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
Final session
Geneva, 5 to 7/9 October 2009

UNIDROIT 2009
CONF. 11/2 – Doc. 12
Original: English
24 August 2009

Comments

(submitted by the Government of Luxembourg)

1. For purposes of these comments we have reviewed the draft Official Commentary (CONF. 11/2 - Doc. 5) and would like to congratulate the Editors for the excellent work they have done in a very short period of time.

2. We will follow below the order of the Articles of the draft Convention and sometimes cross refer to certain paragraphs of the draft Commentary.

I. Article 1(l): definition of "designating entry"

3. The draft Commentary (sections 1-46 and 12-29) suggests that designating entries are characterized by the fact that they "should be visible on any account statement".

4. Whilst we do not exclude that an intermediary may wish to include a reference to a security interest on the account statements it issues, we do not think that this should be compulsory *i.e.* inherent in the definition of "designating entry". The wording of the definition does not expressly require such type of publicity. The designation could quite as well only be made in the electronic system of the intermediary without appearing on the account statements.

5. We do not see why intermediaries should, in a costly exercise, be forced to amend their computer systems and the format of their account statements especially since the information that would appear on such statements would necessarily

(i) have to be rather cryptic;

(ii) be a snapshot of one moment in time only; and

(iii) be incomplete.

6. The information that would appear on the account statements would be of very limited use to third parties since they would, at any rate, have to enquire, in particular, whether

(i) the interest perfected by the designating entry is still in force

(ii) the intermediary is the beneficiary of a security interest;

(iii) the intermediary has received notice of a control agreement.

An enquiry with the account holder and/or the intermediary is thus in all cases unavoidable.

7. We would welcome if the Commentary could be amended in accordance with the above.

II. Article 14(1)

8. We feel uncomfortable with the current wording of paragraph 1.

9. The last part of this paragraph could be read as having an effect on the ranking of [security] interests in an insolvency. This is not what this provision should do.

10. After a first reading it seems that the changes proposed by the Editors will, if retained, cure our concern on this point.

11. If the changes suggested by the Editors were not retained then we think that paragraph 1 ought to be clarified as follows:

> "Rights and interests that have become effective against third parties under Article 11 or Article 12 are effective against the insolvency administrator and creditors in any insolvency proceeding, at least to the same extent as comparable interests in that insolvency proceeding."

III. Articles 17 and 18

12. Although the draft Commentary has mitigated our concerns we continue to express our preference to delete the "ought to know" standard and to merely uphold the actual knowledge standard.

13. Practice has shown that, especially for global custodians and CSDs, it is difficult to determine whether their clients properly segregate client and proprietary securities. When lending cash or securities to such clients to facilitate the settlement of transactions global custodians and CSDs must be sure that they have obtained valid collateral. Considering the speed at which transactions are and must be done, they must be able to rely on what they can immediately see (*e.g.* the segregation as done by the client) and on what they actually know. It is not unlikely that, in an insolvency situation, courts will hold that such custodians and CSDs ought to have done probability tests (*e.g.* on the basis of accounting documents) that would have revealed that client securities were included in the proprietary account of the borrower with the global custodian or CSD and used as collateral and consequently courts will fully or partially invalidate the security interest. The "ought to know" standard will invariably trigger disputes over levels of professional standards that might be interpreted in different manners by courts and that could be seriously detrimental to the entire securities holding system.

14. We had noted certain inconsistencies in Article 18 which would be cured if the changes proposed by the Editors were adopted.

IV. Article 19(3)(c)

15. We suggest to amend sub-paragraph (c) as follows:

> "(c) when a control agreement is entered into between an account holder, the relevant intermediary and another person or, if the relevant intermediary is not a party to the control agreement, when notice thereof is received by it."

16. The first part of the suggested change is added for clarification purposes whilst the latter part aims at curing an ambiguity. The terms "notice is given" used in the current text could be interpreted as meaning either "notice is dispatched" or "notice is received". We think that the latter option is the correct one as third parties, before being granted an interest in securities, will turn to the intermediary to obtain confirmation that the securities are free and clear of any prior third party interest. Legal certainty thus commands the retention of the "receipt of notice" standard as the moment in time the priority is determined.