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Working paper regarding so called "Transparent Systems"

Prepared by the Secretariat on the basis of contributions submitted by Delegations to the CGE

Introduction

At the occasion of the second session of the UNIDROIT Committee of Governmental Experts (CGE) on Intermediated Securities, in the context of the rule prohibiting upper-tier attachment, the question of whether this rule applied to so-called "transparent systems" led to a broader discussion on the special situation of such systems *vis-à-vis* the preliminary draft Convention.

Given the fact that the relation between account holder and the relevant intermediary is one of the linchpins of the draft text, a clarification with respect to transparent holding patterns is most important to the future instrument. This is not only true with respect to the overarching concepts of the draft but also more specifically regarding the prohibition of upper-tier attachment (Article 15 of the preliminary draft Convention). In many transparent systems, the creditor of an account holder-debtor can attach the account holder's securities immediately at the level of the CSD. The purpose of Article 15 is to avoid exactly this scenario and it is generally recognised that this rule is fundamental to the objectives of the Convention, in particular with a view to reduce systemic risk.

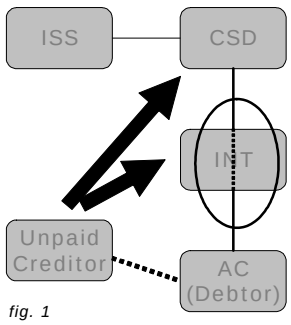


fig. 1

If the "middle entity" in a transparent pattern and the account maintained thereby are interpreted to be the relevant intermediary and the relevant securities account respectively [Article 1(b) and (c)], an attachment against the account maintained by the CSD would not be admitted if the principle of prohibition of upper-tier attachment was to be maintained. However, considering the fact that the identity of investors and the details of their holdings are known at the level of the CSD, one could say that in this case an attachment against the account maintained by the CSD would not cause serious systemic problems compared with an upper-tier attachment under the non-transparent pattern where the CSD maintains an omnibus account and the attachment thereto would lead to difficulties. Based on this understanding, it should be considered whether and by which means an attachment at the level of the CSD should be made possible in transparent systems. If, for example, the view is taken that

the CSD is interpreted to be the relevant intermediary, then an attachment against the CSD would not be an "upper-tier" attachment.

During the second session of the CGE, no clear answers to the above issues were formulated. After the session, the Unidroit Secretariat prepared a first draft of the present paper and invited delegations to contribute to its finalisation, in particular by describing relevant holding systems, clarifying the issues mentioned above and suggesting solutions. Delegates from 11 Member States commented on the paper. Their comments were subsequently included in the text. However, in the present paper, text paragraphs are only attributed to specific countries were this appears necessary or useful.

This paper shall, in a first step, shed some light on what is meant when referring to transparent systems, by presenting some features that are central to the discussion and by describing some national systems that are entirely or partly transparent. The second step will examine which categories of transparent systems need to be specifically addressed in the future instrument. The last, third, step, will examine how the solution can be technically included in the text of the preliminary draft convention.

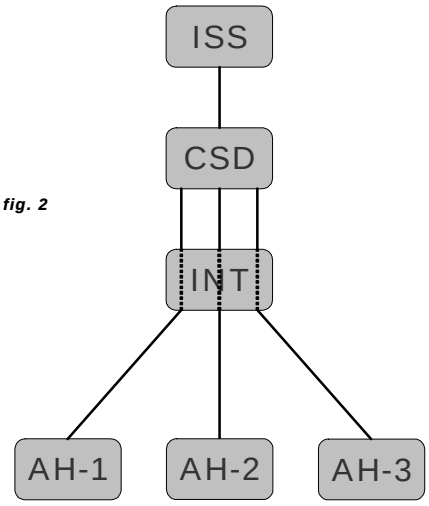
1. Presentation of transparent systems

a. Main features

i. Transparent system or transparent holding pattern?

Transparent systems can be roughly described, in functional terms, as "s*ystems, where there are two or more entities involved in the holding chain (between the issuer and the investor) and where at the top level holdings of all lower tier account holder's interest in intermediate securities are evidenced, in particular by means of maintaining accounts/ sub-accounts for each of those lower tier account holders"* (cf. *fig. 2*).

fig. 2



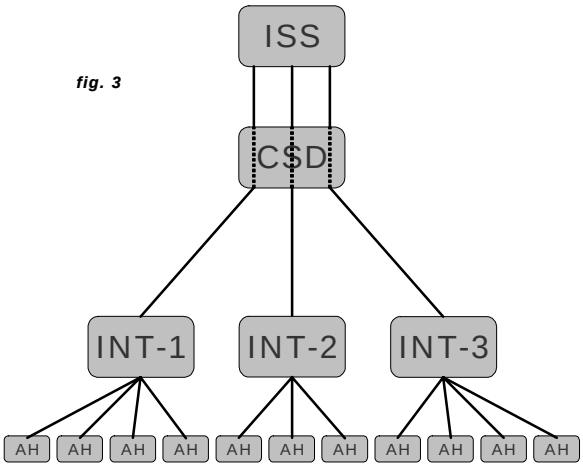
However, there are holding systems that appear to be "mixed systems", i.e. part of the holding chain is transparent while another part is not.

In *fig. 3,* at the upper lever, the system is transparent. This is for example the case where the function of the CSD is mainly keeping the register for the issuer. In this scenario, the participants in the CSD (*here* INT-1, INT-2 and INT-3), hold immediately with the issuer.

Below the level of the participants in the CSD, the holding is organised in omnibus accounts, i.e. the system is non-transparent

Against the background of the existence of mixed systems, it seems to be more appropriate to use the term "transparent holding *pattern*" with respect to a holding structure involving 3 entities (the entity in the "middle" being transparent) instead of using the term "transparent systems" as a global description of the method of holding of securities provided for by law and regulatory means in certain countries. In *fig. 2* the holding pattern ISS/CSD/INT is transparent whereas the pattern CSD/INT/AH is non-transparent. For the entirety of such system the term transparent would not fit. An entire system can be called transparent only if *all* of its tiers are transparent.

fig. 3



As a result, it is understood that mixed systems, as depicted in fig. 2, typically involve one or two transparent patterns (regularly the top-tier) and one or more non-transparent patterns (from the second or third-highest tier down to the investor). This is for example the case for the Brazilian holding system for government bonds and in South Africa, where, in the case of a "Nominee Name" client at the 2nd tier, the system is regarded as non-transparent from the 3rd-highest tier down to the investor.

It is equally understood that in some jurisdictions the system through which securities can be held consists exclusively of transparent holding patterns (e.g., the Brazilian holding pattern for stocks and derivatives) or just one single transparent holding pattern (e.g. the Finnish holding pattern for domestic holders of domestic securities). Both systems are fully transparent.

Furthermore, there are systems which have both a transparent and a non-transparent "branch", as opposed to transparent or non-transparent "layer". E.g., purely domestic holdings are organised in transparent patterns, whereas holdings of foreign investors include omnibus accounts and are therefore non-transparent. In Finland, for example, domestic holdings are transparent but foreign holdings can be transparent or non-transparent. In Sweden, the domestic as well as the foreign investor may choose whether to hold securities directly with the CSD (transparent system) or with a custodian (non-transparent system).

ii. Transparent systems and direct relationship investor-issuer

An additional issue might be whether there is a meaning of the terms "transparent"/"transparency" that goes beyond identification of the ultimate investor: does the term describe the relationship between the issuer and the investor in the sense that there is a direct relationship between them?

Here, the answer should be negative. The issue of transparency, as defined above (systems where at the top level holdings of all lower tier account holder's interest are evidenced), is independent from the issue of direct relationship between the issuer and the investor and there is no causal link between both issues. Indeed, one may find a jurisdiction where there is a direct relationship (i.e. the investor has direct rights against the issuer) but the system is not transparent. This is the case in the French and the German systems for example. Therefore, the terms "transparent"/"transparency", given the definition proposed, should not be understood as addressing the issue of direct relationship between the investor and the issuer.

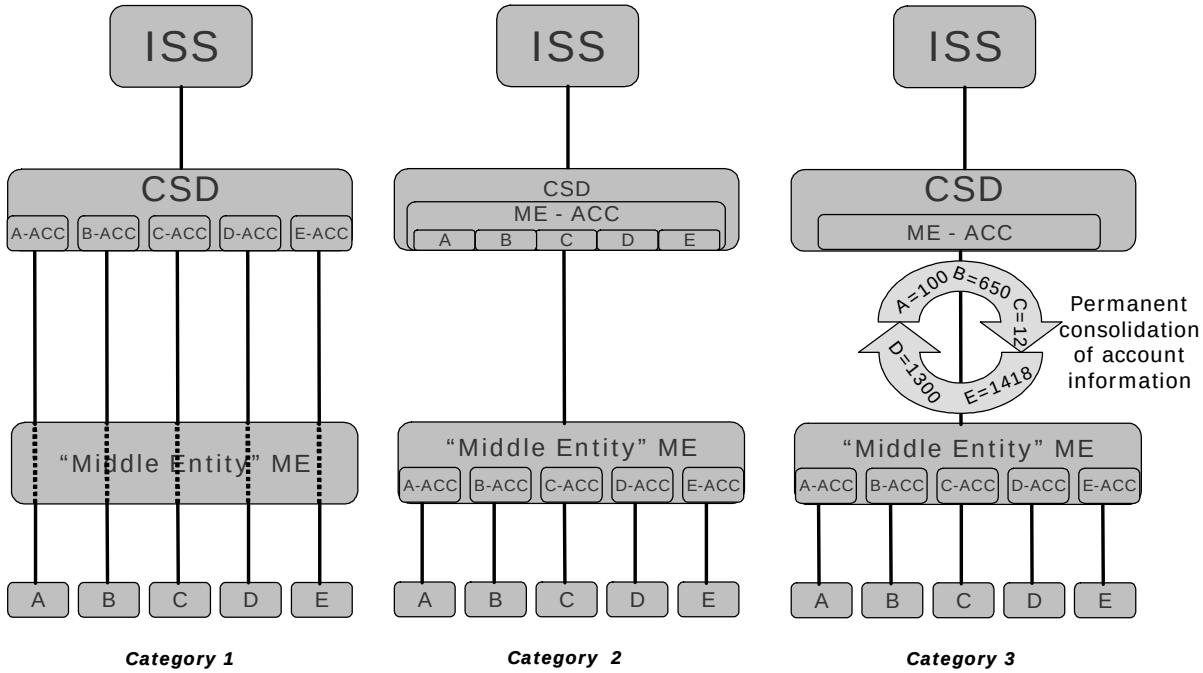
iii. Means of individualisation: 3 categories

There seem to be three basic methods of identifying the holdings of a lower tier account holder at the upper level (*cf. fig. 4*).

In systems belonging to the first category, the upper level (the CSD) maintains accounts in the name of the bottom account holder. In this case, the "entity in the middle" merely operates the accounts, i.e. it has the role of a technical interface.

Systems of the second category work in a slightly different way, as the upper level (the CSD), maintains accounts in the name of the "middle entity" but these accounts are divided in sub-accounts for each account holder (client) of the "middle entity" which reflect each clients holdings.

In systems belonging to the third category, there is an omnibus account at the level of the CSD in the name of the "middle entity". The "middle entity" maintains separate accounts for its account holders (clients). However, account information is permanently or regularly consolidated between both levels in a specific register structure. This enables the CSD at all times to determine exactly what the client of the middle entity has in its account.



Category 1 ***Category 2*** ***Category 3***

fig.4

iv. Mirror register for purposes of the exercise of corporate rights

An additional issue flows from the fact that in some systems, for purposes of the administration of corporate rights of the investors (attending shareholders' meetings, distribution of dividends), the holdings by the ultimate account holders are "mirrored" in a separate register which is kept by the issuer or an organisation mandated to do so by the issuer. Regularly, the relevant changes in holdings are reported to such mirror register by the intermediaries. The question is now whether the existence of such mirror register, where investors can be identified, alone would make a holding system "transparent". The answer to this question might depend on the specific arrangements but the preliminary conclusion should be that such mirror registers do not have influence on the issue of transparency of a system because ownership, holding and transfer are organised through the chain of intermediaries and the issuers mirror register only *reflects* the status of holdings within the system of intermediaries. The mirror register reflects, in some cases with a delay of some days, who is deemed to be entitled to exercise and receive corporate rights. For example, in France there are so called "administered registered securities" ("titres nominatifs administrés", cf. presentation at the Bern Seminar, reproduced in Doc. Sem.1, Annexe 4) which are securities credited to a securities account opened on the books of the intermediary and identified additionally at the level of the issuer. Thus, from an *issuer* perspective, the levels of the CSD and of the intermediaries are transparent. However, this holding pattern is not regarded as being an issue of transparency. Indeed, only the intermediary holding such administered registered securities should be treated as "maintaining" a securities account for the investor.

Similarly, it should be considered irrelevant in the context of transparency of a system that the issuer, a supervisory, tax or any other authority can request data regarding the ultimate account holders. E.g., in South Africa, omnibus accounts are held at the 3rd tier and further down; here, disclosure may be requested by issuers in terms of the law (thought, in practice, the nominee would only be able to disclose the beneficial holder with whom it has a direct relationship as a result of a mandate or contract). Another example is Argentina, where foreign investors hold securities through nominees and the National Securities Commission can request identification of the ultimate investors in connection with their participation in shareholders meetings.

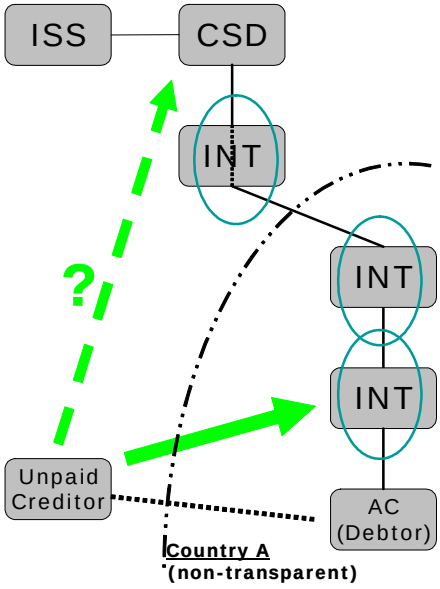


fig. 5

v. Transparent patterns in a purely domestic context and cross-border situations

Another important issue is how systems that are in a purely domestic context transparent holding systems interconnect with parts of the holding chain that are located within a different jurisdiction and that are non-transparent. In this case the full advantages of a closed transparent system cannot be realised. This is particularly the case where, for instance, local investors hold in their local account foreign securities that are held through non-transparent holding patterns ultimately with a foreign CSD, or, foreign investors hold securities deposited in the local CSD through a non-transparent holding pattern. A third scenario is depicted in *fig. 5*.

b. Examples

i. Finland

Fig. 6a depicts the Finnish holding system with respect to investor specific accounts maintained by the CSD. Such a holding model is available both to domestic and foreign investors. Investor specific accounts are kept in the investors' name at the level of the CSD, as opposed to fungible pools. The shareholder is automatically registered in the issuer's register for company law purposes.

Entries with proprietary impacts are effected through the accounts with the CSD on the basis of specific legislation. Entries are made by licensed account operators (a bank or a broker) which operate such accounts in a purely administrative capacity. Nevertheless, the account operators act as the service interface and the contractual partner towards the account holders. The account operators may keep additional records on investors' holdings but this is for economical/business purposes only.

It is also possible for the investor not to use the services of a bank or a broker, in which case the CSD operates the investor specific account.

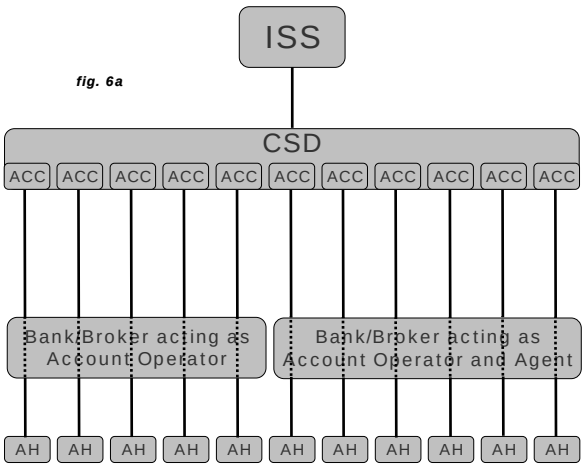
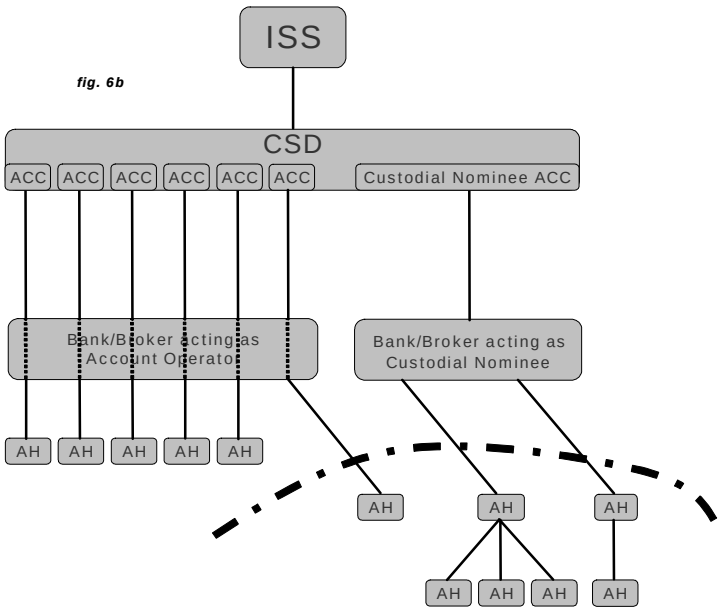


fig. 6a

As regards foreign holdings (*fig. 6b*), the system allows also for separate custodial nominee accounts (omnibus accounts) for intermediaries (banks/ brokers) who keep book entry securities owned by one or more foreign investors. Such accounts contain information only on the intermediary instead of the beneficial owner. The division of rights among the beneficial owners is derived from the sub-accounting system of the intermediary. This means that a pledge, for example, is not registered in the omnibus account but in the sub-account with the intermediary (custodial account operator).

fig. 6b



Consequently, it is very important to note that a bank or a broker has a significantly different role depending on the type of account with the CSD. If it is an investor specific account, that account is with the CSD which is the relevant intermediary for the account and the bank or a broker is only operating the account and is not an intermediary for the purposes of the draft Convention. However, with respect to an omnibus account with the CSD, a bank or a broker maintains sub-accounts for its account holders and is, thus, in this relationship acting in the capacity of intermediary/relevant intermediary towards the account holders.

ii. Spain

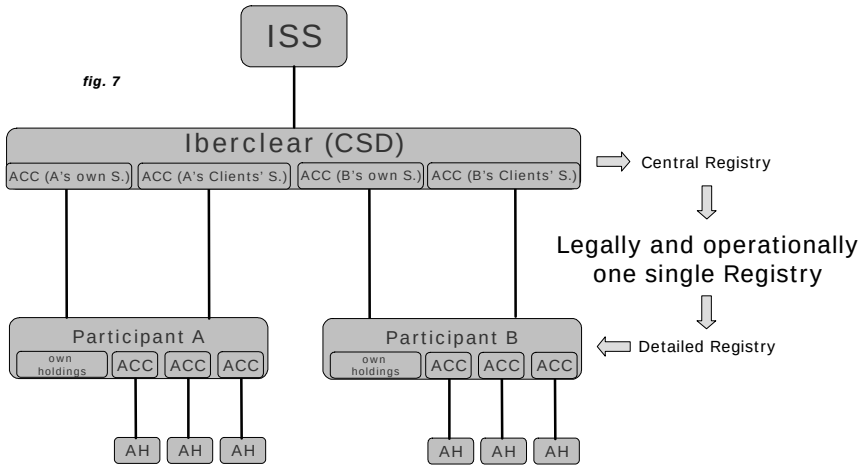
The Spanish system is based on the idea of a single registry where entries take place (=central record-keeping based on accounting entries). The organisation of intermediaries involved in the maintenance of such a book-entry registry depends on whether the securities are listed in a Regulated Market or not.

For *non listed securities* the book-entry registry will be maintained by a sole financial entity that shall register, at all times, the amount of securities owned by each holder, i.e. registering the securities directly in the name of each holder. This requires for each holder to open a securities account in such an entity.

For *securities listed* in Spanish Regulated Markets, i.e. the Public Debt Market, Stock Exchanges and AIAF Fixed Rate Market, the book-entry registry is structured in a two-tier system. In such a system the registry is entrusted *jointly* to *Iberclear*, i.e. the CSD, and to its participant financial entities (the “participants”).

This book-entry registry system is structured in two levels: First, a central registry, managed by Iberclear, containing the aggregate balances of securities issued in two types of accounts opened by Iberclear for each participant: (i) An account in which the securities owned by each participant are held; and (ii) another account, different and entirely segregated from the latter, that reflects the total amount of securities held by each participant on behalf of its clients. The account for client securities, though it reflects the total sum of all of clients´ securities, cannot be considered an omnibus account under the Spanish legal system, which only foresees omnibus accounts "outside Spain", in case they are indispensable for conducting activities in foreign markets (cf. Article 2 of the Order of 7 October 1999)

fig. 7



Second, there are so called detailed registries which are managed by the participants. Each detailed registry reflects the accounts opened by investors (=client of the participant), and the details of the securities that are booked to these accounts.

The system guarantees the connexion between those two levels by a code: a so-called register references ("RR") is attributed by Iberclear to each trade. This allows the system to keep a historical register of all operations and account entries. All operations are numbered, and Iberclear communicates this number to the participants. The RR allows perfect synchronisation of the central registry and the detailed registries. On this basis, the entire mechanism of central and detailed registers is by law regarded as one register (cf. Royal Decree 119/1996, "…a system of two tiers which is not contrary to the idea of a single electronic registry even though it is articulated through a central registry and detailed registries…").

iii. South Africa

The current system for shares is a mixed system, although in practical terms it has more non-transparent holding patterns than transparent patterns. A "subregister system" is in place for uncertificated shares where the CSD's participants (and not the CSD) maintain the accounts and sub-accounts of the clients. The electronic subregisters maintained by the CSD's participants together with the register for paper certificates held by the issuer or its agent, form the total share register for an issuer. The CSD's participants make the transfer entries in the subregisters by law, once settlement has taken place in the CSD. The CSD's participants must have Central Securities Accounts in the CSD and must reconcile the balances daily with the CSD. The CSD acts as a bookkeeper and collates the shareholding information from the various participants (and brokers via the exchange). The CSD "packages" the record information of the names on the subregisters (passed on by the participants) and the available beneficial ownership information (passed on by the exchange) in a "Beneficial Download" product and provide it monthly free of charge to the respective issuers or their agents (transfer secretaries, registrars) in terms of the CSD Rules (subordinate legislation). The "Beneficial Download" product is also available to issuers on an ad hoc basis for a fee.

The account holders have a choice in terms of the CSD rules to hold their securities with the participants in "Nominee Name" or "Own Name" on the subregisters. In the case where a "Nominee Name" is indicated on a participant's subregister (2nd tier), a sub-subregister (3rd tier) must be held with the name of the beneficial owner and certain disclosure requirements are applicable by law [see *infra*]. The CSD could therefore "drill down" one level lower than the participant subregister level to get beneficial ownership information. However, where a nominee is recorded in the sub-subregister (3rd tier), the beneficial owner will usually be recorded in an omnibus account in a sub-sub-subregister (4rd or 5th tier), etc.

The category of "Own Name" client's is strictly defined in the CSD rules and should always be the end investor. Only one South African CSD participant regularly offers this holding pattern to its clients. The identity of the "Own Name" investor is recorded at participant level on the subregister (the legal record; 2nd tier) and "transparent" to both the CSD (top/1st tier) and the issuer. The transparency is not real time or available on a daily basis. This is so because the information is not centralised in the CSD, but fragmented over the various CSD participants. Unless the issuer requests such information on an *ad hoc* basis from the CSD, the CSD will only get the information monthly from the various CSD participants to collate and pass on to the issuers.

In terms of current South African legislation, entries at CSD participant level are recognised as evidence of shareholding. The "Own Name" client recorded in the participant subregister is deemed by law to be a shareholder in the issuer and to have a direct relationship with the issuer.

There are duties to disclose account holder information on various levels of the holding system but as these duties do not have influence on the proprietary situation, the South African system does not comply with the concept of a transparent system.

iv. Czech Republic

In the Czech holding system, the number of owner accounts in the CSD is about 2,5 million. The system operated by the Prague Securities Center (SCP, which will be transferred after legislative changes to a newly formed CSD) is a one-tier system, where all security owners have their owner accounts in the SCP register and have a direct access to their accounts through the SCP offices. The said offices provide all basic services to securities owners. This means that SCP registration is necessary for a change in ownership. This registration is of a so-called constitutive character, i.e. the rights arise only by virtue of registration in the SCP.

The holding scheme of dematerialized securities, once the newly created Central Securities Depositary (CSD) obtains its licence, shall be organised in a manner which resembles partly the Finnish system described above, with the main exception, that omnibus accounts shall be available also for securities owned by domestic, not only foreign investors. The system shall be transparent combining one-tier and two-tier holding models. Both models are available to domestic as well as foreign investors.

Within the framework of the one-tier transparent model, the book entry securities shall be registered in ultimate investor specific accounts kept in the investors name (so called "owner account") at the level of the CSD. The two-tier transparent model consists of custodial nominee accounts/omnibus accounts (so called "customer/client account") at the level of the CSD and owner accounts kept at the level of intermediaries (either or not participants of the CSD).

According to the commercial code, the issuer has a direct relationship with the ultimate investor. To this end, the CSD shall provide the issuer with an extract cointaining details of the account holders for which the securities are registered, the quantity of the securities etc. In case securities are held with an intermediary in an omnibus account, the Commercial Code provides for an obligation of the intermediary to provide the CSD through its participant with details of the person authorised to exercise the rights attached to the security.

As regards the one-tier model, the owner accounts at the level of the CSD can be owned either by participants of the CSD (banks, brokers etc.), who have direct access to their accounts, or by other ultimate investors, who cannot make entries to their accounts directly, but through a participant, who administers their account. Concerning this model the relevant intermediary is, with respect to a securities account, the CSD, while participants are just account operators on a purely administrative basis.

On the other hand, in the two-tier model, the relevant intermediary shall maintain owner accounts, while at the level of the CSD there is only an omnibus account. Should the relevant intermediary be not the participant of the CSD, it shall operate its omnibus account through a CSD participant. There shall be no other omnibus accounts under an omnibus account.

The problem of determining the relevant intermediary arises from section 94(3) of the Capital Market Undertakings Act, which allows further levels of the holding chain providing that "the owner of investment instruments registered in an owner account shall be the individual/entity for whom the owner account has been established unless it is proved otherwise". The owner account, which is legally the lowest tier, can operationally act as an omnibus account for a foreign entity. This entity may be registered as the owner of the securities held on this account while keeping its own record for its customers. The beneficial owner thus remains from one point of view unknown, having the opportunity to prove his ownership. From the other point of view, regarding the provisions concerning register of issues as mentioned above, all parts of the holding chain are obliged to provide the central depository, on request of the issuer, with information of the ultimate owner.

This sets up the question which tier is in fact the relevant intermediary and upon which tier the upper-tier attachment is banned. From a legal point of view, it is the tier on which owner accounts are kept, because Czech law acknowledges only 2 levels of the holding chain. Operationally, when proved that the beneficial owner is another entity than the holder of the owner account, the relevant intermediary may be far away.

v. China

In China, China Securities Depository and Clearing Corporation Limited (SD&C) is the sole institution providing centralized registration, depository, clearing and settlement services for securities trading in Stock Exchanges. Investors should open specific securities accounts through SD&C or its legal agency to record securities listed in Stock Exchanges. Furthermore, in order to buy/sell the securities listed in Stock Exchanges, an investor must place his securities in the custody of a broker/custodian (usually it is a securities firm or commercial bank).

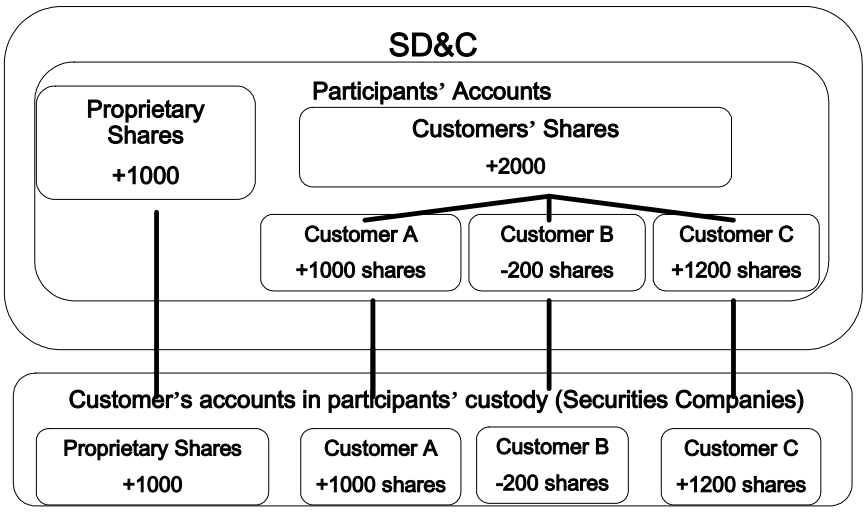


fig. 8 *© SD&C*

SD&C is responsible for directly maintaining all investors' securities accounts and providing register of securities holders for securities

issuers on the basis of securities account records. It should be emphasized that investors retain their shareholders' status and own all the shareholders' rights, such as attending the general shareholder meeting by themselves and receiving dividends and other distributions from issuers. There are also omnibus accounts maintained by the SD&C, but they are only applicable for holdings of some foreign investors. For example, foreign investors might hold B-shares via a nominee account in the name of a custodian.

In its capacity of the central depository, clearing and settlement institution, SD&C is entrusted to make entries to the investor specific accounts according to the result of settlement of securities transaction. The entries made by SD&C have proprietary impacts in accordance with specific legal provisions.

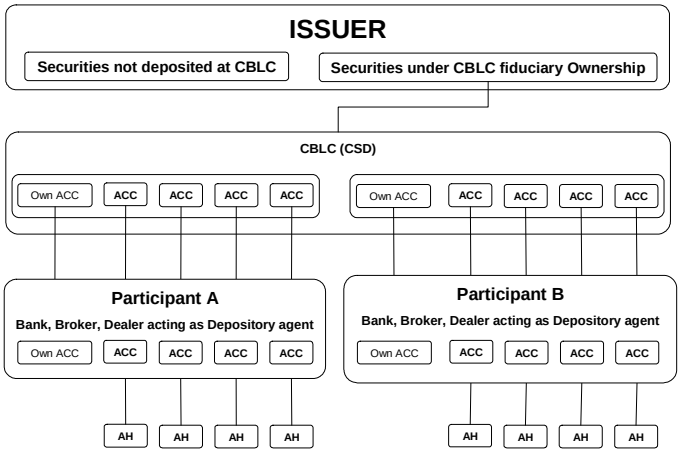
The clearance and settlement are performed at two different levels in China. The first level is between the SD&C and its clearing participants and the second one between the SD&C clearing participants (broker/custodian) and their clients (investors). On this basis, China's securities holding system can be categorized mainly as a direct (one-tier) holding model while making the indirect holding model subsidiary.

vi. Brazil

1 - Stock Holding System

Fig. 9 describes the Brazilian stock holding system. Such a holding model is available for both domestic and foreign investors. The book-entry securities are registered in three different levels. The first level is the issuer's book, maintained in an institution acting as a registrar, where the securities not deposited at the CSD must be registered under the ultimate investor's name.

fig. 9

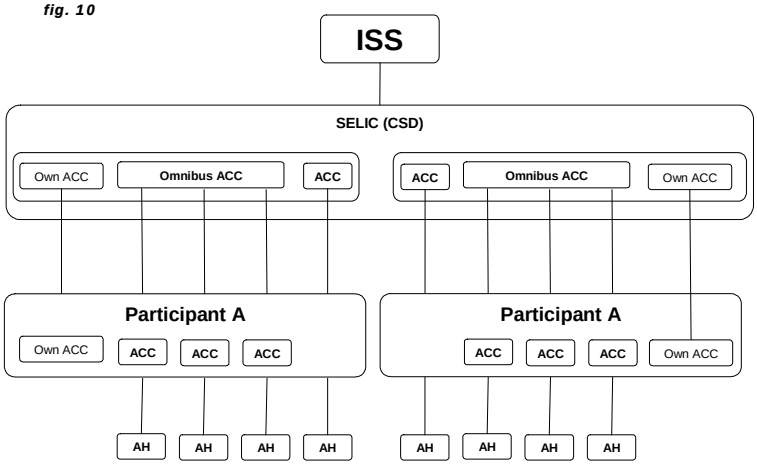


The securities deposited at the CSD (CBLC) - the second level - appear under the CBLC fiduciary ownership just for safekeeping purposes. The CBLC registers are complementary to the issuer's book so that the transfers and pledges carried out at CBLC complement those made in the issuer's system. At CBLC the securities (even the participants' own accounts) are registered in individual sub-accounts under the responsibility of a participant. Corporate Law and Securities Commission Rules provide the legal basis for this account structure and require the CSD to directly inform the investors on their holdings, although the CSD does not have a direct operational or contractual relationship with them.

Only participants can instruct debit or credit entries or can instruct non-mandatory corporate actions on behalf of their clients. These participants are the ones that maintain the securities accounts for the account holders under a direct relationship. The participants environment is the third level which reflects the accounts maintained at the CSD. The number of accounts and holdings in each account is the same in both CBLC and participants' systems. In the entire holding chain, although there are many tiers, the ultimate investor is always identified, leading to the conclusion that the Brazilian stock holding system is a "transparent multi-tier system".

2 - Government Securities Holding System

fig. 10



For government securities (*cf. fig. 10)*, SELIC is the CSD that can be considered a mixed system. The securities are held through three different types of accounts: (1) account for securities owned by the participant (proprietary account); (2) segregated account with the total amount of client's securities, which is considered by the Brazilian legislation as an omnibus account; and, (3) Individual accounts for securities held by special investors such as insurance companies and investment funds.

3 - Derivatives Market Holding System

The Brazilian holding pattern for futures and options contracts (*cf. fig. 11*) is a multi-tier transparent system where accounts on behalf of the ultimate investors are fully identified and replicated in every layer of the structure, including the participants' level. The book-entry registration system is centralized at the Derivatives Clearing House of the Brazilian Mercantile and Futures Exchange (BM&F), the main organized trading system for derivatives in the country. It is also the central counterparty for every trade, hence it maintains accounts for its participants (the commodities brokerage houses) that reflects accounts opened by the final investors (clients of the participants) and proprietary accounts of the commodities brokerage houses, as shown in Fig. Brazil-3.

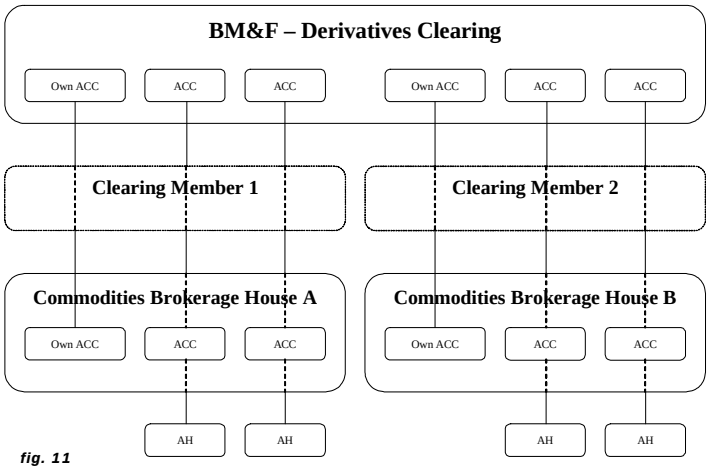


fig. 11

Currently, in Brazil there are no foreign securities held in local accounts. Notwithstanding, if foreign securities were held in local accounts, the requirements for ultimate investors identification would still apply.

vii. Argentina

In Argentina, the CSD maintains accounts and sub-accounts that identify account holders. Brokers, banks and other eligible participants are the account operators for their customers, and move their sub-accounts with the CSD following the instructions given by them. The interest of each account holder is defined as a co-proprietary right in a pool of securities of the same type held by the CSD. The account holder's title is conferred by the book entry in his sub-account with the CSD.

In the event of insolvency of the account operators or of the CSD, each account holder has a right of revindication of his notional portion of the pool of securities. An account operator can also act as an account holder, by opening an account in its name with the CSD, in which case it acquires co-proprietary rights.

Some doubt was expressed that, in the Argentinean system, account operators seemed not to be included within the category of "relevant intermediary" as defined in Article 1(g), since they did not *maintain* a securities account but the CSD did, who could also be directly asked, by the ultimate account holders, to make credits or debits to their sub-accounts.

viii. Sweden

In the Swedish system it is possible for the investor to choose whether to hold the securities directly with the CSD ("transparent system") or with a custodian ("non-transparent system" or more correctly, a mixed system similar to the one in fig. 3 *supra*). The transparent system is similar to the Finnish holding system for domestic account holders (see *supra*), i.e. the account holder has an individual account at the level of the CSD and entries in the account are made by an account operator. As in Finland, a shareholder is automatically registered in the issuers shareholders register for company law purposes.

The non-transparent (or mixed) system works like the one illustrated in fig. 3 *supra*, i.e. the intermediaries hold accounts in the CSD. For shares, the intermediary is registered in the shareholders' register, but it is clear from such an entry that the intermediary holds the shares on behalf of someone else. The fact that the intermediary is registered in the shareholders register does not entitle him to attend shareholders' meetings. Instead, his client ("the end investor") has to request to be temporarily entered as shareholder in the shareholders' register before the shareholders' meeting. After the meeting, the entry is deleted, and the intermediary then appears as the holder again.

Furthermore, an issuer of shares is entitled to ask the CSD to request the intermediaries to give information about individual shareholders and their holdings.

Both the transparent and the non-transparent (mixed) system can be used by domestic as well as foreign securities holders. One single investor can use both systems. As the transparent and the non-transparent (mixed) systems are available to both domestic and foreign investors, there is no real difference between purely domestic and cross-border situations. However, in practice, it is more common for Swedish investors to use the transparent system than for foreign investors.

2. Which categories of transparent systems need to be specifically addressed in the future instrument?

Each system described above can be classified in one of the categories set out under 1)a)iii) *supra* and depicted in *fig. 4*. There is a feature common to all three categories which is that lower tier account holders and their individual holdings are recognised at the CSD level ("transparency"). The difference between these categories lies in the functions of the "middle entity" and the account structure, i.e. the question is whether the middle entity is the "relevant intermediary" and between which parties exists an "account" in the sense of the draft text, *cf.* the definitions of Article 1(b), (c), (d), (g):

> *"intermediary" means a person that in the course of a business or other regular activity maintains securities accounts for others or both for others and for its own account and is acting in that capacity;*
>
> *"relevant intermediary" means, with respect to a securities account, the intermediary that maintains the securities account for the account holder.*

"securities account" means an account maintained by an intermediary to which securities may be credited or debited;

"account holder" means a person in whose name an intermediary maintains a securities account, whether that person is acting for its own account or for others (including in the capacity of intermediary).

- First category

With respect to systems of the first category (*cf. fig. 4 supra*) involving investor specific accounts (parts of the Finnish and Swedish system are probably the most prominent examples), it could be argued that the middle entity ("account operator") does not fall within the definition of "intermediary" and "relevant intermediary" since accounts are directly maintained in the name of the bottom account holder by the CSD (one cannot even say "lower tier account holder" as there is only one single tier). Consequently, the CSD would be the relevant intermediary. It is understood that this solution is also supported by the relevant local law. Additional clarification might be necessary on the following points:

(a) The account operator may keep a register for business purposes where holdings are reflected. This register could be considered being the relevant account. However, under the future Convention, an intermediary *must* maintain accounts for its account holders; furthermore, it is understood that from a legal point of view, these registers are irrelevant for determining as against third parties who the owner of the securities is. Consequently, this should not be an issue.

(b) Under systems belonging to the first category, the "maintaining" of the account is somewhat shared between the CSD (which provides for the infrastructure) and the account operator (which has access to this infrastructure and operates this account). However, it is clear that there is only one single account, the one in the CSD. It is understood that, under the same legal scheme, investors have the choice to hold even immediately with the CSD without the assistance of an account operator. Therefore, ultimately, the conclusion is that the CSD "maintains" the account and that a clarification with respect to the meaning of "maintain" help avoid confusion regarding this point.

(c) There is a contractual agreement between the account operator and the account holder which could be classified as the relevant account agreement, whereas there seems to be no contractual agreement between the CSD and the lower tier account holder. This situation seems to be incoherent with the definitions cited above and additional clarification would be needed. However, this concern cannot lead to a conclusion that the entity in the middle is the intermediary, as there is simply no securities account at this level.

As a result, especially against the background that in such systems there is only one single account (the one with the CSD), it can be retained that the CSD is the relevant intermediary and the middle entity has purely administrative function. Consequently, for all purposes of the convention, including the issue of upper-tier attachment, the relevant relationship between account holder and its relevant intermediary relates to the bottom account holder and the CSD. Where necessary, this should be made clear in the draft text and the explanatory report.

- Second category

Within systems that form part of the second category (*cf. fig. 4)*, the CSD maintains an account for the middle entity ("participant") which is divided into sub-accounts for the participant's clients. There is a separate set of clients' accounts maintained by the participant for its clients which are governed by account agreements between the participant and its clients. Consequently, the participant in the CSD is the lower-tier account holder's relevant intermediary in the sense of Article 1(b), (c), (d) and (g). In Brazil, for example, this result is confirmed by the domestic law. The fact that all holdings are accurately reflected in sub-accounts at the level of the CSD is merely an *additional* feature and does not alter the above understanding. Consequently, such holding pattern falls within the regular scope of the preliminary draft Convention, and all provisions of the text could be applied without further modification or clarification.

A different issue is whether upper-tier attachment should be possible, as it is often the practice, in systems which belong to the second category. On the one hand, the lower tier account holder is identified at the level of the CSD including specifications of its holdings and upper-tier attachment. On the other hand, nominees at the bottom of the chain might render the transparency ineffective, the more as soon as there are parts of the holding chain located in a different country. In this latter case, transparency cannot be guaranteed.

It should be stressed, again, that the architecture of the draft text, building on the relation between account holders and relevant intermediaries, can be applied smoothly to systems falling within this category. Just isolated issues, in particular the prohibition of upper-tier attachment, seem to be incompatible.

- Third category

Systems belonging to the third category of transparent systems (*cf. fig. 4*) operate on a three tier structure where the account of the CSD are permanently consolidated with the account of its participants including an exchange of data on who the ultimate account holder is and what its holdings are.

Although the entire mechanism of central and detailed registers is by law *regarded* as a single register because of synchronisation among registries, the participants under this system fall within the definition of both of "relevant intermediary" as if they acted under a non-transparent pattern. This is because (i) participants actually manage individual accounts in which securities owned by investors are held, and (ii) the CSD holds both of (x) an account in which the securities owned by each participant are held, and (y) another account (hereinafter referred to as the "clients' account") which reflects *only the aggregate amount* of securities owned by investors (i.e., the segregated amount of the securities which each investor holds could *not* be discovered from the records in the clients' account unless the CSD refers to the account opened by each participant). In other words, under systems of the third category, the account opened by the participant for their clients corresponds to the securities account for the lower tier account holder in the sense of the draft convention whereas the account maintained by the CSD does not (it is in fact the relevant account for the participant).

Following this view, it would be possible to treat the Spanish system in the same way as the non-transparent pattern, because the actual holding structures of intermediated securities under these two patterns are closely akin, and the difference between them exists only in the legal perspective in respect to two synchronised book-entries.

Again, the basic architecture of the draft text fits the operational and legal arrangements of systems falling within this third category. Only the prohibition of upper-tier attachment would not fit without changes to domestic arrangements.

3. Methods to include transparent systems

a. Clarification on "relevant intermediary" (only relevant to the first category)

i. Similar to Hague Securities Convention's approach

The Hague Securities Convention addresses the issue by including additional explanations with respect to the term "intermediary" in its Article 1. Paragraphs 3, 4 and 5 of Article 1 address the issue whether a "middle-entity" should be regarded intermediary in the sense of the Convention or not (*cf*. also Goode/Kanda/Kreuzer, Hague Securities Convention, Explanatory Report, pp. 40 *et seq.*).

> *Article 1-1c) "intermediary" means a person that in the course of a business or other regular activity maintains securities accounts for others or both for others and for its own account and is acting in that capacity;*

Article 1-1d) "account holder" means a person in whose name an intermediary maintains a securities account;

Article 1-1g) "relevant intermediary" means the intermediary that maintains the securities account for the account holder;

Article 1-3. A person shall not be considered an intermediary for the purposes of this Convention merely because –

a) it acts as registrar or transfer agent for an issuer of securities; or b) it records in its own books details of securities credited to securities accounts maintained by an intermediary in the names of other persons for whom it acts as manager or agent or otherwise in a purely administrative capacity.

Article 1-4. Subject to paragraph (5), a person shall be regarded as an intermediary for the purposes of this Convention in relation to securities which are credited to securities accounts which it maintains in the capacity of a central securities depository or which are otherwise transferable by book entry across securities accounts which it maintains.

Article 1-5. In relation to securities which are credited to securities accounts maintained by a person in the capacity of operator of a system for the holding and transfer of such securities on records of the issuer or other records which constitute the primary record of entitlement to them as against the issuer, the Contracting State under whose law those securities are constituted may, at any time, make a declaration that the person which operates that system shall not be an intermediary for the purposes of this Convention.

According to the Article 1-3 b) *supra* middle entities in systems of the first category ("account operators") do not fall within the definition of intermediary in the Hague Securities Convention, since they operate such accounts in a purely administrative capacity as a service interface, and additional records on investors' holdings maintained by them are not regarded to have any legal effect.

Yet, the wording of some provisions in the UNIDROIT draft Convention, for example Articles 7.3, 8.1, 9.1.b-c and 16, might raise problems of interpretation and application even if the above clarification is made. The problem lies with the fact that even though the investor specific account is with the CSD, the account holder does not give instructions directly to the CSD. The instructions are given to the account operator which makes the entries on the basis of specific legislation. It could possibly be argued that there would not be any problems to apply the above provisions to systems of the first category with investor specific accounts, for instance by interpreting that the account operator is acting on behalf of the CSD. Another possibility would be to recognise in the draft Convention the role of the account operator with respect to securities accounts maintained by the CSD. This could be done for example by a general provision stating that certain provisions concerning the relevant intermediary may have relevance to account operators or corresponding persons, if so provided by domestic non-Convention law.

ii. Additional definition of "CSD"

One commentator was not sure that the proposed solution to add an explanation on the definition of intermediary would be helpful and would not create more confusion given the complexity of the definition. As an alternative, the commentator recommended the introduction of a definition of CSD and distinguishing the CSD from the intermediary. Indeed in all systems and in particular in

transparent systems CSDs had a specific role. Introducing a specific definition would allow the recognition of its specificity for article 15 as well as for the rest of convention should other issues arise.

b. Declaration with respect to the quality of intermediary (relevant to all 3 categories)

Another method, which was proposed during the second session of the CGE, would be to set up a declaration mechanism under which Contracting States can designate entities that are not regarded as intermediaries in the sense of the convention.

However, a plain declaration mechanism would probably lead to an opaque patchwork of entities that do or do not enter the scope of the future instrument. Therefore, a declaration mechanism would only make sense in combination with objective criteria describing the characteristics of entities that can be outside the scope of the future instrument. The Hague Securities Convention takes a similar approach (with a very limited scope) in its Article 1-5 in regard to systems the entries to which constitute the primary constitutive book entry.

c. Exemption from the prohibition of upper-tier attachment (only 2nd and 3rd category)

i. Declaration with respect to non-application of certain provisions in certain systems

Alternatively, there was the proposition to open certain provisions of the draft instrument for an opt-out in the sense that for example the prohibition of upper-tier attachment would not be applicable in certain systems or to certain entities. For example, a new paragraph could be added to Article 15 stating that the provision of Article 15.1 will not apply in transparent systems where there is full knowledge and control of the account holders and the disposition of securities of the securities account.

A conceptual difficulty is caused by the variety of the legal and operational arrangements in the various systems which might make it difficult to carve an exemption that is formulated in a way that all interested systems are covered without undermining the overall goal of prohibiting upper-tier attachment.

ii. Wide interpretation

In some systems, upper-tier attachment is initiated through the CSD which receives the order in the first place. Subsequently it blocks the relevant securities in the investor-specific sub-account of its participant. It could be considered to interpret such method as an attachment which is “made against” the relevant intermediary (participant), as it would not matter which person is responsible for *processing* the attachment.