INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW
INSTITUT INTERNATIONAL POUR L'UNIFICATION DU DROIT PRIVE

UNIDROIT COMMITTEE OF GOVERNMENTAL EXPERTS FOR THE PREPARATION OF A DRAFT CONVENTION ON HARMONISED SUBSTANTIVE RULES REGARDING SECURITIES HELD WITH AN INTERMEDIARY

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COMMENTS BY GOVERNMENTS AND INTERNATIONAL ORGANISATIONS

(Comments by the Governments of Germany and of the United States of America)

Comments by the Government of Germany

The Federal Ministry of Justice, which has overall charge in this matter on behalf of the German government, takes the liberty of submitting the following comments to the UNIDROIT Secretariat.

The Federal Ministry of Justice would like to express its thanks to the Secretariat for forwarding the preliminary draft Convention on Harmonised Rules regarding Securities Held with an Intermediary and for the opportunity to comment on it. The preliminary draft and the accompanying Explanatory Notes show the comprehensive the work of the Study Group and of the UNIDROIT Secretariat. In view of the growing international trade in securities, harmonised rules regarding securities held with an intermediary are of very great interest to the German banking industry in particular. The Federal Ministry of Justice therefore welcomes the fact that UNIDROIT is tackling the issue. Following an initial examination of the preliminary draft and as a result of initial consultations on a national level, we would like to submit the following comments in the form of a preliminary evaluation of the preliminary draft Convention.

I. Regarding the preliminary draft Convention as a whole

Many of the proposals meet the demands of banking practice, where securities (e.g. embodied in global certificates and held in centralised safe custody or created via issuer registers where the central securities depository is registered or via any other method) have for many decades been transferred on the basis of a book entry (clearing and securities settlement system). A multi-tiered holding system has developed in which "intermediaries" (custodians) are involved at various levels.

The preliminary draft Convention provides a simple, comprehensible model which could be suitable for increasing legal certainty in cross-border trade in securities, for reducing system risks and lowering costs.

On the other hand, however, it seems open to question whether the preliminary draft has sufficiently allowed for the various, mature structures in national systems of law and whether the systematic approach it embodies is sufficiently neutral. Adaptation of the existing German law on

securities would be necessary, which currently provides a high level of protection for investors. Furthermore, changes to contractual, corporate and property law would be necessary. The same most likely applies to many European legal systems. Interposing the intermediary would lead to the severing of the direct legal relationship between the issuer and the holder of securities. Also, the permanence of the security would be annulled, since its existence would in the end be made dependent purely on the intermediary's proper book entries (cf. Article 3 of the preliminary draft). Furthermore, problems arise in connection with corporate law. The preliminary draft creates uncertainty regarding the permanence of membership rights.

Moreover, the proposal set out in the preliminary draft (Articles 2, 3 and 5), according to which the securities are acquired by means of original acquisition of rights as a result of a mere book entry, creates considerable problems. Accordingly, the account holder acquires a legal status which is reminiscent of the German legal bases for funds available for credit transfers, according to and as a result of which the payee of a credit entry acquires an independent right to recover a debt against the bank in charge of the account. This would enable the creation or multiplication of securities. In the end, such an approach could lead to even an erroneous entry creating "new" securities and that without the prerequisites of national law concerning securities being fulfilled (cf. Article 3(4)): Even if the acquisition process were reversible, Article 5(4) provides for "good faith acquisition" (acquisition by an innocent person) in the event of temporary disposition. According to the preliminary draft Convention, such acquisition by an innocent person is possible for all securities and even in cases when the securities are born of an erroneous entry and do not actually exist. Article 10 extends this to third parties ("adverse claims").

From Germany's standpoint, the regulation set out in Article 16 of the preliminary draft Convention is also to be considered problematical. Accordingly, if the aggregate number/amount of certain securities held by the intermediary is less than the aggregate number/amount credited to securities accounts, the amount of securities of all account holders of the intermediary in question is allocated pro rata. Ultimately, for example in the event of the intermediary's bankruptcy or if the missing securities are no longer available on the market, all the intermediary's account holders would suffer. Each account holder would therefore permanently be at risk of suffering the consequences of one single erroneous entry – even if there were proof of their own error-free acquisition dating back several years. Such a regulation, according to which the consequences of a single entry would be distributed across other account holders, does not seem fair. Rather, an alternative solution should be sought, for example providing security by means of a fund for credit institutes. In any case, the preliminary draft must determine that, in the event of an erroneous entry, the book entries should be reversed, irrespective of the applicable law.

The three aforementioned points (acquisition of the security and legal status of the holder of the securities; acquisition in the event of insufficient securities held; relationship to corporate law) necessitate fundamental changes under the German opinion.

II. I would like to make the following – preliminary – remarks concerning the individual Articles of the preliminary draft Convention:

1. Re Article 1

The definition of the term "securities" in Article 1(1)(a) should not be based on vested titles, but rather on technical features of the security (separateness, transport and legitimisation function). When creating a uniform legal framework the definitions should be chosen in such a way that the terms applied by various legal systems – in particular those used in European Union legislation – fit into the overall legal framework.

At any rate, the term "securities" in Article 1(1)(a) should be more narrowly defined. In particular, in view of Article 17 of the Convention, one should avoid it covering shares in a partnership which are not or should not be conferred on the basis of book entries (including shares in stock corporations).

It will not be possible to completely harmonise the definitions applied in the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary with those of a convention on substantive rules.

2. Re Article 2

The regulation should set out that the duty of the intermediary to assert the rights of the investor against the issuer or against "higher-tier" intermediaries should not only be set out in the account agreement, but that statutory regulations are also permissible.

It should be made clear that not only certain rights, but rather all the rights deriving from the security are conferred on the account holder.

Article 2(2)(b) is problematical, since the investor only acquires rights against the custodian bank but not against the issuer. This regulation would compromise the investor's position.

3. Re Article 3

The proposed acquisition of original rights by the credit of the securities is different from existing legal concepts applicable in Germany and presumably also in many European countries. In accordance with these concepts Article 3 should foresee that, along with the crediting of the securities, secondary rights must also be conferred, if the law so provides.

Furthermore, Article 3(3) should make it clear that not the mere crediting of the securities, but the effectiveness of the credit is the precondition for acquisition of the right. This already results from Article 5(1), but should be explicitly pointed out in Article 3.

In our view, an inconsistency could arise between Article 3(3) and Article 5(1) of the preliminary draft Convention. Article 3(3) determines that, apart from the credit of the security, no further steps or events are necessary to acquire rights from securities held with an intermediary. According to Article 5(1), however, the debit or credit of securities is not effective unless it is made with the "authority" of the account holder. Furthermore, according to Article 5(2) a book entry is only possible if the condition is satisfied.

Further problems should arise regarding the regulation in Article 3(4), according to which a credit to a securities account is to be effective if the securities account or debit is not identifiable (tracing).

The regulation contained in Article 3(4) could be formulated exactly to the contrary, to the effect that an entry only becomes effective if the relevant account to which the security is credited or the entry can be identified. The form of this regulation is of essential importance due to the rules on adverse claims in Article 5(4) and Article 10.

4. Re Article 4

There should be further discussion concerning whether Article 4(1)(b) should more clearly express the fact that the identification of securities only represents identification for internal purposes between the account holder and the intermediary.

In addition, one could consider whether to create a rule according to which the intermediary could reach a different agreement with the account holder so that the intermediary and the account holder could only jointly dispose of the securities held with an intermediary.

There should also be further discussion of the significance of Article 4(2). The element of publicity regarding the statement of securities has no relevance for legal dealings. At any rate, German law does not require such annotation.

5. Re Article 5

One could consider extending Article 5(3) so as to exclude securities being created without preconditions pertaining to securities set out in national law being fulfilled in the event that the applicable law provides for the reversal of an entry.

Furthermore, it should be examined whether Article 5(4) should be extended so that temporary disposition does not lead to innocent acquisition subject to an adverse claim. Such acquisition by an innocent person would otherwise be possible for all securities and would also occur if the securities result from an erroneous entry and do not actually exist.

6. Re Article 6

The terms "effective" and "finality" could be more precisely delimited. It should be examined to what extent the terms could be co-ordinated with those applied in EU Directive 98/26/EC of the European Parliament and of the European Council of 19 May 1989 on settlement finality in payment and securities settlement systems (OJ EC L 166, p. 45 of 11 June 1998; the so-called Settlement Finality Directive).

7. Re Article 7

The terms "clearing" and "settlement" should be more precisely defined.

8. Re Article 8

The regulation provides for special protection of the debtor which does not seem justified. This rule could, for example, lead to the issuer or the intermediary who is not the leading intermediary being protected against acquiring a new creditor following the execution. According to German law, however, a substitution of creditors is generally possible without the approval of the debtor.

In the German government's opinion, this regulation should ensure that attachment of the securities account is effective against the issuer and other third parties.

9. Re Article 9

All in all, we would suggest examining whether this regulation is in fact necessary. The reasoning for Article 9 of the preliminary draft Convention does not sufficiently expose the motives for which it has been included.

10. Re Article 10

One should include a regulation to the effect that the acquisition "in good faith" of the right to lodge an objection solely by means of a book entry being made should be made subject to other preconditions. Otherwise it will conflict with the precept that innocent acquisition is only possible in the case of the secondary acquisition of securities. In such cases there is no reason to protect the person acquiring the securities.

Furthermore, one should include a rule to the effect that the mere erroneous book entries do not lead to innocent acquisition.

Article 10(3) should be more clearly defined to the effect that knowledge of the facts, in consequence of which innocent acquisition is excluded, can be ascribed in the event that the organisation becomes party to the relevant information, but, in breach of duty, does not pass it on.

11. Re Article 11

The importance of the regulation regarding protection against insolvency should not be underestimated. To what extent the Articles in the preliminary draft Convention could provide protection against insolvency needs to be further examined, which we reserve the right to do.

12. Re Article 14

The regulation dealing with the intermediary's duty to hold sufficient securities should be stricter. Instead of the mere rule, either a prohibition liable to criminal prosecution or control subject to supervisory or commercial law should be introduced.

The regulation should also explicitly state that the temporary holding of insufficient securities will not be tolerated.

13. Re Article 16

Further discussions should be held regarding the clause on allocation of any shortfall. It is inconsistent with the principles of the German legal system. All account holders are permanently at risk of suffering the consequences of a single erroneous entry, even if their own acquisition has demonstrably been error-free and even if it dates back several years. Problems will also arise in practice regarding the exercise of membership or other rights attaching to securities (e.g. voting rights).

14. Re Article 17

The proposed wording requires that it would only be possible to issue securities in such a form so that they could be held by an intermediary. However, from Germany's standpoint there are many reasons why shares should only be issued individually. These reasons could be that the mere decision of the issuer or that it is prescribed by the respective legal system (shares in a certain legal form of commercial entity such as a limited liability company). Any existing freedoms should not be limited.

Further examination should be made regarding whether Article 17(2)(b) is actually necessary for the harmonisation of the law.

Article 17(2)(d) should be further examined. It may be questionable whether the regulation would violate national regulations on share registers.

It would be desirable to include Article 17(3) in the Convention – in particular should the more broadly defined version of Article 17(1) be applied.

15. Re Article 21

We do not believe it would be desirable for the collateral taker to have the right to use and dispose of the collateral securities before an enforcement event, as proposed in the preliminary draft. Such an option should require the explicit prior approval of the collateral provider.

In addition, it should be possible to confer such rights to securities held with an intermediary which do not automatically confer the right of use. The collateral provider should also have the right to issue further restrictions, for example the provision that securities can only be realised by public auction (cf. Article 20(4)).

16. Re Article 22

The possibility of furnishing collateral for securities should not be allowed following the commencement of insolvency proceedings. This would be in contravention of general principles of insolvency law.

The Federal Ministry of Justice looks forward to further discussion of these and other aspects of the preliminary draft Convention.

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Comments by the Government of the United States of America

Thank you for providing us an opportunity to comment on the preliminary draft of the Convention on Harmonised Substantive Rules regarding Securities Held With an Intermediary (the "UNIDROIT Convention"). Since receiving the preliminary draft convention, the United States Delegation has held a series of consultations with private sector participants, academics, and government agencies, with a view toward making the upcoming deliberations as constructive as possible. With that goal in mind, we thought it might be helpful if we shared with you certain initial thoughts of the United States Delegation prior to our arrival in Rome.

We would like to emphasize our support for the substantive goals of the UNIDROIT Convention. In light of the increasingly large transnational marketplace for the holding and transfer of securities, modernizing and harmonizing national laws regarding the indirect holding of securities is vital to the reduction of legal risk and systemic risk and the promotion of market efficiency and capital investment in both developed and emerging markets. The UNIDROIT project has the potential to be a major step toward accomplishment of these goals.

As you know, similar goals motivated the international community to successfully complete the Convention on the Law Applicable to Certain Rights in respect of Securities Held With an Intermediary (the "Hague Securities Convention"). In light of the large value of cross-border securities transactions, agreement on the text of the Hague Securities Convention was an important step toward achieving legal certainty and predictability regarding the law applicable to securities held through clearing and settlement systems or other intermediaries. This achievement will be fulfilled when the Hague Securities Convention is ratified and becomes national law in the states party thereto.

We support the start-up of this project on the basis of the acceptance of the Hague Securities Convention as the foundation for moving forward on substantive law revision. The United States Delegation strongly feels that the ratification of the Hague Securities Convention should not be placed on hold while national governments negotiate and adopt the UNIDROIT Convention, which, considering the complexities involved, may take a number of years. We recognize that the ability of many legal systems to adapt to the pace of change in the marketplace for the holding and the

cross-border transfer of securities will be challenging. In the United States, it required several years to reach consensus on the revisions to Article 8 of our Uniform Commercial Code to satisfactorily take account of the realities surrounding the holding of securities through securities intermediaries. As stated above, while the UNIDROIT Convention will build upon the strong foundation of the Hague Securities Convention, there is no reason to delay implementation of that foundation while the UNIDROIT Convention takes form.

We note with approval the aims of the UNIDROIT project both to promote the development of internally sound, modernized national laws and to ensure that such national laws are compatible with each other. Holders of securities through intermediaries need to be confident that their rights and interests are protected in the event of the insolvency of the intermediary, and to know that clear rules and fair procedures will govern the acquisition, holding, disposition, and realization of their interests, and the determination of the priority of competing interests. Further, holders need to know that the possible differences in national laws governing their interests will not unduly burden the cross-border exercise of their rights relating to such interests. We also agree with the intention of the UNIDROIT project to reduce systemic risk in increasingly integrated capital markets. As the work of the G-30 and the Giovanni Group, among others, makes clear, it is important to reduce the risks in clearance and settlement systems that arise from participants and depositories being located in different national jurisdictions.

The United States Delegation does not, at this point, have a clear preference as to what form the instrument should ultimately take, but believes that continued consideration of that question will be constructive. For the most part, the preliminary draft is in the form of a convention, with the apparent intention that it would become the substantive law of each jurisdiction to ratify it. There are portions of the preliminary draft, however, that seem to be written more as a set of key provisions the substance of which is to be incorporated by Contracting States into their existing laws.

For example, we note that Article 17 appears to be drafted more in the form of a directive, rather than a convention, in that it establishes certain concepts that must (or must not) be incorporated as part of national law, while leaving it to each jurisdiction to determine how this is to be accomplished. Drafting the instrument, or portions of it, as a directive may have value, especially considering the divergence in how national legal systems approach the holding of intermediated interests in securities. The instrument, or some aspects of it, could also take the form of a model law, which may be beneficial for those countries that have not undertaken a modernization of their laws. Another approach would be to develop the instrument as a legislative guide, capable of projecting to national lawmakers the fundamentals of an internally sound and internationally compatible system for the intermediated holding of securities.

Further, if the instrument is drafted, in whole or in part, as a convention, it may be practical to designate certain articles as optional – either as “opt-in” or “opt-out” in order to better ensure the convention’s chance of securing widespread approval. The United States Delegation looks forward to having a discussion in Rome about the form that the instrument will ultimately take and also believes that the final decision on form will need to be deferred until the content of the provisions are better developed and understood.

Because of the complexity and difficulty of achieving fully harmonized rules, the drafters employed what they termed a “functional” approach to the drafting of the Convention. The United States Delegation agrees that the functional approach of the current preliminary draft has its uses, and is perhaps appropriate, depending on the nature of the ultimate instrument, for the development of a body of a law that must be implemented across diverse legal traditions. We must

take care, however, that the functional approach does not obscure the fundamental purposes of the convention. In this regard, it is important to make clear that convention is directed toward clarifying rights and responsibilities applicable to the intermediated holding of securities, rather than simply developing rules applicable to individual securities held in book-entry, instead of physical, form.

To be effective, a modern functional approach also must clearly articulate priority rules, as well as rules that protect the interests of account-holders *vis-à-vis* other interests. It may be that the foregoing may be facilitated by delineating the nature of the rights or interests in a modern intermediated system. While the functional approach may work within a particular legal tradition, it may turn out that it may not be sufficient where cross-border transactions take place across jurisdictions that use very different concepts in describing the nature of the interests in the intermediated system. To better enable the UNIDROIT Convention to make a contribution to the compatibility of national laws, the reduction of legal and systemic risk, and the promotion of market efficiency and capital development, it may be desirable to clarify and define the property and other rights that accrue to a holder of securities held with an intermediary, and then to elaborate clear rules and procedures that would apply to such intermediated interests. A critical part of this elaboration would be an agreement on the priority rules that apply among account holders, secured creditors including the intermediary itself, and creditors of the intermediary.

Finally, the United States Delegation would like to add its support for the inclusion of Chapter VII in the convention. While we look forward to working through the specifics of the chapter, we consider the attainment of legal certainty surrounding the creation and realization of collateral interests in intermediated securities, free from unnecessary formalities and impediments, to be a very important goal of the UNIDROIT project. These provisions are in accord with developments in modern capital markets and reflect the transactional realities of today's investment securities field and its participants. We believe they are needed if our work is to have real value in the developing marketplace for investment securities.