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

(submitted by the Government of the United States of America

I. General Observations

1. The United States looks forward to a successful conclusion of the draft Convention ("Convention") during the final session of the diplomatic Conference and to the adoption of a final text of the Convention. It also wishes to thank the Editors of the draft Official Commentary as well as the Steering Committee, the Secretariat, and other participants in the drafting process for their efforts in producing an excellent initial draft.

2. Based on the limited number and scope of suggestions for amendments that have been submitted, the Convention text that emerged from the first session of the diplomatic Conference is in almost all respects acceptable and ready for adoption by the final session. The principal substantive exception is the draft Convention's approach to the relationship between the Convention and insolvency law (discussed below), and in particular the troubling treatment of Articles 11 and 12 interests in insolvency proceedings (other than those of the relevant intermediary). In this connection the United States supports in principle the proposals made by the Editors of the draft Official Commentary.

II. Specific Observations

(a) Relationship of the Convention to Insolvency Law and Insolvency Proceedings

3. As mentioned above, the United States supports in principle the insolvency-related proposals made by the Editors of the draft Official Commentary. The text that emerged from the first session of the diplomatic Conference did reflect some general points of consensus reached during the plenary discussions. However, the drafting approach and technical aspects of the text, in particular Articles 7 and 14, were of necessity formulated by the Informal Working Group and the Drafting Committee in the last hours of the session with only limited time for reflection. Moreover, there was no time to adequately consider all of the Convention's provisions in light of Article 7's baseline rule that the Convention does not affect rules of law applicable in an insolvency proceeding, unless the Convention otherwise provides.

4. There also was inadequate time for substantive discussions that would have revealed that the approach of Article 7 unfortunately diverges from what is becoming an established method of treating similar issues. We need not repeat here the observations made by the Editors in connection with their insolvency-related proposals. But we should note that the formulation of Article 7's blanket rule is inconsistent with the approach taken in all of the recent international instruments focusing on similar or analogous subjects, namely the UNCITRAL Legislative Guide on Secured Transactions, the United Nations Convention on the Assignment of Receivables in International Trade, the Cape Town Convention on International Interests in Mobile Equipment, the Ottawa Convention on International Financial Leasing, and the Ottawa Convention on International Factoring (the latter three all being UNIDROIT products).

5. Article 7 aside, discussions during the first session reflected a consensus on three principles. First, the relationship between the Convention and insolvency law – in particular the treatment of Convention interests in insolvency proceedings – should be clear from the Convention text. Second, Convention interests effective against third parties generally should be effective in insolvency proceedings as well. Third, the Convention should recognize that the second principle nonetheless sometimes must give way to certain important public policies reflected by the varying domestic insolvency laws of Contracting States. The declaration mechanism proposed by the Editors, inspired by the Cape Town Convention, reflects each of these principles. And it does so in a more nuanced and transparent manner than the ambiguous approach of the "comparable interests" test in Article 14.[1]

(b) Recognition of Nominee Holding

6. The United States believes that the Convention strikes an appropriate balance with respect to the rights and duties of issuers. Appropriately, the Convention affects these rights in an extremely limited manner, including by generally deferring to non-Convention law on the question of whom the issuer is required to recognize as the holder of the securities (Article 8(2)). On the other hand, as is evident from discussions and drafts throughout its drafting history, the Convention is intended to provide for at least some accommodation by all Contracting States of intermediated securities holding practices. Article 29(2), which recognizes nominee holding, is an important part of this accommodation, and we believe that this provision must be retained.

7. With respect to the issue raised by Germany (CONF. 11/2 – Doc. 11, paragraph 16), we would suggest that there is only minimal inconsistency between Article 29(2) and Article 8(2). Article 29(2) addresses only one narrow aspect of the relationship between the issuer and its holders, namely, the issuer's giving effect to votes or other rights that a nominee exercises in different ways in respect of different parts of its holding. We do not think that this provision requires the issuer to recognize a holder different from the one dictated by non-Convention law. Instead, the provision merely requires the issuer to accommodate one level of detail that is important to the practice of intermediated securities holding. Thus the draft Official Commentary perhaps overstates the issue when it states (paragraph 29-24) that Article 29(2) is "an exception" to Article 8(2). Any such exception is fairly abstract rather than practical and we would hope that the issue can be resolved by clarification of the Commentary.

8. If the issue does need to be clarified in the Convention text, the United States believes that Article 29(2) should be expressed as prevailing over Article 8(2) to the limited extent necessary. We believe that this has generally been understood as the intention, and that it is important to the

[1] The Cape Town Convention, with its similar approach to insolvency, has been notably successful in fostering international transactions. For this reason it is not necessary to speculate whether the declaration mechanism proposed for the present Convention "would" or "should" be operationally feasible and understandable in practice.

Convention's purpose of establishing a reliable cross-border framework for intermediated securities holdings.

(c) Scope of Convention: Limitation to Regulated Intermediaries

9. The United States has noted a small number of proposals that the application of the Convention be limited to securities accounts maintained by certain types of regulated entities. See, e.g., CONF. 11/2 – Doc. 8 (France); Doc. 9 (Spain); Doc. 14 (European Banking Federation). In this respect we believe that the compromise reached at the first session of the diplomatic Conference for a declaration mechanism (found in Article 4) directly and adequately addresses these concerns. The compromise followed a lengthy debate and we believe that it would not be useful to reopen that debate at this late stage.

10. However, if there is strong support for the proposals mentioned above, the United States would find the proposed approach acceptable.[2] We also note that the proposed approach would greatly reduce any perceived need to expand or further elaborate the so-called "core duties" of an intermediary (discussed immediately below).

(d) Expansion and Specification of So-called "Core Duties" of Intermediaries

11. There are a few proposals for an expanded specification in the Convention text of so-called "core duties" of intermediaries. See, e.g., CONF. 11/2 – Doc. 8 (France); Doc. 14 (European Banking Federation); Doc. 16 (Italy). The United States wishes to point out that essentially the same proposal was made in connection with the first session of the diplomatic conference. See CONF. 11 – Doc. 16, Annex 2 (France). That proposal was not accepted during the first session (indeed, it was not pursued in any depth during the plenary).

12. The issue of an intermediary's core duties is also directly linked to the proposals for limiting the Convention's scope to regulated intermediaries. If those proposals are accepted at the final session, then any perceived need for an additional elaboration of intermediary duties is greatly reduced or eliminated. After all, the duties of an intermediary are precisely the sort of matter that regulatory regimes address. The Official Commentary could point this out and explain that obligations of intermediaries to provide information and reporting to account holders, for example, normally could be expected as a part of a regulatory regime. The limitation of scope approach would recognize that the regulatory regimes that States maintain or elect to establish under the non-Convention law are best equipped to address intermediary duties while also taking into account the varying attributes of each intermediated securities structure or system.

13. Moreover, proposals for additional core duties pose risks for the Convention's success and are unnecessary. First and most important, an expanded list of duties could seriously undermine the Convention's carefully balanced functional approach, and it risks delaying or precluding completion of a final Convention text. Consensus is unlikely to be reached on such issues as (i) which additional duties should be listed, (ii) how to describe those additional duties and any appropriate limitations, (iii) which additional duties should be governed by the non-Convention law (including applicable regulatory frameworks) and, where permitted, the account agreement or the uniform rules of a securities settlement system, (iv) which additional duties should be governed by (and limited to) those already specified in the Convention, (v) which if any additional duties should be more or less absolute, and (vi) similar issues. Providing an internationally agreed baseline of duties is a laudable project, but this would be difficult to achieve at the last minute.

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[2] As we understand these proposals they would merely limit the scope of the Convention. Contracting States would be allowed to permit unregulated entities to act as intermediaries under the non-Convention law, albeit outside the scope of the Convention.

14. In addition, an additional listing of duties is unnecessary. Article 10 already provides the mirror image of the Article 9 rights that arise upon a credit creating rights in intermediated securities. Further elaboration or specification can add nothing to the intermediary's duties concerning rights an account holder is to receive under Article 9. In addition to Article 10, the Convention already provides other core duties of intermediaries and limitations on the rights of intermediaries in some detail while observing the Convention's functional approach: Article 15 (limitations on account entries by intermediary), Article 23 (intermediary's duty to follow only instructions of account holder), Article 24 (intermediary's duty to maintain sufficient securities to cover credits to account holders), and Article 25 (intermediary's duty to allocate securities to account holders). Moreover, given the lengthy discussions and the considerable time it has taken to identify, describe, limit, and qualify these duties and limitations, the difficulty of adding to the list at this stage is obvious.

15. Both of the foregoing points can be illustrated by considering the list proposed by France in connection with the first session and proposed again in connection with the final session (see Doc. 8, paragraph 3.2.5). The first three appear to be largely redundant of duties expressed elsewhere in the Convention, or if they are intended to impose additional duties, then the specifics of those duties are not apparent. The fourth appears to impose an absolute obligation to provide information, but again the specifics do not appear. The fifth again appears to impose an absolute payment obligation, but in some system an intermediary does not function as a part of the system for payments to account holders and such an obligation would be inappropriate even if carefully detailed and limited. The sixth appears to impose an absolute reporting obligation but it seems to add nothing to the non-Convention law.

16. Nonetheless, the United States would be happy to work with other delegations either to collect for clarity in Article 10(1) the other obligations that the Convention already expressly imposes, or to make Article 10(1) more descriptive (perhaps with non-exclusive examples) of the types of measures that an intermediary must take. These amendments would seem feasible so long as additional and vague or overbroad duties are not imposed.

(e) Proposals to Restrict the Role of the Non-Convention Law Concerning the Obligations and Liability of Intermediaries

17. One delegation has proposed that the second sentence of Article 28(1) be deleted. CONF. 11/2 – Doc. 8 (France). In the event that a substantive discussion of this proposal is necessary, the United States strongly believes that the sentence should be retained.

18. The second sentence of Article 28(1) provides generally that if the substance of a Convention obligation is addressed by the non-Convention law then an intermediary's compliance with that law constitutes compliance with the Convention obligation. A similar provision was added to the Convention at the fourth session of the Committee of governmental experts. It was discussed at the first session of the diplomatic Conference; no proposals for change were accepted; and there is no adequate basis for reopening that discussion at the final session or for reversing the results reached in that discussion.

19. Moreover, the draft Official Commentary should alleviate concerns that the sentence would allow overly permissive provisions of non-Convention law to eliminate the Convention's basic framework of intermediary obligations. Specifically, section 28-13 of the draft provides that the non-Convention law shall not be given effect for purposes of the sentence if the non-Convention law "is so contradictory of the Convention obligation, or is so minimal that it amounts to no obligation in substance."

20. On the merits of this proposal, we would vigorously respond that the second sentence of Article 28(1) implements an idea at the heart of the functional approach. Specifically, the substantive goals of the Convention's intermediary obligations may be fully and appropriately achieved under the non-Convention law and regulation, in a manner that is more nuanced and suited to the particular legal and operational system than under the basic framework of obligations as articulated in the Convention alone.

21. For example, an intermediary's obligation to have available sufficient securities under Article 24 is intended to protect the intermediary's account holders from loss.[3] The proposal fails to take into account that a strict correspondence between available securities and securities credited to account holders' accounts is not the only way to protect the account holders against the risks of shortfalls. Moreover, the proposal also is incompatible with market practices and expectations in some markets. Complex and nuanced customer protection regulations under United States law, for example, would somewhat relax the strict approach of Article 24 while providing other means for customer protection. The proposal would make it unnecessarily difficult and problematic to consider the Convention for implementation in certain large securities markets, and we take exception to the proposal.[4]

22. Finally, the second sentence of Article 28(1) would become even more important to the extent that the Convention were amended to provide additional so-called core duties as discussed in section (d). In the absence of the sentence, each new core duty would only multiply the inconsistencies between the Convention's basic framework and the particulars of each body of non-Convention law and regulation.

(f) Limitation on Exclusions of Intermediary Liability

23. The United States does not object in principle to the proposals of a few delegations to limit the exclusion of intermediary liability for willful misconduct or gross negligence. See, e.g., CONF. 11/2 – Doc. 8 (France); Doc. 19 (Austria). However, we have some concern that the concept of "gross negligence" may not be a familiar one in some jurisdictions and, consequently, might be equated with "negligence" or "ordinary negligence." If the proposals are accepted at the second session, it will be important to provide strong and clear guidance on this point in the Official Commentary.

(g) Securities Credited by an Intermediary to Itself

24. There are a few proposals that Article 24 be expanded to require an intermediary to have available sufficient securities to cover not only the intermediated securities credited to the securities accounts of its account holders other than itself (as Article 24 currently provides) but also to cover intermediated securities credited to securities accounts that it maintains for itself. See, e.g., CONF. 11/2 – Doc. 8 (France); Doc. 14 (European Banking Federation); Doc. 19 (Austria). Like Spain (see CONF. 11/2 – Doc. 9), the United States considers such an expansion of Article 24 to be unnecessary but probably innocuous. However, the issue could implicate auditing,

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[3] The United States does not agree with the contention of the European Commission that because Article 24(4) addresses methods of compliance with article 24 it follows that Article 28(1) has no application to the Article 24 duties. See CONF. 11/2 – Doc. 18 paragraph 13-16. We see no basis for that contention. The second sentence of Article 28(1) would have little or no content if it required a result that amounts to strict compliance with a Convention obligation. Article 24(4) addresses only compliance with that Article directly and Article 28(1), second sentence, deals with the effect of compliance with the non-Convention law.

[4] The United States also notes that the European Commission has suggested that the word "addressed" in the second sentence of Article 28 be replaced with the word "specified." If the point of this proposal is that the relevant non-Convention law must specify essentially the exact substance of the Convention obligation, then the United States takes exception to that proposal as well for the same reasons.

reporting, or other compliance or cost requirements, and we would ask delegations to be attentive to any concerns of that nature which might be voiced by industry participants.

25. In addition, the United States wishes to raise a caveat relating to the Article 26 insolvency sharing provision. As presently constructed, Art. 25 requires an intermediary to allocate securities to its account holders so as to comply with its duty under Article 24 to maintain sufficient securities for its account holders other than itself. Article 26 then provides a sharing rule for shortfalls in securities required to be allocated under Art. 25. If Article 24 were expanded so as to require an intermediary also to have available sufficient securities for accounts it maintains for itself, then, as currently written, Article 25 would require the intermediary to allocate those securities as well. Article 26 would, accordingly, apply to those securities.

26. As a result, in the event of a shortfall of securities in the intermediary's insolvency proceeding, the intermediary's insolvency administrator (i.e., on behalf of its general creditors) would share in the available securities under Article 26. Such a result would offend both Article 21 and Article 25(2). We do not think that this result is intended by those proposing to expand the scope of Article 24. It follows that if the scope of Article 24 is expanded as proposed, adjustments must be made to Article 26 (or elsewhere, if more appropriate) to ensure that any such claims of the intermediary's insolvency administrator would be subordinated to those of the other account holders in the intermediary's insolvency proceeding. The intermediary's insolvency administrator should not share in the available securities under Article 26 to the detriment of the other account holders.

III. Conclusion

27. In closing, the United States would briefly note the very limited time available for discussions and drafting during the final session of the diplomatic Conference. We urge all delegations to be mindful of these limitations as they develop their interventions, positions, and proposals. In particular, we urge delegations to be cautious about reopening discussion of previously settled issues and provisions. We also hope that delegations will be alert to proposals and positions that could have the obviously undesirable result of delaying or precluding the possibility of a successful adoption of a final Convention text. Over the past several years of cooperative effort, the Convention has developed into a well-constructed and useful instrument that genuinely promises to improve the stability of intermediated securities transactions. Recent conditions in the financial markets are only one reminder of the continued importance of the Convention's subject matter.

28. The United States adds its voice to those of the many delegations and other interested parties who anticipate a successful and timely conclusion of the diplomatic Conference.

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