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REPORT
of
Ad hoc Working Group on Article 19.1 of the *preliminary draft Convention on Harmonised Substantive Rules regarding Intermediated Securities*

(prepared by the Secretariat)

At the first session of the Committee of Governmental Experts ("the CGE") for the preparation of the preliminary draft Convention on Harmonised Substantive Rules regarding Intermediated Securities ("the preliminary draft Convention"), discussion of draft Article 19.1 (formerly draft Article 17.1), entitled "Position of Issuers of Securities", concluded with the decision that inter-sessional work should be undertaken in order to clarify what the policy objectives of the draft provision should be and to assist with its re-drafting. The discussion had highlighted insufficient agreement on, and incomplete understanding of, the draft provision.

An informal *Ad hoc* working group chaired by the delegation from Switzerland ("the Article 19 Group") was established to exchange views and to report to the next meeting of the CGE. An invitation to join the Article 19 Group and to submit comments on the draft provision was extended to delegations and observers in August 2005. The Article 19 Group was to prepare first a draft report for circulation and comment and to follow that with a final report for delegations and observers to consider before the CGE's second meeting in March 2006. This document comprises the final report of the Article 19 Group.

BACKGROUND TO DRAFT ARTICLE 19.1

Draft Article 19.1 addresses two distinct situations which may prevail in Contracting States. Both prevent the holding of securities through an intermediary. In the first, holding through intermediaries is expressly or implicitly prohibited by law. In the second, although here is no such prohibition, investors are *de facto* prevented from holding securities in this manner. This is particularly the case where an effective exercise by or on behalf of investors of the right attached to the securities is impossible solely because of intermediation. Examples of ways in which an investor who holds securities through an intermediary may be prevented both from exercising and enjoying rights derived from ownership are described in detail in draft Article 19.2.

From these and other examples of limitations which may be placed on investors who hold through intermediaries, the policy intent behind the current draft Article 19.1 seems to be to oblige Contracting States to modify their domestic law so far as is necessary either to remove any express prohibition or any *de facto* limitation on holding through intermediaries.

From these and other examples of limitations which may be placed on investors who hold through intermediaries, the policy intent behind the current draft Article 19.1 seems to be to oblige Contracting States to modify their domestic law so far as is necessary either to remove any express prohibition or any *de facto* limitation on holding through intermediaries.

To help the Article 19 Group focus on the policy question the letter inviting their comments asked participants to consider specifically whether the draft provision should make it clear that, where securities are or can be held through intermediaries (including nominees), any discrimination between investors with respect to the rights attached to such securities should be prohibited.

SUMMARY OF OBSERVATIONS RECEIVED

BELGIUM

Belgium is in favour of draft Article 19.1 giving effect to a policy which will result in the elimination of legal barriers that prevent the full implementation of major market initiatives being undertaken in the fields of consolidation and harmonisation. It gives as examples local laws, regulations and regulatory practices that –

- give different rights to “domestic”, versus “foreign” intermediaries - for instance, by granting certain categories of “domestic” intermediaries special status,
- effectively restrict access to capital markets to intermediaries who are members of “local” settlement systems, or
- by requiring the maintenance of individual records or accounts for every beneficial owner, do not recognise the multi layered holding structure that is the norm in cross-border activity.

CANADA

Canada agrees with the policy objective of removing inappropriate barriers to intermediated holdings but questions whether such a general objective is best achieved by a multilateral convention or treaty. A simple rule such as draft Article 19.1 that would force Contracting States to modify their domestic law fails to accommodate unique legal or regulatory frameworks designed to facilitate and safeguard intermediated holdings. Such frameworks are a complex system of rules that integrate corporate, commercial, insolvency, regulatory and other laws.

Canada explains that the draft provision contradicts many provisions in existing Canadian law, including the rule of corporate law which permits an issuer to treat the registered owner as the person exclusively entitled to vote, receive dividends etc. Various applications of that rule appear in Canadian statutory mechanisms that reflect sound corporate or regulatory policy. Such measures, since they may prevent holding through intermediaries, are inconsistent with draft Article 19.1. Examples include

- legislation which requires private issuers (who represent over 99% of corporations in Canada) to restrict the transfer of their securities or which requires certain corporate entities (such as banks) to restrict the transfer of securities for regulatory reasons, and
- requirements sometimes imposed by securities regulatory authorities on issuers to ensure that certain securities are not transferred for a period of time to which issuers give effect by imposing restrictions on transfer.

This particular corporate rule is only one of many in a complex system involving over 50 statutes that provide for property, rights and obligations throughout the holding chain from issuer to account holder. The fact that the well-intended simple rule to which Article 19.1 is intended to give effect may in fact *contradict* more complex provisions that have the same purpose illustrates how counter-productive such a rule may be.

Sophisticated intermediated holding systems provide superior risk management and cost controls in the clearance and settlement process. Therefore if a Contracting State inappropriately prevents such systems issuers, investors and other market participants in that State will, compared to market participants in other States, be at a competitive disadvantage. They will either press for change or move elsewhere. This strong, natural incentive is, Canada believes, more likely to achieve the policy objective behind the draft provision than a simplistic rule.

Canada suggests a "soft law" approach as more likely to remove inappropriate barriers to intermediated holdings. Accordingly, Article 19 should be drafted as a principle that encourages Contracting States to reform their laws to permit the holding of securities with an intermediary and the effective exercise by an account holder of rights in respect of intermediated securities. It believes that, in making this suggestion, it shares the views of other delegations .

FINLAND

Finland supports the right of Contracting States to permit issuers to choose whether or not to issue securities that can be held through intermediaries, subject to retaining the right of Governments to require that all issuers fulfil certain conditions before exercising that choice. The draft provision should not apply so as to sanction *only* multi-tiered holding systems but should encompass intermediated systems such as "Nordic" systems which enable securities to be held through an intermediary either in the form of a CSD or, for foreign investors, a custodian Bank. Where a holding system enables foreign investors to hold securities in an omnibus account national law should not discriminate between intermediaries – i.e. the investor should be able to hold securities with any (including any foreign) intermediary (though EU law may impose a different regulatory regime on EU, as opposed to non-EU, intermediaries). Finland also makes the point that rights that attach to securities from the time of their issue should not be affected by their later disposition or any change in their holding pattern.

Finland considers that, where an issuer decides that securities may be held through an intermediary, including a nominee, there should be no discrimination as to the ability to exercise those rights between an investor who holds through an intermediary and one who does not. In particular, investors should, regardless of how their securities are held, be entitled to determine how to exercise their voting rights, albeit that, where they exercise a right to vote in a Contracting State which does not permit rights to be cast anonymously, they should not be able to retain anonymity by virtue of holding through an intermediary or nominee.

FRANCE

France would prefer that draft Article 19.1 should not be expressed as a prohibition. Instead, it should clearly state that the laws of Contracting States should permit an issuer to choose either to issue securities that can be held through intermediaries or securities that cannot be so held. It should not impose a duty on Contracting States to require issuers to open themselves up to the intermediary system.

GERMANY

Germany supports the idea of preventing discrimination generally between investors who hold securities through an intermediary and investors who hold securities directly as regards the exercise of their rights.

Germany feels however that, as currently expressed, Article 19.1 goes further than it needs in order to achieve these objectives. It appears to oblige Contracting States to have national legislation in place under which the only form in which securities may be issued is one in which they may be held through an intermediary. Germany believes that there are many reasons why issuers should instead be free to decide for themselves the form of issue.

Germany suggests that Article 19.1 should be redrafted so as to make clear that it does not restrict issuers' freedom of choice so as to prevent them from issuing securities unless they can be held through intermediaries.

JAPAN

Japan believes that the draft provision should be clarified. It should state clearly, first, that Contracting States are under an obligation to recognise the phenomenon of intermediated securities – namely, Contracting States should be obliged to permit the holding of securities through an intermediary including the holding of securities in a multi-layered fashion in which one or more intermediaries stands in a vertical chain. Second, it should, where the holding of intermediated securities is permitted in Contracting States, prohibit discrimination in those States between investors who hold non-intermediated securities and those who hold intermediated securities.

More particularly as to the first obligation – i.e. to recognise intermediated securities - it seems enough for a Contracting State to permit issuers of securities to choose to have their securities held with an intermediary (*not* including a nominee), although dematerialisation coupled with requiring such a holding system may be ideal for certain securities. As a separate matter Contracting States should be obliged to recognise nominee ownership – i.e., even in a situation in which securities are directly held by investors, the law of the Contracting State should permit those investors to hold those securities through the investor's nominees.

As to the second obligation – i.e. not to discriminate - the "person" on the "bottom rung" in the intermediated holding pattern should be entitled, either directly or indirectly, to exercise voting and other shareholder rights and to receive dividends and other payments or the like from the issuer. In this context, by "indirectly", means "through his intermediary". To give effect to this obligation or duty not to discriminate Contracting States must recognise differential voting and related matters. The rule against discrimination should apply equally where the "person" on the "bottom rung" is a nominee – i.e., the law of a Contracting State should permit an investor to exercise his rights as a beneficiary through his nominee.

THE RUSSIAN FEDERATION

The Russian Federation is concerned that Article 19 should not result in intermediaries or their account holders being treated more favourably than direct investors and should not provide opportunities for the evasion of restrictions properly imposed by company law for reasons of public policy or good governance. For example, Article 19.2(a) should not prevent a Contracting State

from imposing restrictions on the exercise of votes attached to securities held or controlled, directly or indirectly, by the issuer itself or by its affiliates.

SWEDEN

Sweden bases its observations on the assumption that the policy underlying Article 19 is the prohibition of discrimination against investors regarding the exercise of rights attached to securities where such securities are or can be held through an intermediary, including a nominee. In its view, the current draft begs a number of questions. Focussing on "discrimination", it asks what that means, in relation to both intermediaries and investors, and therefore what national laws or practices would be targeted by a prohibition. As to the treatment of intermediaries, it wonders whether "discrimination" is, in essence, any incompatibility between how a "foreign" intermediary is treated "at home" and how that intermediary is dealt with under its own national law. Sweden cites as possible examples of "discrimination" national practices such as charging account holders for some services (such as proxy voting) but providing others (such as distributing dividends) free and national requirements such as the segregation of an intermediaries own securities from those of its clients. As to the treatment of investors, it wonders whether a prohibition against exercising voting and other rights without being regarded (which intermediaries are not), and registered as, "owner", in a shareholders register on a relevant date amounts to "discrimination".

Focussing on the language of the draft provision Sweden wonders whether a "nominee" or "nominee holdings" comes within the scope of what is meant by "intermediary" or "intermediated securities" and, if these expressions are used throughout the preliminary draft Convention, whether their respective meanings should be clarified by means of definitions. It considers "nominee" to be a term which, in some, but not all, jurisdictions has a specific meaning in national law and suggests that "nominee" be either defined functionally or not used at all. A further issue linked to the language of the draft Article is its heading – "Position of *issuers* of securities". This, Sweden points out, is misleading, since it is more likely to be Contracting States than issuers who are responsible either for prohibitions or *de facto* limitations on intermediated holdings.

A further matter raised by Sweden relates to the interaction between draft Article 19.1 and draft Article 4.2. It questions whether the two provisions are compatible since Article 4.2 appears to provide that an intermediary may not vote as if it were an owner where this is not permitted under national law. Sweden concludes its comments with the proposal that the provision should, essentially, be directed at "non-domestic holdings"; that national restrictions should be permitted as long as they do not "discriminate" (and "discrimination" should not encompass any treatment under revenue law) and that it should permit a "real owner" (i.e. whoever is entitled to rights against a issuer) to exercise its rights through the intermediation of a third party.

THE UNITED KINGDOM

The UK supports a provision incorporating the substance of the current draft Article 19.1 since such a provision addresses important problems that occur in the course of cross-border clearance and settlement such as prohibitions on split voting and the application of company law restrictions on significant stakes or foreign holdings to intermediaries rather than underlying end investors. The UK accepts that the preliminary draft Convention should not impose a duty on Contracting States to require all kinds of issuers, even those of a private character, to open themselves up to the holding of securities through intermediaries, but considers that such a duty would be appropriate for entities that, by arranging for their securities to be traded on public exchanges or markets, have enabled the ownership of these securities by the public at large. The UK believes that such a policy

does not prevent Contracting States' domestic corporate law from imposing whatever restrictions Governments or other regulators believe should – perhaps on grounds of public policy – be imposed regarding matters such as permitted maximum levels of holding or holding by foreign investors provided that such restrictions do not discriminate against investors who hold through intermediaries.

THE UNITED STATES OF AMERICA

The USA views draft Article 19 as particularly important [1] in the context of updating laws and practices that predate the realities of current practice in intermediated clearance and settlement systems. The USA believes the current structure of the draft provision clearly addresses the resulting difficulties.

The focus of the draft is, as is appropriate, on the need to protect rights rather than on the precise method of their protection. Article 19 therefore begins, in paragraph 1, by stating the general and fundamental proposition that a holder of intermediated securities should, as far as possible, enjoy the same benefits as one who holds securities directly. The manner of holding should not materially affect the benefits to be derived from ownership.

Article 19.2(a), by making it clear that an intermediary holding intermediated securities for others need not necessarily exercise all voting rights in the same manner, goes on to address a specific problem – encountered, for example, in a recent bankruptcy in Asia - that, where an intermediary is instructed to exercise votes differently, all votes will be disallowed. Article 19.2 (b) (i), by recognizing that, so long as investors receive information about notices concerning securities, it does not matter how, addresses the reality that such information is likely to be conveyed or accessed in different ways. Article 19.2 (b) (ii) similarly addresses the fact that, where there are one or more intermediaries, provision must be made to ensure that the investor is able to vote whether in person or by proxy. Article 19.2 (c) provides for possibly the most fundamental right of an investor – the right to hold securities through an intermediary. A clear statement of such an essential requirement of a modern clearing and settlement system is vital for legal certainty. At the same time this draft provision does not require an issuer to make arrangements with a CSD (or other intermediary) to issue securities through that CSD or in any particular form – such as a global note, or in book – entry. For example, an issuer can issue its securities in a fully certificated form and its investors should be able to deposit those certificates with their intermediaries to reduce the risk of theft or fraud, hold those securities as intermediated securities and be able fully to exercise rights as holders. Similarly, their intermediaries (banks or brokers) should be able to deposit those certificates with their intermediaries – including, if the securities are eligible under its rules, a CSD. Since, unless such a provision is in force in a State, it is not possible to ensure that those who participate with it in international cross-border can do so safely, this provision must, in the view of the USA, be mandatory. Article 19.2(d), by providing for the adoption of laws which recognise the dematerialisation of securities (as distinct from "book-entry-only" (global or jumbo certificates) or classic certificated securities) ensures the removal of obstacles to cross border clearance and settlement that arise where some States allow dematerialisation and others do not. Article 19.2(e) will, if it can be further refined, ensure that States' laws may not discriminate inappropriately by requiring that only certain persons can hold securities or act as intermediaries. The USA points out that some forms of discrimination, such as the majority ownership of certain companies by

[1] The US draws attention to the proposed changes to Article 19 set out in Appendix 9 to UNIDROIT 2005 - Study LXXVIII, Doc. 23 rev. It believes they would both clarify and improve the draft Article in a manner consistent with the provision's objectives. The USA would also like to draw attention to the notes to the proposal which require something more than is currently present in the original text or in the proposed changes described in Appendix 9.

nationals, may be appropriate. It may therefore be necessary to indicate which types of discrimination would, prima facie, be "appropriate", which "inappropriate" and which do not clearly fall into either type.

CONCLUSIONS

Observations made by contributors to the work of the Article 19 Group on the draft provision appear to point to the following broad conclusions -

(a) Discrimination against Investors

As regards the policy to which draft Article 19 is intended to give effect, there seems to be agreement that it is directed against discrimination in the sense that cross border intermediated holding ought not to be treated differently as far as the exercise of rights which flow from the securities is concerned. In other words, the manner of holding should not materially affect the benefits which derive from ownership. The investor who holds intermediated securities must be in a position to benefit from his rights, either through his intermediary or through "direct channels" with the issuer. Any legal, regulatory or other provision that directly or indirectly prevents such investors from being able to exercise their rights as effectively as investors that are in a direct relationship with the issuer needs to be disapplied.

Equally, it seems to be common ground that this point is already included in the current draft but, as a matter of drafting, draft Article 19.1 might be better expressed not as a prohibition but as a clear statement that the laws of a Contracting State should ensure freedom to an issuer to choose whether to issue securities that can be held through an intermediary or not. Further, Article 19 should not lead to a situation where investors that hold through intermediaries are treated more favourably than investors that do not.

(b) Obligation to open intermediated holding to every investor

The answer to the question whether and to what extent Contracting States should be obliged to make intermediated holding possible is not clear.

One option would be for Contracting States to permit issuers to choose whether to open a securities issue up to intermediated holding or not. A choice, in the sense that issuers should not be obliged to offer the option of holding through intermediaries, is particularly significant in relation to legal entities of a private character such as partnerships. In this context, *inter alia*, the definition of the term "securities" is important. Another option – which might be most likely to ensure efficient and reliable cross-border settlement – would be for Contracting States to be obliged to ensure that all securities may be held through intermediaries. By way of a compromise a further option, taking into consideration the thinking underlying the other two, could give effect to the following proposition -

> *Article 19, whilst not obliging Contracting States to require all kinds of issuers, especially those of a private character, to enable their securities to be held through intermediaries, should oblige them to require such a holding pattern where issuers, by arranging for their securities to be traded on public exchanges or markets, have enabled the ownership of those securities by the public at large.*

(c) "nominee holding"

The definition of "intermediary" for the purposes of the preliminary draft convention includes nominee holding. Therefore a rule against discrimination (cf. lit. [a] above) applies equally to investors that hold through nominees. It is essential to cross-border compatibility that investors that hold through a nominee can exercise their rights as effectively as investors that hold through other types of intermediaries – i.e., as effectively as investors in securities who do not hold through intermediaries (cf. above [a]).

It is however debateable (depending on the policy decision described under [b], above) whether draft Article 19 should oblige Contracting States to include nominee holding in the choice they are obliged to offer to domestic issuers or investors respectively.

(d) Restrictions on the grounds of public policy?

It is for discussion whether the draft provision should state that a Contracting State may, in its domestic corporate or other law, impose such restrictions on the holding of securities as it considers appropriate on grounds of public policy or good governance (such as permitted levels of holding by foreign investors). At first sight there seems nothing to prevent Contracting States from imposing such restrictions provided they do result in discrimination. It is therefore arguable that such a statement need not be included.

(e) Drafting issues

The CGE may wish to consider the suggestion that, instead of attempting to achieve the objective for which the draft provision is designed by the means of a "hard law" rule, a "soft law" approach might be more effective. This is because, as it stands, such a provision could have the effect of forcing Contracting States to dismantle sophisticated mechanisms which achieve precisely what the rule is attempting to achieve. If such an approach were adopted, Article 19 might simply state a principle which encourages States to permit the holding of securities with an intermediary and the effective exercise of their rights by an investor who holds securities in that manner.

The CGE might wish to ask the Drafting Committee to suggest a title to Article 19 that better reflects its content.

It is clear, from the views expressed by contributors to the Article 19 Group, that the current structure of the draft provision – with paragraph 1 providing for a general rule and paragraph 2 giving a non exclusive list of examples – meets with general approval.

APPENDIX

CHAPTER VI – RELATIONS WITH ISSUERS OF SECURITIES

Article 19
[Position of issuers of securities]

1. - Any rule of law of a Contracting State, and any provision of the terms of issue of securities constituted under the law of a Contracting State, which would prevent the holding of securities with an intermediary or the effective exercise by an account holder of rights in respect of intermediated securities shall be modified to the extent required to make possible the holding of such securities with an intermediary and the effective exercise of such rights.

2. - Without limiting the generality of Paragraph 1, that paragraph applies in particular to any rule or provision:

(a) which restricts the ability of a holder of securities to exercise voting or other rights in different ways in respect of different parts of a holding of securities of the same description;

(b) [which does not include adequate provision for making available to account holders holding intermediated securities, or to intermediaries for transmission to such account holders:

(i) copies of notices, accounts, circulars and other materials addressed by the issuer to holders of such intermediated securities; and

(ii) means of exercising the rights attached to the securities either in person or through a proxy or other representative;]

(c) which prohibits or fails to recognise the holding of securities by a person acting in the capacity of nominee or intermediary;

(d) under which recognition of the holding of securities by an intermediary or the exercise of rights by an account holder holding intermediated securities is conditional on the maintenance of records in a particular medium;

(e) which imposes restrictions on the holding of securities or the exercise of rights attached to securities by reference to the identity, status, residence, nationality, domicile or other characteristics or circumstances of any person acting in the capacity of intermediary.

[3. - Subject to paragraph 1 and paragraph 2, nothing in this Convention makes an issuer of securities bound by, or compels such an issuer to recognise, a right or interest of any person in or in respect of such securities if the issuer is not bound by or compelled to recognise that right or interest under the law under which the securities are constituted and the terms of the securities.]