



**DIPLOMATIC CONFERENCE TO ADOPT A
CONVENTION ON SUBSTANTIVE RULES
REGARDING INTERMEDIATED SECURITIES
Final session**
Geneva, 5 to 7/9 October 2009

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Comments

(submitted by the European Commission)

1. The European Commission would like to thank the Secretariat for the opportunity to comment on the text of the draft Convention ahead of the second stage of the Diplomatic Conference for the adoption of the draft UNIDROIT Convention on substantive rules regarding intermediated securities.

2. Our comments relate to the text of the draft Convention and to the draft Official Commentary to the extent that the Commentary provides an "interpretation" of the text of the Convention.

3. As provided in the Resolution N° 1, we understand that the requests for amendments of the draft Convention that will be submitted by the various delegations will be examined by an *ad hoc* Committee, the so-called Filtering Committee. The Committee will provide recommendations to the Diplomatic Conference, it being understood that such recommendations are not binding.

I. Insolvency related provisions (Articles 7, 14 and 21 et al.)

4. We have taken note of the Memorandum CONF – 11/2 Doc. 6 comprising suggestions by the Editors of the Official Commentary on this issue. We fully agree and therefore also request that the second session of the diplomatic Conference should re-discuss these provisions and the new proposals and, more generally, the overall relationship of the Convention and its provisions with national insolvency laws.

II. Scope of Article 28(1) and the relationship with Article 24 in particular

II-1 Article 28 (1): Sentences 1 and 2

5. Article 28(1) introduces, with respect to intermediaries, a functional approach. Under this approach, the results which an intermediary has to achieve are identified by the Convention, whereas the details of how to meet the goal are not set out in detail in the text of the instrument. Therefore, the first sentence of Article 28(1) provides that the non-Convention law may specify obligations of an intermediary, including the manner in which it complies with the obligation.

6. Article 28(1) adds in its second sentence that, if the substance of any Convention obligation is addressed by any provision of the non-Convention law [etc.], compliance with that provision satisfies that obligation.

7. There is the need to set clearly the relationship of those two sentences, in the sense that the effect of the second one is merely to avoid double-regulation. Otherwise, there might be room for interpretation that domestic law may contain (a) rules specifying obligations under the Convention, and, (b) rules addressing the same substance without being a specification of the Convention. Such undesirable interpretation is fuelled by paragraph 28-11 of the official Commentary, which evokes the possibility of a simultaneous existence of a "treaty standard" and the "standard provided or permitted under the non-Convention law".

8. However, the integration of the future Convention into the law of Contracting States cannot lead to "two standards". Roughly speaking, in some Contracting States the Convention will apply directly, and all non-complying provisions of the domestic law will have to be amended or abolished. Only rules specifying Convention provisions and rules addressing issues not dealt with in the Convention are possible. In a second group of Contracting States the Convention will need to be implemented, i.e. a domestic law reflecting the substance of the Convention will need to be drafted and enacted, or the existing laws will need to be changed so as to reflect the substance of the Convention. Again, there is room for specification but not for conflicting provisions.

9. Consequently, we propose to clarify the wording in Article 28(1) along the following lines:

The obligations of an intermediary under this Convention, including the manner in which an intermediary complies with its obligations, may be specified by the non-Convention law [...]. If the substance of any such obligation is ~~addressed~~ specified by any provision of the non-Convention law [...], compliance with that provision satisfies that obligation.

10. The next question is to what extent a "specification" represents a mere technical integration of the substance of the Convention to the legislative and regulatory technique of a Contracting State, without abrogating substantial aspects of the Convention. It is obvious that Article 28(1), when "providing that the non-Convention law may specify the content of [...] Convention obligations" (*cf.* commentary 28-10) does not allow that the Convention obligations should be "turned upside-down", to take an extreme case. The Official Commentary does not provide sufficient guidance on this point.

11-2 Specification of Article 24

11. Section 28-9 of the Official Commentary explains that the Convention imposes express obligations on intermediaries in Articles 10, 23, 24 and 25 (presumably Article 15 should also be included in that list). The Commentary then discusses a number of examples mainly involving obligations contained in Article 24.

12. The examples provide an excellent basis for an analysis of how far the "specification" in the sense of Article 28(1) can go, with Examples 28-2 and 28-5 considerably stretching the substance of Article 24(1), whereas Example 28-3 seems to illustrate specifications in terms of purely technical implementation of a Convention obligation.

13. Apart from these substantial considerations, there is a technical one. In its paragraph 1, Article 24 sets out the baseline obligation. In paragraphs 2 and 3, Article 24 contains immediate specifications giving a certain leeway to Contracting States (and even a relatively wide one, considering paragraph 2(e) – "any other appropriate method"). Paragraphs 2 and 3 appear therefore to be rules specifically designed to address the question of how to comply with the obligation contained in paragraph 1.

14. Paragraph 4 of Article 24 is similar to Article 28(1), though not identical, in stating that:

This Article does not affect any provision of the non-Convention law, [...], relating to the method of complying with the requirements of this Article [...].

15. In other words, the method of complying with paragraphs 1, 2 and 3 can be specified by the non-Convention law, though the obligations flowing from this provision cannot be altered. In that respect, there is a difference with the first sentence of Article 28(1).

16. The fact that specifications of the obligation of Article 24(1) are given in paragraphs 2 and 3, and that paragraph 4 gives an additional leeway to non-Convention law to prescribe the manner in which to comply with the obligation does not leave room for further specification under Article 28(1). Consequently, Article 28(1) does not apply to matters dealt with in Article 24.

III. Article 33(2) read in conjunction with Article 34(2)

17. Article 33(2) on the effectiveness of close-out netting refers to two scenarios (see sections 33-17 and 33-18 of the official Commentary), the second concerning situations (subject to Article 34) where in a security collateral agreement, the collateral provider has agreed to allow the collateral taker to use the securities given as collateral, on condition that it returns equivalent collateral at the latest by the time when the secured obligation is discharged.

18. Article 34(2) then clearly provides that where a collateral taker exercises a right of use, it incurs an obligation to replace the collateral securities originally delivered by delivering to the collateral provider equivalent collateral not later than the discharge of the relevant obligations.

19. We feel that the use of the wording "no later than the discharge of the relevant obligation" in Article 34(2) introduces an element of uncertainty and should be replaced by the words "not later than the due date". The actual discharge of the obligation can be delayed and not take place on maturity of the obligation. Nonetheless, the collateral taker should be in a position to fulfill his obligation to retransfer (equivalent) collateral as of the due date.

IV. Article 35

20. This provision should be amended so as to take out the reference to Article 32 as per document CONF. 11/2 – Doc. 6.

V. Article 36(1)(a)(i)

21. The explanations provided in section 36-13 and the Example 36-1 of the Official Commentary raise an important issue on the protection offered by Article 36 to the provision of top-up collateral in excess of what may be necessary to cover changes in the value of the original collateral.

22. Normally, additional collateral is provided to take account of changes in the value of the collateral delivered. It should cover what is pre-agreed (including any (reasonable) haircuts applied). The value of the collateral assets and changes thereto will normally be outside the influence of both the collateral taker and the collateral giver (ex-ante evaluation methods).

23. On that basis, one could envisage the following possibilities:

(a) The original collateral agreement simply requires the provision of additional collateral to take account only of the changes in the value of the original collateral. In that case, one would expect the assessment to be that the provision of any "excess" collateral, i.e., collateral in excess of the change of the value of the original collateral, not to be covered by the terms of the collateral agreement. In that case, such "excess" collateral could not benefit from the protection of Article 36.

(b) To the extent that, obviously, both parties agree ex-post with the provision of such "excess" collateral, could this be considered as an amendment to the original contract? In that case, protection of the "excess" collateral could only start from the date the amendment has been agreed and subject to the fulfilment of any other formal conditions that might be applicable (e.g., that the amendment should be in written form).

(c) The original collateral agreement provides for the possibility of the collateral giver to deliver collateral in "excess" of what is necessary simply to meet the falling value of the original collateral. This seems to be implied in the Example 36-1 by the words "if the collateral agreement provides to that effect". What would the agreement provide in that case? That if value of collateral falls by, say, 20%, the obligor needs to provide collateral which should exceed the drop of the value? In such a case, the reasons invoked or implied in the agreement for such provision may not be ignored; depending on circumstances (e.g., concurrent rating downgrading of the obligor), there might be a possibility for the re-characterisation of the provision of such "excess" collateral as, say, a credit deteriorating top-up. In that case protection under Article 36 might depend on whether the contracting State recognises the provision of credit rating top-up collateral.

(d) Finally, it might be necessary to consider this issue further in sections 36-27 *et seq.* since the protection that might be offered to the provision of "excess" collateral under Article 36(1)(a)(i) only concerns "timing claw back rules". Shouldn't that mean that Article 36(1)(a)(i) of the Convention cannot offer protection from any non-Convention law provision that does not allow the provision of "excess" collateral or that may limit the provision of "excess" collateral to what may be considered as "objective" and "necessary" under the circumstances of each case, such determination to be made by, say, the courts?

VI. Article 39

24. Upon re-reading Article 39, we have the impression that paragraph (2) needs redrafting; it is obscure, and extremely difficult to comprehend on its own as an exception to the grandfathering clause introduced in paragraph 1. In addition, while we agree with the comment made by the drafters of the official report concerning the definition of "pre-existing interests", we would think that the defined term should also be used in the first paragraph. Using different terms to indicate the same interests will add to the confusion of an already obscure text.

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