



**DIPLOMATIC CONFERENCE TO ADOPT A  
CONVENTION ON SUBSTANTIVE RULES  
REGARDING INTERMEDIATED SECURITIES  
Final session**  
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## Comments

*(submitted by the Government of the United Kingdom)*

*These comments principally set out requests for clarifications to the relevant text (which can be done through the Official Commentary); suggestions for changes are shown in the Draft Convention with underlined text, and in the Draft Official Commentary with **italic** text.*

*Unless otherwise stated, all references are to paragraphs of and Examples in the Draft Official Commentary.*

### **Central Banks as Intermediaries**

1. In paragraph 1-25, can it be clarified as regards "*in the course of a business or other regular activity*" whether a Central Bank is also included within the definition of intermediary. The reference to the declaration mechanism in paragraph 4-12 is presumably not intended to mean that Central Banks are *not* intermediaries/not within the scope of the Convention *unless* a declaration is made under Article 4(b).

### **Collateral Takers as Intermediaries**

2. In paragraph 1-28, can it be clarified as regards "*and is acting in that capacity*" whether an entity acting solely/at all times as the recipient/holder of collateral is within the scope of the Convention.

### **Securities of the same description**

3. In paragraph 1-43, reference is made to "securities of the same description only if the issuers are the same"; this relates back to the definition in Article 1(j). It could be clarified that securities are also of the same description or equivalent where the original securities have been converted, sub-divided or consolidated or have become the subject of a take-over or merger such that the holders of securities have become entitled to receive or acquire other securities in the issuing company or some other company (see for example, reference to securities being "equivalent to" other securities in the TBMA/ISMA Global Master Re-Purchase Agreement – 2000 version).<sup>1</sup>

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<sup>1</sup> Mention of "securities of that description" is also made in paragraph 24-12. See also the comments on paragraph 31-15 below.

### ***The effect of the Convention on national insolvency law***

4. In paragraphs 7-4 to 7-6, the Official Commentary questions the drafting of Article 7 and other insolvency-related Articles adopted at the First Session of the Diplomatic Conference pursuant to the acceptance by it of a proposal made by the Informal Working Group on Insolvency. The Official Commentary alleges that the provisions of Article 7 are “ambiguous” (paragraph 7-5) and states that Article 7 is not intended to preclude the operation of say, Articles 11, 12, 18, 19 “and the like” despite those provisions not containing any explicit wording (“otherwise provide”) that they are to override national insolvency law.<sup>2</sup>

5. As a consequence, this leads to the proposal set out at paragraph 2 of the Memorandum, whereby Article 7 is removed, Articles 14 and 21 are merged, and a new “declaration” mechanism is included.

6. The proposal constitutes a return to the approach whereby the general structure of the Convention would be for the preservation of national insolvency law *only* to the extent of provisions relating to avoidance of a transaction as a preference or a transfer in fraud of creditors,<sup>3</sup> together with a declaration mechanism, whereby in relation to interests effective against third parties under either or both of Articles 11 and 12, Contracting States would have to “opt-in” to those “categories” of national insolvency law that they would wish to be preserved. This approach represents a reversal of the approach expressly adopted by the First Session of the Diplomatic Conference, whereby the effect of national insolvency law should be preserved unless explicitly stated (“otherwise provide”) in the relevant Articles of the Convention.<sup>4</sup>

7. We believe for the reasons set out in the Report of the Informal Working Group on Insolvency, and those set out in the Paper prepared by the Informal Working Group on Insolvency-related Issues,<sup>5</sup> which were extensively debated at the First Session of the Diplomatic Conference, that the approach adopted in the current wording of Article 7 is the right approach, and we therefore oppose the deletion of Article 7/the merging of Articles 14 and 21 and the proposed declaration mechanism. In our view, the Convention should not establish a general “carve-out” or disapplication of national insolvency law so as to create an asset class that is dealt with differently on insolvency than other classes of asset or rights arising under national law.

### ***Some suggested changes re effect of insolvency***

8. We would however, suggest some further amendments re the effect of national insolvency law in certain individual articles as appropriate.<sup>6</sup> In particular, Articles 11 and 12 (as set out below) should have further clarifications in relation to the disapplication of “any steps” that might otherwise be required pursuant to national insolvency law. Furthermore, the discussion in the Official Commentary of “comparable interests” in Article 14 should be elaborated as to interests in intermediated securities

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<sup>2</sup> The Editors say that this was because the Diplomatic Conference did not re-visit these Articles (paragraph 7-6). We find this surprising since the Drafting Committee specifically considered the need for amendments to these and other Articles taking into account the wording of Article 7 (i.e. whether they would benefit from clarification as to the effect on insolvency law so as to “otherwise provide”). However, the Drafting Committee was content to leave these Articles (and all other Articles) in the form they currently appear.

<sup>3</sup> As set out in Article 18 of the previous draft of the Convention (CONF.11 – Doc 3)(February 2008).

<sup>4</sup> This was adopted on the proposal to this effect from the Informal Working Group on Insolvency (CONF.11 – Doc 31)(8 September 2008).

<sup>5</sup> Study LXXVII – Doc 97 (December 2007).

<sup>6</sup> In the Report by the Informal Working Group on Insolvency (at paragraph 5), it was suggested that certain Articles (including, the “old” Articles 9 and 10, being now the “new” Articles 11 and 12 in the current draft of the Convention) of the Convention might have to be re-visited in connection with the adoption of their proposal (i.e. what is now Article 7) that national insolvency law should not be affected by the Convention unless explicitly stated (“otherwise provide”) in the relevant Articles of the Convention.

recognised under the Convention being treated “no differently” or “no better/no worse” than any other interests capable of being dealt with in the relevant insolvency proceedings.

#### *Registration of security*

9. In paragraph 11-11, reference is made to “*no further step*” being necessary to render the acquisition of intermediated securities effective, and that the non-Convention law may not require that, in addition to the credit itself, the interest acquired by the account holder must be “registered in a public registry”. However, in Example 14-2, the fact scenario refers to the possibility of there being a law applicable in any insolvency proceeding requiring say the registration of interests (presumably in relation to security) in intangible movables in a public register.

10. We think it is consistent with the approach of the Convention, that such registration should *not* be necessary where a security interest is granted in intermediated securities (since that would constitute a “further step” precluded by Articles 11 and 12). To that end, we consider that Article 11(2) (and Article 12(2) in similar terms) ought to be amended:

“No further step is necessary, or may be required by the non-Convention Law (including any provision with respect to perfection or relating to priorities between competing interests that would otherwise apply by reason of an insolvency proceeding), to render the acquisition of intermediated securities effective against third parties”.

11. This wording <sup>7</sup> is necessary given that certain jurisdictions (such as the UK, Ireland and possibly other “English” common law jurisdictions) do indeed require certain formal or further “steps” (i.e. registration) upon the creation of certain security interests. If not registered, such security interests are void as against the insolvency official of the entity having created the security interest and any creditors.

#### ***Comparable Interests***

12. In paragraphs 14-1 to 14-4 generally, it would be helpful if the text were also to refer (in addition to Convention interests being “effective to the same extent”) to Convention interests being “*treated no differently*” or “*no better/no worse*” than any other comparable interests capable of being dealt with in insolvency proceedings. This means that they are of course subject to no further or additional (nor equally, any less) burdens or requirements merely because they arise as a consequence of the Convention.

#### ***Status of Conditional Credits and Article 18***

13. In paragraph 16-22 and Example 16-4, the fact scenario refers to an account holder (A) granting a security interest in respect of securities (or rather an interest in securities represented by a credit to its account with IM) where the credit entry is *conditional* (i.e. subject to a condition subsequent allowing reversal if say, the relevant settlement failed). It states that where (A) creates a security interest in respect of its securities account (by way of designating entry or control agreement), then the recipient of the security interest (B) is protected by Article 18(2) with the consequence that IM has to “buy-in” shares for the account of (A) and to credit (A)’s securities account so that (B)’s security interest is duly funded/can attach to “real securities”. It further states that IM may protect itself by making a note in the designating entry, or as the case may be, the control agreement, that the credit of securities is or may be conditional, or otherwise liable to be reversed. However, in a system in which IM merely receives a *notice* of a control agreement

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<sup>7</sup> The wording suggested is based upon the wording found in Article 11.3 of the Hague Convention on the Law applicable to Certain Rights in respect of Securities held with an Intermediary (5 July 2006).

(i.e. subsequently to the execution thereof/without being a party to it) then it would not be in a position to protect its ability to reverse the credit.

14. We find this example very thought provoking and somewhat perturbing. To the extent that (B)'s security interest is perfected *not* by a transfer of the securities to another account of (B) with IM (and where the credit is unconditional) or to a "new" securities account of (B) with a third party intermediary, but remains a security interest in securities/an interest in securities credited to (A)'s securities account, then our reaction is to conclude that (B) takes the asset which is the subject matter/*corpus* of the security interest *subject* to whatever conditionality that such a credit possesses, irrespective of whether (B) has notice of that conditionality at the time the security interest was taken. In essence, (B) cannot obtain a better interest in securities (or a right to require a transfer or buy-in of securities by IM) than (A) itself had. The fact that IM did or did not (or may not have the ability to) give notice to (B) of the conditionality of the credit before (B) took its security interest should be irrelevant.<sup>8</sup> An IM/account provider should not (through no fault of its own and having no ability to guard against it) have to buy-in securities, which were never represented a completed credit to the account of the account holder. We therefore conclude, that in these circumstances, Article 18 ought *not* apply to protect/extend to an innocent acquirer as regards conditional credits.

#### ***Who is an Acquirer***

15. In paragraph 17-6, reference is made to an acquirer as being a person to whose securities account a credit or designating entry is made. It should be clarified that the term acquirer also applies to a person holding the benefit of a control agreement (which is indeed referred to in the text of paragraph 17-5 and Example 16-4), with the result that in the final sentence of paragraph 17-6, it should also expressly refer to "what is or constitutes a credit or designating entry to a securities account ***or a control agreement*** is determined by the non-Convention law".

#### ***Determining whether a person ought to know of an interest or fact***

16. In paragraph 17-7 to 17-11, the interpretation/contents of the "determining whether a person ought to know of an interest or fact" as regards Article 18 are discussed. However, it appears that the "ought to know" test is only to be failed by a person that is either "dishonest" or consciously decides not to make any further enquiry of very suspicious circumstances of which it is actually aware (as *per* the discussion in paragraph 17-10 to paragraph 17-11). This will "rarely apply" outside the acquirer's "actual collusion" or knowledge (and consciously refusing to enquire further) of highly suspicious circumstances tantamount to/just short of, and therefore representing "actual knowledge".

17. Put another way, although it is accepted that there is no *general* duty of enquiry, there may be exceptional circumstances in which a specific duty of enquiry does arise, and where the defence of innocent acquisition should not to be available to a purchaser/transferee who ought to have made enquiry (i.e. without acting "in collusion" with the transferor, or without having "deliberately" closed its eyes/made no further enquiry when it was aware of highly suspicious circumstances that is tantamount to "actual knowledge").<sup>9</sup> An acknowledgement to this effect should be made in the Official Commentary.

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<sup>8</sup> Similarly, the asset or bundle of rights represented by (A)'s credit to its securities account could be limited by other terms of the securities account agreement. For example, that the account holder may not be entitled to charge, assign or otherwise deal with the account/the benefit of credits to the account without the consent of the account provider or there may be rights of set-off existing in relation to the account. Does the effectiveness of all these conditions/terms to which the account is subject "fall away" by reason of a control agreement executed in favour of a third party taking advantage of Article 18?

<sup>9</sup> For example, if one were purchasing securities from Bernard Madoff, with knowledge that he was subject to investigation by the SEC, ought not there to be a specific duty of enquiry in such a case. An acquirer cannot claim to be innocent simply because he did not collude in the fraud or although stupid, he was by his

18. In paragraph 17-13, reference is made to the fact that merely because the acquirer has read or is otherwise aware of a third party's public notice that another person has an interest in intermediated securities does not, by itself, constitute awareness that the acquisition "violates the rights of that other person" so as to take the acquirer outside the scope of Article 18(1). Furthermore, it states that it is common for a third party who has filed a public notice nonetheless to permit and desire the account holder to sell or otherwise transfer the intermediated securities (e.g. in order to generate funds). Thus, an acquirer is "entitled to presume", without further enquiry or investigation, that such is the (permitted) arrangement in a particular transaction (and therefore, in such circumstances, that the acquirer's interest does not violate the interest of the third party).

19. Example 17-4, thus refers to a fact scenario whereby an acquirer (B) is aware (by means of a public notice) that a lender (L) has a security interest in intermediated securities credited to an account holder (A)'s account (under applicable law, L's interest in the securities having been made effective against third parties by means of a publicly filed notice in accordance with Article 13). It would appear that mere knowledge of L's interests does not deprive (B) of protection under Article 18(1); however, in contrast, if in addition to being aware of the content of (L)'s notice, (B) has also been "told" by (L) that (A) has promised not to sell the intermediated securities, then the circumstances taken together make it plausible that (B) ought to know about the violation of (L)'s rights.

20. We find the assumption in paragraph 17-13 and the distinction (of being actually "told" of the restriction) made in Example 17-4 surprising. A commonly-occurring fact scenario, would be where say, (L)'s security document and/or the public filing thereof *expressly* set out a form of "negative pledge" forbidding the creation of any security interest, or transfer or intermediated securities without the prior written consent of (L). If (B) had actual knowledge of such a negative pledge,<sup>10</sup> but went on to take the interest in the intermediated securities without further enquiry, then we think applicable non-Convention law ought to determine whether such knowledge should of itself constitute knowledge of the third party's interest being violated (and therefore take (L) outside the protection of Article 18(1)). Put another way, it is not the function of the Official Commentary to lay down a fact specific harmonised rule as to the meaning of knowledge of the rights of another person being "violated".

21. Furthermore, it appears odd that if a third party takes a security interest under Article 12, under Article 19 their Convention interest "trumps" an existing (Article 13) non-Convention security interest *irrespective* of notice/whether they knew of the existence of the earlier security interest, whereas if the third party instead acquires an outright/ownership interest (Article 11) they would be bound by any pre-existing non-Convention security interest of which they had notice under the innocent acquirer test. Put another way, the acquirer of a more limited Convention *security interest* under Article 12, is in a better position than that of the outright acquirer under Article 11. One way to resolve this apparent inconsistency, might be to suggest that the holder of an Article 12 interest as referred to in Article 19(2) ought also be made subject to the same Article 17 acquirer knowledge test before they have priority over an existing non-Convention security interest.

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own terms honest (kind heart/fat-head)? The fact scenario at Example 17-3 suggests the right result, but the foregoing commentary does not easily justify such a conclusion.

<sup>10</sup> This might be due to the negative pledge being entered on the register or otherwise set out in the relevant security document, and where (B) had, in either case, read/actually seen the wording. Indeed, under English law knowledge of the negative pledge might involve (B) in liability for the tort/civil wrong of knowingly inducing breach of contract between (A) and (L).

***Effectiveness in the insolvency of the relevant intermediary***

22. In paragraph 21-5, it refers to the fundamental protection to be afforded by the Convention to account holders in relation to the insolvency of the relevant intermediary being the account provider (as in Article 21(1)). However, there appears to be no clear “Example” of the operation of this simple vertical insolvency aspect (both examples set out in paragraph 21-1 and 21-2 are rather more complex and concern the grant of security interests). Perhaps it might be helpful to provide an Example in relation to the simple vertical insolvency aspect.

***Article 12 interest granted to relevant intermediary***

23. In paragraph 21-7, it refers to the situation where an account holder has granted an interest under Article 12 to its own intermediary, which is dealt with in Article 21(2). We are not entirely sure that we see the relevance/need for Article 21(2) in the context of an Article that is headed/expressly concerns the insolvency of the *relevant intermediary*; the problem in Article 21(2) is not the insolvency of the relevant intermediary to whom the security interest was granted, but the insolvency of the *account holder* who granted the security interest under Article 12. Article 21(1) concerning the effect of the relevant intermediary’s insolvency on third parties that have an Article 11 or Article 12 interest, is irrelevant where it is the relevant intermediary that holds a security interest.<sup>11</sup> We therefore suggest that Article 21(2) is deleted.

***Exception: avoidance powers and procedural rules***

24. In paragraph 21-8, reference is made to the fact that under Article 21(3), the protection as against the insolvency of *the relevant intermediary* afforded by Article 21(1), does not apply in relation to certain rules of law applicable in the insolvency proceedings<sup>12</sup> (presumably “*the insolvency proceeding*” in Article 21(3) refers to those of the relevant intermediary referred to in Article 21(1)). This drafting is said to be “inspired” by Article 30(3) of the Cape Town Convention.

25. Whilst we agree with the logic, the same wording is used for the limited “preservation” or rather content of national insolvency as was used (and expressly rejected at the First Session of the Diplomatic Conference) in the context of the (new) Article 7 debate. We believe that the circumstances referred to in Article 21(3)<sup>13</sup> and the obvious intention of Article 21(3)<sup>14</sup> would more clearly be delivered by amending Article 21(3):

“This Article does not apply to rights acquired under Article 11 from the relevant intermediary or interests granted under Article 12 by the relevant intermediary”.

On this basis, the entity entitled to those rights or interests under Article 11 or 12 respectively, will not benefit from the protections of Article 21(1) and their interests will be effective in the relevant intermediary’s insolvency proceedings on the same basis as provided by Article 14(1) (i.e. no differently/no better no worse than the holder or any comparable interest as explained in the Official commentary on Article 14).

<sup>11</sup> The situation referred to in Article 21(2) would therefore simply be addressed under Article 14, and nothing requires that it is mentioned in Article 21 at all.

<sup>12</sup> I.e. those relating to the avoidance of a transaction as a preference or a transfer in fraud of creditors (Article 21(3)(a)) or any rules of procedure relating to the enforcement of rights to property which is under the control of supervision of the insolvency administrator (Article 21(3)(b)).

<sup>13</sup> I.e. where an interest has been granted by the relevant intermediary (which has subsequently become the subject of an insolvency proceeding) in favour of the account holder under Article 11 or a third party under Article 12.

<sup>14</sup> I.e. that the “blanket” protections against the insolvency of the relevant intermediary under Article 21(1) in favour of a person having the benefit of an Article 11 or Article 12 interest, should *not* apply where that interest is granted by the relevant intermediary.

### ***Instructions to intermediary***

26. In paragraph 23-15, it refers to the fact scenario in Example 23-3, and that an IM will incur “no liability” to a person (Y) who asserts an adverse claim that securities held by an account holder (X) with the IM, are stolen. Furthermore in paragraph 23-27, it states that even though Article 23(1) is subject to “any applicable provision of applicable non-Convention law”, such law (whilst capable of addressing such matters as the account holder being deceased/lack of capacity in minors) cannot deliver a result which would require an intermediary to act on a stranger’s assertion of an adverse claim or permit an intermediary to refuse to act on its account holder’s instructions as in Example 23-3. This is so “even if non-Convention law would have a different result”.

27. We do not accept this breadth of these assertions, and believe that it is not the function of the Official Commentary to restrict the operation of non-Convention law in this manner without any support in the text. Whilst not being circumstances where non-Convention law “allows a third party... to give instructions” (as mentioned in paragraph 23-26), we believe that there are exceptional circumstances, such as fraud or collusion of the intermediary, or knowledge/notice of breach of trust or fiduciary duty, or the application of other mandatory provisions of law (e.g. relating to crime/money-laundering, terrorist financing, sanctions legislation) where the non-Convention law might impose a liability on an intermediary for acting on instructions from the account holder, or alternatively, provide a defence to an intermediary for not acting on instructions from the account holder. The ability of non-Convention law to determine when this is so, is expressly preserved by the Convention. We therefore suggest that paragraphs 23-15 and 23-27 should reflect the complexity of these issues.

28. In paragraph 23-24, we query the reference to the exception in Article 23(2)(c) concerning a judgement, award, order or decision of a judicial or administrative authority, which is “subject to Article 22”, such that the ability of public authorities to “give instructions to intermediaries directly under their law” cannot address an attachment of an upper-tier intermediary. We are concerned that this does not clearly allow the justifiable ability of a Contracting State to implement and enforce criminal and sanctions-related powers against assets held by intermediaries where the account holder is or is suspected to be acting in collusion with or is a nominee for a prescribed person/the assets are or are suspected to be the product of a prescribed activity.<sup>15</sup> This is obviously different to the situation of attachment by creditors in relation to debts, but is not distinguished as such by the text.

### ***Insolvency of system operator***

29. In paragraph 27-18, it refers to the fact that “exceptionally” the “text of the Convention addresses issues of payments”. This relates back to the contents of Article 27(a), which refers expressly to instructions “for making a payment” relating to an acquisition or disposition of intermediated securities and to the intent that such instructions shall be irrevocable.

30. We would strongly suggest that the references (in the Official Commentary and possibly the Article itself) to payments in Article 27 are to be read as relating only to payments that are executed “within” the securities settlement system or securities clearing system concerned. Put another way, whilst the Convention can address the effect of the insolvency of a system operator or participant (as set out in Article 27(b)) in relation to the invalidation or reversal of a debit or credit or a designating entry “in a securities account which forms part of the system”, the rules of that system cannot “reach out” or impose finality on the settlement of payment instructions that

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<sup>15</sup> For example, in the fact scenario of Example 23-24, if IM2 were a “front” or “sham” intermediary for (X) a terrorist suspect, then this appears to say the public authorities could not address an attachment at the level of IM1 but only at the level of IM2. Terrorist or criminal sanctions legislation would be capable of being addressed at any asset which is or may be held by a prescribed person or the product of a prescribed activity irrespective of the identity of “the account holder”.

take place *outside* that system (such as in a payment system, whether RTGS or otherwise) unless that other payment system or the arrangements for irrevocability/finality of payments is included within the relevant securities settlement or securities clearing system. To hold otherwise would be to seek to impose irrevocability/finality of payments upon payment systems or corresponding bank arrangements that are outside the scope of dealings in intermediated securities within the Convention.

### ***Obligations and liability of intermediaries***

31. Paragraph 28-13 notes that “if a provision of non-Convention law, account agreement, or uniform rule relating to the subject of a Convention obligation is so contradictory of the Convention obligation, or is so minimal that it amounts to no obligation in substance, then such a provision would not be one that addresses “the substance of any such [Convention] obligation” within the meaning of the second sentence of Article 28(1).

32. Whether or not a limitation in scope or liability in respect of a Convention obligation renders it “so minimal that it amounts to no obligations in substance” may be open to varying interpretation. It is, however, important that account providers and account holders have clarity as to whether or not a limitation of liability for a Convention obligation is consistent with Article 28. Further explanation of what would be considered too minimal would be helpful in the Commentary (e.g. is it acceptable to exclude liability other than for gross negligence?) or - if this is felt to be legislating outside of the Convention - in the Article itself.

### ***Chapter V application to other assets***

33. In paragraph 31-15, it states that Chapter V only applies to an interest granted in respect of intermediated securities and not any other asset “unless specified explicitly, as in Articles 34 and 36”. Similarly, in paragraph 34-2, reference is made to the fact that a collateral agreement may specify an obligation for the collateral taker to transfer “other assets”; however, the example given (and similarly in paragraph 34-13) is of where “following a merger or-take-over concerning the issuing company” securities of the same description are no longer available. This is also reflected in the terms of Article 34(2), whereby a right of use refers to the delivery of “equivalent collateral” or “the delivery of other assets following the occurrence of any event relating to or affecting any securities delivered as collateral”.

34. We agree with these references in so far as they relate to original securities being replaced with other *replacement securities* by reason of corporate events affecting the original securities. However, as referred to in our comments on paragraph 1-43 above, the fact of the “original securities” no longer being available due to some corporate action should be dealt with by making the replacement securities fall within the *definition* of “securities of the same description” as distinct from being treated as a separate additional asset. This means that in the context of the right of use under Article 34(2), the resulting re-delivery obligation for “equivalent collateral” (being securities of the same description) is to be satisfied by the redelivery of the original securities or their “replacement” securities or other contractually agreed assets provided they are securities and not by “*any other asset*” (not being securities at all). This of course is consistent with the scope of the Convention applying only to interests in intermediated securities.

35. Similarly, in relation to paragraph 36-23, it refers in the case of top-up or substitution of collateral securities to any “other assets” being provided such that “in principle, substitution of a mortgage in real estate with a security interest in a vessel could be within the scope of Article

36(1)(b)". Again, we do not agree that "any other asset" should be given this meaning but rather should be limited to securities.<sup>16</sup>

#### **Reference to debt**

36. In paragraph 31-17, the references to "debt" being owed by a collateral provider or a third person should be amended to more generally refer to "**obligations**" which is indeed consistent with the definition of "relevant obligations" in Article 31(3)(d).

#### **Zero-hour rules**

37. In Example 31-1 (and paragraph V-7), the reference to "zero-hour rules" having a "retroactive effect" could be more precisely referred to as "an **automatic** retroactive effect".

#### **Right of pledge**

38. In paragraph 31-21, the reference to a security collateral agreement envisaging the grant of an interest "such as a right of pledge" could be better expressed by reference to "a right of pledge **or charge**" (especially taking into account that in some jurisdictions, a pledge is a form of *possessory* security interest, that is capable only of applying to physical tangibles – which of course is somewhat inappropriate in a context of interests in intermediated securities).

#### **Chapter V declaration re types of securities**

39. In paragraph 31-26, the reference to the declaration mechanism (in Article 38(2)(b)) might be better expressed as to: "specify the types of collateral securities to which Chapter V **does not apply**".

#### **Close-out netting**

40. In paragraph 31-31, reference is made to the definition of close-out netting being "phrased in a broad manner". It might however, be appropriate to clarify at this point that the definition is only intended to cover "*bilateral*" close-out netting (and not for example, multilateral or cross-affiliate netting).

#### **Provisions as to enforcement/operation of close-out netting**

41. In paragraph 33-1, it should be clarified that any enforcement must be conducted subject to any terms agreed (which may contain stipulations as to agreed periods of notice) in the security agreement concerned. A suggested amendment to paragraph 33-1 would be: "Where such securities are given under a security collateral agreement, the collateral taker may, **subject to its terms**, either sell or appropriate the collateral securities". Similarly, we would suggest an amendment to Article 33(1)(a):

"(a) the collateral taker may realise the collateral securities delivered under and subject to the terms of, a security collateral agreement .....".

42. In paragraph 33-3, we would suggest an additional reference to the operation of close-out netting provision: "Moreover according to Article 33(3)(b), the commencement or continuation of an insolvency proceeding relating to the collateral provider or collateral taker is no impediment to enforcement **or the operation of a close-out netting provision**".

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<sup>16</sup> In the context of the EU Financial Collateral Directive, the Directive extends to "financial collateral", but this is defined to include securities *and* cash; given that top-up/substitution provisions frequently deal with securities and/or cash, then to that extent cash could reasonably be said to be within the scope of the Convention.

### **Scope of Chapter V**

43. In paragraph 33-23, reference is made to the effect of the Convention on eliminating formalism with respect to the realisation of collateral or the operation of a close-out netting provision. Furthermore, in paragraph 33-24, reference is made to the realisation as well as to the implementation of a close-out netting provision taking effect notwithstanding the opening of an insolvency proceeding that affects the collateral provider or a collateral taker.

44. It should be noted (perhaps in a new paragraph) that: ***“Subject to other Articles of the Convention (i.e. the disapplication of so called “zero-hour rules” under Article 36 and Article 37 relating to the entry into of collateral agreements and the provision of collateral) other provisions of national insolvency law will still apply on an ex-post basis (i.e. insolvency challenges may still be brought, subsequent to enforcement, based on the entry into of a collateral agreement or close-out netting provision as a preference or a transaction in fraud of creditors)”***.

45. In paragraph 35-10, it states that Chapter V is subject to the rules of non-Convention law on rights with respect to restitutions, errors or lack of capacity. However, rather than being presented as an *exhaustive* list, these should be presented as examples of a wider principle that: ***“Whilst Chapter V is intended to remove provisions of national law imposing formalities and restrictions on the creation and enforcement of collateral agreements and close-out netting provisions, and disapply certain aspects of insolvency laws (in particular, “zero-hour rules” re the delivery/top-up or substitution of collateral, and insolvency restrictions on the enforcement of collateral/operation of close-out netting provisions) all other provisions of national law relating to rights which any person may have and which arise otherwise than under the terms of a collateral agreement or by reason of the commencement or continuation of insolvency proceedings (including restitution arising from mistake, error or lack of capacity) are not within the scope of Chapter V”***.

46. Furthermore, the Official Commentary does not yet reflect that other provisions of national law relating to the operation of netting provisions and preferential claims, which commonly have a mandatory status, are outside the scope of the Chapter V. We therefore suggest that paragraph 35-10 (or Article 35) ought to state: ***“Articles [32,] 33 and 34 do not affect any requirement of the non-Convention law relating to rules on bringing into account claims or obligations to set-off or netting (including the reciprocity of claims or the effect of notice of the commencement, or of any mandatory legal act leading to the commencement, or continuation of insolvency proceedings), or rules relating to the ranking of categories of claim (including those which have a preferential status)”***.

### **Top-up and substitution**

47. In paragraph 36-1, the reference to an imbalance in value of the collateral to the relevant obligations may occur not merely as a result of “price fluctuations in the financial market” but also ***“or in relation to the size of the relevant obligations”***.

48. In paragraph 36-3, the reference to a “zero-hour rule” should include a reference to it having a ***“automatic*** retroactive effect” and by reference not merely to the “beginning of the day on which such a declaration is issued”, but also ***“or by reference to the making of any order or decree or the taking of any other action or occurrence of any other event in the course of proceedings on which such declaration is issued”***. Such a clarification is necessary, given that in some jurisdictions the “relating back” commences not from the date on which the relevant order or declaration was made, but from the date on which the filing or petition (on which such an order or declaration was subsequently made) was presented.

49. In paragraph 36-15, we have difficulty in understanding what is meant by "*the term relevant obligations must be understood to cover such obligations as secured by the collateral agreement (and not obligations under an unsecured loan agreement)*". Similarly, we do not understand the distinction between the failure of a borrower to pay interests that would result in "*increase in the relevant obligations*" but "*cannot be considered as a change of the value of the obligations (as these include the obligation to pay interest)*" and why this is "*not within the scope of Article 36(1)(i)(a)*".

50. In paragraph 36-23, the reference to the substitution of a security over a "*vessel*" (as noted in our comments on paragraph 31-15 above) is not appropriate.

51. In paragraph 36-11, reference is made to the fact that Article 36 only applies in the case of the delivery of "*additional*" collateral, and not where there was originally no collateral/the relevant obligation was unsecured, or where the obligation to deliver collateral arises by reason of some extraneous event (even though that trigger event is included within Article 36(1)(a)(ii), such as a ratings downgrade). Furthermore as stated in paragraph 37-5, whilst Article 37 has a broader scope than Article 36 (in the sense that it covers any delivery of collateral and not just "*additional*" top-up/substitute collateral) Article 37 is narrower in effect as only Article 36 (for additional top-up/substitute collateral) covers *antecedent debts/existing obligations*. The cumulative effect is that the Convention will only protect collateral provided "*after the relevant obligations have been incurred*" where that collateral is "*additional collateral*". We do not understand the justification for these limitations.<sup>17</sup>

52. Furthermore, both Article 36 and Article 37 only cover the situations where the relevant collateral is delivered in a prescribed period before or on the day of but *before* the commencement of an insolvency proceeding; there is no provision dealing with the situation where the collateral is delivered on the day of but *after* the commencement of an insolvency proceeding. We do not understand the justification for this limitation.<sup>18</sup>

53. In the Commentary on both Articles 36 and 37, it is important (for the reasons set out in our comment on paragraph 36-3 above) to mention that a reference to the commencement of insolvency proceedings includes: "*a reference to the making of any order or decree **or the taking of any other action or occurrence of any other event in the course of proceedings***".

54. In paragraph 36-24, reference is made to substitution not being possible where the value of the substituting (i.e. replacement) collateral is less than the value of the substituted (i.e. the original) collateral. To the extent that the substituting collateral is worth less than the substituted collateral, then might not this be treated as a withdrawal and substitution, since presumably the intention is that what remains as collateral after this process has taken place is sufficient to meet the level of collateral required by the terms of the collateral agreement.

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<sup>17</sup> The cumulative effect of the relevant provision of the EU Financial Collateral Directive (Articles 8(1) and 8(3)) is that the entry into of collateral arrangements and the *provision* of financial collateral, or additional financial collateral (and the delivery of substitute collateral), whether provided in respect of existing obligations or provided after the relevant obligations have been incurred, are protected against "zero-hour rules" if it is made under an obligation or pursuant to a right contained in the relevant financial collateral arrangement.

<sup>18</sup> In the corresponding provision of the EU Financial collateral Directive (Article 8(2)) a collateral agreement or a relevant obligation that has come into existence or any provision of collateral securities under such collateral agreement on the day of, but after the commencement of an insolvency proceeding in respect of the collateral provider, should be legally enforceable and binding on third parties if the collateral taker can prove that it was not aware, nor should have been aware, of the commencement of such proceedings. In other words, a form of innocent acquirer defence for the receipt of collateral.

### **Declarations**

55. In paragraph 38-2, reference is made to the declaration mechanism set out in Article 38, whereby it is possible to exclude intermediated securities which are not permitted to be traded on an exchange or regulated market. It might be sensible to extend the reference in Article 38(2)(b) to include:

“in relation to intermediated securities which are not permitted to be traded on an exchange or regulated market or within such other categories as may be specified in the declaration;”

56. Such flexibility may be appropriate depending on the particular circumstances of a Contracting State.<sup>19</sup>

### **Other**

57. We note that there is no draft text of the Official Commentary for Articles 40 to 50 of the Draft Convention. Whilst these may not relate specifically to matters concerning interests in intermediated securities (e.g. they relate to such matters as declarations and denunciations) we note that at least certain aspects of these Articles were referred to in the report of the Final Clauses Committee.<sup>20</sup> Certain of the comments set out in that report refer to matters which should be included in the Official Commentary. In particular, as regards “Applicability of Declarations” (Article 46 in the current Draft of the Convention) the Final Clauses Committee added an extensive comment and wording to be included in the Official Commentary.<sup>21</sup> We should be grateful for confirmation that such wording is indeed to be included.

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<sup>19</sup> For example, EU Member States are able to exclude from the scope of the EU Financial Collateral Directive any securities consisting of a collateral provider’s own shares, or shares in affiliated undertakings, or shares in undertakings whose exclusive purpose is to own means of production that are essential for the collateral provider’s business or to own real property (Article 1(4)(b)).

<sup>20</sup> CONF.11-Doc.40 (11 September 2008).

<sup>21</sup> The Official Commentary should state that: “Nothing in this Convention prevents any State Party, when applying according to its own conflict rules the law of another State Party, to have recourse to a clause of public policy (*ordre public*) of the forum, or to apply overriding mandatory provisions, to the extent that they are applicable to any situation falling within their scope, irrespective of the law otherwise applicable (*lois de police*).”