UNIDROIT 2002
Study LXXVIII - Doc. 5
(English only)

INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW

STUDY GROUP FOR THE PREPARATION OF HARMONISED SUBSTANTIVE RULES ON TRANSACTIONS ON TRANSNATIONAL AND CONNECTED CAPITAL MARKETS

Restricted Study Group on Item 1 of the Project: Harmonised Substantive Rules for the Use of Securities Held with Intermediaries as Collateral

(First session, Rome 9 – 13 September 2002)

Summary Report

(***prepared by the UNIDROIT Secretariat***)

Rome, October 2002

1. INTRODUCTION

The *Restricted Study Group for the Preparation of Harmonised Substantive Rules for the Use of Securities Held with Intermediaries as Collateral*, set up pursuant to a decision taken by the UNIDROIT Governing Council at its 80th session, held in Rome from 17 to 19 September 2001[1] and endorsed by the General Assembly of the organisation at its 55th session held on 7 December 2001,[2] met in Rome at the seat of UNIDROIT from 9 to 13 September 2002. The session was opened at 10.30 a.m. on 9 September by Mr Herbert Kronke, Secretary-General of UNIDROIT, on behalf of Mr Berardino Libonati, President of UNIDROIT. Mr B. Sen, member of the UNIDROIT Governing Council, was elected Chairman of the Study Group pursuant to a proposal by Mr Guy Morton seconded by Ms Dorothée Einsele, both members of the Restricted Study Group. Mr Luc Thévenoz, member of the Study Group, was elected Vice Chairman pursuant to a proposal by Mr B. Sen.

The meeting was attended by the experts and representatives set out in *Appendix 1*.

The materials set out in *Appendix 2* were submitted to the members of the Study Group.

The Study Group approved the draft agenda after deciding to open the discussions it would have on the afternoon of Thursday 12 September 2002 to representatives of competent authorities. The agenda as approved is set out in *Appendix 3* to this Report.

2. PROCEEDINGS

In essence the Study Group used its first session to conduct an exploratory review of the need for and possible acceptance of a future instrument, as well as of its scope and possible content. It also examined various aspects of the working method that should be adopted.

2.1. ASSESSMENT OF THE NEED FOR AN INSTRUMENT

The first point dealt with by the Study Group was the primary issue of the assessment of the need for harmonised substantive rules relating to the use of securities as collateral in indirect holding systems. The members were aware of the fact that legal uncertainty existed in all fields of law and was often tolerated. However, taking into account the likelihood of realisation of the existing legal risk, and the possible extent of damages caused by its realisation, the members were of the opinion that the legal risk that existed in the field of indirect holding of securities was not tolerable.

---

1 See UNIDROIT 2001, C.D. (80) 21.

2 See UNIDROIT 2001, A.G. (55) 8.

2.1.1. General Issues

In general terms the indirect holding of securities, which has become the normal holding pattern, faces a number of problems. The first is of a conceptual nature, and rests upon the attempt to comprehend the indirect system under the terms of traditional direct holding of securities, where the possession of certificates still has a crucial function. The second issue is that securities are traded internationally, which implies transnational dispositions. The interests in securities therefore move through many different jurisdictions. However, in most cases the certificates concerned are either immobilised (or held in one global certificate), and therefore remain within one national legal system, or completely dematerialised, which means that the initial book-entries are kept under the laws of one jurisdiction. There is no clear and consistent framework as regards the rights of the participants in an indirect holding system *vis-à-vis* the other participants if the different tiers are located in different countries. This is considered to be one of the major obstacles to a reliable and efficient international securities market. The most that can be done at present to remedy this deficiency is to construct "bridges" between the different national systems. Each bridge has to be especially designed taking into consideration the characteristics of the systems it is trying to link. The resulting system is therefore highly complex. Apart from legal diversity, transnational securities transactions face also legal uncertainty, because the national legal systems, or the bridges which should link two systems, are legally unclear or insufficient. Even if the national holding patterns of some countries may be considered to work reliably, market participants in such countries may be affected by the "importation" of legal risk from another country.

2.1.2. The Future Hague Convention

The Study Group also considered the draft convention being prepared by the *Hague Conference on Private International Law* relating to the law applicable to certain rights in respect of securities held with an intermediary, which will be submitted to a diplomatic conference in December 2002. Assuming the final success of the envisaged convention, the conflict of laws issue relating to transnational dispositions of securities may be considered to have been resolved to the greatest extent possible. Hence, the question is if there is a need for an instrument which goes beyond the conflict of laws approach. The Members agreed that there was still a number of different legal systems that interconnected for the same securities as a result of the indirect holding system. The various layers were not easily compatible because they were situated in different jurisdictions. Even if the applicable law relating to transnational securities dispositions could be identified without any doubt, legal uncertainties would remain because of the different approaches that existed in the different national jurisdictions as regards substantive aspects. This was generally considered to be obvious as regards the differences between so-called "civil" and "common" law countries. One member of the Study Group however pointed out that even common law countries (such as, for example, the UK and the USA) do not always speak the same language where the holding of securities is concerned. As the Hague Convention defined only the applicable jurisdiction,

procedure and documentation relating to the substantive aspects of each international transaction would still have to fulfil the requirements of each of the jurisdictions concerned.

2.1.3. Remaining Difficulties

The members of the Study Group agreed that the list of fourteen questions established by the Secretariat[3] and relating to the question of legal risks that would persist even after a solution on the conflict of laws issue had been found, represented crucial issues which pointed to the need for harmonised substantive rules for securities held with intermediaries. Principally, questions (2) (the rights of the account holder), (6) (the effect of an insolvency of the security taker or intermediary) and (7) (the so called upper-tier-attachment) were identified as primary. More precisely, the Study Group identified the examples of legal uncertainty listed below and used case studies to test them.

2.1.3.1. General Legal Diversity

In a multinational context, a collateral taker will under certain circumstances have to deal with the issue of legal diversity, i.e. he has to take more than one different legal systems into consideration in order to realise the collateral in case of insolvency of the collateral provider. Thus, assuming the application of the Hague Conference Convention's PRIMA-approach, the question of whether he has a good security interest will be governed by the jurisdiction where the intermediary is situated. Questions of insolvency law fall under the scope of the collateral provider's jurisdiction. If, moreover, for the providing of collateral the law of a third jurisdiction (for example the collateral taker's) has been chosen to apply, this law will govern questions of the validity of the pledge.

2.1.3.2. Upper-tier attachment

Some jurisdictions (e.g. Switzerland) allow the attachment of securities at the holding tier where the securities are physically held. If they are physically held with a higher-tier intermediary, this intermediary is vulnerable to freezing orders on the basis of interests that are not known to or knowable by it at a particular level, because it only has knowledge of the interests of its own immediate account holders (lower-tier intermediaries). As the securities belonging to the investor therefore cannot be identified, an attachment order blocks the totality of the securities of the species concerned that are held with the higher-tier intermediary.

---

[3] See UNIDROIT 2002, Study LXXVIII Doc. 1.

2.1.3.3. Interconnection Problems

Problems may also arise when two or more national legal systems interconnect if they are based on fundamentally different legal concepts.

One example is the question of the certification of securities, which is an essential requirement in some countries (e.g. Japan), but prohibited in others (e.g. France). If the lower-tier intermediary requires certificates to treat the interest concerned as a security, the higher-tier intermediary is only able to manage this by issuing substitutes, because there is no physical primary issue. But substitutes can only be issued if the higher-tier intermediary is authorised to issue them. In the example of France only the CSD is authorised to do so, not other institutions.

The differences as regards the recognition of financial instruments may serve as a second example. In some countries certain instruments are not considered to be security. In these countries they therefore do not benefit from the special protections afforded security interests (e.g. recognition of property interest or of a special security entitlement), but are treated as mere contractual claims. In case of the insolvency of an intermediary that is situated in such a country, this may lead to a complete shortfall of the interest.

A third example of the fundamentally different legal approaches that exist is the question of whether security certificates represent or merely evidence the underlying security interest. Under the terms of their securities legislation, some jurisdictions (e.g. Germany) do not recognise as securities certificates that only evidence the underlying interest (e.g. United Kingdom Shares). In this case, securities from an issuer situated in a jurisdiction of the second type that are held through an intermediary situated in a jurisdiction of the first type are not considered to be securities as such in the intermediary's jurisdiction and therefore do not follow the normal legal system as to holding and transferring of securities, but rather a special legal regime. In some jurisdictions it is uncertain whether there is a sound protection against the insolvency of the intermediary in this case.

2.1.3.4. Systemic Risk

The Study Group also discussed the issue of systemic risk, with the events that took place in the United States in 1987 serving as a model. At the time, the present version of U.C.C. Art. 8 did not exist, and a major participant in the US clearing and settlement system became insolvent. As the interests in the securities evidenced by its accounts were not clear as a result of the insufficiencies of the legal system, these securities could not take part in the netting process that was normally conducted every night. Because of this, the market could not close, and no participant of the clearing and settlement system was able to meet the obligations entered into during the day. In this situation, the only solution was for the US Government to provide the participants with considerable financial assistance and guaranties in order to make the netting process possible and thus to permit a closing of the market.

One member of the Study Group pointed out that, in general terms, systemic risk had increased in recent years as a result of the merging of clearing and settlement institutions. Securities were therefore today very often cleared and settled in one centralised system.

2.2. SCOPE OF THE PROJECT

As regards the scope of the project, the Study Group felt that it should not be defined only in terms of the best and easiest way to achieve its objectives, but also in terms of its acceptance by States. Furthermore, the Study Group had to take into consideration the resources at its disposal, and the desire to maintain the momentum that had been attained. The Study Group discussed the points examined below.

2.2.1. Subjects of Integration

The members of the Study Group agreed that their work should only deal with the circulation of securities by real book entries, and not with dispositions concerning the physical circulation of certificates, as all nations already had a sound system for the circulation of paper.

There was no doubt that the project should not only aim at transactions to provide collateral, but also at any type of consensual creation or disposition of securities. It was impossible to create two different regimes, as very often collateral was provided by outright transfers (e.g. "*repos*"). By the same token, the future instrument should envisage not only international, but also domestic transactions.

On the other hand, it was questionable whether UNIDROIT's work should create a full range comprehensive code relating to transactions in indirect holding systems. Prioritisation and limitation to the most important issues seemed to be more appropriate.

As regards the persons affected, the Study Group agreed to cover all participants in an indirect holding system, not only specific classes of investors or collateral takers.

2.2.2. Degree of Integration

As regards the question of the depth that a future integration of the legal system regarding indirectly held securities could and should have, the Study Group identified four different options: (1) supranational law; (2) uniform national law with substantially the same rules; (3) national law completely harmonised in all material aspects; (4) partially harmonised law with differences remaining as to the conceptual framework. In this last case the law would be harmonised as regards the most important rules, but there would be a mutual recognition clause for the fields which have not been harmonised.

The Study Group discussed the question of the possible benefits of a relatively high degree of integration and who might be the gainer. In other words, it was not yet clear if the project should address efficiency issues to improve the infrastructure, or only basic issues regarding the safety and soundness of the existing systems. As regards this question, the opinion was expressed that the benefits of the highest level of integration would be mainly to make possible more efficient and truly international securities transfer systems. A basic protection against risk could on the other hand be achieved at a relatively low level of integration, but at the cost of economic efficiency.

2.2.3. Acceptance of the Scope of the Project by States

The Study Group was also aware of the fact that the implementation of a future instrument might have the consequence of forcing the adopting States to make considerable amendments to their national laws. It was therefore felt that the definition of the scope of the project must necessarily take into consideration the acceptability of a future instrument: States would only adopt amendments to their national securities and related laws if they were convinced of the benefit of the future regime, and they would only support the work of the Study Group if they were persuaded that it was advantageous to them. Two aspects were important: the benefit of the regime and the possibility to achieve the aims.

2.2.3.1. Benefit of a Future Instrument

As to the benefit of the implementation of new rules, the following factors were considered to be important from the point of view of States: (1) the prevention of risk threatening the securities holding system; (2) the increased economic efficiency of the capital market; and (3) the time aspect.

As to the time aspect, the Study Group was aware of the fact that some countries were considering a revision of their legal system for the indirect holding of securities. On the one hand, an UNIDROIT instrument, or any UNIDROIT activity in this field, could be taken into account in this internal amendment process. On the other hand, if internal work on an instrument were to proceed faster, interest in an international instrument might decrease. In any event, States normally appeared to be more interested in short- and mid-term projects. Consequently, any UNIDROIT activity should not take too long to complete.

The importance of these aspects to States varied depending on their different situations, in particular on the different degrees of sophistication of the legal systems that were already in place as regards the indirect holding of securities.

2.2.3.2. The Possibility to achieve the Objectives

In order to muster the necessary political will it must be possible to achieve the aims identified for any future instrument. As to the scope of the instrument, the question was whether the future instrument should address also basic legal concepts (e.g. law of property) and areas of law other than securities law (e.g. insolvency law or the law of corporations). Furthermore, the degree of integration to be achieved had to be determined not only taking into consideration the best and easiest manner to achieve the objectives of the project, but also the probable willingness of States to give up autonomy in this field.

2.3. APPROACH AS TO CONTENT

As regards the content of a future instrument, the Study Group took a functional approach. Three basic aims that marked the starting point of all further considerations were identified:

- the protection of the investor in securities;
- the protection of a lender who takes securities as collateral;
- the protection of the integrity and efficiency of the financial system as such.

2.3.1. Main Conditions

With a view to achieving the above aims, the Group identified two main conditions that are set out in the *Discussion Paper* established by the Study Group (see *Appendix 6*): the legal basis of indirect holding must be sound as regards its internal operation ("internal soundness") and the legal structures must be compatible with foreign systems ("compatibility").[4]

2.3.1.1. Internal Soundness

Rules of substantive law, which are often initially created to govern only the direct holding of securities, must function adequately when they are applied also to the modern system under which interests in securities are held through tiers of intermediaries. This involves both operational and legal issues. Operational issues are beyond the scope of this project. The following points were considered to be essential to ensure internal soundness:

---

[4] This Report necessarily repeats a number of the explanations relating to "*Internal Soundness*" and "*Compatibility*" that are to be found in the discussion paper reproduced as Appendix 4.

- that the investor has a legally robust interest, essentially that his interest is not exposed to risks such as the insolvency of an intermediary or interference by third parties. Protection in the case of the insolvency of the intermediary involves also the protection of the collateral taker. The insolvency of the collateral provider is also an important issue, but would be more difficult to integrate into a future instrument;

- that the character of the investor's interest is clear;

- that there are clear rules governing the transfer of securities, the provision of collateral and its realisation. As to collateral, formalities for its perfection and enforcement must to be reduced;

- that the priorities between competing dispositions are easily identified. In order to achieve this, a special regime is needed, except where there is only one way to create the interests. However, the prohibition of certain types of transactions would reduce the effectiveness of the system. A very simple regime might be that any valid disposition must be registered in one way or another in order to get priority over subsequent dispositions;

- that "upper tier attachment" is precluded, i.e. that an intermediary need only recognise claims based on the rights of its immediate account holders;

- that there is a regime in place ensuring the transferability and evidence of rights by book entries, as well as clear rules as to the finality of settlements. A *bona fide* purchase should be possible;

- that there is an "In/Out-Option" between direct and indirect holding systems, because of the probable persistence of direct holding in most jurisdictions. What the conditions to enter or to leave an indirect holding system might be, and what the investor is entitled to receive from his intermediary in case of exit, must be made clear. In case of exit from the highest tier intermediary, certificates can only be offered to the extent to which the law that applies to the issuer requires the issuer to offer a paper alternative. The instrument should however not attempt to govern the law relating to primary issues of securities and to the circulation of paper; and

- that there is a sound allocation of risk for operational failures and fraud (even if they cannot be avoided by private law).

2.3.1.2. Compatibility

A future instrument must also ensure the compatibility of national securities holding systems with different legal systems, i.e. the interaction of

different substantive laws must be made free from legal uncertainty. Such an uncertainty may for example arise:

- where the rules of different jurisdictions on the matters referred to above under *Internal Soundness* differ;

- where the categories of instruments recognised as securities differ between two legal systems;

- where one legal system caters for securities held in traditional paper form or alternatively in fully dematerialised form and the other does not;

- where the interest of an investor is treated under one system as a direct interest in the underlying securities and under another as a separate, derivative interest;

- where the rules of different jurisdictions differ regarding the allocation of loss among customers of an intermediary in the event of a shortfall.

The Study Group was aware of the fact that any future UNIDROIT instrument will not be adopted by all States. The system devised must therefore of needs interconnect with other systems.

2.3.2. Functional and Neutral Approach

The Study Group discussed whether future work should concentrate on defining the rights and duties of the participants in the indirect holding system only in functional terms. For example, whether the instrument should

- describe the rights within the chain, from the investor right up to the highest-tier intermediary;

- describe what relationship exists, if any, between the rights and third parties (e.g. transfer/effect of transfer);

- describe the duties and functions of the intermediary as such, as a mirror of the investor's rights; and

- describe the effect of the protection of the investor against the insolvency of the intermediary.

Closely linked to the question of whether a functional approach should be applied is the issue of neutrality. It was considered that the conceptual framework should be defined without any preconceptions based on existing law and should break away from characteristic methods of thinking in this field. Rights and interests should therefore be set out in as non-legal a language as possible and without preconceptions

- as to whether a system is paper based (including immobilised and global certificates) or dematerialised;

- as to trust/entitlement and other constructions as against more direct relationships between issuer and investor (especially co-ownership);

- as to whether the creation of a workable system requires the legal relationship between issuer and investor to be disconnected; and

- as to the technology applied.

Neutrality might facilitate the implementation process and increase acceptance by States.

2.4. FURTHER WORK

2.4.1. Fact-Finding

The members of the Study Group discussed the extent to which the project required detailed fact-finding as regards a number of national systems and if travelling to the countries concerned would be necessary.

On the one hand, one of the members of the Group pointed out that fact-finding was very difficult because the relevant rules were very often not clear or not understandable. One should therefore not place too much emphasis on fact-finding and rather concentrate on discussions with Governments and interested circles to make sure that the list of items the project would deal with (in functional terms) was refined. On the other hand, fact-finding might be very useful in order to identify objectives of world-wide importance and to understand the different ways in which the different systems achieved these objectives. Similarly, risks due to the absence of harmonised substantive national laws might be identified and prioritised. Especially as to the question of compatibility, it was not yet clear where the problems lay and how they could be identified. Moreover, it might be useful to understand how securities were actually held in a very practical sense. By collecting such information the Study Group would at the same time draw the attention of States to the project as well as receive feedback from them as to, for example, whether the features identified were important and of value to them.

The members did not agree on the question whether national systems should be tested as regards their compliance with the objectives established by the Study Group. They agreed that such a process would be very time- and resource consuming, but did not agree on whether such a study was needed before starting to draft an instrument.

As to the issue of which countries' jurisdictions should be subject to study, no decision was taken on the criteria of selection of the countries (e.g. countries with an important securities market or countries with a "typical" legal

system) or on the number of countries to be studied (suggestions of from five up to thirty were made).

Some members suggested travelling to the countries concerned in order to obtain correct and direct information. This was supported by the other members, albeit some emphasised the need for the conducting of preparatory studies and the utilisation of their own expertise before travelling. There was broad agreement that studies should be conducted by members of the Study Group as national experts in co-operation with the Secretariat.

2.4.2. Choice of Instrument

No decision was taken as to the character of the future UNIDROIT instrument. It was agreed that the question of whether the most appropriate type of instrument would be a convention or a set of principles accompanied by a model law should be decided in the light of further discussions.

2.4.3. Inter-sessional Work

The Study Group decided to continue work between sessions. The Secretariat was entrusted with the co-ordination of this process.

2.4.4. Next Meeting

The Study Group decided to meet in February or March 2003. The Secretariat will fix the date in accordance with the preferences expressed by the members of the Group.

3. JOINT MEETING WITH THE COMPETENT AUTHORITIES

On Thursday 12 September 2002, the Study Group met representatives of competent authorities. The representatives present are listed in *Appendix 5.* The purpose of this meeting was on the one hand to assess the support that these bodies would extend to the project, and on the other hand to permit the Study Group to benefit from the input of major official decision-making bodies as regards the content of the project. The outcome of the meeting was that the work of the Study Group received the full support of the bodies represented.

The Study Group began by offering an overview of the discussions it had held and presented the preliminary results of those discussions as set out in this Report. Namely, the Study Group explained that had arrived at the conclusion that there was definitely a need for an international instrument that went beyond the conflict of laws approach. To illustrate the conclusions it had reached, it gave several examples of legal uncertainty arising from general legal diversity, upper-

tier attachment or problems of interconnection of different legal systems relating to indirect holding systems,[5] and also illustrated an example of systemic risk.[6] The Study Group made suggestions as to possible approaches to dealing with these issues. In particular, the discussion paper *Indirectly held Securities: Legal Soundness and Compatibility (Appendix 4)* was introduced and illustrated to the representatives.

The representatives of the competent authorities thereupon the commented on the issue of indirect holding of securities in general and on the results of the work of the Study Group in particular.

The representatives agreed with the Study Group that there was a need for an international instrument that tackled substantial law, as the conflict of laws approach could not resolve every possible problem that might arise. As to the possible degree of integration, the representatives could not come to an agreement on the degree of integration that they should suggest. Similarly, the representatives differed as regards the question of the areas of law that should fall within the scope of the project. In particular the opinion was expressed that insolvency law provisions relating to indirect held securities should be covered. The representatives unanimously agreed that the rights of the investor should be made clear. They however disagreed on whether this required a uniform definition of the nature of the right (e.g. "co-ownership" or "securities entitlement"). In general, the representatives endorsed the functional and neutral approach of the Study Group.

* * *

---

[5] See points 2.1.3.1 – 2.1.3.3 above.

[6] See point 2.1.3.4 above.

APPENDIX 1

LIST OF PARTICIPANTS

Chairman

- Mr B. SEN, Senior Advocate at the Supreme Court of India, New Delhi, India

Members of the Restricted Study Group

- Mr J. Michel DESCHAMPS, Partner, McCarthy Tétrault, Montreal, Canada

- Mr Philippe DUPONT, Partner, Arendt & Medernach, Luxembourg, Luxembourg

- Ms Dorothee EINSELE, Professor of Law, Christian-Albrechts-Universität zu Kiel, Kiel, Germany

- Mr Hideki KANDA, Professor of Law, University of Tokyo, Tokyo, Japan

- Mr Guy MORTON, Partner, Freshfields Bruckhaus Deringer, London, United Kingdom

- Mr Frédéric NIZARD, Direction juridique, Crédit Agricole SA, Paris, France

- Mr Richard POTOK, Potok & Co., Darlinghurst, NSW, Australia

- Mr Curtis R. REITZ, Professor of Law, University of Pennsylvania Law School, Pennsylvania, USA

- Mr Luc THÉVENOZ (*Vice Chairman*), Professor of Law, Centre for European Legal Studies, University of Geneva Faculty of Law, Switzerland

Observers from intergovernmental organisations

- Mr. Spiros BAZINAS, Senior Legal Officer, UNCITRAL Secretariat, Vienna, Austria

- Mr Christophe BERNASCONI, First Secretary, Hague Conference on Private International Law, Permanent Bureau, The Hague, The Netherlands

UNIDROIT

– Mr Herbert KRONKE, Secretary-General
– Mr Philipp PAECH, Research Officer (*Secretary to the Study Group)*
– Ms Marina SCHNEIDER, Research Officer

APPENDIX 2

MATERIALS DISTRIBUTED TO THE STUDY GROUP

- *Scope of the Project: Harmonised Substantive Rules for the Use of Securities Held with Intermediaries as Collateral* (Unidroit 2002 Study LXXVIII – Doc. 1)

- Comments submitted by the *Commercial Financial Association - CFA* (Unidroit 2002 Study LXXVIII – Doc. 3)

- Comments submitted by the *International Swaps and Derivatives Association – ISDA* (Unidroit 2002 Study LXXVIII – Doc. 4)

- *Policy Perspectives on revised U.C.C Art. 8*, James S. Rogers, UCLA Law Review 1996, 1432

- *Proposal for a Directive of the European Parliament and of the Council on financial collateral arrangements,* European Commission, 27 March 2002, COM (2001) 168 final

- *Proposal for a Privately Sponsored Meeting to launch the Multi-Tiered Project in Conjunction with a Seminar open to Representatives of the Financial Community*, established by the UNIDROIT Secretariat.

- *Proposal for an EU Directive on Collateralisation*, European Financial Markets Lawyers Group, June 2002

- Comments submitted by the *Federal Reserve Bank of New York* (letter from September 9, 2002)

APPENDIX 3

AGENDA APPROVED BY THE STUDY GROUP

1. Election of Chairperson and Vice-Chairperson

2. Adoption of the Draft Agenda

3. Feasibility and desirability of drawing up uniform rules relating to the use of securities held with intermediaries as collateral (scope of application, type of instrument)

4. Future work

5. Other business

6. Meeting with competent authorities

APPENDIX 4

DISCUSSION PAPER PREPARED BY THE STUDY GROUP

* * * * *

INDIRECTLY HELD **S**ECURITIES: **L**EGAL **S**OUNDNESS AND **C**OMPATIBILITY
DISCUSSION **P**APER OF THE **U**NIDROIT **R**ESTRICTED **S**TUDY **G**ROUP

(i) Introduction

Over recent years, central banks, supervisory authorities and market participants have focused on legal risks associated with the holding and transfer of securities, including their use as collateral. While the laws governing the direct issue and holding of securities are in general well established, the same is not always the case for securities held indirectly. Of the risks that emerged, the most urgent was uncertainty about the law applicable to cross-border holding and transfer. It became clear that in most jurisdictions there was serious doubt as to the law which investors, transferees and takers of collateral needed to satisfy in order to be confident of obtaining a good interest. This issue is being addressed by work of the *Hague Conference on Private International Law*, which is expected to result later this year in a convention that will provide for the first time a clear and uniform set of rules for determining the applicable law.

Assuming the final success of the Hague project, attention now focuses on individual systems' substantive laws, looked at both separately ("Internal Soundness'') and in their interaction with each other ("Compatibility").

In conducting this examination, it is important to bear in mind the continuing evolution of the arrangements under which securities are indirectly held and dealt with in practice. Since these arrangements are often developed by practitioners in response to practical and market pressures and technical factors, the risk of their outrunning or diverging from existing legal principles is particularly acute.

(ii) Internal Soundness

The first set of questions addresses whether rules of substantive law work adequately when applied to the modern system under which interests in securities are held through tiers of intermediaries. Can indirect holders of securities be confident that their interests are robust and can be dealt with under simple, clear rules and procedures for acquisition, holding, transfer (including both outright transfer and provision as collateral) and realization?

Establishing that an interest in indirectly held securities is robust involves both legal and operational issues. Operational issues are beyond the remit of this study group, but as a legal matter it is clearly essential that the investor's interest is not exposed to risks such as the insolvency of any intermediary or interference by unrelated parties.

Having established that the interest is legally robust, it is also of key importance that the law should provide clear rules on:

- the characterization of the investor's interest
- transfer
- the provision and realization of collateral
- priorities between competing dispositions

where the rules of different laws on the matters referred to above (for example, characterization or priorities) differ where the categories of instrument recognized as "securities" differ between two legal systems where one legal system caters for securities held in traditional paper form (or in fully dematerialized form) and the other does not where the interest of an investor is treated under one system as a direct interest in the underlying securities and under another as a separate, derivative interest

It is also important that the rules clearly preclude "upper tier attachment" - that is, that they confirm that an intermediary need only recognize claims based on the rights of its immediate account holders. More difficult questions, involving a balance of conflicting policy considerations, include whether intermediaries should be able to use investor securities as collateral in order to facilitate efficient market settlement systems; it is, again, essential that the rules on this subject be clear.

(iii) Interaction of different substantive laws

Structures for cross-border clearing and settlement currently have to combine elements derived from different legal systems. This carries the risk of uncertainty resulting from incompatibilities among different systems. This risk may for example arise:

- where the rules of different jurisdictions differ regarding the allocation of loss among customers of an intermediary in the event of a shortfall.

In addition to any question of legal risk, continuing differences among substantive rules of law raise questions of cost and efficiency. A settlement system that has to be designed to accommodate complex legal differences is unlikely to be as streamlined or as cost effective as one that does not.

(iv) Conclusion and further work

The study group regards the issues described above as being of crucial importance from the standpoint of systemic risk, financial stability, investor protection and issuers' confidence in the capital markets. It also believes that they are a major factor in increasing settlement efficiency and facilitating the availability of capital, in particular through collateralized transactions. Extensive further work is needed to refine and complete the legal analysis and to test that analysis and its conclusions against a fuller understanding of the facts. At this stage, it is too early to reach any firm conclusions about the final product of the study group's work, for example whether it will be a set of standard principles, a model law or clauses, or a draft convention. The support and participation of all interested parties - supervisors, infrastructure providers and market participants - is essential for this process to be brought to a successful conclusion.

Rome, 12 September 2002

* * * * *

APPENDIX 5

REPRESENTATIVES OF THE **C**OMPETENT **A**UTHORITIES **P**ARTICIPATING IN THE **12 S**EPTEMBER **2002 M**EETING

Bank of England	Mr Antony Beaves, Senior Legal Adviser
Bank of Italy	Mr Paolo Zamponi Garavelli, Head of Legal Department
European Central Bank	Mr Klaus Loeber, Senior Legal Counsel
Swiss National Bank	Mr Hans Kuhn, Head of Legal Department
Department of Treasury, France	Ms Maya Atig-Cochard, Dep. Head of Financial Market Division
Ministry of Justice, Germany	Mr Fabian Reuschle, Executive Assitant
Ministry of Justice, Japan	Mr Norimitsu Yamamoto, Attorney attached to the Civil Division