate actions including the decision power at general shareholder meetings. The notion of shareholder is thus becoming subordinate to that of account holder. For the benefit and convenience of the securities industry, all rights would be derived from the fact of being the holder of a securities account. In a system where securities are held through a chain of intermediaries, there is a series of account providers and therefore also account holders for every securities position held by an end investor. It is then easy to understand that the draft Convention aims at laying all weight with account holders, read the securities industry, as most of the account providers in the chain are also account holders. This is an absolute assault on the core of corporate rights as well as on basic corporate governance principles. Such a provision should accordingly be repealed or, at least, fundamentally amended (see additional comments below).

Article 8(2)

Article 8(2) does not determine whom the issuer is required to recognise. However the examples given in the draft Official Commentary seem to suggest that this provision would only hold for registered shares and that for bearer shares the rights attached to the securities, including voting rights, will definitely go to the account holder, whatever the issuer law says, according to Article 9. The comments should explicitly spell out that the principle laid down in Article 8(2) applies to all types of shares without distinction.

c) Proposal

Article 8(1) should be rewritten as follows:

1. This Convention does not govern corporate law matters, including the relationship between the issuer and the shareholder, and does not affect in any way the law of the issuer concerning the establishment, alteration or disposal in whatever form of the position as a shareholder of an issuer or of any shareholder rights against the issuer contained in or evidenced by intermediated securities.

Article 9 - Intermediated securities

a) Draft Convention text

"1. The credit of securities to a securities account confers on the account holder:

(a) the right to receive and exercise any 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 so provided by the non Convention law;

(b) the right, by instructions to the relevant intermediary, to effect a disposition under Article 11 or grant an interest under Article 12;

(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 by the applicable law, the terms of the securities and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system;

(d) unless otherwise provided in this Convention, such other rights, including rights and interests in securities, as may be conferred by the 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 applicable law;

(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 11(4), the non-Convention law determines any limits on the rights described in paragraph 1 of this Article."

b) Comments

Article 9(1) refers to the rights attached to the shares resulting from book-entry on the securities account. As indicated above, a clearer distinction should be made between the rights conferred upon the shareholder, which are determined by the applicable "lex societatis", and the legal effects of the acquired rights by the account holder and their enforceability against third parties, which should be the onus of the draft Convention. Whereas the former relates to the relationship between the issuer and the investor and should be left outside of the Convention, the latter covers the relationship between the account holder and the relevant intermediary, which should remain the only subject matter of the Convention.

Rather, while it is clear that the same legal significance should be given to book-entry on securities accounts, it is the core role of the account keeper/ account provider in protecting the interests of the ultimate account holder (see comments under Article 10 below) which should take precedence over any listing of legal attributes, by way of minimum rights attached to securities, which is a matter of the applicable corporate law and should not fall within the ambit of the envisioned text. As already expressed in previous papers by EuropeanIssuers, the rights attached to securities can only be exercised by the ultimate account holder and their scope should be determined by the applicable corporate law.

What is the *ratio legis* for having a provision that describes the rights of a shareholder in a convention that is meant to protect the rights of a holder of a securities account against (a possible insolvency of) the account provider?

If this provision serves to bring the book entry system to the same level as non intermediated shareholding, it should simply state that a holder of a securities account who is an ultimate account holder - thus excluding any intermediary that is not acting for its own account, enjoys the rights of a shareholder with respect to the securities credited to that account. It should limit itself to merely but clearly state that, without describing what these rights are. Indeed, we cannot stress enough that the Convention is not the adequate legal framework to address shareholder rights, which are a matter of corporate law.

Article 9(1)(a)(ii) threatens to pave the way for the exercise of the rights attached to securities by any intermediary up the chain, "if so provided by the non-Convention law", which may result in conflicting entitlements as the "non-Convention law" may differ from the applicable corporate law. Moreover it violates the fundamental rights of the ultimate account holder.

According to the commentary to Article 1(m) of the draft Convention, the non-Convention law refers to the substantive law (other than the Convention) of the Contracting State, which is relevant to the issues covered by the Convention. In some instances, the Convention prevails over these rules, in other instances the Convention contemplates that its provisions may be supplemented by these rules, in yet other instances, these rules may derogate from the provisions of the Convention.

Application of both the Convention law and the non-Convention law is determined by Article 2 of the draft Convention. According to Article 2(1) of the draft Convention, "*the Convention applies where the applicable conflict of law rules designate the law in force in a Contracting State as the applicable law*". This conflict of law rule may point to the application of the law of another State, which is a Contracting State and, which, accordingly is not necessarily the substantive law of the forum State.

The non-Convention law, it is further asserted, should not be confused with the applicable law, "*which is the law that is applicable by virtue of the private international law rules of the forum. The applicable law may or may not be the non-Convention law*".

What is implied is that the applicable law designated by the conflict of law rule of the forum in matters not covered by the Convention, e.g. corporate law, may not be the same law than that applicable by virtue of the conflict of law rule of the forum in matters falling within the ambit of the Convention, resulting in a potential conflict of entitlement as far as the relationship between the issuer and the ultimate account holder is concerned.

Article 9 of the draft Convention may also call into question the principle of registered shareholding, in so far as it may result in rights deriving from the credit to the securities account maintained by the intermediary (Article 9(1)) and being considered effective against the issuer (Article 9(2)), whereas it should be the recording in the company's register which is evidence of ownership of registered securities. Language in the first sentence of Article 9(2) should accordingly be amended to make room for the "non-Convention law" in a matter covered by the Convention.

c) Proposal

Article 9 should read as follows:

"1. The credit of securities to a securities account confers on the ultimate account holder the rights enjoyed by a shareholder according to the applicable corporate law, without prejudice to any explicit additional requirements laid down by such applicable corporate law. *2. Unless otherwise provided in this Convention or in the non-Convention law, the rights referred to in paragraph 1 are effective against third parties.* *3. …*

Alternatively, Article 9(1)(a)(ii), "in any other case , if so provided by the non Convention law", should be deleted.

A definition of "ultimate account holder" is to be added to Article 1 to distinguish between an account holder in general and an account holder that is not acting for somebody else, but strictly acts in its own name and for its own account. It should read as follows:

"ultimate account holder" means an account holder who is acting for its own account.

Article 10 - Measures to enable account holders to receive and exercise rights

a) Draft Convention text

"*1. An intermediary must take appropriate measures to enable its account holders to receive and exercise the rights specified in Article 9(1).*

2. This Convention does not require the relevant intermediary to establish a securities account with another intermediary or to take any action that is not within its power."

b) Comments

The duty to take "appropriate measures to enable" an account holder "to exercise the rights specified in Article 9(1)" could imply in certain (especially non-EU) jurisdictions the exercise of voting rights by a person acting in his own name but on behalf of another person (including a nominee). However, in many EU countries provisions on corporate actions and general corporate governance principles require the identification of the shareholder, whilst the intermediary is usually considered as mere depository of the financial instruments concerned. In order to avoid problems stemming from different rules and for the sake of ensuring transparency, the Convention should safeguard the right for the issuer to require from the intermediary the disclosure of the

identity of the ultimate accountholder.

c) Proposal

The Article should therefore read as follows:

"1. The relevant intermediary must take appropriate measures to

i) enable its legally entitled account holders to receive and exercise the rights specified in Article 9(1)

ii) when so requested by or on behalf of the issuer of a security credited to a securities account provided by the account provider, disclose the identity of the ultimate accountholder with respect to that security.

2. …"

Article 29 - Position of issuers of securities

a) Draft Convention text

"*1. The law of a Contracting State shall permit the holding through one or more 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.*

2. In particular, the law of a Contracting State shall recognise the holding of such securities by a person acting in its own name on behalf of another person 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."

b) Comments

This provision does not deal with the relation between the account holder and the account provider. It deals exclusively with the manner in which securities can be held which is a matter of corporate law and ought therefore not to be addressed in this Convention, which is not the appropriate legal framework. This is all the more true for paragraph 2 as it even provides for the exercise of the voting rights which is far beyond the scope of the Convention. Not only does it amount to entitling every intermediary in the chain to cast votes on behalf of the shareholder/ ultimate account holder, but it also interferes in the manner in which these rights can be exercised. The official commentary should make it crystal clear that the conditions the non Convention law may provide for, include conditions of transparency.[2]

c) Proposal

We strongly advise to entirely delete Article 29 or, if that proves impossible, at least paragraph 2.

[2] These conditions of transparency, could for instance include the following:
- The representative should, if so requested, notify its status of representative to the issuing company.
- The representative should disclose, if so requested by the issuing company, its principal's name as well as the number of shares held on its behalf.
- The representative should be authorized to exercise the voting rights only in accordance with the instructions by the shareholder and be able to provide evidence of these instructions.