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UNIDROIT COMMITTEE OF GOVERNMENTAL EXPERTS FOR THE PREPARATION OF A DRAFT CONVENTION ON HARMONISED SUBSTANTIVE RULES REGARDING INTERMEDIATED SECURITIES
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COMMENTS BY GOVERNMENTS AND INTERNATIONAL ORGANISATIONS

(Comments by the European Banking Federation)

I. Introduction

We congratulate UNIDROIT on the improvement achieved with this revised draft of the Convention. We are well aware of the major challenges posed by international legal harmonisation and appreciate the difficulties involved in drafting a text that takes account of the special features of numerous different legal systems.[1] Great credit is due to UNIDROIT for these endeavours.

Nevertheless, it is evident that efforts to compromise have frequently resulted in exceptions being envisaged. This could detract from the Convention's success in bringing about a lasting harmonisation – and thus a simplification – of the cross-border transfer of securities by book-entry. We would therefore call on UNIDROIT to recollect the objectives set out in the August 2003 position paper by the Study Group – namely to contribute to the internal soundness of the legal systems involved while at the same time achieving compatibility between these systems. That position paper set out the principle that *a harmonised rule should be regarded as appropriate if, but only if, it is clearly required to reduce legal or systemic risk or to promote market efficiency*. Yet the more exceptions the Convention permits, the less likelihood there is of reducing legal risk and achieving harmonisation.

It would be worth considering setting out the Convention's objectives in Article 1 or in a preamble in addition to what can be described in the Explanatory Notes, so that they could be used as yardstick by which to measure future drafts.[2]

[1] As a European representative organisation, FBE is indeed aware of the differences existing between national legislations across Europe and acknowledges the different background of its membership which is rooted in both civil law and common law systems.

[2] A more structured order could then be given to the first articles of the Convention:
- Article 1 could be used to state, at the very beginning of the text, the objectives of the convention;
- the scope of application in Article 2 would then explain to what kind of situations the Convention is due to apply (scope of application *rationae materiae* and *rationae loci*);
- finally, the definitions could identify in a subsequent Article 3 the meaning of specific words used in the Convention.

II. Comments on specific provisions

Chapter I

Definition of *securities* (Article 1.a)

Although we share the view that the future UNIDROIT Convention should not thwart the industry's potential of putting forward innovative products on the markets, we believe the definition of *securities* in Article 1.a should be clearer in order to avoid ending up covering holdings that are not usually transferred - or at least evidenced - by book-entry. We thus recommend that the criterion underlying Article 1.a be spelled out as follows: *"securities" means any shares, bonds or other financial instruments or financial assets (other than cash) which are transferable or evidenced by book-entry, or any interest therein*[3].

Definition of *intermediated securities* (Article 1.f)

This definition should be clarified, since it could lead to a confusion among the securities, the rights that are 'attached' to those securities, and the way in which the securities/rights may be transferred ('*…resulting from a credit of securities to a securities account*').

Definition of *disposition* (Article 1.h)

Following our comment to the first draft, we still see a benefit in clarifying what is meant by the word '*disposition'* throughout both the revised draft Convention and the (to be updated) Explanatory Notes. Indeed, in the Notes '*disposition'* is used coupled with '*acquisition'* and in an interchangeable way with '*debit'* and '*credit'*, while the definition under Article 1.h tends to include both the kinds of transaction by referring to "transfer of title". We would suggest to add a definition of 'acquisition' or alternatively to clarify the meaning of Article 1.h.

Definition of "control agreement" and "designating entry" (Article 1.m and 1.n)

The definition of "control agreement" and "designating entry" stipulates that the relevant intermediary is not allowed to comply with **any** instructions given by the account holder without having received the consent of the collateral taker (see (i) in each case). This would also cover instructions regarding the exercise of voting rights, the exercise of right of avoidance of shareholders' resolutions and participation in shareholders' meetings. Article 1.m.(i) and 1.n.(i) should therefore include a qualification as already contained inversely in (ii) for the collateral taker. This qualification could be worded as follows:

> *Article 1 (m) (i)*
>
> *"that the relevant intermediary is not permitted to comply with any instruction given by the account holder, in respect of the intermediated securities to which the agreement applies in such circumstances and as to such matters as may be provided by the account agreement or the domestic non-Convention law, without having received the consent of the collateral taker;"*
>
> *Article 1 (n) (i)*
>
> *"that the relevant intermediary is not permitted to comply with any instruction given by the account holder, in respect of the intermediated securities in relation to which the entry is made in such circumstances and as to such matters as may be provided by the account*

[3] As regards the French version of the revised draft, we recommend to retain the adjective "*négociables*" instead of "*cessibles*", since the former encompasses also the transfer by way of "*traditio*" while the latter does not. Furthermore, if '*or evidenced'* is included in the English version, it should be added to the French one the following wording: "*ou prouvés"*

agreement or the domestic non-Convention law, without having received the consent of the collateral taker;"

Missing definition of clearing or settlement system (to be added to Article 1)

As pointed out below (see our comments on Article 8), a definition of clearing or settlement systems is needed in order to clarify what the derogations to the application of the Convention provided by Article 8 and 13 are meant to apply to[4].

Scope of Application (Article 2)

The revised draft Convention now contains a scope of application (Article 2), which is to be welcomed. However, it would be worth considering expanding the definition of the scope in order to provide a clarification of what is the 'objective' scope of application (or application *rationae materiae*) of the Convention, i.e. to what kind of situations and/or securities the Convention is due to apply.

Article 2 could, for example, state more explicitly that the Convention applies only to securities held with an intermediary and not to (physical) securities held in individual safekeeping on behalf of the investor/shareholder[5].

As regards the reference to the applicable law identified by following the principle of international private law, the statement in Article 2 seems quite obvious and thus not necessary, being the rule applying in any case as a principle of international private law.

Principles for Interpretation (Article 3)

The revised draft Convention now has a new Article 3 bearing a few principles to be referred to when interpreting and applying the Convention, namely:

- to have regard to the Convention's ***purposes***;
- to have regard to the Convention's ***international character***
- to have regard to the need ***to promote uniformity and predictability*** in the Convention's application.

We believe this is an improvement; however, in order to avoid a "circular" reference, it should be spelled out at least in a preamble or introduction or (new) Article 1 of the Convention, what these purposes are. This would also allow verifying that, when ratifying and implementing the Convention, such purposes are not in conflict with domestic legislation of the Contracting States ('non-conventional domestic law').

[4] One option might be removing the reference to clearing, since the latter appears to be out of the scope of the Convention, and introducing a definition of "*securities settlement system*" possibly modelled on the EU Settlement Finality Directive.

[5] For instance, see, in France, the '*titres nominatifs purs*' directly held with the issuer, or in Germany and Austria, the *Streifbandverwahrung*.

Chapter II

Intermediated Securities (Article 4)[6]

This article governs the rights conferred to the holder of the securities account, and the exercise of those rights. While we welcome the fact that Article 4 is now worded more clearly, we would suggest replacing the current version of the title with the following:

"*Conferment and exercise of rights attached to intermediated securities*".

This amendment would allow clarifying that the existence of those rights is independent from the intermediated nature of the holding of the securities they are attached to[7].

Article 4.3 now explicitly states that the rights conferred on the account holder by the credit of securities to a securities account may be enforced not only against the intermediary, but also against the issuer. We welcome this amendment[8].

Limitations on the Account holder's Rights (Article 4.4-6)

According to Article 4.4 the intermediary must take appropriate measures to enable its account holders to *receive and exercise the rights* conferred by crediting securities to a securities account. This obligation is subject to paragraphs 5 and 6, however, two versions of which are proposed. Both versions envisage that the account holder's rights will be limited if it would be unreasonable to require the intermediary to take appropriate measures. Under version A *the scope of those rights is limited to such an extent…*while version B reads: *the account holder is not entitled to any such right to the extent that….*

We prefer version A of paragraphs 5 and 6. This is because this version upholds investors' rights even if, in order to enforce these rights, investors require the assistance of an intermediary, for which the assistance constitutes an unreasonable burden (see Article 4.5, sentence 2 in version A, in contrast to "is not entitled to any such right" in version B). Version A is also more consistent with

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[6] As a matter of mere consistency of the two linguistic versions, what is written in the English version under Article 4.1.d is missed in the French version; the following part should then be added to the latter: *"~~dans la mesure~~ dans les conditions prévues par le droit régissant la constitution des titres, leurs conditions et la convention de compte".*

[7] We also wonder whether an additional definition, currently missing under Article 1, should be added as regards the law under which the relevant securities are constituted; a possible wording for such a definition might be the following: *"Law under which the relevant securities are constituted" designates the provisions of the law regulating the issuer or regulating the issue contract".*

[8] The first intergovernmental conference in Rome in May 2005 made clear that, where the exercise of rights resulting from securities credited to a securities account is concerned, two fundamentally different systems have to be taken into account on an equal basis:

(i) A number of jurisdictions, e.g. USA, Canada, Australia, UK, only give the investor as account holder rights against his immediate intermediary (account provider) in the bilateral custody relationship. Consequently, the intermediary then has to arrange or take the necessary steps so that the account holder can enjoy the "fruits" of his investment: receipt of distributions (interest, dividends) and repayments, exercise of membership rights (right to vote, right to ask questions, right of avoidance). The bilateral structure of the custody relationship means that the investor has no rights of his own that are enforceable directly against the issuer.

(ii) In other jurisdictions, e.g. Germany, France, Italy, Spain, Scandinavia (Nordic countries), the account holder receives all the rights resulting from the securities, which he can enforce directly against the issuer and other third parties; he is the holder of these rights. His intermediary acts only as a service provider on his behalf when he collects interest and dividends or exercises any voting rights.

The new version of the Convention presented by the Drafting Group, particularly Article 4.3 thereof, puts both systems on an equal footing for the first time. For this reason, the fundamental idea it contains should be left untouched to allow implementation of the Convention in as many jurisdictions as possible.

the functional approach pursued by UNIDROIT than version B. In addition, version A fits better into national legal regimes, as it only limits the exercise of rights and thus does not concern the very existence of such rights.

Acquisition and disposition: effectiveness against third parties (Article 5.2)

Article 5.2 refers to the effectiveness of the acquired rights against third parties. It is not clear whether the explicit reference to third parties is intended to exclude effectiveness against the relevant intermediary. There would be no reason for this, in our view. Article 5.2 should deal with the effectiveness of the acquisition in general, and not only with its effectiveness against third parties.

In the Explanatory Notes on the previous draft of November 2004 it is indeed stated on page 26 (regarding prior Article 2.2): *Most jurisdictions give an account holder's right the status of being generally effective against anybody, i.e. the intermediary and third parties. This is also one of the foremost objectives of the preliminary draft convention.* The wording *against third parties* should therefore be deleted, or it should at least be explained what the term is intended to cover.

***No further step is necessary' (*Relationship between Article 5.2 and Article 7)**

Article 5.2 states that, apart from the credit of securities to a securities account (Article 5.1), *no further step is necessary* to render the acquisition effective. This categorical statement fails to take account of the content of Article 7 and is thus incorrect. Under Article 7.1, a credit of securities to a securities account is basically ineffective unless the intermediary is authorised to make the entry. Moreover, according to Article 7.4, an entry may also be made on a conditional basis (see also our comments below on Article 7). We believe a clarification would be necessary on this point.

Transfer by way of security (Article 5)

Article 5 deals with the acquisition and disposition of intermediated securities. Wording previously contained in Article 3(6) – *Securities …. may be disposed of and acquired under this Article by way of security* – has been dropped in the new draft. We assume that it will continue to be possible, under the Convention, to transfer securities by way of security. Nevertheless, we would appreciate a clarification of this point.

Creation of security interests (Article 6)[9]

The new wording of Article 6 in the revised draft Convention now appears to better take into account the interests of both parties of the transaction, the collateral taker and the collateral provider, although the focus seems now on the effectiveness against third parties rather than on the creation itself, of security interests. In that perspective, a more coherent title could head the article, e.g.

"Effectiveness against Third Parties of security interests"

Article 6.4 allows the Contracting States to declare whether a control agreement or a designating entry is sufficient under their legal system and describe which requirements must be satisfied to give effect to the transfer of possession or control. Although this provides more clarity and legal certainty, we would support UNIDROIT in seeking standard conditions for creating a security interest that applied in all jurisdictions, in order to avoid complex procedures involving States' declarations and to ensure harmonisation of these rules.

[9] The sequence of provisions in Articles 5 to 7 is not logical in our view. Article 5 deals with the acquisition and disposition of securities held with an intermediary. Much of Article 7 also contains rules on acquisition and disposition - although it refers to credit and debit. The interposed Article 6, on the other hand, concerns the creation of security interests in intermediated securities. We believe it would be preferable to place the rules on acquisition and disposition in a single article or in two consecutive articles before moving on to the creation of security interests.

Article 6.5 provides that a Contracting State may declare that Article 6 does not apply where certain parties are involved as collateral providers or takers. It might be useful for the Convention to be more specific about the function or nature of the persons for which the Contracting States may envisage exemptions[10].

Authorisation, timing, conditionality and reversal of debits and credits (Article 7)

We welcome the amendment to the title of Article 7, coupled with the deletion of prior Article 6, which has removed ambiguity over the terms 'effectiveness' and 'finality'.

Authorisation by domestic non-Convention law (Article 7.1.b)

According to Article 7.1.b, a condition for effectiveness is that the intermediary is authorised to make the debit or credit entry, either by the account holder (possibly together with the collateral taker) or by domestic non-Convention law (Article 7.1.b). A clarification of what is meant by 'authorisation' by domestic law should be given in the Explanatory Notes, in order to identify the regulatory purpose and scope of application of this option under Article 7.

Conditional debit or credit entry (Article 7.4)

We expressly welcome the possibility introduced by Article 7.4 to make credit or debit entries conditional, since we believe that the possibility for the satisfaction of the condition to have retroactive effect is consistent with the purpose of Article 10. However, there may be a practical necessity for the satisfaction of the condition to take effect *ex nunc*. Moreover, it would be consistent with the principle of freedom of contract and other provisions of domestic non-Convention law, for the parties to be able to determine themselves when satisfaction of the condition should take effect.

Disposition by way of gift (Article 7.6.a-b)[11]

We would appreciate a clarification from UNIDROIT on the underlying reason for which in the draft Convention the protection of the further acquirer is made dependent on the gracious nature of the disposition.

In addition, a clarification of the meaning and aim of Article 7.7 would be useful, since in our view it remains unclear.

Overriding effect of rules of clearing or settlement systems (Article 8)

As mentioned above (see our comments on Article 1), we believe that the derogation provided by Article 8 should be supported by a definition of what is intended by a clearing or settlement system, in order to avoid confusion and legal uncertainty. It would also be advisable to merge Article 8 and 13 as they both provide derogations to the Convention.

It is also necessary to clarify what the overriding rules are, since the current statement in Article 8 appears to be too general when referring to "any" provision of the rules or agreements governing the operation of a clearing or settlement system which is directed to the stability of the system or the finality of dispositions effected through the system. In our view, this would give the clearing (to

[10] On this matter, see Article 1.3 of the Financial Collateral Directive 2002/47/EC, which allows EU Member States to exclude from the scope of application of the directive those collateral agreements where one of the parties is a person mentioned in Article 1.e, i.e. a person other than a natural person, including unincoporated firms and partnerships, provided that the other party is one of those envisaged by Article 1.a-d (a public authority, a central bank or other assimilated international credit institutions, a financial institution subject to prudential supervision or a central counterparty).

[11] For the sake of more clarity, we would suggest replacing, in the French version, the words "*n'est pas valable*" with "*est sans effet*".

the extent this is necessary) and settlement systems the flexibility needed for their secure and efficient operation, while guaranteeing a minimum level of harmonisation and transparency.

Prohibition of upper-tier attachment (Article 9)

As already mentioned in our previous comments, the revised draft Convention should be amended as to distinguish between (i) rights enforceable by account holders for own account and (ii) rights enforceable by account holders for third parties, in order to prevent any attachment of account held for third parties at the omnibus level. The current definition of "relevant intermediary" in Article 1.g does not prevent upper tier attachment since any intermediary, and especially those holding an account on behalf of third parties, qualifies as a relevant intermediary. In this respect, UNIDROIT should ensure that the relevant definitions are made efficient and consistent with this purpose throughout the whole Convention.

On another point, we would recommend to clarify - possibly in the Explanatory Notes if not in the text of the Convention - that Article 9 is not meant to exclude attachment measures against the issuer whenever the latter fails to comply with its duties arising from the intermediated securities (see also Article 4.3).[12]

Priority of interests (Article 10)

Article 10.4 envisages that the priority of interests may be modified by the parties to the agreement. As remarked in our previous comments, we believe that the text of the convention should clarify that this is possible only if the interests of third parties remain unaffected. A statement to this effect is included in the Explanatory Notes[13], but not in the text of the draft Convention itself. We suggest either including it therein or deleting Article 10.4 to avoid incorrect interpretations.

Chapter III

Acquisition in good faith (Article 11)

On the matter of the expression used we would like to refer to our previous comments on the notion of *bona fide* acquirer without notice and would recommend that the words "by an innocent person" were replaced by "*in good faith*", in order to avoid misinterpretation when translating the text of the Convention in other languages.

We are in favour of deleting the text in brackets in Article 11.2 since the collateral taker is not less deserving protection because of the reason for creating the security interest.

We understand the final clause of 11.3 to mean that acquisition in good faith is excluded if information about the adverse claim is received by an organisation but not duly passed on to the appropriate person within that organisation. If this interpretation is correct, it should be clearly expressed either in the Convention itself or at least in the Explanatory Notes.

[12] It should be noted on this point that legislation of Contracting States could already provide more stringent rules: in Italy, for instance, Article 85 of the Consolidated Law of Finance provides for the joint and several liability of both the company running the central depository and the relevant intermediary, in case of damages caused by fraudulent or negligent behaviour involving securities held with the central depository. This regime is of course without prejudice of the right to internal recourse by the central depository against the intermediary. Accordingly, an obligation to take out proper insurance against legal actions seeking compensation for damages has been put on the central depository by the Italian financial markets supervisor (see CONSOB Regulation 11768/1998, Article 32).

[13] See p. 30 of the Explanatory Notes to the draft of November 2004.

Chapter IV

Effects of insolvency (new Article 14)

The newly inserted provision excludes any effect of the Convention on the national insolvency rules, subject to Articles 13 (effectiveness of debits, credits and instructions on insolvency of operator or participant in securities clearing or settlement system) and 24 (top up and substitution of collateral).

We believe this is an improvement since national rules on insolvency have a wide scope of application and, in the absence of a specific exclusion of the above mentioned articles, they might endanger the legal certainty of security interests and contractual agreements.

Chapter V

Instructions (Article 15)

We welcome the amendment to Article 15.2.e, which now brings more consistency with Article 8.

However, we draw the attention to the fact that the need for a definition of what is intended by a clearing or settlement system is evident here too, in particular because Article 15.2.e refers to the case where an intermediary is the operator of a clearing or settlement system.

Duties of the intermediary with respect of holding or credit of securities (Article 16)

Article 16.1 should, in our view, be retained since it aims at avoiding securities' inflation.

We welcome the deletion of prior paragraphs 4 and 5, although a new paragraph 4 has now been inserted to specify that the obligation for the intermediary to remedy to a situation of lack of securities does not deprive it of the right to allocate the cost of such an intervention following either the domestic non-Convention law, the clearing or settlement system rules or the account agreement in place.

In our view the principle underlying the rule is valuable but should be possibly left to contractual agreements between the intermediary and the account holder.

Allocation of securities to account holders' rights (Article 17.1)

Article 17 of the revised draft Convention now displays a duty for the intermediary to clearly allocate securities to the right of the account holder, to the extent necessary to cover the credit entries made by the relevant intermediary for that account holder.

This is a fundamental provision which protects the account holder (in particular, the investor) from the risk of insolvency of its relevant intermediary, so that it should remain possible to distinguish the property of the account holder from the property of the intermediary, especially where the latter goes financially distressed or bankrupt.

In addition, a rule should be inserted in order to ensure that the intermediary is obliged to allocate its own securities to the right of the account holder only if a shortfall in securities held for the account holder is due to an unlawful disposition made by the intermediary.

Allocation of liability in the event of a shortfall (Article 18)

This article deals with arrangements in the event of a shortfall. In the first place, we would suggest including a definition of shortfall in Article 1 for the sake of clarity.

Article 18.1.b establishes the principle that a shortfall is to be allocated among all the intermediary's account holders on a pro rata basis. in the case where the intermediary happens to be the operator of a clearing or settlement system and the rules of that system impose both (i) the elimination of that shortfall, and (ii) that determined manner (pro-rata allocation) to do it.

Article 16.2 requires the intermediary to take immediate action in the event of a shortfall to ensure that its holdings of the securities in question are replenished

Whenever a shortfall persisted despite the fulfilment of the obligation under Article 16.2 by the intermediary, we believe that a distinction should be drawn as follows.

As a matter of fact, it may not always be possible in practice to pinpoint which of the numerous credits taking place every day has been made without sufficient securities being available. In such situations or if a loss to the collective holdings occurs as a result of *force majeure*, (civil disorder, war or natural disaster, etc) the intermediary is not responsible for the shortfall but it may require the clients concerned to cover their debit positions by acquiring securities on the market or by acquiring itself such missing securities at the expenses of the relevant clients. If the shortfall were not covered, the intermediary should not cover itself the loss, which should be allocated between its clients following the provisions of the account agreement and/or the domestic non-Convention law. We support the draft Convention on this.

On the other hand, in our view, losses caused by an intermediary due to careless or unlawful action on its part must be borne by that intermediary only: the Convention should not allow circumventing allocation of liability for wilful or grossly negligent breach of duty by the intermediary at any event.

Furthermore, the principle of pro rata allocation of liability envisaged in Article 18.1.b appears debatable in situations where the shortfall is due to a single investor receiving an uncovered credit to his securities account. In this case we feel it would be fair to make that investor bear the consequences of insufficient cover alone, provided that investor is identifiable and unless the conditions for acquisition in good faith are satisfied.

Chapter VI

Position of issuers of securities (Article 19)

Article 19 aims at eliminating any national rules and any provisions in the terms of issue of securities which would preclude collective safekeeping. We see no problem as far as national rules and regulations on custody are concerned.

By contrast, we believe that Article 19 should not restrict the number of different forms of issue available to issuers and investors.

Restriction on exercising rights with respect to different parts of a holding of securities (Article 19.2)

Article 19.1 requires modifications of all statutory rules and terms of issue that would prevent the indirect safekeeping of securities or the exercise, by account holders, of the rights associated with intermediated securities. According to Article 19.2.a, this includes, in particular, rules restricting the ability of the *securities account holder* to exercise voting or other rights in different ways with respect to different parts of a holding of securities. We understand Article 19.2.a meaning that it should be possible for an account holder to exercise rights in respect of one part of a holding of securities in a manner different from the one in which it exercises rights in respect to another part of the same holding; that is, for example, to vote “yes” for 70 and “no” for 30 of the 100 securities held by it.

Should the intention of Article 19.2.a be to deal with cases where a nominee, instead of the ultimate investor, is entered in the issuer’s stock register and ensure that this nominee can exercise the voting rights of different ultimate investors in different ways, this should be made clear, possibly in the Explanatory Notes.

Exercise of rights conditional on maintenance of records in a particular medium (Article 19.2.d)

The expression '*records in a particular medium'* is unclear. We understand it to mean that an entry in a register may be required, but not the maintenance of such a register in a particular form. If an entry in a register can actually be made a requirement for the exercise of shareholders' rights, then stipulating the form of register as well would not appear to be any further obstacle to the exercise of rights by the intermediary.

Article 19.2.e

This subparagraph requires the elimination, in particular, of any national rules and regulations restricting the holding of securities by reference to the status or other characteristics or circumstances of the relevant intermediary.

We believe however that some restrictions may be justified, on an exceptional basis, by public policy reasons in certain sensitive areas (such as Defense, energy, telecoms, etc.).

The Explanatory Notes of the first draft [14] refer to a possible domino effect on associated intermediaries if one of them is not in a position to meet its obligations. Where intermediaries are located in States which would not subscribe to the UNIDROIT convention, their applicable law would also likely to be relevant when assessing the stability of the system – with respect to both internal soundness and compatibility. Against this background, Article 19.2.e should be deleted in its entirety.

Set-off (Article 20)

It would be more logical, in our view, to include Article 20 on set-off in the event of insolvency in Chapter IV (Insolvency).

Chapter VII

Interpretation of terms in Chapter VII (Article 21)

For the sake of clarity of the text, we believe the content of this article might be moved in the part of the Convention containing the definitions.

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[14] See page 11 of the Explanatory Notes.