UNIDROIT

INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW

UNIDROIT Seminar on Intermediated Securities – Paris, France

31 January – 1st February 2006

FEDERATION BANCAIRE FRANCAISE

AFTI

INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW

UNIDROIT Seminar on Intermediated Securities – Paris, France

31 January – 1st February 2006

Rome, 2006

NOTICE

The participants and other speakers at the seminar are each expert in the field of financial markets law in the legal system of their country. However, they participate in the work of UNIDROIT on a strictly personal basis. The views expressed in this paper are those of the speakers and do not necessarily reflect those of their institution, their Government or UNIDROIT.

UNIDROIT 2006 - Study LXXVIII / SEM. 3 (English only)

UNIDROIT

FEDERATION BANCAIRE FRANCAISE

AFTI

UNIDROIT SEMINAR ON INTERMEDIATED SECURITIES
Paris, from 31 January to 1 February 2006

Venue	*Fédération bancaire française* (FBF), 18, rue La Fayette, 75009 Paris, France.
Participants	Delegates and observers to the UNIDROIT CGE on Intermediated Securities *The number of partipants is limited.*
Language	English and French
Information	Isabelle Dubois, i.dubois@unidroit.org, Tel. +39 06 69 62 135 Brigitte Gayral, bgayral@fbf.fr, Tel.: +33 1 48 00 04

Programme

30 January

Reception with dinner from 7 to 9 p.m. at the invitation of PNB Paribas
Place: l'Orangerie, 3 rue d'Antin, Paris, 2ème arrondissement

31 January 2006
Chair : *Hans Kuhn* *(Swiss National Bank)*

9.00 a.m. Welcome

1. The definition of « securities »
Alexander Dörrbecker, Federal Ministry of Justice, Berlin

11.00 – 11.30 a.m. Coffee break

2. Segregation : different methods / pertinency / necessity
Philippe Goutay, *Gide Loyrette Nouel, Paris*

1.00 – 2.30 p.m. Lunch

3. The definition of good fait in the sense of civil law and the common law equivalent
Hubert de Vauplane, *BNP PARIBAS, Paris*

4.00 – 4.30 p.m. Coffee break

4. Loss sharing : Cause? Assessment base? Why « pro rata »?
Chuck Mooney, University of Pennsylvania

6 p.m. End

1 February 2006

9 a.m. Opening

5. The impact of intermediated holding on the relation between investor and issuer
Ignacio Gómez-Sancha, Iberclear, Madrid

10.30 – 11.00 a.m. Coffee break

6. Disposition of the right and transfer between accounts: any links?
Klaus Löber, Banque Centrale Européenne, *Frankfurt*

12.30 – 2.00 p.m. Lunch

7. Clearing and settlement systems : definition and examples
Diego Devos, *Euroclear S.A., Belgium*

4.30 p.m. Conclusions

End : at around 5 p.m. and departure for the Louvre Museum (by metro – line 7 – 3 stops)
6.00 – 7.30 p.m.: guided tour at the Louvre Museum
Meeting: Hall Napoléon underneath the Pyramide, in front the Auditorium entrance
7.30 – 8.00 p.m.: Café Danon for a last drink

Presentations will be about 30 minutes and
each be followed by a discussion.

The Seminar is supported by
the Fédération bancaire française (FBF) and
the Association française des professionnels des titres (AFTI)

Introduction

The seminar was opened by Mr Philippe LANGLET, Société Générale, on behalf of the co-organisers of the event, the French Banking Association (FBF), the *Association française des professionnels de titres* (AFTI), BNP Paribas and Société Générale. In his opening statement, he stressed the hope of the co-organisers that this seminar would contribute to the progress of the UNIDROIT project on indirectly held securities as had two other UNIDROIT seminars held in Bern, Switzerland and in Sao Paolo, Brazil.

Mr Hans KUHN, Swiss National Bank, who chaired the seminar, reiterated the importance of using these fora to express and discuss ideas informally, independently from the official intergovernmental negotiation. This seminar provided an important opportunity to discuss and debate possible solutions to many fundamental issues still under discussion. He expressed his gratitude to the co-organising organisations, namely the French Banking Federation, the *Association française des professionnels de titres* (AFTI) and the UNIDROIT Secretariat.

Mr Philipp PAECH of UNIDROIT, Secretary to the Committee of Governmental Experts, joined Mr Kuhn in thanking the co-organisers. He recalled that this was already the third meeting on this project organised by UNIDROIT with local partners in Paris: a fact-finding meeting had taken place at Crédit Agricole in 2003, when the project was still in its early stages and a first seminar had been held 2004, supported by both FBF and AFTI, with the aim of informing the private financial sector about the UNIDROIT initiative.

Topic 1: The Definition of the Term “Securities”

A - Report by Mr Alexander Dörrbecker, Federal Ministry of Justice, Berlin[1]

–Things were much easier in the days when it was possible to say simply that securities were investments in stocks and shares, when certificates were issued to show who owned the stocks and when only one jurisdiction was involved in the process. With the advent of international markets, this situation has changed. Securities are now transferred over many jurisdictions. The phenomenon of book entries has also had a significant impact. It is important that the legal issues associated with these changes are appropriately managed. It is also important to bear in mind that securities can be corporate stocks, mutual funds, bonds, options, derivatives and, as we shall discuss later, units of limited partnerships and other kinds of corporate organisations. We will consider whether, given this great variety, the definition of “securities” given in Art. 1(a) of the draft Convention is sufficient.

We must also consider whether the rights embodied in the security relate only to the payments derived from the security or whether they include other personal rights under the terms of the issue, such as the right to receive certain information or voting rights. The fact that shares in companies give such additional rights means that there is an upstream, from the investor to the issuer, as well as a downstream, from the issuer to the investor. As Mr Javier Diaz stated in his presentation at the UNIDROIT seminar held in Sao Paolo,[2] there is no clearly recognised international concept of what is meant by “securities”. In his view there are risks involved in building a theoretical or dogmatic definition of securities on an international scale. The draft Convention should instead try to find a basic, all – encompassing definition.

---

[1] Cf. Appendix 2.

[2] Cf. UNIDROIT 2005 Study LXXVIII, S. 2 (Sao Paolo), Appendix 9.

–As was discussed at the first session of the Committee of Governmental Experts ("CGE"), the draft Convention takes a functional approach and uses legally neutral language in order to make its application across different jurisdictions possible. We must discuss what would be understood by the term "securities", as defined, in each of our jurisdictions and consider the implications of that definition in relation both to our own jurisdiction and to its possible interaction between one jurisdiction and another. The final aim is, of course, harmonisation.

Art. 1(a) of the draft Convention states: "'Securities' means any shares, bonds or other transferable financial instruments or financial assets(other than cash) or any interest therein." Although this is a broad definition, it is clear. Nevertheless, difficulties may arise when it comes to defining individual terms within the definition.

As this was not discussed at the first session of the CGE, I have considered both the relevant explanation contained in the Explanatory Notes to the draft Convention and the more detailed information contained in the Explanatory Report of the Hague Securities Convention. The Explanatory Notes to the draft Convention state that the definition of "securities" used in it should match that used in the Hague Convention, which reflected a consensus reached by the contracting States. There are, however, some differences in the drafting. In his presentation, Mr Diaz pointed out that the existence of different definitions could lead to "convention shopping". It will be interesting to consider which position the draft Convention should take, given that it relates to the harmonisation of substantive rules rather than to the conflict of laws. The Explanatory Notes also make clear that a very broad definition was provided precisely so as to avoid having to provide an exclusive list of all instruments that could be considered to be "securities".

Shares and bonds are examples of assets that are traditionally considered to be securities. As many jurisdictions have a similar understanding of what is meant by shares and bonds, I feel that it is not necessary to go into detail on this point.

Other instruments are encompassed by the additional words in the definition "...other transferable financial instruments or financial assets…". In the report of the Hague Securities Convention, it is stated that financial instruments or financial assets typically include *…a tradable entitlement to money* (with or without other rights, such as a right to vote and/or membership rights) *and, where not intended to be held solely by a single investor, are issued on terms standard for each unit of the issue with a view of being held, directly or indirectly, through intermediaries, as a medium for investment*.

The question is whether these three elements – tradable entitlement to money, issued in a large number and issued through intermediaries as an investment – form an exclusive definition; that is, may instruments only be considered as "…financial instruments or assets…" only if they meet these conditions? The Hague Securities Convention rejects a minimum-standard approach and makes clear that "instruments" were to be credited to a securities account and to be of a financial nature. The definition went no further. Mr Diaz noted that the element of credit is very important and that the definition of "account" will depend on the specific regulations of the market in question. The crucial elements are, therefore, that the assets are financial in nature and are credited to a securities account.

In general, financial instruments should be *transferable*. In this respect, this draft Convention appears to be more strict than the Hague Convention in that it refers to "transferable financial instruments" while the Hague Convention does not use the word "transferable". I am not sure whether "transferable" is sufficiently clear and, indeed, whether this element of the definition is even necessary, given that securities are always transferable. I do not have any insights from the former UNIDROIT Study Group on why this word was included, nor could I find further information in the Explanatory Notes.

The definition applies to all kinds of financial assets "..(other than cash)…". In this respect, cash is not restricted to physical money but is used in a broad sense to encompass bank deposits in general.

The approach taken is very flexible: there is no enumeration of specific instruments nor is there a fixed list of instruments. Although the Explanatory Notes refer to a "fluid" approach, Mr Diaz feels that "elastic" is a more appropriate word. Given that the term "securities" does not apply only to shares or bonds, I believe it is reasonable to think that further developments might arise and that the definition should, therefore, be left as open as possible.

The Explanatory Notes state that, for the definition of "securities", it is not important where the "securities" are issued, whether the "securities" are certificated, the form in which the "securities" are constituted, whether the "securities" can be withdrawn from the holding system and held directly by the investor or whether the "securities" are listed on the stock exchange. I hope that we will discuss whether this means that the definition of "securities" used in the Convention applies only if the securities are in an intermediated system and, by extension, whether those that are not in the system do not fall under the Convention. We should also consider whether intermediation should be possible for all "securities". These are certainly crucial questions which should be discussed in depth.

The reference in the definition in the draft Convention to interests in securities ("…or any interest therein;") makes it clear that, in addition to full ownership, rights deriving from possessory and non-possessory security interests and certain indirect holding positions are also included. In broad terms, therefore, it can be argued that interests derive both through full ownership and lesser forms of ownership. In his presentation, Mr Diaz observed that there were, in a way, three forms of "securities". If the owner of a share created a security interest over it for the benefit of a creditor, such as a bank, there would be three "securities" according to the terms of the draft Convention: the certificate share, the ownership over or in that share, and the security interest created in that share. Further discussions should consider whether this could give rise to problems.

With regard to *rights embodied in securities*, the draft Convention mentions rights attached to securities and Article 4(1)(e) opens this to rights conferred by national law: "..subject to this Convention, such other rights as may be conferred by the domestic non-Convention law." It would be interesting to hear the views of the audience on this point, particularly as Germany, in its first statement, advised that this matter be left to individual jurisdictions. It should be noted that this approach might give the issuer of the securities certain rights which are not enumerated in the Convention.

Given that the draft Convention relates to intermediated securities, the question of whether or not securities are *capable* of being intermediated is crucial. It would be interesting to consider whether, as the Convention applies only to those securities that *are capable* of being intermediated, all securities *must be capable* of intermediation.

Prior to the first session of the CGE, the European Banking Federation stated that it should be made more clear that bearer and registered shares are included in the definition. I would ask whether, given the breadth of the definition, this is necessary or would be useful. Germany favoured taking a technical approach to the definition. This should also be discussed, even though it could be argued that the functional approach taken by the draft Convention is, in fact, more appropriate given the number of jurisdictions involved. It is important to understand how far the definition in the Convention should go and whether any restrictions should be applied, particularly with reference to Art. 19 - "Position of Issuers of Securities". Many delegations at the last session of the CGE appeared to read this article to mean that all securities *must be capable* of intermediation. This would give rise to a new concept in many jurisdictions, in particular to the extent that units for limited liability partnerships might be included in this broad definition. In my view, the definition of "securities" contained in Art. 19 should be redrafted and restricted.

The CGE should discuss whether the draft Convention should be strictly aligned with the Hague Securities Convention, keeping in mind that the Hague Securities Convention's definition only applies to the conflict of laws.

A *conclusion* might be reached, based on the following fundamental points:

the draft Convention explicitly avoids giving a exclusive list of existing instruments;

the draft Convention aims to harmonise, so the definitions used are very broad;

the demands of competitive financial markets should not be limited or restricted by the draft Convention; and,

the draft Convention should lead to more integrated and flexible markets.

These points raise several questions, when discussing the definition of "securities":

Should the draft Convention explicitly state that it does not apply to securities not held by an intermediary?

Are the contracting States able to uphold provisions which permit securities to be transferred other than on the basis of book entries, depending on the terms of the issuer or the legal framework?

Should there be a further core element for "securities" in this definition or can the future instrument work with this broad definition?

Thank you very much for your kind attention.

B - Discussion

Thanking Mr Dörrbecker for his presentation, commentators stressed the complexity of its subject matter and the fact that it was not clear whether a definition that fulfilled all requirements expected of it to the satisfaction of all jurisdictions was possible. The various definitions of financial instruments and securities that have been produced, for instance, at the level of the European Union over recent years showed that this was a challenging area. In fact, there were three different definitions available, illustrated by the following examples:

The Settlement Directive states that securities means all financial instruments defined in part (B) of the former ISD Directive, which includes financial instruments and derivatives – the main issue is clearly derivatives on OTC market. The Settlement Directive means that, rightly or wrongly, there are incorporeal derivatives on the OTC market.

The definition in the Collateral Directive is clearly more complex than that of the Settlement Directive: financial instruments are defined, more or less, as a tradable instrument, but the definition is quite broad.

The Hague Convention defines "securities" to mean "any shares, bonds or other financial instruments or other financial assets (other than cash), or any interest therein". The main difference between the Hague Convention and the Collateral Directive is the concept of "tradable", which for some does not include derivatives on OTC markets for collateral. We must decide on how we want to treat those instruments for the purposes of the draft UNIDROIT Convention.

1) On the need for additional elements compared to the definition in the Hague Securities Convention:

There was agreement, that, in an ideal world, both definitions, the one provided by the Hague Securities Convention and the one proposed by the UNIDROIT draft instrument, should be identical. There was, however, discussion as to whether the already existing definition would fit the purposes of a substantive law instrument.

Some advocated that the definition contained in the Hague Securities Convention, the content of which had been reached after years of debate, offered the best compromise that could be expected to be achieved in the short term. While future contracting States to the draft Convention were in fact not bound by the definition given in the Hague Securities Convention, it could equally fit the purposes of a substantive law convention, irrespective of the conflict of laws orientation of the Hague Securities Convention.

Others pointed to the two options that were open with respect to the definition of securities. One option was to say that the definition of securities should be left to national law. The second option was to provide for a uniform definition of securities, as did the Hague Securities Convention, even though this might oblige Contracting States to adapt their national definitions of securities.

Another participant drew attention to the fact that, in reading the draft UNIDROIT Convention, no provisions had been identified in which applying the current definition of securities might result in problems. In keeping a definition that basically resembles the one used in the Hague Securities Convention, all types of securities were covered. The major part of the UNIDROIT draft text applied to "intermediated securities", rather than to "securities" which narrowed the scope to securities which are recorded on securities accounts – a considerable limitation.

Others wanted to go further and pointed out that, at present, the only difference between the definition in the Hague Securities Convention and the one given in the draft instrument was the insertion of the word "transferable". Participants questioned whether it served a purpose, particularly given the existence of the definition of "intermediated securities". Against this background, "transferable" could be eliminated from the definition in order to achieve full conformity with the definition given by the Hague Securities Convention.

Another participant recalled that, relative to the Hague Securities Convention definition (and therefore possibly relative to the future UNIDROIT draft Convention definition), it had been argued that the definition was circular as a purely logical construct in that it says that securities were everything that can be credited to a securities account, and securities accounts were defined as things on which there were securities. However, consideration should be given to the question of whether this logical circularity completely relieved the definition of any functional utility. It could be argued that it remained relevant as the very purpose of the definitions was to be wide.

One participant questioned whether there should be a further core element added to the definition of "securities", if the draft text was no longer to apply only to securities that are held by an intermediary but also to those which are capable of being credited to a securities account. If this really was one of the core elements of that a security, there should be a common understanding of what exactly constituted securities accounts and what their defining features were.

2) On the exclusion of bilateral contracts:

Several participants explained, that, as a matter of practice, in many jurisdictions derivatives were not registered in accounts; instead, derivative OTC transactions gave debit cash or credit cash in the account but there was no specific book entry. Therefore, OTC derivatives were not held in the intermediated system and were not registered in an account. This raised the question of whether derivatives were included in the definition of securities as proposed by the UNIDROIT draft text.

The audience clearly tended to the view that purely bilateral financial contracts should be excluded from the scope of the draft Convention, though, in the long term, it might be appropriate to have them covered by instruments like the draft Convention.

One participant explained that this issue highlighted the differences between the scope of the Hague Securities Convention and the draft UNIDROIT text: for example, in an account opened by a butcher, there would be rights over meat. Applying the draft Convention to this account would lead to the conclusion that the applicable law was the law of that contract, for example French law. Under French law, this would be a mere claim and the debate would be over. If the future UNIDROIT Convention applied, and if the butcher went bankrupt, his customers would be entitled to certain rights that they were not intended to have, such as separation in case of bankruptcy. Consequently, the same definition of "securities" could have different impacts in different contexts. For this reason, although desirable, it was not clear whether a very broad definition should be adopted for the UNIDROIT Convention.

To illustrate this further, it was explained that were two main differences between, on the one hand, securities and, on the other hand, other types of financial instruments that were not securities but were bilateral financial contracts. First, the content of a bilateral financial contract is tailor-made by the two parties and is not for just any investor. It was for this reason that the applicable law is determined by the Rome Convention rather than the Hague Securities Convention or the Financial Collateral Directive in Europe. The second key difference was that securities were thought to be transferred without the risk of being subject to the previous relationship of the former holder with the debtor. This meant that, for example, if Person A had a bilateral derivative with Person B, Person B might oppose a close netting to Person A. If Person A was the creditor, he could transfer his position to Person C, according to the law agreed by the parties. When Person C acquired the instrument, he knew that the debtor might not be in a worse position than when he was the debtor of Person A. He might, depending on the applicable law under the Rome Convention, oppose the setting off that he had with Person A *vis-à-vis* Person C. This would be unthinkable in the context of securities. It was for this reason that financial contracts, when referring to the applicable law as ascertained by the Rome Convention, were generally not immune from the consequences of the insolvency of the debtor. With respect to securities, however, there was this immunity. Consequently, the risk of the issuer, but not that of the intermediary, was retained for securities. In financial bilateral derivative contracts, the holder faces risk from both side. Therefore, bilateral financial contracts should be excluded from the scope of the future Convention. It was not clear whether the definition of "securities" as it stood could be read to exclude bilateral contracts, as it included "…any interest therein…", and a derivative agreement between two parties might be such an interest.

There was no agreement on whether the current definition of "securities" was sufficiently broad to cover purely OTC contracts. It could be argued that it was, but the argument hinged on the interpretation of "interest". The Explanatory Report on the Hague Securities Convention made it clear that the "interest" referred to means proprietary interest. If that is the case – admitting that "proprietary" could equally be controversial in terms of comparative law – the mere fact that some OTC derivatives referred to other types of financial assets, such as equity derivatives, did not bring them within the scope of the definition because that was purely an economic or synthetic reference and not an "interest" in a proprietary sense.

It was pointed out that there are, on the one hand, bilateral derivatives (such as those negotiated through ISDA Master Agreements), which are mere contractual arrangements and have nothing to do with securities. If book entries were used in this context, this was merely for control purposes, as two banks might have hundreds of different derivatives and needed accounts to control the open risk between them. This type of derivative was clearly outside the scope of the future Convention. On the other hand, there were derivatives that were negotiated and traded in an organised fashion, which implied having a central counter-party or an organised derivative market. It could be argued that those interests could equally only be held against a single and predictable counter-party, normally the central counter-party. However, they were regularly traded and transferred through securities accounts; this was sometimes even a legal requirement. In contrast to the first class of derivatives described above, this second type should fall within the scope of the future UNIDROIT instrument.

Others agreed, mindful that it would be a good idea to incorporate bilateral financial instruments in case it was felt that any future evolutions in the market would necessitate this. But at the moment it was difficult to predict the possible consequences of including those instruments in the scope of the draft Convention. Therefore, at present, the risks of including those instruments outweigh the benefits of leaving the door open to such future evolutions.

One possible solution, in order to differentiate securities from bilateral financial contracts, was to include in the relevant definition the idea that shares, bonds or any interest, if transferred, concede a right to the acquirer that is autonomous from that of the transferor.

3) On the intermediary as "gatekeeper"

One participant proposed that the draft Convention might have a broader scope if there were a common understanding of "securities" and a definition of the kinds of "securities accounts" to which it referred, as intermediaries could then be relied upon as "gatekeepers". The draft Convention could also refer to book entries with respect to assets that, while not securities in themselves, could be dealt with by intermediaries and credited to accounts under the draft Convention, as supplemented by national law.

A related proposal was, since the title of the draft Convention indicated clearly that the text is on *intermediated* securities, to include the element of intermediation in the definition of securities. If the idea of an intermediary *was* included, it should refer to *any* intermediary. This meant that the terms and conditions according to which an intermediary defined a security needed to be taken into consideration, and this would return the thinking to the broad definition that was proposed but would be at odds with the Explanatory Report of the Hague Securities Convention, where this broad definition was restricted. A reference to the intermediary would open the door to any financial instrument, including derivatives and those that are not securities in the classic sense, to fall within the scope of the draft text.

Another participant questioned whether it was true that "legal chaos" *would* be the result *if* the future instrument does not predetermine in advance what might be credited to securities accounts. The competing view, referred to above, was that intermediaries should be used as gatekeepers and that, as a matter of policy, it should be assumed that the only such things as intermediaries would place on securities accounts would be those for which it would make commercial sense for them to open accounts for. It was a difficult and sensitive policy decision whether either market activity itself or rules made in advance of market activity should operate as the "gatekeeper".

4) On the relationship between "securities" and "intermediated securities":

The audience raised the question whether it would be sensible to define "securities", as a first step, in a very broad way, including credit derivatives, in order to account for the fact that, in some legal systems, these derivatives were tradable and could even be registered. Then, as a second step, necessary differences between both instruments could be reflected in the definition of "intermediated securities". This two-stage process would allow all kinds of financial assets to be encompassed, by the definition before being restricted to intermediated securities.

Following up on this, one possible solution was not to define securities at all, leaving this for domestic non-convention law, and instead to restrict the scope by defining intermediated securities. The second possible solution would be to add additional requirements elements to the definition of securities.

Others believed that the way in which intermediated securities are defined in the draft Convention is not ideal. Intermediated securities were those covered by the draft Convention; their distinctive elements were that they were credited to a securities account and transferable by book entry. The definition of securities, in contrast, should be flexible and cover all those which are both inside and outside the intermediated holding system.

Others considered that the distinction between the definition of the term "securities" and the scope of the draft text needed to be kept in mind.

5) Other points

One participant made the point that the draft Convention already added one significant element to the definition of "securities" for the purposes of the Hague Securities Convention, namely the concept of transferablity. This represented a huge difference which significantly narrowed the definition. It should be considered whether further elements were necessary - to take an example, whether securities that are not issued in series should be excluded from the scope.

A further point was, whether the definition of "securities" should refer to "tradable" instead of "transferable" financial assets. For instance, in French civil law, "tradable" or "negotiable" meant that the assets could be traded easily without recourse to formal civil law processes. This did not mean, however, that they are registered in a securities account: there are also assets that are traded easily without book entry. Tradability and transfer by book entry should not be confused.

Another participant was of the opinion that the various suggestions for additional defining elements, such as "transferable by book entry" and "tradable across accounts", made it clear that there was no distinction between regulatory and legislative qualifications. Instead, it should be considered what the result would be if a specific country introduced rules that made it possible to transfer mere credit claims by book entries and whether this would bind other jurisdictions if the transfer were being made to the books of an intermediary in another country. Against this background, the draft text should be more precise about what constituted a securities account for the purposes of this Convention. It should be clear what had to be accepted across borders. Rather than simply introducing additional elements like, for instance, "transferable by book entry", the meaning underlying those terms should be considered.

Topic 2: Segregation – Methods, Pertinence and Necessity

A – Report by Mr Philippe GOUTAY, Gide Loyrette Nouel, Paris[3]

Segregation is one of those legal concepts that is regularly used but rarely, if ever, defined. My aim is to provide you with a broad definition of segregation outside any specific legal context. Segregation means to separate or distinguish assets that would not otherwise be distinguished. Segregation typically covers fungible assets. In a legal environment, segregation is implemented in order to apply different legal regimes to similar assets. In that respect, if segregation is not applicable to similar assets, it is difficult to apply different legal regimes.

Segregation is particularly important in deposit or custody agreements, particularly when transfer of title does not occur, when the custodian may also own some securities or assets for its own account. In that respect, we clearly understand the need to distinguish between assets held on the account of third parties and those held for the account of the custodian. Segregation may be useful in such cases.

This issue is fundamental when it comes to fungible assets and, in particular, with respect to regular or irregular deposits. With respect to regular deposits, it is usually the case in continental law that, when you deposit fungible assets that are not distinguished or identified, the transfer of title occurs to the benefit of the custodian. In that respect, it might be important to segregate the positive assets in order not to acknowledge a transfer of ownership with the depositor.

With respect to dematerialised and fungible assets, segregation is a key element that contributes to the efficiency and safety of a legal regime of intermediated securities and, in particular, a specific right to final investors on the securities credited to their account. Please note that I refer to ‘a specific right’ and not to property or creditor rights. From that perspective, it is important to bear in mind that securities that are credited to an account in the name of a third party are supposed to benefit from a proprietary right for the benefit of that person and should not be considered to be the property of the custodian.

During this presentation, I will discuss why segregation rules should be implemented and, secondly, how segregation rules could be applied to intermediated securities.

- Why implement segregation?

With respect to assets held in custody, segregation prevents the co-mingling of assets that belong to different people, not only those belonging to different customers but also those belonging to the custodian from those belonging to third parties. This is important in custody agreements as there is no transfer of property or of title. Deposit agreements, by which a person grants custody of an asset while retaining the property or title over it, need to be distinguished from sale agreements, where both the title and the asset are transferred and custody is granted to the buyer. In the custody activity, the transfer of custody is made but there is no transfer of title.

In many civil law countries, the deposit of fungible assets can lead to a transfer of title for the benefit of the custodian. Under French law, there is a risk that, if the assets are not identified or are co-mingled with other assets held by the custodian, a transfer of title in favour of the custodian could occur. With respect to indirectly held securities, reference is now made to ‘very fungible’ assets. When assets were tangible, it was possible to distinguish between them by the number on the certificate; now, with a book entry alone, there is no way to distinguish a security from one issue from another.

It should also be borne in mind with regard to indirectly held securities that, normally, customers are not supposed to transfer the title of the securities to the custodian but certain rights, if applicable, remain directly with the issuer. The custodian is not supposed to have title on the

[3] Cf. Appendix 3.

security. It is important to segregate these assets to ensure that the assets of the final investor are properly protected.

The first goal of segregation is to distinguish securities held by the custodian according to their beneficial owner, as could be done for materialised securities, where the custodian could be expected to safeguard the physical certificates in a named deposit box. The custodian would be expected to take a similar approach for dematerialised securities in order to protect the rights of the beneficial owners. The prevention of co-mingling is particularly important in certain cases, notably: (1) insolvency of the custodian; (2) attachment or seizure performed by creditors of the depositary or the custodian; and (3) accidental misuse by the custodian.

Segregation can facilitate the supervision and auditing of account keepers and custodians relative to their obligation to protect customers' assets. If customers' assets are clearly segregated, it is easier to audit compliance with rules relating to the use of those assets.

Segregation can be used to check, at any moment, the perfect accounting balance with respect to securities held on behalf of clients. If the aim is to protect investors' asset rights, there are clear advantages to being able to check whether the global amount held by a custodian on behalf of its clients matches the totals of clearly segregated accounts dedicated to individual customers. Without such a system, the assets held by the custodian and those held on behalf of investors must be added together and checked against the global figure of the upper-tier intermediary. A segregated system makes it possible to confirm that there is neither creation nor destruction of securities.

- How to Implement Segregation

Indirectly held securities involve at least two 'account keepers': issuer plus custodian, that is, financial intermediary; CSD plus custodian; issuer or CSD plus custodian one plus custodian two. Segregation can apply in each of these situations.

An effective right that is enforceable vis-à-vis the issuer is acknowledged to a final investor. This is already provided by Art. 17 of the Draft UNIDROIT Convention if a number of securities is held on behalf of that investor at any level of the account-keeping chain. In other words, even if there are only two account keepers, segregation should be applicable at all levels of the chain to ensure that the final investor has securities held on his or her behalf at each level of the chain.

Should any discrepancy arise in the chain, for example if there are fewer securities in the upper chain of custody, the financial investor or beneficial owner may not be in the position to exercise and perform its rights directly vis-à-vis the issuer, for example in terms of voting rights. It is important that, at all times, the securities held on behalf of third parties match the assets held by the upper-tier intermediary. Strict equality of securities must be respected at each level. This leads to the obligation in Art. 17 with respect to the allocation of securities: any custodian must have securities held with an upper intermediary equal to those acknowledged to its own customers. There should be a perfect match with respective asset figures.

Let us consider an example that illustrates this point. A CSD that has admitted 10 000 securities on the account of an issuer acknowledges 1 000 securities to Custodian-1 and 9 000 securities to Custodian-2. Custodian-1 can then divide its 1 000 securities between Custodian-A, with 300, and Custodian-B, with 700. Custodian-A holds 200 of these securities on its own account and 100 on the account of an investor, Investor-A.

Segregation is intended to enable the control of third-party allocations. The first objective of segregation is to ensure that, at customer level, the assets belonging to different customers are clearly separated. This is the basic segregation that any account keeper makes when he opens separate accounts for each of his customers rather than holding assets belonging to ten or fifteen investors in a single, global account. The real debate centres on the extent to which upper-tier custodians should be expected to segregate holdings.

The perfect solution would be to segregate securities at each level of the chain, up to and including the CSD, by implementing a solution that would clearly identify all the final investors in a CSD. Given that such a system would imply that all final investors could be identified at any point in the chain, legal issues regarding privacy and banking secrecy would be likely to arise in an international, cross-border environment. Furthermore, it should be recognised that it would be technically difficult to maintain precise segregation at all levels of a chain in a rapidly moving environment. It should also be noted that complete segregation could have a financial impact through reductions in economies of scale. If all custodians in a chain have to open an account for each final investor, the management of the account and account systems would become complex and costly.

An alternate solution might be to insist that upper-tier intermediaries segregate their assets into at least two accounts, that is one for their own assets and one for third-party assets. Minimal segregation of this type could prevent accidental misuse of securities, prevent upper-tier attachment, and protect customers' assets in case the custodian becomes insolvent.

The following example shows how segregation can protect against accidental misuse. Custodian-A holds 300 securities, of which 200 are held on behalf of Investor-A. Custodian-A issues an instruction to Custodian-1 to deliver 200 securities from its own account to Custodian-B. The problem is that while Custodian-A is in a position to make this transfer, he only has 100 securities of his own so the issuing of this instruction will result in him effectively owing 100 securities to Investor-A even though Investor-A should not have been affected by this delivery.

This situation should not be interpreted as Investor-A lending 100 securities to Custodian-A, as Investor-A was not consulted about the transfer or the instruction. The situation could also be viewed as resulting in the destruction of 100 securities in Custodian-A's account, as Investor-A would not be able to recover his 200 securities were Custodian-A to go bankrupt. In neither case is the protection of assets assured.

If the accounts were segregated, Custodian-A would hold two accounts: 100 securities in its own account and 200 in the third-party account of Investor-A. Given that Custodian-A only has 100 securities in his own account, if Custodian-A issued an instruction to deliver 200 securities, Custodian-1 would be obliged to reject or only partially execute the instruction and Investor-A's securities would remain secure.

Segregation can, therefore, protect against accidental misuse by preventing transfers for which the party in question does not have sufficient securities in its own name.

Let us consider a third case. Again, of the 1 000 securities in the CSD account, 700 are acknowledged to Custodian-B and 300 are acknowledged to Custodian-A, who has segregated them, placing 100 securities in his own account and 200 in third-party accounts. If a creditor of Custodian-A attempts to attach securities held in Custodian-1's account, Custodian-A should not allow the securities to be attached when they are credited to the third-party account because Custodian-A does not have title to these securities. In this respect, the assets of Investor-A are protected.

It should be noted that, in France, a new rule is being implemented that prohibits upper-tier attachment based on a segregation obligation. Art. L.211-4-1 of the Monetary and Financial Code provides that no attachment may be performed against an intermediary on assets held by the latter with another intermediary, where such assets are owned by third parties. In such cases, segregation allows for the easy identification of such securities in the books of upper-tier intermediaries and thus prevents upper-tier attachment.

Investors are protected against the insolvency of their custodians by legal provisions granting them a direct right on such securities, and by a strict segregation in the books of the custodian among the different holders. That is, if there is no question of a shortfall or any discrepancy in the upper chain of custody, the mere fact that the accounting is properly conducted by the custodian is sufficient to acknowledge to any investor the number of securities credited to their account. In this respect, protection relies on the general legal framework applicable to account keeping.

B - Discussion

On a general note, one participant was of the opinion that many of the issues regarding segregation were of a rather "metaphysical" character. This was because there were no "securities" in the accounts so there were no securities to segregate in the computer systems. While segregation might be a necessary means of obtaining legal title in certain jurisdictions, a more practical approach might be to find ways of keeping track of the number and type of securities held by an investor. This kind of separation could be used for regulatory purposes, for keeping track of liabilities, particularly those of intermediaries relative to their customers, and for accounting. The ordinary language which was used to refer to physical things seemed to be overstretched when it was used to refer to intermediated securities that did not really "exist".

1) On the need for segregation:

One participant wondered whether there should even be a choice given to account holders regarding the different models of segregation, i.e. between no segregation, minimum segregation and full segregation. In this scenario, the account holder would take into consideration the cost involved in segregation.

Others were supportive of minimal segregation as they could not think of any disadvantages related to it. However, they believed that a proper distinction was needed between segregation that is necessary for the establishment of property rights, and segregation that, for mere reasons of transparency, does not alter property rights.

Another view was that segregation was a key tool for preventing the inflation of securities and that therefore segregation was not yet adequately reflected in the draft UNIDROIT Convention.

In this context, others said that segregation could obviously not eliminate fraud or malpractice. From the Continental European perspective, segregation was a tool that provided protection at an accounting level, i.e., that the assets of investors were not used in an 'accidental' manner.

Another issue that was discussed related to the ability of segregation at the upper-tier to prevent upper-tier attachment. Some believed it a useful tool in this regard, others advocated that a simple prohibition of upper-tier attachment would do a better job.

In another attendee's view, it was possible to view the Convention's goal as being to provide a common understanding of what an account holder was entitled to receive and identify the benefits that arise from a credit to a securities account. It seemed that this discussion had established that there were many ways in which a contracting state could ensure that an account holder receive his rights. Probably, it would be too ambitious to try to specify suitable regulatory methodologies, leaving aside the question whether such an approach would favour harmonisation. Segregation could be an enormously useful tool depending on the system in place in a given jurisdiction, but it was not, and could not be, a complete solution because the intermediary could order the movement of customer securities, whether wilfully or accidentally. This was not a necessary detail of an intermediated system: it was the point. In general, people who invested in securities did so because they wanted to be able to trade them. It was for this reason that they placed them with intermediaries who were empowered to take decisions on their behalf.

There was strong support for the view that the ends sought by segregation could also be achieved through the application of an allocation rule of the type currently seen in Art. 17 of the Convention. This solution would provide inter-operability across jurisdictions and would allow those countries that wished to apply formal segregation to do so.

2) On feasibility of segregation:

As regards the technical limits to full segregation, the example of cash transfers, where large amounts of information had to be given to guard against money laundering, indicated that technical infrastructure had reached a stage where full segregation is operationally feasible.

3) Issues that can not be solved by segregation:

Another attendee stressed that segregation could not solve all the issues that could arise, as, for instance, undue use of segregated client assets could still arise, whether through wilful misconduct or accidental misuse, and ‘drawing on the pool’ would still be possible, that was, using the assets of client A to perform transactions on behalf of client B. These issues could only be avoided by introducing segregation between clients in addition to segregation between the clients and the intermediary and even this would not completely solve the problem unless the securities of each owner were segregated, a solution that would be costly and complex to introduce on a large scale. Therefore, it should be recognised that segregation was of limited relevance, that was, it was relevant to regulation rather than to the recognition of ownership rights.

4) Liability of the upper tier:

Following up on this, others reminded attendees to consider a potential downside to segregation, notably an additional liability of the upper-tier intermediary. Given the above-mentioned limits on the effect of segregation, especially in cases where there was intentional misuse of client assets, it should be asked whether, with a segregation rule, the upper-tier intermediary would be expected to check whether the segregation had been properly made. It was, of course, impossible to draw a very clear line between own assets and customer assets. However, depending on the client base of the upper-tier intermediary, it was likely that most assets would be client assets rather than own assets. All this related to a typical insolvency scenario: In practice, a segregation rule was only useful when the intermediary who opened the account felt insolvent and the role of the upper-tier intermediary became relevant. The upper-tier intermediary would be expected to have noticed that the intermediary who opened the account had to have been using client securities. What was the extent of the obligation of the upper-tier intermediary to verify whether the segregation had been properly conducted?

Topic 3: The Concept of Good Faith in International Securities Transactions

A – Report by Mr Hubert DE VAUPLANE, BNP Paribas, Paris[4]

In discussing the concept of good faith in international securities transactions, I will address the differences between common and civil law and discuss whether or not there is a need to incorporate the concept of good faith into the Convention.

When dealing with international securities transactions, the need for legal certainty requires the implementation of a common rule that will protect the *bona fide* acquirer. In order to acknowledge the transferee with a clear and valid title, protection should be granted to any transferee if the transferee was not aware of any challenging action at the time he received the securities into his account. In this respect, the acquirer should be in a position to clearly ascertain whether the conditions under which he received the securities were, to his knowledge, clear or challengeable.

Adverse Possession

The debate on good faith acquisition hinges on the concepts of limitation and statutory period.[5] Under the doctrine of adverse possession, the occupier of land can acquire title to the land, even if he is not the 'true' owner, without the consent of or paying compensation to the 'true' owner. This legal rule, found in both civil and common law systems, specifies that after a certain period of time, often limited by statute, not even the true owner of the property can bring action to eject an unauthorised possessor.

Adverse possession places a statute of limitation on the owner's right to bring action against the possessor. Adverse possession was formalised in English common law in the Statute of Limitations of 1632. According to this rule, after a certain period of time, a person who acquires possession of a property, whether rightfully or wrongfully, is protected from actions to recover possession of the property. Although the doctrine of adverse possession has been adopted in all US states, its legal implementation and interpretation varies. Under the general common law system, adverse possession provides a person with the means to acquire title through possession according to the law. In France, the concept of limitation known for movables uses principles taken from the Paris court of the *Ancien Régime* and conceptualised in the 17th century.

With the exception of variations in the period, and other minor differences, the doctrine of adverse possession under common law does not differ significantly from that seen in other civil law systems. Under French law, good faith is used as a means to shorten the usual statutes of limitations with regard to the acquisition of moveable goods. Good faith is also referred to in the civil code's treatment of contract performance. Good faith is considered both under the view of truth and mistake and as missing an intent to deceive.

The main difference between civil and common law systems regarding possession is the significance of the distinction between good and bad faith possessors. In Anglo-American law, there is a debate about whether the intention of the possessor has an impact on the application of the adverse possession doctrine. A familiar starting point for discussion on the notion of contractual good faith is to highlight the differences between common and civil law systems. Civil law systems explicitly expose and apply the principles of good faith whereas common law systems, and particularly English common law, do not accord recognition to a general doctrine of good faith.

The Concept of Good Faith in Some National Jurisdictions and International Conventions

The concept of good faith is broad. As proposed by French law, it is possible to distinguish between the function of good faith in purchase and in performance in negotiation. In a more general sense, the doctrine mentioned by *Mackaay* and *Leblanc* in their book *The Economics of*

---

[4] Cf. Appendix 4.

[5] The following paragraphs have been inspired by the article from B.Bouckaert & B. Depoorter, "Adverse possession – Title systems".

Good Faith In the Civil Law of Contracts, often distinguishes between the subjective and objective meanings of good faith. The subjective interpretation includes, for example, the defence of justifiable ignorance in contexts of purchase and possession. The objective interpretation applies to dealings in bilateral relationships where actions by one party avoid taking undue advantage of the other, vulnerable party. It has been suggested that expressions such as *surprendre la bonne foi de quelqu'un*, and *abuser de la bonne foi de quelqu'un*, indicate that good faith should be understood as describing actions taken without an intent to deceive. It should be noted that we are discussing good faith in the subjective context of acquisition deals.

Common Rules of Civil and Common Law Systems

While rules are similar in the civil and common legal systems, they are presented in quite different ways. In the Anglo-American system, the focus is on the type of title; this is not usually the case in the continental system. Two major common rules can be identified: first, a party can regain possession of its property; second, a party may not be deprived of its property without consent.

The two primary ways in which a party can lose possession of its property without consent are loss or theft. A corollary to those rules is the rule known as *nemo dat quid non habet*, according to which one can transfer no better interest than one had. This means that, in all jurisdictions, in the case of loss or theft, the title of the intermediate party is void.

Various jurisdictions diverge in their treatment of two other categories of cases: those where the intermediate party has voidable title; and those where the owner entrusts property to the intermediate party. In such cases, 'entrust' is taken to mean that a trustee has received the property either as payment or as a result of a contract which is later held to be invalid.

A conflict of policy arises when Owner A has entrusted or has otherwise transferred possession of his property to another Person B, who then transfers the property to an innocent Third Party C in exchange for valuable consideration. Owner A may recover damages from Person B, to whom he entrusted his goods, although such recovery is often academic. Both Owner A and Third Party C are innocent and both have socially protected interests – for A, the security of his property and for C, the security of his acquisition.

Anglo-American Rules

The law in various jurisdictions reflects the inherent difficulties of these policy choices. Again, I am not a specialist on US law. However, as I understand it, in Anglo-American jurisdictions, if a party entrusts its property to a merchant who deals in the same sort of goods, a good faith purchaser who buys the goods in the ordinary course of business with such a merchant could prevail against the owner. A purchaser of goods acquires the title which the transferor had the power to transfer. A party who leases his property to the same sort of merchant will be found to have entrusted it to a bailee. In consequence, a *bona fide* purchaser will prevail against the owner.

It is important to note that, in Anglo-American jurisdictions, the mere separation of ownership and possession, for example in a lease, will not amount to an entrustment or bailment situation. The holder of the property must be a merchant who deals in goods of that kind. In general, therefore, a lessor can recover his property from a *bona fide* purchaser who purchased it from a lessee. In American law, a party with voidable title can pass good title: the *bona fide* purchaser will prevail. This is true under American law for both real and personal property.

English law is quite similar to American law in this respect. A party with voidable title can pass good title to a *bona fide* purchaser. The relevant statute is the Sale of Goods Act of 1979.

Civil Law Rules

Continental law does not take the same approach to entrustment, bailment and voidable title. Under continental law, until a court declares that a voidable contract is invalid, it remains valid. It is, therefore, reasonable to suppose that a party with voidable title can pass good title to a *bona fide* purchaser. This is, indeed, the law.

In the French Civil Code, protection for the *bona fide* purchaser derives from the combination of two articles. The first article refers to adverse possession while the second addresses the issue of protection for the buyer in the context of a sale. Art. 2279 (1) provides, as a principle, that "In matters of movables, possession is equivalent to a title", "*En fait de meuble possession vaut titre*". This is a statue of limitation rule, under which one may receive title by possession over a period of time. Art. 1141 specifically deals with *bona fide* purchasers: "When a thing which one is bound to transfer or deliver to two persons successively is purely moveable, the one of the two people who has been put in actual possession is preferred and remains the owner, although his title is subsequent, provided however that the possession is in good faith."

A good faith possessor is someone who believes that he has good title or is the true owner of real property. Under French law, actual possession of a moveable good has two key effects: if the possessor acquired the moveable good on *non domino* basis and is a good faith possessor, possession allows him to receive good title over the original owner. If possession was received from the original owner, there is a legal non-conclusive presumption of ownership and good title is assumed.

French law is not, however, fixed upon the title but upon the will and the contract. In the case of theft or other crime by which a party obtains property, the rules are the same as those applied in an American jurisdiction: the owner can recover, even from a subsequent *bona fide* purchaser, as possession of the property did not pass according to will of the owner. This applies to both moveable and non-moveable goods because contracts and other juridical acts that have been declared invalid are invalid *ab initio*, from the moment at which they were formed.

Quebec

Some codes, such as that of Quebec, contain explicit provisions dealing with situations where personal property has been left for safekeeping or repair or has been forgotten. After a time and after giving notice to the owner, the bailee may sell the property at auction or transfer it to charity. The owner may 'revendicate' the proceeds received by the bailee minus the bailee's expenses. However, if the property is an immoveable good that was sold in the ordinary course of business to a *bona fide* purchaser, the owner can revendicate the property but must reimburse the *bona fide* purchaser the price of the purchase.

For Value

For a person to be considered as a *bona fide* purchaser, he must have obtained the property for value That is, he must have paid or promised to pay, or given or promised to give, some thing or service of value in exchange for it. In some jurisdictions, the *bona fide* purchaser must have taken the property under onerous title, for value, meaning that he must have exchanged something for it.

Successive Transfers

Successive transfers do not change the situation. Under American law, if a person with voidable title transfers it gratuitously to a third party, and the third party transfer it for value, the owner prevails. The first transfer is the one that matters: if the first transfer is not in good faith, the owner will prevail, even if the property then goes through a number of good faith transfers.

Exception for Securities

In all jurisdictions, it is not possible to recover certain types of property that are in the hands of a *bona fide* purchaser. This is often the case for fungible goods, money and securities. The idea is that since money and securities are fungible and circulate, the law must protect the security of the acquisition above all. This can, for example, be seen in the new Russian Civil Code, paragraph 302.3.

Opposition Between Common Law and Civil Law Systems

Until recently, much was made of the reluctance of common law to come to terms with the concept of good faith. With the advent of several comprehensive harmonisation schemes, including UNIDROIT, and the huge influence of European civil law on English common law, the concept of good faith has become more and more of an issue. Part of the doctrine argues that the concept of good faith is not common in all western countries. Statements to the effect that English contract law does not recognise a general concept of good faith are legion. As Professor Bridge notes, common law lawyers have traditionally regarded good faith as, “An invitation to judges to abandon the duty of legally reasoned decisions and produce unanalytical incantations of personal values.”

A closer inspection of the problem shows that it is more complex. The distinctions become even less definite once it is acknowledged that common law systems such as those found in the US or Australia, are defined as ‘mixed’ and have an amalgam of civil codes and common law principles. As Professor Farnsworth pointed out many years ago, “The wide-ranging doctrine of implied terms, functioning as a repository of principles of fairness, good faith and ‘reasonableness’, is at the heart of our understanding and construction of contract law.” It should be remembered that there are significant global developments which seem to highlight not only the ubiquity of the principles of good faith and fair dealing in western systems, regardless of whether they are civil or common law, but also that they are central to the rationale underlying contracts. I refer particularly to the movement towards the harmonisation of contract law in Europe, as illustrated by the Principles of European Contract Law, the UNIDROIT principles, the UN Treaty on Sale of Goods, the US Uniform Commercial Code and Second Restatement of Contracts, and, in the UK, the Unfair Contract Terms in Consumer Contracts Regulations of 1994 and 1999.

Both the Principles of European Contract Law and the Principles of International Commercial Contracts contain general provisions according to which, “In exercising his rights and performing his duties, each party must act with good faith and fair dealing.” In its Principles of Interpretation, the 2004 UN Convention on the Assignment of Receivables refers to, “the need to promote uniformity in its application and the observance of good faith in international trade.” On the other hand, we should note that, in the recent UNIDROIT Convention on International Interests on Mobile Equipment, references to good faith have been dropped because it was felt that they could cause uncertainty in operations dealing with important amounts of money. Instead, the focus was placed on the necessity of promoting the foreseeable views of the Convention and promoting predictability in the application of the Convention.

It could be argued that this is a turning point with regard to good faith in the context of international conventions. I believe that the lack of references to good faith in international conventions is due to a misunderstanding of the good faith concept in both civil and common law systems; it is important that we return to the essentials of good faith acquisition in both civil and common law systems.

Farnsworth writes that the difference between civil and common law systems, with respect to understanding and developing the notion of good faith, is often illusory. He makes two relevant and related points: not only do the widely accepted UCC and the Restatement (Second) function, in effect, as a civil code within a common law jurisdiction, but the articulation of good faith contained in section 205 – “Every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement.” – has a fairly precise provenance. If we are prepared to accept that section 205 of the UCC is effectively a translated version of the concept of the principle of *Treu und Glauben* in the German civil code, the distance between civil and common law systems appears suddenly reduced and we have a useful illustration of their close connection and potential compatibility.

In civil law systems, good faith is an overriding principle that governs the interpretation of law in contractual relations and applications where, as *Steppenton* puts it, there is a need for a legal doctrine ‘to temper the deliberate pursuit of self interest in situations where the conscience is bound’. If the US application of good faith in Section 205 is, as both *Farnsworth* and *Eusi* suggest, a version of *Treu und Glauben* from the German civil code, it could be assumed that it shares some of the logical and historical connections just noted. However, the reference is not to the objective meaning of good faith, that is the interpretation of law in contractual relations: it is a subjective meaning of good faith, that is the faith of good acquisition for a possessor and the need to protect the voidable title.

Limits of a Neutral Approach

In order to ensure the uniform application of the future UNIDROIT Convention's provisions, it has been agreed that all references to traditional concepts should be avoided where possible. This principle is considered by the drafters to be one of the most important principles of the Convention. With regard to the concept of good faith acquisition, the Secretariat of UNIDROIT considered that the requirements "need to be defined in as plain a wording as possible in order to avoid recourse to traditional concepts. In the end, it was decided that the entire concept of what is traditionally known as a 'good faith acquisition' should be replaced by a description."

In this sense, the new Art. 11, 'Acquisition by an innocent person of intermediated securities', addresses the issue by providing that, "A person who acquires intermediated securities by credit through a securities account under Art. 5, or who acquires a security interest in such securities by an agreement or designation under Art. 6, and who does not at the time of acquisition have knowledge of an adverse claim with respect to the securities is not subject to that adverse claim." Knowledge of an adverse claim is a key principle used to address the 'good faith acquisition' rule. Art. 11 of the text indicates what should be understood as 'knowledge of an adverse claim' in such cases. In Rome, several delegations argued that 'knowledge' as used in the former Art. 10(3) was unclear. One delegation was concerned that a broad interpretation of knowledge would impede dealings between intermediaries and questioned whether 'knowledge' of adverse claims gave sufficient protection to the *bona fide* purchaser.

Conclusion

To return to the discussion of Rome, I have found no reason, other than the need to use neutral language, to avoid references to the concept of good faith. In general, I am not convinced of the need for neutral language with respect to the notion of good faith acquisition. The principle of neutral language, as used for the purposes of the draft Convention, is flexible and can be accommodated. As the Secretariat recognises, it reflects a clear desire to accommodate different legal and concepts and produce the least obtrusive instrument possible by employing fact-based rules. This does not, however, mean that intrusion can be avoided entirely. In this case, the fact that the English and French versions differ ("Acquisition by an innocent person" against "Aquisition par une personne de bonne foi") highlights the difficulties involved in addressing similar views in different languages.

Secondly, I believe that the concept of good faith with regard to possession does not differ significantly between jurisdictions. If good faith in the sense of fair dealing for contractual parties is not fully recognised by some common law jurisdictions, the concept of good faith for possession is recognised by all jurisdictions.

Thirdly, the notion of knowledge of adverse claims addresses questions like significant possibility and knowledge itself.

Fourthly, the good faith acquisition rule is crucial to the protection of third parties. It is clearly better to use legal terminology which is known and used in various jurisdictions than to describe this rule and risk that judges will miss the real meaning of the rule.

Due to the uncertainty of the scope of the concept of knowledge of adverse claim, I suggest that we should cast aside the principle of neutral language in this respect and return to the concept of good faith in order to avoid the risk of requalification by judges. I see no difference between civil law and common law in the protection they accord to the purchaser. If the legal answer defers title versus contract, the objective and the answer are common.

B – Discussion

One attendee explained, on a general note, that it might be extremely difficult to depart from concepts which had been established for centuries. From a civil law perspective, it was extremely important to be able to link any new concepts to existing provisions in the civil code. Introducing new concepts which were justified from a functional perspective might create an area of uncertainty. If the concept of knowledge was to be introduced to the statutes, a compromise would have to be found because actual knowledge created the same uncertainties from a civil law perspective as the concept of good faith creates for the common law perspective.

Another participant drew the audiences to the report given earlier, where the differences in the draft between the English language and French language versions had been highlighted. However, the difference was only in the title which had no real legal significance per se, although it did have the merit of making the reader aware that the discussion related to good faith. The substance of the French version, which was a faithful translation of the English version, introduced a fairly restrictive concept of good faith from a French law perspective. That is something of which delegations should be aware. The question was whether all jurisdictions could live with such a restrictive approach to good faith, which was still a fundamental issue which lay at the very heart of civil contract law.

1) On the need for the concept:

One participant explained that, in the case of the Cape Town Convention, the concept of good faith was dropped entirely. This was because a difference was developed between rules based on standards and pure rules. Since the idea was that people with a limited legal background would need to know what is, and what is not, a Cape Town situation, it was agreed predictability was everything and, therefore, standards were not helpful. Clear rules were deemed preferable to standards with margins of interpretation. Historically speaking and from a real comparative point of view, there were far more radical solutions available regarding the acquisition of title from a non-owner. There were legal systems which protected acquisitions from a non-owner even without good faith, and there are others which did not acknowledge any good faith acquisitions at all. Common law and the French civil code were, in fact, not particularly far apart on the spectrum.

Another attendee added an example: The Cape Town Convention dealt with the acquisition of commercial aircraft. There was an international registry where all the records of interest in these aircraft were listed; this registry was open to public scrutiny. The priority rules were quite crisp: rights were based on the time of registration, regardless of whether another interest was known about, because the registry was intended to be the objective indicator of interest. During the negotiations there had been concerns that the addition of good faith would undermine the priority rule which made the registry the defining element.

2) On knowledge vs. good/bad faith:

One participant wondered whether the criterion of knowledge or good/bad faith with respect to specific *securities* made sense. In fact, in modern systems there were no specific securities which formed the object of the transfer. Rather, credits and debits in different accounts were made. In most cases, debit and credit were not linked, at least not in a manner that gave the acquirer the possibility to check the circumstances of the transfer. The traditional concept of good faith hinged on the exact identity of the property and the right of the purchaser to the exact property held by the seller: however, the only thing about which an account holder could have good faith was the *credit* on his account. For this reason, the wording proposed in the draft Convention should be retained. This was supported by many participants.

Another participant pointed out, that for this reason, good faith for acquisitions was abandoned in UCC Art. 8 and replaced with text which captured the concept of notice of adverse claim. By this means, parties were insulated from liability unless they acted in collusion to violate the rights of another party. The aim had been to create a fresh standard of culpability that would allow someone to be exposed to liability in the securities markets.

3) On ”first” and “second” acquirer:

The first issue discussed by the plenary was whether roles on good faith acquisition should equally apply to the first acquirer and to the second acquirer.

An example for the first *bona fide* acquirer was the following: A sold to B 100 securities. The contract is void. Is B a good faith acquirer? An example for the second *bona fide* acquirer was the following: As before, B had obtained possession and sold them correctly on to a third person, who acquired *bona fide*.

There was agreement that it was fundamental to decide whether both the first and the second acquirer should be covered by the same provision in the draft convention.

4) On “adverse claim”:

Several participants proposed that the concept of adverse claim be discussed in more detail at the next session, as it seemed to be incompatible with existing national legislation. One important issue was, for example, whether the concept would cover bankruptcy estates claims on the basis of voidable transactions. Some countries might have objective grounds for transactions to be voidable.

Another participant replied that adverse claim, as he read it in the current draft, meant a legally valid claim. The reason that the text only mentions ‘an adverse claim’ rather than ‘a legally valid adverse claim’ was apparently that it came from a culture in which legal rights were defined primarily through litigation and not through codified law. Whether good or bad, the fact remained that legal rights in a common law culture were defined primarily by litigation. Others agreed.

Others pointed to the definition of adverse claims with respect to any securities: “a claim that a person has an interest in those securities that is effective against third parties”. It seemed clear that the drafters had valid adverse claims in mind.

There was also the proposal to bridge the gap in understanding between the common and civil traditions regarding what is mean by ‘adverse claim’, by discussing the concept of opposability in relation to claims. Opposability encapsulated the idea that a right could be defended against the claims of others. This might provide a basis for transforming the concept of adverse claim into a more universally applicable form of words.

5) Conclusion

To conclude, one participant reminded the audience that first a policy decision about the substance of the provision needed to be made. Subsequently, the terminology could be discussed. The policy decision is about who should be protected and under what circumstances. Rather than using the good faith concept which was designed for systems where the buyer and the seller knew each other, a test might be more appropriate. As it was not possible to know who the buyer was in securities systems with multilateral trading platforms, the current concepts could have a different meaning and application.

Topic 4: Loss-sharing: Cause? Assessment Base? *Pro Rata*?

A – Report my Mr Chuck MOONEY, University of Pennsylvania

The importance of a pro-rata sharing rule along the lines of Art. 18 has become apparent in the course of our discussions in Rome and in Bern and in internal discussions in the US. One way of looking at this is to consider that pro-rata sharing may be important less for its actual terms than for what it provides, namely a cause-based way to trace and unwind transactions and determine what caused the shortfall.

Pro-rata sharing must be considered alongside other crucial provisions in the draft Convention, such as a coherent set of innocent acquisition rules and limited reversibility of credits. In our group, it was felt that concepts like innocent acquisition and good faith should be given a dedicated place in the Convention.

It should be noted that the handout marked 'Draft'[6] will be finalised and submitted for discussion in Rome. Footnote 2 in the Draft makes reference to another concept that we will be proposing for discussion, namely the concept of immunity. In many cases, intermediaries serve as conduits for securities that flow through them under circumstances where they do not actually acquire an interest. We believe that those intermediaries, under the principle of innocent acquisition, should be protected from liability when they act innocently in the markets. Given that acquisitions often occur without the transferor being identified or identifiable, this could be of great importance in the world of intermediated securities.

In discussing Art. 18 and the principle of shortfalls, I should like to recall the report given by the relevant working group at the seminar held in Bern, which dealt with priorities, the effect of book entries, and loss sharing. We identified a couple of ways in which the interests of an account holder who receives a credit could be viewed. One way would be to view the pool of securities allocated to account holder interests as a bulk in which account holders have a pro rata share. This would result in a constant, potentially shifting, shared property interest.

This view does not sit well with those who operate in systems which have a precise view of the identifiable property interests that an account holder might have. I understand this. Some take the position that, in their domestic systems, it is impossible to have a shortfall. I think that is wonderful, particularly as these people have no grounds for resisting a pro-rata sharing rule because it would never apply in their jurisdiction. The primary purpose of the Draft is not to identify hypothetical problems, but rather to establish how intermediaries operating in different jurisdictions can inter-act effectively. The inter-relationships between systems oblige us to consider all of the systems in question.

Most of the group felt that some pro-rata sharing rule would be a good idea because, in almost every system, it is possible to identify events that could give rise to a shortfall. For example, an account holder might receive a credit but there might be a failure to deliver to the relevant intermediary in the settlement system, thus giving rise to a shortfall. There are a number of ways in which a shortfall could arise.

As the working group's report indicated, shortfalls almost always apply in insolvency situations. If no one ever knows of the insufficiency and everything is in place when the time comes to sell or give dividends or receive information about the issuer and every account holder receives that to which he is entitled, no one would ever find out about any shortfall. Although the regulators might find out and blow the whistle, the account holder is unlikely to notice any adverse effect. It might be that, in order to ensure that there is no interference with other conceptions of property rights, this rule should only be triggered by insolvency.

[6] Now UNIDROIT 2006 Study LXXVIII Doc. 35 and Doc. 36.

Art. 18 leaves some questions unanswered, such as the time at which it is applied and the role of national laws relative to the Convention.

I would like to offer some hypotheses that might clarify the reasons for having such a system and the basic fairness of such a system. Some of my suggestions might seem radical at the outset.

Let us start by assuming that we have Customer A of Intermediary A who has 100 shares of Y Securities credited on its account. Customer B of Intermediary A has 100 shares of X Securities credited to its account. There is a shortfall in the X securities. Under a pro-rata sharing ruling, the customer claiming Y securities would be fully satisfied in accordance with the applicable insolvency rules – their property rights, at least, would be recognised – while the customer with the X securities would receive 50%. The American courts would apply this ruling regarding the property interest; I believe that this is generally how Art. 18 would be interpreted. The issue is one of sharing on an issue by issue basis. It could be questioned, however, whether this should be viewed as an insolvency distribution rule.

Let us take another example. We have the same two customers but the intermediary, for whatever reason, failed to buy the 100 Y securities which the customer wanted and had paid for. In this case, there would be an even greater disparity of treatment between the two account holders: one customer would be fully satisfied, because the 100 shares would be available for distribution to that account holder, while the other account holder would simply have an unsecured claim and would not, therefore, have any property interest.

These two account holders have done exactly the same thing and taken exactly the same risk with exactly the same intermediary. Nothing they did, including their selection of securities, made it any more or less likely that the securities would be available or not available to satisfy their claims. This is pure chance. Nothing would have made them behave differently ex ante as they were satisfied with the security and with the intermediary.

One approach would be to say that such situations should not be handled on an issue-by-issue basis, nor even according to particular property rights. Instead, all securities in which all account holders claim an interest should be put in a pool and then allocated pro rata across the board to all claimants, according to value. There could be any number of additional rules, for example to provide that the insolvency administrator buy in like securities or offer cash distributions, etc. This is the system which is applied in the US for insolvency proceedings for stockbrokers. In the case of banks, the property distribution pro rata rule is applied depending on the issue. In short, the creditors of the intermediary cannot reach the customers' securities.

A distribution rule of this kind gives each account holder a higher risk of a lower loss. As it is much more likely that there would be a substantial shortfall in a particular issue than that there would be substantial shortfalls in a range of issues, every investor has a lower risk of a big loss and a higher exposure to a small loss.

We should decide whether we really need a uniform sharing rule in the Convention. The lack of uniformity in distributional rules in insolvency proceedings – a lack of uniformity with which we have survived for a long time – is not the driving force which has taken us to Rome and Bern and Paris. The driving force was the need for investors to be safe and secure in their transactions on the market. It might be preferable to defer this issue to states in order to maximise flexibility and allow them to choose the insolvency sharing rules they prefer, as long as they select one and defer to the innocent acquisition package of rights. Not only would this relieve the pressure on the Convention to find the right wording, it would also make it more likely that jurisdictions which believe they already have optimal sharing rules would accept to be bound by the Convention. I believe that we do not need to insist on absolute uniformity provided that does not upset legitimate transactions.

B - Discussion

One attendee concurred that if all the customers of an intermediary shared the loss on a pro rata basis, the risk of a loss was greater even though the size of the loss would be reduced. This pointed to a possible disadvantage of segregation, namely that the risk for some customers was likely to increase in case of segregation which was a clear disadvantage.

Others believed, with regard to the general issue of whether or not a general pro rata loss sharing arrangement should be applied, that ex ante it was clear that it would be beneficial to have a pro rata loss sharing arrangement. It was an example of the prisoner's dilemma: when people do not know what will happen, they want to make sure that they have the smallest possible loss. As shortfalls happened more frequently on securities that were subject to very volatile trading, especially where hedge funds did naked short selling, conservative clients (account holders) who would never invest in very volatile assets would not be willing to share the risks faced by those clients who willingly invested in assets which were more exposed to a shortfall. Although ex ante pro rata is a logical approach, it was unlikely to meet with the approval of clients.

Furthermore, any pro rata rule needed to have a rule for valuation and one that indicated the point in time on which the assets of the insolvency estate would be valued.

Another attendee did not expect, on the basis of earlier discussions, anyone to contest the idea of pro rata sharing. However, two questions remained. First, at what point in time should pro rata sharing kick in and what were the prior measures which had to be made with recourse to insurance schemes or remaining assets? Secondly, and perhaps more importantly, how could shortfalls be *avoided* in the first place? One solution would be not to credit before sufficient coverage has been obtained.

Following up on this, others emphasised that the pro rata shortfalls rule should be a mere default. Not every situation was comparable to that of US stockbroker, other systems required different solutions. For instance, German law provided for a kind of pro rata loss sharing but this did not occur in the first place.

Another participant supported that pro rata loss sharing should be a solution reserved for the situation of the insolvency of the intermediary. Others were of the opinion that proper loss allocation rules were also necessary outside the intermediary's solution because there were situations where shortfalls occurred due to other circumstances (e.g. securities certificates which were held with a foreign sub-custodian turned out to be forged). In situations like this it was highly questionable whether, instead of sharing the loss, the intermediary was obliged to make up the deficit.

A formula proposed by others in this context was that loss sharing should be applied as soon as losses were incurable, i.e. shortfalls that remained when every option had been explored and everything possible had been done. This was a typical situation of the final stages of an insolvency. From a conceptual point of view, pro rata sharing in a shortfall was not a choice but was a logical consequence, because if the conception was that the investor held part of a pool of assets, it followed that the value of the part declined as the pool got smaller.

Another participant strongly agreed that the focus should be on incurable shortfalls. Additional discussion on what an incurable situation is might be needed. It was questionable whether it was possible to have recourse to own holdings, if there were any, as it was unclear whether the liquidator should be expected to try to buy in residual assets? These were matters of national insolvency law. This clearly showed that, when insolvency was discussed, one should not care about issues for national insolvency law. Probably, incurable situations were those which were outside insolvency.

A French attendee pointed to the fact that the French system was often viewed as a direct system. However, under current French regulations, there was a pro rata rule exactly like that described in the draft Convention.

As regards the question whether a rule on loss sharing should be left to the national jurisdiction, there was a third view advocating a middle way: the principle should be included in the future UNIDROIT instrument while precise definitions and the exact scope of application were left to national law, or, that the future instruments addressed the shortfall scenario in the case of insolvency and the treatment of any pre-insolvency situation was left to the national law.

Others, having in mind situations where the intermediary was not responsible for the shortfall, were in favour of a general rule which stated that each investor should recover the number of securities on his account and recover his rights and that, if there was a shortfall which had not been cured and which remains once all the agreed initiatives have been taken, there is a need for a loss-sharing arrangement. This could be left to national legislation or regulation. It might be that the French solution of allocating loss across the investors on a pro rata basis was the best option for handling securities shortfalls. If, at the end, there were securities which could not be allocated, there should be a solution which allowed investors to recover their rights through securities that were available in the intermediary's own portfolio, which should be available to satisfy investors.

Others agreed that a remedy of the shortfall should come first. The intermediary had a duty to all of its clients to ensure that their credits were good. For as long as the intermediary was solvent, he was obliged to try to solve the issue. Any provision on pro rata loss sharing should be a worst case provision for insolvency situations.

There was agreement that in case the securities necessary to match the credit to a customer's account were not available on the market, this should be resolved among the intermediary and the account holder. It should not have an impact on other customers and their account holding status outside insolvency.

One participant illustrated this issue by giving a practical example: a non-resident financial institution was issuing warrants in Country F. As required by disclosure requirements of the regulatory authority, financial information had to be updated on an annual basis. Subsequently, the regulatory authority had changed its rules with respect to disclosure of information by non-resident institutions. At that point, the non resident financial institution wanted to issue a new set of warrants which were assimilated to a former issue. Normally, this was a very simple process which took a few days. As the legal advisers were still in the financial information process, the issuer – perhaps imprudently – issued and sold the warrants on the market in the meantime. Clearly, the issuer could not deliver them. It was highly arguable, whether holders of warrants issued under the previous assimilation should be participating in the sharing of the loss or whether there should be an indemnity mechanism. The participant himself tended to the view that in circumstances like this the intermediary should be liable rather than that loss sharing applied.

Topic 5: The Impact of Intermediated Holdings on the Investor-Issuer Relationship

A – Report by Mr Ignacio GOMEZ-SANCHA, Iberclear, Madrid[7]

I will start with a description of indirect holding and the question of how we can make a direct holding work before moving on to the issuer-investor relationship, its operation in the electronic era, the status quo in the intermediated arena, the fact that issues may be sold in the transfer of corporate entitlement, and the EU Directive on Shareholder's Rights. Finally, we will consider whether issuers would be happy with the current UNIDROIT draft.

The securities markets were born when entrepreneurs and businessmen became tired of paying commercial fees to banks and decided that it would be better to ask the investors directly for the money. When they gave money directly to entrepreneurs, they wanted to have liquidity. In a company there are three things which are important: the decision-making process; the flow of capital inside and outside the company; and the mechanism for transferring shares. From the investor's point of view, a share is no different from a credit right because the satisfaction of the right depends on the capacity and willingness of the debtor to comply with and satisfy that right.

This relationship was not initially documented and only a simple receipt was given. This was not sufficient as transfers of credit rights suffer from well known problems. For example, if I assign my credit right to another person, that person may be exposed to the set-off that the debtor had against me. It was decided that rights should be incorporated into certificates in order to avoid this problem. I feel that this was an excellent legal solution. It was good for issuers because they knew who the creditor was; it was good for investors, because they could have liquidity without giving notice of the assignment to the issuer. Additionally they gained the legal protection granted by the possession and publication of the paper, as investors were protected from shortfalls as their rights were vitiated by the issuer's previous relationships.

Then the paperwork crunch came. At the end of the 1960s, the US had to stop the markets to allow settlement to keep pace with trading. This solution was also inconsistent with foreign investment as the paper needed to be kept close to the issuer. The common solution throughout the world was to allow transfers in form of entries into electronic records. This solution is not yet in place in all countries. For example, there are cases of less developed countries where settlement occurs only on days when it does not rain as the papers are transported by motorcycle and have to be kept dry.

The issue is how to keep the advantages for issuers and investors that I have just mentioned while not closing one's eyes to reality. In the late 20th century, two kinds of solutions were proposed: the first about adapting the law to reality through indirect or intermediate holding systems; the second about adapting reality to the law with direct holding systems as soon as this was possible. Generally, in intermediated holding systems, the investor has an entitlement with a relevant intermediary and there is no formal legal relationship between the investor and the issuer. The transfer of rights does not require the intervention of the upper-tier CSD or intermediary and credits and debits may occur by mere confirmation and the creation and destruction of securities on each occasion. This is not always the case, of course. It is important to remember that there is a huge difference between the two main types of system in terms of confirmation versus crediting. In some systems, mere verbal confirmation that the securities have been bought suffices to create a securities entitlement. In others, for example in France, an entry in a concrete account is required. In the case of insolvency, there is no traceability, so there is a need for shortfall allocation arrangements.

In direct holding systems, the law tends to recognise the account holder as the legal counterpart of the issuer. Intermediaries are, therefore, mere book-keepers with no interest in the securities.

---

[7] Cf. Appendix 5.

They are entitled to charge fees in their capacity as a service provider. The issuer is considered to have met its obligations when it complies with the direct holder. Generally, it should be in a position to know the identity of the holder. Upper tier attachments are sometimes felt to provide more protection for the investor. As I mentioned, rights are acquired through entries in accounts and not by mere confirmation.

In an electronic world, there is a need for external controls as an infinite holding chain is not compatible with a direct holding system; the laws that state that the issuer has a legal relationship with the final holder are not very realistic. If the issuer has no way of controlling who holds the securities, there is a risk that he will be confronted with claims which exceed the issue. Someone must bear responsibility for cases where securities claims are created, for maintaining electronic records, and for facilitating the exercise of rights. It is for this reason that CSDs play a vital role in direct holding systems.

There are two possible realistic structures: a single-tier centralised system such as that operated by Greek, Brazilian and Nordic CSDs, where there are as many accounts as there are investors and indirect investors are subject to potential legal contingencies depending on the system; and a two-tier centralised system, such as that introduced by Spain in 1992. In this kind of system, there is the stock exchange, a broker acting for Client A, and a seller with Broker B. When there is a trade, the stock exchange gives that trade a number and gives the buyer a fifteen-digit number which is communicated to Iberclear and the custodian designated by the broker. That number is inscribed both in the client's account in Iberclear, which has full segregation, and in Custodian A's books. When the buyer wants to go to another bank, he does not transfer entitlement or destroy an entitlement to create a new one. Instead, the entitlement against the issuer, represented by the fifteen-digit number, is transferred through the system. Of course, this is only possible within the system, which contains CSDs and direct participants.

This fifteen-digit number, which is very important in Spain, is structured as followed. The first number shows the origin of the transaction; the next six digits show the date of the transaction; the next digit shows whether it is a bilateral loan or a donation or something else; the last digits are a sequential number and a control digit. The system pivots on these numbers and uses them to keep track of transactions and contracts. The numbers are used to update the registry of shareholders of nominative shares – the name of a registered shareholder is linked to the number. Without this number, an investor does not have property rights; he only has a mere claim against the intermediary. The number allows traceability throughout the whole chain as it is used by all participants. It is for this reason that Spain has direct holders in the first two tiers; indirect holders are less well protected.

There are pros and cons associated with both direct and indirect systems. The direct system is as legally sound as the paper certificate system and is fully integrated with the settlement process but it does not allow internalised settlement in lower tiers. Numbers are not granted in lower tiers and the numbers granted further up the chain reflect the date on which that number was granted, not the date on which the security was acquired. The system is designed to meet the needs of issuers but does not facilitate divided voting, takeovers, and distance voting, among others. There is full protection for direct collateral in this system as individual securities can be blocked on the basis of their number and the risk of shortfalls avoided. Traceability, public supervision and transparency are excellent. Unfortunately, the owner is considered as a mere nominee or trustee.

The indirect system is much more realistic for cross-border investment even though it can become legally unsound when the chain of holdings is long. It allows internal settlement but it is incompatible with some complex local clearing and settlement arrangements. The flow of economic rights through the chains is excellent but there are weaknesses with regard to political rights. The system allows for cross-border collateral, although the extent to which this can be enforced is not clear.

Let us turn away from intermediated securities for a moment and consider corporate law. Under corporate law, a shareholding is a complex, legally protected situation that is composed of rights and, sometimes, obligations for the investor. For example, in Spain, fund managers who manage portfolios that represent more than 1% of the shareholding of a listed company are obliged to vote. The basic legal need in this complex situation is identification. This is not identification to the extent of identifying the ultimate shareholder but identification of the counterparty. It is important for a creditor to know who his debtors are. If not, how can he know who to sue? It is important that debtors know whom they have to satisfy to obtain their freedom. Good documentation is, therefore, of the greatest importance.

When shares were documented in paper certificates and inscriptions in a shareholders' registry, it was easy to manage identification procedures. It is important to be able to identify the counterparty so that the investor can be sure that he is entitled to his rights, even though such knowledge might also require him to comply with obligations. The shareholders' registry, as an abstract concept, performs the same function for the shares that the notice to the debtor has in an assignment of receivables. It protects the principle which provides that the debtor should not be placed in a worse position because the creditor decides to transfer his interest. It is a defensive tool for the issuer as, if he does not receive notice of a transfer, he will be free to pay his current creditor and not the person to whom he transferred his rights.

I shall discuss the Spanish situation, which is excellent for the direct system and very poor for the indirect system. It is important to differentiate between 'bearer' and 'registered'. In the UK, 'bearer' means paper, 'registered' means registry. In Spain, both 'bearer' and 'registered' could be on paper. Instead, the difference is that 'registered' allows the transfer of the paper through endorsement although, for that to give title against the issuer, that paper needs to be inscribed in the register, while 'bearer' means that the shareholder does not always know what is happening between the shareholders. Spanish law provides shareholders with the right to ask for a list of shareholders on the record date, which is D-5. This is not a very good solution, however, as it does not allow sufficient time for the issue and delivery of attendance cards. These cards are not homogeneous, do not always refer to the same record date, and are expensive to issue. In Spain, some issuers have as many as 1.8 million shareholders.

In the case of nominative shares, intermediaries send the transactions to Iberclear daily; Iberclear, having squared the transactions, sends them to the issuers who tally them against their own shareholders' registry. This allows the issuers to issue and send cards at the right time and perform a valid recap at D-5.

Let us consider how this abstract concept applies in the intermediated arena. As we all know, foreign investment flows through intermediated chains. Additionally, issuers can voluntarily choose their issue to be traded in several countries, a process which requires several different models of linked systems to enable clearing and settlement. Corporate law, however, is not generally adapted to this new reality and continues to consider shareholders as the immediate account holders because theirs are the only names on the books. The consequence of this is that, for corporate law purposes, the final investor does not exist. This is not good whatsoever. Sometimes the indirect holding of shares is formally forbidden, preventing foreign investment. At present, some countries – including one in South America – do not allow any foreign investment in the country, whether direct or indirect. In addition, major nominees and custodians are considered to be major shareholders, which makes no sense. There can be problems with share blocking and problems can also arise when certain mandatory takeover thresholds.

Issuers need to communicate with relevant shareholders in certain situations, for example in order to promote participation. Of course, finding the ultimate investor is 'mission impossible', as the ultimate investor can be defined as the one bearing the economic risk of the issue but that risk is divided as a result of the issue of derivatives. Nevertheless, if the counterparty cannot be identified, there is no recognised legal relationship. This results in corporate schizophrenia: issuers want the final investor to be reachable but they do not want to lose the positive effects of identification, namely that a party is free if they know who they have to pay.

This situation raises two important issues: how this situation is currently managed, and whether there is a legally acceptable solution for those countries which do not allow for a split between legal and beneficial ownership.

At present, there is a general consensus that economic rights flow correctly. This is a minimum: no one would invest in an instrument if they did not believe that they would receive their dividends. Political rights are possible but more cumbersome and difficult and depend to an extent on the 'rationale of apathy'. There are timing problems associated with gaining approval from different levels of the chain within the period allowed in notices sent to shareholders; there are obstructive problems, for example arising from the need to block shares during the notice period; there are information problems; and there are execution problems. Issuers want to remain within the bounds of the legal entitlement contained in corporate law of intermediaries to cast votes and not concern themselves too much with the issue of who holds the vote. Issuers are not interested in who controls the vote: they want to know who casts the vote.

As a result, global custodians and other intermediaries are frequent and instructed voters, whether directly or by proxy. Issuers view these parties as shareholders even though they know that they are not the parties which bear the economic risk of the investment. Final shareholders face a veritable obstacle race if they want to attend a meeting. In practice, the final shareholder has to pass instructions up the chain that he wants to attend the meeting and wait to receive notice from the top of the chain about how and when he will receive the documentation required to enter the meeting. Once inside, he receives an attendance card that states that he is a proxy holder. This situation has created a new business for 'proxy agents' and 'proxy advisors' who deal with these administrative issues on behalf of fund managers.

I believe that a legal solution exists for countries that are not allowed to split legal and beneficial ownership: transfer of corporate entitlement. The issue is that, if the concept of a counterparty needs to be maintained but it is recognised that the counterparty is not a shareholder, it is important that the rights may be transferred if it is to the benefit of the company. Conceptually, the shares belong to the final investor but, as the final investor cannot be identified, it is accepted that the corporate entitlement is, instead, in the hands of the direct investor. The obligations of the intermediary, both upstream and downstream, must be clearly defined and regulated and a standard of diligence must be established.

The question arises of whether the intermediaries should be subject, as counterparties, to the obligations of the investors. The answer, of course, is no. There is also the matter of whether the burden of proof that a transfer of corporate entitlement occurred should be assigned to the person who put it forward.

The EU Proposed Directive on Shareholders' Rights is relevant to this discussion. The EU has now been working on this for four or five years and has now issued a proposal, the objective of which is to remove obstacles to cross-border voting and exercises of rights in shareholders' meetings by a minimal legal harmonisation. There is no longer an attempt to find the final holder. The definition of 'shareholder' includes a person holding in his own name but on behalf of another as it is a corporate law concept. This approach is valid only for the purposes of this directive, which concerns the exercise of rights and establishes minimum standards for shareholding system operation. The Directive allows for three kinds of non-resident voting: proxy voting; voting in absentia, whether by post or by electronic means .

I am sure that the intermediaries are very happy with the current draft of the Convention because it says that it is difficult to vote on behalf of clients and give them notice. Art. 19 is potentially circular. It says that issuers are not bound to recognise a shareholder if, according to corporate law, they are not obliged to recognise them. However, corporate law should be amended to oblige them to recognise that. I do not think that issuers would be very happy with the idea that the principle that counterparties must be identified might be lost. This is not in keeping with the style of the rest of the text. In my opinion, it would be better to regulate the process of exercising the rights and the behaviour expected of intermediaries and issuers rather than insisting that all states should lift their barriers. Art. 20, the set-off provision, is also difficult to accept in a direct world because, of course, issuers will only recognise parties in the direct registry as counterparties. Again, a corrective rule is needed to ensure that the burden of proof of the intermediated holding, that is the intermediated debt against the issuer, and that no shortfall is in place, are against the account holder or his intermediary. If it is against the issuer, it will not be accepted.

B – Discussion

1) On "direct/indirect" holding

One attendee stressed that in his opinion there were not two types of systems, direct and indirect, but rather a variety of systems, some of which were very close to each other.

Another participant made the remark that, sometimes, the discussion was on systems being direct systems and others being indirect systems; at other times the formula direct holding patterns versus indirect holding patterns was applied. However, there had to be a direct holding somewhere in every holding chain. For instance, in the derivatives area of the London market it was almost never seen that the collateral that was given from one party to another was given in direct form. There was always at least one intermediary between the issuer and the provider, or taker, of collateral. That meant that nearly all cases of financial collateral arrangement were indirect. The real question therefore was whether the jurisdiction of a direct system recognised and gave effect to the indirect holding pattern. However robust the direct system was, and this was the value of the UNIDROIT project, some minimal protections to those indirect holding patterns were essential precisely because most investors had an indirect relationship.

On the basis of these remarks, others proposed to avoid the terminology of direct-indirect entirely.

One participant pointed out that dropping the terminology of direct-indirect holding would usefully reveal the underlying issues, which were the legal compatibility of certain structures. Consequently, the underlying techniques and legal concepts had to be examined with a view as to whether they could inter-operate, and if so, how the correct results could be achieved. A convention, or some other tool was therefore necessary in order to combine the different structures. The problem was not direct or indirect holding systems as such, it was rather the combination of the two in cross border transfers.

There was some discussion on whether legislation that provided for direct holding systems was not an impediment to the indirect holding of securities. This probably depended on the quality of the direct holding system that was looked at. For example, this was not a problem in the Spanish system; in other countries, the direct system might be insufficient so as to impede any indirect holding. For example, if the direct holding system did not provide protection against insolvency, it was it impossible to provide protection in subsequent tiers. When there was protection in the first, direct tier and that tier complied with the substantive provisions of the future UNIDROIT Convention, there would not be any problems in the indirect tiers. If a direct holding, in the case of Iberclear for example, provided that indirect holders had to be allowed to control – not cast – the vote, through intermediaries, then this part of the direct holding is not a problem.

One attendee concluded from the presentation that direct holding systems worked best in a national environment. However, as soon as securities were held across borders, the system could not work any more. The difficulty was to reconcile the fact that securities were also held indirectly and so that direct holding systems had to have some features to recognise the indirect holding system.

2) On the investor-issuer relationship in general

Participants supported the idea of discussing the "corporate entitlement mechanism" and remembered that barriers to indirect holding systems currently existed, for example in terms of prohibition of split votes, that were considerably obstructing the holding of securities on behalf of clients and represented negative incentives for foreign investment. A more detailed solution was needed in this respect, Art. 19 of the draft Convention was only a starting point.

Others recalled that it would in theory be possible to see the draft Convention as a tool to facilitate the lifes of intermediaries but were concerned that this could be a guarantee for its failure, as only a balanced approach would be appropriate. A prescriptive approach for intermediaries and issuers which established their rights and obligations would be the best solution.

On a more general note, one participant wondered whether it was the purpose of this project to change the methods by which the intermediaries, as defined in the convention, enabled the account holders to get the economic and political benefits of the investments. Moreover, market structures would not change to conform with the future UNIDROIT Convention. Therefore, a neutral and balanced way to provide the protections and benefits to the issuers, intermediaries and investors in a way that would fit with all of the systems was needed.

3) On set off in particular

As regards set off, one participant wondered how it was possible to be sure that there was not a shortfall in the middle of the holding chain. If there was a shortfall in the middle, a set off would trigger a hole in the balance sheet of the issuer. Therefore, there should be a correct allocation of the burden of proof in order to make set off possible. Others warned that a burden of proof requirement should not be set too high. A more detailed discussion was necessary to determine what counted as the burden of proof. In the best possible case, it would initially be easy to discharge the burden of proof, with the subsequent possibility, in the case of a shortfall within the chain, of revisiting and adjusting the set-off accordingly. There was the opinion that the solution already existed in Art. 19(3): "Subject to paragraphs 1 and 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." This meant that, if corporate law identified the shareholder, only corporate law should be taken into account. If the same rule could be applied to Art. 20, the issue might be settled. Another speaker drew the audience's attention to the fact that, the ambition of Art. 20 remained very limited with a provision which only applied in cases of insolvency of the issuer. Nothing is said about whether and to what extent offsetting is allowed or not during normal operations.

Topic 6: The Disposition of Rights and Transfer between Accounts

A – Report by Mr Klaus LOEBER, Principal Legal Counsel, European Central Bank[8]

I chose to look at this topic by ignoring the compelling arguments to consider commercial necessities. I think that to satisfy supervisors, overseers and judges, commercial necessities need to be backed up by a sound legal foundation. They need to be adjusted to the realities of the markets, but when it comes to breaking point, a legal justification is necessary for the established positions.

All systems work. Some work better than others but the real problem is how they interconnect and the minimum elements of commonality required to make them do so. To this end, I have established six theses which are intended to provide a structure for further debate. The pros and cons of different philosophies will not be discussed here, but rather the jurisdictions as they exist and the ways in which they can be made compatible.

On closer examination of my title, "The Disposition of Rights and Transfer between Accounts", I realised that a number of issues had to be clarified, notably the definition of these rights, their acquisition and the conditions under which they are acquired. These represent the principal source of misunderstandings concerning this subject. Preconceptions concerning the meanings of these terms abound and tend to make subsequent discussions difficult.

Disparities Between Jurisdictions

For this exercise, I am relying on my personal expertise of twenty-five jurisdictions in a single continent and on a number of expert descriptions of national legal structures. Referring to what is disposed of in securities transactions and taking the responses, without qualification or classification, it can be seen that there are disparities in the notions of how they are identified. Some jurisdictions refer to transfer of securities, some take a more legal approach to the property rights in securities, or the notion of UNIDROIT intermediated securities is identified in some jurisdictions as the object of disposition.

The problems occur when under one jurisdiction, the transfer of direct ownership in securities, on crossing a border to another jurisdiction, is considered to be an indirect right. This is where a common understanding of what the recipient receives is necessary. On crossing a border, certain elements of the "right" can be lost in its re-qualification. The same holds true for the question of who is acquiring what. Again, the answers differ considerably.

I have a number of qualifications here; the list is not exhaustive: direct acquisition, derivative acquisition, systems where the intermediary acquires all rights and legal ownership, and systems which combine all these elements. The disposition is effected differently in each jurisdiction. In the EU jurisdictions there is a wide variety of different combinations: straightforward systems where it is just a credit entry; some where it is the lowest tier; others where it is the CSD entry; and still more where it is a combination. There are jurisdictions which have additional requirements, such as a valid underlying contract. In some cases the contract is in itself sufficient, and in others the book entry performs an additional function. Every combination can be found, even within the limited range of the EU.

Book Entry Systems

There are three main streams: legal systems where the book entry creates an autonomous effect; systems where the book entry is derivative, i.e., it is dependant on additional elements to be effective; and systems where the book entry is only reflecting something exterior. All these structures work, but the way they inter-react is what needs to be examined. Looking at an exercise

[8] Cf. Appendix 6.

where an emphasis is placed on book entry systems, with intermediaries operating accounts, the last category is called into question as the book entry contains no cognitive element.

Six Theses

This brings me to my six theses. Concerning the category I just mentioned, in which a transfer can take place by agreement and disposition without involving a book entry; in that case the book entry can be construed as being a rebuttal evidence of a position. However, in a cross border situation, there is a risk that the effects of a book entry and the effects created externally to the book entry world are not the same. In order to avoid the creation of possible distortions, the connecting of the disposition effective by virtue of a non book entry disposition to the book entry world simultaneously therefore needs to be considered. This will ensure that the legal completion of the transfer is related to the book entry credit.

Let us now examine the relationship between book entries which are autonomous and those which are derivative. An autonomous book entry can take place at any level of a tier of holding and can only have effect against the direct intermediary. It needs to be asked whether it is desirable to have backing positions at the upper tiers to ensure the overall soundness of the system. For derivative book entries the situation is different. The effectiveness of the book entry depends on the prior establishment of similar positions. Sometimes the validity of a book entry is dependant on additional requirements , for example a valid underlying contract. The difficulty then arises of who is responsible for checking whether the requirement is being fulfilled. There is, therefore, a need to identify whether a book entry is dependant on such a condition. If so this information must be passed on. It is necessary to indicate in a book entry system that the book entry is contingent and for the indication to be removed once the contingency has been satisfied, rendering the book entry final. In some systems there is an additional indication that such a position *is* final. Consequently there is no need to consider “good faith” acquisition.

There exists a wide variety of classifications as to what a disposition entails. A derivative book entry is dependant on prior positions up a chain of holding: it is impossible to acquire more from a lower tier than from an upper tier. At best, the content remains the same throughout the chain of holding. In a bad situation, some elements are lost. What UNIDROIT is doing in the draft Convention is to define a minimum content of the rights to be passed on through the chain of holding and to ensure that these are safeguarded however many tiers there are in the intermediate systems. In the case of an autonomous book entry, there is no reliance on passing on something which has been acquired at an upper level. Alternative means to safeguard what has been acquired by an investor have to be found. The mechanisms currently exist in the UNIDROIT draft and it remains to be seen whether they work under all conditions sufficiently to safeguard the integrity of an issue, notwithstanding questions of fraud, as a final book entry can be relied on.

Some jurisdictions which require correspondent bookings state that a credit has to relate to a correspondent debit. The central element is the credit. This credit should be sufficient to create such legal effects so that there are no conflicting rights. However, jurisdictions exist which have additional requirements. Within one system the fact that matching credits and debits are required presents no problem. Transfers between different systems create problems of whether the transactions are traceable. It is virtually impossible in many situations to identify a direct link between a debit position on one side of a complex transaction and the corresponding credit on the other. What needs to be safeguarded is the overall consistency of all positions. If proper accounting mechanisms are applied, and all the upper and lower tier connections are being matched correctly, there is no problem.

My last point concerns the timing of the passing of rights and what are the consequences of gaps and overlaps in time. If the rule is that a final credit supersedes all other situations, again there is no problem. The same is true for systems based on simultaneous debits and credits. In a situation where a credit book entry takes place before the correspondent debit is being registered elsewhere, there is the risk is of creating excess securities. This risk is mitigated if book entry credits are conditional, as in that way the effect of the transaction only takes place once the adequate amendments to the positions of intermediaries have been made. However if they are autonomous, there is the risk of temporal excess positions in securities. A debit occurring a long time before the credit on the acquired side can lead to two different situations. One is that in the interim phase nobody holds the respective positions. In the case of an over issue, during this interim phase either the number of outstanding securities is reduced, or unallocated securities are floating somewhere. Alternatively the positions are held by the intermediary until the corresponding credit takes place. This creates a situation of certainty except in a default or insolvency situation. To avoid these problems, one could either establish a general presumption that, until the final credit has taken place, the rights remain on the transferor's side or alternatively, these rights become allocated to an intermediary during the interim phase.

Conclusion

These remain options. UNIDROIT is trying to achieve its goal of a sound and matching legal infrastructure, which requires proving that all the potential possibilities that can a occur in a cross border transaction have been addressed to create sound legal results. It remains to be seen whether all the variants have been addressed in UNIDROIT's current draft

B - Discussion

First, the audience discussed the practical consequences of having different systems: In some jurisdictions the rights were transferred without the book entries having any constitutive effect. This meant that there might be scenarios in which, through a non book entry transfer, rights were being passed, creating a legal allocation which did not correspond to the book entry situation. Furthermore, once a string of matching positions had been established, an autonomous right was created. Various jurisdictions only place legal significance on the lower tier, disregarding the upper tier positions. That could create a situation where the book entry on the lower tier established a position which might not be matched by upper tier situations. In situations where the various claimants came from different jurisdictions, a common approach to resolving such conflict was necessary. Others stressed that the necessary backing of position at upper tier level entailed an intermediary reconciling the position in his books with the position that he is holding at upper tier level. However, a duty for the intermediary to preserve the integrity of the issue needed to be avoided, especially in situations where the entirety of the issue was not being held by that intermediary.

Another participant reminded the audience that the use of the word "transfer" was problematic. The preliminary draft Convention used the word "disposed" and this was deliberate. For normal thinking a transfer had a starting and an ending point but in the world of securities there was neither a beginning nor an end. Consequently a "disposition" was a process of causing a debit or a credit, coupled with the provision of there not necessarily being a direct connection between a debit and a credit. The continued use of the word "transfer" in connection with "moment of", contradicted what was stated in Article 5. This avoided the problem of deciding what was being transferred - it remained simply to be assessed what "credit" and "debit" meant in the convention.

Another attendee was of the opinion that it could be questioned whether the compatibility between systems really presented a problem. First and foremost, it had to be established what a security really was. What is transferred was this security and the rights that arose from it. Whatever that meant for each individual jurisdiction was a different question.

There was the view that if the future instrument could a) harmonise the package of rights which occur upon a credit, b) create a common set of understanding of what those rights and the corresponding equivalent duties of the intermediary are, and c), then (as the current text did), subject clearing and settlement rules to contract and national law as to when that credit might be reversed, a great service would have been done to the market place . It would be clear what these packages were in every contracting State. A lot of the market participants were not going to be concerned with the theoretical aspects of domestic property law. The draft Convention might not be very successful if it undertook to change those basic aspects in all of the contracting States.

Perhaps a more modest view should be envisaged. Relying on the various local laws for many of the issues raised might be advisable. While that may not be ideal, it was possible in this area that the best was the enemy of the good and how ambitious or modest the draft Convention ought to be, should be considered. There remained the danger of an expectation gap. There was so much that could be achieved by an instrument trying to create harmonised rules on property law and there was so much more that could not be achieved. The term "functional approach" needed to be used with care. It was a very good approach to looking at things, dealing with them and drafting solutions or answers to problems. At the same time one must be aware that the functional approach did not mean that the result would not encroach on any national legislation. There might be national provisions that did not match up with the final instrument. So "functional approach" did not mean "harmless". If it were harmless it would mean that the draft Convention was irrelevant. Furthermore, the use of the functional approach lead to clearly distinguishing the property side of what was being dealt with.

A first example concerned conditional credits: in an ideal world the conditional status was reflected in the account and it was known whether this book entry was final or might be reversed. This was not achievable and achieving it was unnecessary for the purpose of the future instrument, which is drafting harmonised rules; instead it was a matter for operational arrangements and regulatory requirements. The proper scope of this instrument was to say 'under certain conditions a conditional entry will become valid against third parties at a certain time, notwithstanding any operational aspects that are required in that country'. Therefore, the functional approach lead into clearly distinguishing the property issues, whereas all the operational and regulatory issues had to be left to the individual countries and also to the evolution of technology.

Furthermore, there was the view that the word "transfer" being used as transfer of title in a particular disposition, had deliberately been avoided in the draft because "transfer" was one way of looking at acquiring securities by book entries and was one way of looking at how things were moved through the system. To do so was not necessary and might be detrimental to the convention. In those countries where the acquirer derived his interest from the previous owner, a credit was thought of as being linked to a debit. It is very important to make sure that excess securities were not created, and to make sure that when an interest was moved to one party it was extinguished from the account of the first party. That was only one model. In other jurisdictions nobody would think of it as a transfer because the model was different. The functional approach consisted of trying to draft rules that gave predictability when adjudicating property interests without depending on such intellectual models, operational arrangements or regulatory requirements. This was clearly one case where functional approach was not harmless because it said "a credit will not be invalid because you cannot identify a corresponding debit" which was a statement against transfer in terms of a necessary requirement for the acquisition of property and at the same time said nothing about whether a specific regulator from one country or in one market would require credits and debits to be closely matched up. They might be required but if a credit could not be matched up by a debit, it did not prevent that credit from being valid.

Others agreed that there might be points where existing systems had to be changed, to a greater or lesser extent. Contracting States had to know which points in each jurisdiction had to be changed. The report, for instance, lead to the conclusion that the functioning of the future regime required that book entries had a constitutive effect. There were jurisdictions that did not have this to-date and delegations should make it very clear to national experts that amending this point was needed with a view to achieving the desired cross-border compatibility.

Another participant added not every aspect could be left to the national regulators. For some elements legislation was clearly needed. The regulator could impose a certain behaviour but that might not always be enough.

On *bona fide* acquisition, one attendee recalled that Art. 7(6) dealt with third party situations, but Art. 11 could be read as protecting a second party. This was a problematic concept as it was traditional to protect a third party's *bona fide* situation but when it came to protecting a *bona fide* second party things were relatively unclear. For example there could be a case where insolvency proceedings were opened in relation to the first party. It appeared that Art. 11 only covered third party cases. If so, what was the purpose of both Art. 7(6) and Art. 11?

Topic 7: Relevance and Implications of UNIDROIT draft Convention on Intermediated Securities for Securities Settlement Systems

A – Report by Mr Diego DEVOS, Euroclear S.A., Belgium[9]

While the primary focus in this presentation will be the security settlement system, this does not mean that I feel that clearing entities should not be covered by the draft Convention. They should, because they act as account holders for the holding and transferring of securities through settlement systems.

I will start by discussing the holding structure, then I will consider the basic elements which are important with regard to security settlement systems from a legal perspective, and finally I will consider what constitutes a security settlement system to see whether it would be possible to cover them properly in the Convention, why they should be covered by the Convention and, if so, whether any exceptions are required as currently foreseen in the draft text.

The holding structure is the basic structure that is found, with variations, almost everywhere. The investor holds securities through participation in the security settlement system and the associated rights are recorded in the books of the system operator. Security settlement systems can operate in direct relation with the issuer because the issuer can issue directly to the system as, for example, in the case of dematerialised securities or when the books of the system operator are assimilated to the register of the issuer, as occurs in the English settlement system. In general, direct relationships with the issuer can occur through a direct holding system or when the investor has the securities account in their name in the books of the operator, as occurs in the Scandinavian system.

It is often the case that security settlement systems can hold foreign securities as well as domestic securities. In such cases, the operator of the security settlement system can hold the foreign securities only by using an intermediary within the local settlement system or by using a custodian. Every layer in these chains is governed by specific legislation.

On that basis, I would say that all systems have book entry securities in their accounts and, therefore, they all act as an intermediary between the investor and the issuer even though, in some systems, the investor may have direct rights vis-à-vis the issuer. Almost all security settlement systems may hold both domestic and foreign securities and operate through other intermediaries. Security settlement systems can act as banks, can extend credit and can use collateral to secure the transactions on their books against professional risk.

There is no commonly agreed definition which to security settlement systems and central securities depositories. The concept of a security settlement system encompasses not only CSDs but also other structures that offer settlement services to their clients. Definitions do, however, exist in some regulatory publications and in various reports and published standards. For example, in the BIS Report of 1993, a security settlement system was defined as a “concept of institutional arrangements for confirmation clearance and settlement of securities, trades and the safekeeping of securities.” The Blue Book gives a more elaborate definition: “A system which permits the transfer of securities either free of payment, for example in the case of pledge, or against payment. Central securities occur for securities deposit accounts held with CSD, private CSD or the national central bank, save with the operational account. In another case the central bank acts as the intermediate custodian of the securities. The final custodian is normally the CSD. Settlement of cash occurs in an inter-bank fund transfer system through a settlement agent.” Such a definition of a security settlement system gives you an idea of the difficult exercise that lies ahead of us if we want to include such a definition in the Convention.

---

[9] Cf. Appendix 7.

According to the Red Book BIS publication and the Blue Book of the ECB, "A CSD is a facility or an institution for holding securities which enables securities transactions to be processed by book entry. Physical securities may be mobilised by the depositary of securities and may be dematerialised. In addition to safe keeping, a central security depositary may incorporate comparison, clearing and settlement functions." I am not sure that these definitions are of immediate relevance to UNIDROIT as they aim to illustrate matters for regulators rather than to provide legal definitions that could be applicable in the context of an international convention.

At the EU level, there is an intense discussion about clearings, settlements, ESBs, and added value functions, all of which are being examined by the Cesame Group that was set up by the Commission as a follow-up to its communication on clearings and settlements. It is comprised of representatives of the industry and of regulators. At the moment, it is difficult to predict the outcome of this work. These definitions could eventually be used in an EU Commission directive.

We should also examine the definition of a security settlement system from a legal and operational point of view. For example, an exercise being undertaken by ECSDA – the European Central Securities Depositary Association – which is available on their website, contains the results of a questionnaire regarding the way in which every CSD in the twenty-five member States is performing its activities. The results show that, within a single country, the services that are provided to the issuer are not always the same but depend on the entity in question, the participant and the type of instrument. Again, this highlights the difficulty of arriving at a definition that covers every eventuality. It is my view that, if UNIDROIT starts trying to define an security settlement system, there is a risk that the debate will continue for years, particularly given the politically sensitive climate of the EU. Given that this could endanger or delay the project, I would advise against trying to define security settlement systems and suggest that it might be better to refer this question to the national contracting States. This does not, however, overcome the need to obtain a common understanding for the purposes of the Convention.

Even if we all agree what a security settlement system is, despite not having a definition, there remains the issue of why security settlement systems should be covered by the UNIDROIT Convention. I think they should be covered because, on a global basis, it is necessary to provide protection to foreign investors when they hold securities in security settlement systems abroad. There is a need to clarify and harmonise the protection of rights for book entry securities against the risk of custodian insolvency and to establish a basic regime for the holding and transferring of book entry securities. The same is needed for collateral transactions in security settlement systems; this is the basic purpose of Chapter 7. While this is now less of an issue in Europe, it remains necessary for other countries. Even countries that recently modernised their securities legislation, such as the United States, Switzerland and Japan, need to further enhance their legal provisions to ensure that there is no longer any upper-tier attachment risk in other countries where foreign holdings exist and to protect good faith purchasers and cross border transactions.

The UNIDROIT Convention for security settlement systems is also needed because there are foreign participants in all systems. In the event that a foreign participant in a system becomes insolvent, the law of the system will be applied. It is clearly vital that all parties have a full understanding of the applicable law. This aspect is covered in Art. 6 of the Settlement Directive. The Hague Convention deals with the protection that would be applied in case of insolvency; the operator of the system would be expected to settle the operation on the basis of its rules.

Let us imagine that the receiver of the foreign participant, in China or elsewhere, challenges the way the operator of a system settles his position under the applicable mandatory legislation concerning insolvency. In such a case, the holder might face an issue in terms of insolvency and any assets available in that country could be at risk. It is for this reason that it is important to have a minimum level of harmonisation between the legal systems under which system operators perform their duties. Furthermore, as each national security system also holds foreign securities via other local custodians, any security settlement system that holds foreign securities has to behave like any other custodian in an indirect holding system and should, consequently, also have full protection in terms of the rights that are granted under its own domestic legislation with respect to foreign securities.

Generally, while the situation is very clear in a domestic context, it becomes less clear when the securities held belong to another country, Country B, and the law of Country A has not been designed to cover adequately the holding of foreign securities. Different treatment may also be applied depending on the type of account relationship that the operator of the system has developed with foreign custodians and their eligibility. Depending on their requirements, it is possible that different rights will be granted to investors holding foreign securities.

Operators' systems also need protection concerning the recognition of the nominee position, especially in indirect holding systems where the security settlement system is acting on behalf of participants by using a special vehicle or trust or acting as commissionaire. In this case, the question centres on the specific treatment required by the security settlement system and the need for an exception to the UNIDROIT Convention rules. In my view, security settlement system operators are acting like any other custodian and should, therefore, be treated equally. In Art. 7(4) and 7(5) the rules concerning conditional credits and reversal are equally applicable to system operators and custodians.

Some security settlement systems can certainly be regarded as playing a specific role. They are at the top of the pyramid, especially for domestic securities, because they list certain services to the issuer, such as the allocation of newly issued securities for distribution on the primary market and the allocation of income payments. They can even be accountable for the integrity of the issue when they have 100% of the issue, which is normally the case for dematerialised securities. Generally they are granted specific protection under the applicable national law and are subject to specific regulatory standards. This situation would seem to justify the granting of an exceptional specific treatment under the UNIDROIT Convention to security settlement systems; the rules of those systems should prevail in the case of insolvency, as defined by the Convention.

It must be remembered that the Convention provides that rules can have overriding effects when they are justified by systemic reasons. A number of interpretations of 'systemic reasons' are possible and a clearer definition is, therefore, desirable. For example, it can be argued that finality rules are justified by systemic reasons, as are the treatment of corporate actions and accounting rules.

Conclusions

The security settlement system is simply a specific class of securities intermediaries that hold securities in the same way as any other custodian and should, therefore, be granted the same level of protection. The specific role they play can be seen as justifying a specific treatment which would ensure the overriding effects of their rules, especially in cases of insolvency.

The draft Convention should not be obstructed by "taboos" at the EU level. For example, we know that there is a Settlement Finality Directive, but nothing is cast in stone. We should approach this issue in a very open manner and ensure that we are not influenced by political debate.

B - Discussion

There was broad agreement that the future instrument should provide for some kind of exemption for certain entities, as for instance securities settlement systems ("SSS"). However, the personal and material scope of such exemption as well as the technique that should be applied in shaping such a rule were unclear.

1) On the types of entities that should be covered:

The issue of whether an SSS, for the purposes of the draft text, should and could be distinguished from a CSD was intensely discussed.

One participant mentioned that in some countries, there were SSS and CSDs that were separate entities and that he tended to the opinion that their functions could be distinguished clearly. There was no obvious difference that required a distinction with respect to a potential exemption from the rules of the future Convention.

One delegate, with respect to the question whether SSS and CSD should be treated similarly, pointed out that the role of the CSD or SSS was not the same in all jurisdictions. In some jurisdictions, there was a distinction between a CSD and an SSS. Some countries did not have CSDs at all, and only had SSSs. In other countries, the CSD acted as both a CSD and an SSS. The third possibility was a clearly separate role for the CSD and the SSS. As this could hardly be defined universally, as a matter of principle, a CSD, an SSS and a custodian should all be considered as an intermediary in the sense of the future instrument. However, in some cases, specifically where the intermediary in question played a key role, a specific treatment would be appropriate.

Others agreed, because for the purpose of the future UNIDROIT Convention, which had investor protection as a primary aim, it might not be necessary to differentiate between CSDs and SSSs, irrespective of the service and irrespective of their specific roles. They both needed to be protected equally to the extent of a custodian. Because of their pivotal role, they might deserve specific treatment, in particular a preservation of their rules regarding insolvency. The relation with the issuer might equally deserve special treatment.

It was mentioned that some provisions of the draft text in practice have no relevance for CSDs which showed that a CSD could be clearly distinguished from an SSS and similar entities. Others replied that one needed to distinguish between the rules contained in the draft Convention and the application of those rules in practice. There were situations where the rules would in fact apply differently in practice to CSDs. However, there was no obvious reason that the rules of the instrument should be framed differently for CSDs or SSSs.

Others felt that SSS was a neutral term which included also a CSD. If the scope was narrowed down too much, the future Convention could exclude entities that also deserve specific treatment because they are playing a pivotal role in the system.

3) On how they could be defined in the future instrument:

From the audience, there was agreement that it will be a difficult task for the future UNIDROIT instrument to attempt to define "an SSS".

Several attendees were of the opinion that, given this difficulty, the draft instrument should not attempt to define "an SSS" and should instead leave the determination of the envisaged entities to the national law and a declaration mechanism.

Others said that, since SSSs, CSDs and similar entities were subject to specific national regulation, the scope of application of any potential derogation needed to be limited to them. Accordingly, there need to be a minimum definition in the future Convention, on which the key element of the exemption, a declaration by the Contracting State, can be based.

One example of a minimum definition was given by the EU Settlement Finality Directive's definition, which was very broad (basically: three participants with common rules). In case the future Convention would similarly go for a very wide definition, Contracting States were called upon to include in the declaration only entities that were envisaged by the purpose of the provision.

The way relevant institutions (SSSs, CSDs) are referred to in the draft text should be sufficiently broad, for example, as it stands it mentions "clearing or settlement"; it does not, for instance, mention "registry", which could be the approach applied in certain countries.

Some highlighted that if States were allowed to make a declaration as to which entities qualify as SSSs, the parameters had to be defined, and that there had to be a common understanding of what should be covered under the derogation or the specific treatment, without going into too much detail.

A basic definition, an illustrative list or detailed explanations in an accompanying report could also give guidance to Contracting States that were “newcomers” with respect to this issue.

Others supported the idea of “guidance”. “Minimal features” should be given which both defined the specific functions that were required and also served to restrict the scope of the exception to those functions. Single purpose entities were however not targeted by the exemption: beyond CSDs and SSSs, there are additional functions performed by entities that should not be granted an exception from the application of the Convention. Leaving it entirely up to States to designate which entities should be covered is not perhaps an adequate solution.

One participant described the three different options as follows: First, the Convention might refer simply to “securities settlement system”, which means that it will be up to judges to decide in individual cases whether an entity qualifies as an SSS, and therefore whether its rules pre-empt the Convention rules. In this scenario, there was a danger of a lack of legal certainty. Second, a full definition could be included in the future instrument, which was probably too huge a task. Third, the dynamic approach of a designation mechanism could be adopted. In this latter case, some governments might list SSSs that other governments might not accept as such, which would result in a fragmented world.

Another proposal was to take a definition that had two components. First, the system might have to exercise one or more of a menu of functions that characterise an entity as having a pivotal role in the system. Second, the contracting State would file a declaration that specified either the entities or the type of entities it controlled so that other market participants could be sure when they were dealing with an entity whose rules they need to review very carefully, and when they are dealing with an entity that would be governed simply by the Convention and national law.

Others pointed out that this menu approach would bear the political difficulty of defining core functions and added value functions.

4) On what can be overridden:

One participant proposed to recognise another area of special treatment for CSDs, relating to the intermediaries’ duties under Article 4. In arrangements among CSDs, it was quite common that the rights that the account holder had or might require from a CSD were less than those that could be found in Article 4 of the draft Convention. For example, traditional CSDs were not in charge of the flow of payments. They only introduced securities into the system and they left the payment part of the process to the particular payment agent appointed by the issuer. It should therefore be clear that they could renounce some of the duties.

Another participant advocated that for the issues set out in the Convention, as SSS or a CSD should be treated like any other intermediary for virtually all purposes. Although it was common sense that an SSS and a CSD had a special role, concrete examples of where the Convention should provide for special rules were not obvious.

Others replied that there were already two provisions that are clearly derogations compared to the situation of custodians. First, the new Article 8 on the overriding effect of certain rules of clearing and settlement systems, stated that any provision of a clearing and settlement system should prevail either over any provision in Article 7 on reversal and conditionality or over any provision of the draft Convention. Second, the other obvious case was Article 13 on the effectiveness of debit, credit and instructions on insolvency of the operator or participant in the clearing and settlement system, where a derogation from insolvency rules that would not necessarily benefit other intermediaries made much sense.

5) On what rules can replace the rules of the future instrument

There was the suggestion that it should not be possible for entities that are exempt from the rules of the future instrument to put in place rules that are inconsistent with the rationale behind any of the provisions of the future Convention; in other words, rules that are substitutes for the provisions of the UNIDROIT instrument should address the kinds of risks that are targeted by the latter.

APPENDIX 1

SEMINAIRE D'UNIDROIT SUR LES TITRES INTERMEDIES
Paris, du 31 janvier au 1er février 2006

UNIDROIT SEMINAR ON INTERMEDIATED SECURITIES
Paris, from 31 January to 1 February 2006

LISTE DES PARTICIPANTS
LIST OF PARTICIPANTS

M. Stéphane BERAUD	Juriste Banque de France 31 rue Croix des Petits Champs 75049 Paris France Tel. : +33 1 42 92 99 14 Fax : +33 1 42 92 34 66 e-mail : stephane.beraud@banque-france.fr
Mr Christophe BERNASCONI	First Secretary Hague Conference on Private International Law Scheveningseweg 6 2517 KT The Hague The Netherlands Tel.: +31 70 363 3303 Fax: +31 70 360 4867 e-mail: cb@hcch.nl
M. Nicolas CASTELL	Direction des Affaires Civiles et du Sceau Ministère de la Justice 5 boulevard de la Madelaine 75001 PARIS France Tel : +33 1 44 86 14 81 Fax : +33 1 44 86 14 69 e-mail : Nicolas.Castell@justice.gouv.fr

M. Hubert DE VAUPLANE	Directeur juridique Banque de Financement et d'Investissement BNP Paribas 34, Avenue de l'Opéra F-75078 Paris France Tel.:+33 1 4298 7719 Fax:+33 1 4298 6615 e-mail : hubert.devauplane@bnpparibas.com
Mr Federico DE TOMASI	Senior Legal Counsel Banca d'Italia Via Nazionale, 91 00184 Rome Italie Tel.: +39 06 4792 5108 Fax: +39 06 4792 2397 e-mail: federico.detomasi@bancaditalia.it
M. Jean-Pierre DEGUEE	Conseiller Commission Bancaire, Financière et des Assurances Rue du Congrès 14-16 1000 Bruxelles Belgium Tel. : +32 2 220 54 67 e-mail : jean-pierre.Deguee@cbfa.be
Mr Diego DEVOS	Deputy General Counsel Euroclear S.A. Boulevard du Roi Albert II, 1 1210 Bruxelles Belgium Tel. : +32 2 224 14 44 Fax : +32 2 224 25 68 e-mail : devos_diego@euroclear.com devos.diego@skynet.be
Ms Daniela DOHNALOVA'	Ministry of Finance of the Czech Republic Financial Market Legislation Department Letenská 15 118 10 Prague 1 Czech Republic Tel.: +420 257 04 2957 e-mail: Daniela.dohnalova@mfcr.cz

Mr Alexander DÖRRBECKER

Executive Assistant
Federal Ministry of Justice
Mohrenstraße 37
10117 Berlin
Germany

Tel.: +49 30 2025 9975
Fax: +49 30 2025 9339
e-mail: Doerrbecker-Al@bmj.bund.de

Ms Ivonne Schwindt

Assistant to Mr Alexander Dörrbecker

Mr Philippe DUPONT

Partner
Arendt & Medernach
14, rue Erasme
2010 Luxembourg
Luxembourg

Tel: +352 407 878 205
Fax: +352 407 804 627
e-mail:
philippe.dupont@arendt-medernach.com

Mr Ignacio GÓMEZ-SANCHA

Iberclear
C/ Pedro Teixeira, 8, 2nd Floor
28020 Madrid
Spain

Tel.: +34 91 417.4810
Fax. +34 91 556 7086
e-mail: ignacio.gomez-sancha@iberclear.es

M. Philippe GOUTAY

Gide, Loyrette, Nouel
26, cours Albert 1er
75008 PARIS
France

Tel : + 33 1 40 75 36 59
Fax : + 33 1 40 75 69 65
e-mail : goutay@gide.com

Ms Julia KELLNER	Lawyer Project Planning and Quality Clearstream Banking AG Gruppe Deutsche Börse Neue Börsenstraße 1 60487 Frankfurt Germany Tel.: +49 69 211 177 56 Fax: +49 69 211 6 177 56 e-mail: julia.kellner@clearstream.com
Mr Hans KUHN	Director Head of Legal Swiss National Bank Börsenstrasse 15 8022 Zürich Switzerland Tel.: +41 1 631 32 59 Fax: +41 1 631 39 10 e-mail: hans.kuhn@snb.ch
M. Herbert KRONKE	Secrétaire Général UNIDROIT Via Panisperna, 28 00184 Rome Italy Tel.: +39 06 69 62 140 Fax: +39 06 69 62 152 e-mail: h.kronke@unidroit.org
Mr Philippe LANGLET	Head of Legal Department of Global Securities Services Société Générale 50 Boulevard Hausmann 75431 Paris France Tel.: +33 1 5305 4512 Fax: +33 1 5305 4550 e-mail: philippe.langlet@socgen.com

Mrs. A. LIVA

Ministry of Economy and Finance
Directorate for Financial and Fiscal Affairs
5, Nikis Street
GR-10180 Athens
Greece

Tel:+30 210 33 32 657
Fax:+30 210 33 32 810
e-mail: aliva@mnec.gr

Mr Klaus LÖBER

Principal Legal Counsel
European Central Bank
Kaiserstrasse 29
60311 Frankfurt am Main
Germany

Tel.: +49 69 1344 7225
Fax: +49 69 1344 7406
e-mail: klaus.loeber@ecb.int

M. Antoine MAFFEI

Avocat à la Cour de Paris
De Pardieu Brocas Maffei
64-66 Avenue d'Iéna
BP 2004
75761 Paris Cedex 16
France

Tel: +33 1 5357 7171
Fax: +33 1 5357 7170
e-mail : maffei@de-pardieu.com

M. Aymeric CASTELNAU

Collaborateur de M. Antoine Maffei

Ms Maria Chiara MALAGUTI

Professor of Law
Università degli Studi di Roma
Via di Foro Traiano 1/A
00187 Rome
Italy

Tel.: +39 06 671 61
Fax: +39 06 6790 005
e-mail: mcmalaguti@hotmail.com

Ms Arianna MELLINI SFORZA	Legal Adviser Rue Montoyer, 10 B-1000 Brussels Belgium Tel.: +32 2 508 3747 Fax: +32 2 511 2328 e-mail: a.mellinisforza@fbe.be
Mr Charles W. MOONEY, Jr	Professor of Law University of Pennsylvania Law School 3400 Chestnut Street Philadelphia, PA 19104 USA Tel: +1 215 / 898 6075 Fax: +1 215 / 573 2025 e-mail: cmooney@law.upenn.edu
Mr D. Miguel MORA HIDALGO	Senior Advisor (Treasury) Ministry of Economy and Finance Paseo del Prado, 6 28014 Madrid Spain Tel.: +34 91 20 99 541 Fax: +34 91 20 99 731 e-mail: mmora@tesoro.mineco.es
Mr Edward H. MURRAY	Partner Allen & Overy LLP One New Change London EC4M 9QQ United Kingdom Tel. +44 20 7330 1837 (Direct) Tel. +44 20 7330 3000 (General) Fax. +44 20 7330 9999 e-mail: ed.murray@allenovery.com
M. Philipp PAECH	Secrétaire du Comité d'experts gouvernementaux UNIDROIT Via Panisperna, 28 00184 Rome Italy Tel.: +39 06 6962 143 Fax: +39 06 6994 1394 e-mail: ph.paech@unidroit.org

Ms Xenia PARSHIKOVA

Legal counsel
Ministry of Economic Development and Trade
of The Russian Federation

Tel.: +33 1 4727 41 39
Fax: +33 1 4553 68 56
e-mail: k_Parshikova@inbox.ru

Mr Peter PÖCH

Rechtsanwalt / Lawyer
Oesterreichische Kontrollbank AG
Austrian Central Securities Depositary
Strauchgasse 3
1010 Vienna
Austria

Tel.: +43 1 53 53 721
Fax: +43 1 53 31 555
e-mail: office@opf.at

Ms Sandra ROCKS

Counsel
Cleary Gottlieb Steen & Hamilton LLP
One Liberty Plaza
New York, NY 10006
USA

Tel.: +1 212 225 2780
Fax: +1 212 225 3999
e-mail: srocks@cgsh.com

Ms Marianne SANDEL

Deputy General Councel
Euroclear S.A.
Legal Division
Boulevard du Roi Albert II, 1
1210 Bruxelles
Belgium

e-mail : sandel_marianne@euroclear.com

Mr Han J.A. van SON

Senior Policy Advisor
Ministry of Finance
Financial Markets Policy Directorate
P.O. Box 20201
2500 EE The Hague
The Netherlands

Tel: +31 703428975
Fax +31 70 3427928
e-mail: h.j.a.son@minfin.nl

M. Gilles STUER

Juriste
Banque Nationale de Belgique
Boulevard de Berlaimont 14
1000 Bruxelles
Belgium

Tel. : +32 2 221 53 74
Fax : +32 2 221 31 59
e-mail : gilles.stuer@nbb.be

Mr Marek Svoboda

Administrator
secondment lawyer from ECB
Avenue de Cortenbergh 107
1040 Brussels
Belgium

Tel. : +32 2 29 53451
Fax : +32 2 29 93071

M. Luc THEVENOZ

Professeur à l'Université de Genève
Membre de la Commission fédérale des banques
Université de Genève UNI-MAIL,
Boulevard du Pont d'Arve 40
Genève 4
Suisse

Tel. : +41 22 / 379 86 54
Fax : +41 22 / 379 86 62
e-mail : luc.thevenoz@droit.unige.ch

M. Mehmet CAN EKZEN

Assistant to Mr Luc Thévenoz

Mr Martin THOMAS

Detached National Expert
European Commission
Avenue de Cortenbergh 107 – C107 3/62
1049 Brussels
Belgium

Tel.: +32 2 29 21 395
Fax: +32 2 29 93 071
e-mail: martin.thomas@cec.eu.int

Mr Konstantinos TOMARAS	Administrator Avenue de Cortenbergh 107 – C107 2/4 1049 Brussels Belgium Tel.: +32 2 29 64 275 Fax: +32 2 29 93 071 e-mail: konstantinos.tomaras@cec.eu.int
Mr Gianfranco TROVATORE	Officer Consob Italy
Ms Marja TUOKILA	Legal Advisor Ministry of Justice P.O. Box 25 00023 Government Finland tel. +358 9 1606 7721 fax + 358 9 1606 7658 e-mail marja.tuokila@om.fi
Mrs Karin WALLIN-NORMAN	Senior Legal Adviser Nordic Central Securities Depository Nytorgsgatan 33 11640 Stockholm Sweden Tel.: +46 73 68 49 144 e-mail: karin.wallin-norman@ncsdgroup.com
Mr Peter WERNER	Policy Director International Swaps & Derivatives Association One New Change London EC4M 9QQ United Kingdom Tel.: +44 20 7330 3550 Fax: +44 20 7330 3555 e-mail: pwerner@isda.org

M. Alexis ZAJDENWEBER	Direction Générale du Trésor et de la Politique Economique Ministère de l'Economie, des Finances et de l'Industrie 139, rue de Bercy 75572 PARIS CEDEX 12 France Tel : +33 1 44 87 70 18 Fax : +33 1 53 18 36 12 e-mail : alexis.zajdenweber@dgtpe.fr
M. Pascal THORAVAL	Délégué Général Association Française des Professionnels des Titres 18 rue La Fayette 75440 Paris cedex 09 France Tel : +33 1 48 00 52 00 e-mail : pthoraval.afti@fbf.fr
M. Marcel RONCIN	Président Association Française des Professionnels des Titres 18 rue La Fayette 75440 Paris cedex 09 France Tel : +33 1 48 00 54 02 e-mail : mroncin.afti@fbf.fr
M. Eric DEROBERT	Président des services d'investissements Crédit Agricole 59-61 rue Pernety 75684 Paris cedex 14 France Tel : +33 1 43 23 04 64 e-mail : eric.derobert@ca-is-fastnet.com
M. Dominique DE WITT	Directeur Général Adjoint Crédit Agricole Titres SNC Paris France Tel : +33 1 69 39 85 77 e-mail : dominique.dewitt@ca-titres.fr

M. Philippe CASTELANELLI

Directeur des Opérations Corporate :
Investment Banking and Markets
109 avenue des Champs Elysées
75419 Paris cedex 08
France

Tel : +33 4 40 70 28 22
e-mail : philippe.castelanelli@hsbc.fr

Mme. Emmanuelle SCELLES

Juriste
Banque de Financement et d'Investissement
BNP Paribas
34, Avenue de l'Opéra
F-75078 Paris
France

Tel.:+33 1 42 98 02 37
e-mail : emmanuelle.scelles@bnpparibas.com

Mme. France DRUMMOND

Maître de conférences
Université Panthéon Assas Paris II

Tel : +33 1 46 34 16 04
e-mail : drummonds@wanadoo.fr

M. Philippe ARESTAN

Responsable Regulatory
Service juridique des Marchés de Capitaux
CALYON
9-25 quai du Président Paul Doumer
92920 Paris La Défense Cedex
France

Tel: +33 157 87 17 87
e-mail: philippe.arestan@calyon.com

M. Jean TRICOU

Directeur de département
Banque d'investissement et de marchés
Fédération Bancaire Française
18 rue La Fayette
75440 Paris cedex 09
France

Tel : +33 1 48 00 50 84
e-mail : jtricou@fbf.fr

M. Marc NOEL

Juriste
Banque d'investissement et de marchés
Fédération Bancaire Française
18 rue La Fayette
75440 Paris cedex 09
France

Tel : +33 1 48 00 50 89
e-mail : mnoel@fbf.fr

Bundesministerium der Justiz

Securities

The Definition of the term „Securities“ in the context of the UNIDROIT Preliminary Draft Convention on Harmonised Substantive Rules regarding Intermediated Securities

Presentation at the third intersessional seminar
in Paris, January 31, 2006

by

Dr. Alexander Dörrbecker, LL.M.
Attorney at Law (N.Y.)
Federal Ministry of Justice, Germany

1

Bundesministerium der Justiz

I. Introduction

- Disclaimer (!):
  - **First:** I was not in the study group, and
  - **Second:** Mr. Javier Diaz, the delegate from Chile, has already pointed out many relating questions on the second seminar in Sao Paulo; to these and other questions I may refer in this presentation;

2

Bundesministerium der Justiz

The world was easy in those days, when the definition of securities accurately could state:

- **Securities:** investments in stocks and shares; certificate to show that someone owns stocks.
- Differentiations could be made between bearer and registered securities.
- These days are certainly over:
  - The use of securities has expanded greatly over the last 40 years;
  - varieties of securities have been increased;
  - the methods of exchanging securities have changed extremely;
  - changes occur on an international level;
  - **That's why we are here!**

3

Bundesministerium der Justiz

- **Types of securities to keep in mind:** corporate stock, mutual funds, bonds, options, derivatives, units of limited partnerships etc.
- Rights embodied in a security in general:
  - Holder of a security is owed a debt by the issuer,
  - holder is entitled to the payment of principal and interest,
  - other personal rights under the terms of the issue (e.g. the right to receive certain information)
  - additional elements may occur with shares in companies etc.
- No clear concept internationally recognized (as Mr. Diaz explained):
  - It seams to be a risky attempt to build a theoretical or dogmatic concept of "securities" that may be satisfactory for different jurisdictions.

4

Bundesministerium
der Justiz

II. Functional approach of the Draft Convention

- As many times before mentioned and discussed:
  the Convention follows the functional approach:
- Words used by the Convention, were chosen trying to follow a legally neutral language.
- **This means also:** The Convention must be drafted in a way that it can be understood and applied in a similar way by the legal practice in all jurisdictions of contracting states.
- **Consequence:** Therefore it seems to be important that delegations will talk about their understanding of the wording.

5

Bundesministerium
der Justiz

III. Article 1(a) of the Draft Convention

The definition reads:

"Securities" means any shares, bonds or other transferable financial instruments or financial assets (other than cash) or any interest therein.

6

Bundesministerium
der Justiz

→ Interpretation given by the Explanatory Notes:

- Draft Convention uses the same definitions as used in the Hague Convention,
- **Reason:** Definitions are the result of a consensus among contracting states; concept promotes interoperability between the two international instruments; better chances for implementation in domestic law.

→ According to Notes definition is intentionally broad.

7

Bundesministerium
der Justiz

1. Shares and Bonds

- “Shares” and “Bonds” are examples of assets traditionally considered as securities;
  - What these legal terms mean in the specific contracting state, must be left with the national law.
  - But there will be a broad basis for a similar understanding.

8

Bundesministerium der Justiz

2. Other Instruments

- Other transferable financial instruments or financial assets
- According to the explanation in the Report of the Hague Convention financial instruments or financial assets typically include "... a tradable entitlement to money (with or without other rights, such as a right to vote and/or membership rights) and, where not intended to be held solely by a single investor, are issued on terms standard for each unit of the issue with a view of being held, directly or indirectly, through intermediaries, as a medium for investment."
- **Question:** Are these minimum requirements? Tradable entitlement to money, issued in large numbers, held through intermediaries as investment.

9

Bundesministerium der Justiz

- ❖ Explanatory Report of the Hague Convention seams to reject this minimum standard approach:
  - "financial instruments or financial assets" credited to a securities account do not have necessarily to fulfill with any of these features;
  - **It is necessary:** that they may be credited to a securities account and that they are financial in nature.
- ❖ **As Mr. Diaz pointed out:** The possibility of crediting the assets to a securities account will depend on the specific regulation of each market.
- ❖ **Therefore, the crucial element may be reduced to:** the assets have to be financial in nature.
- ❖ Stricter than the Hague Convention by saying: <u>transferable</u> financial instruments or financial assets.
  - Is the word "transferable" neutral enough?
  - Is it redundant?

10

Bundesministerium der Justiz

3. Other than cash

→ All kinds of financial assets, other than cash are included.

→ **No cash:** The Draft Convention does not apply to money deposited or paid into a bank for whatever reason and to whatever account.

11

Bundesministerium der Justiz

4. Flexibility

- ✓ Flexible approach; no enumeration of certain instruments;
- ✓ A fixed list may prevent an open development of new types of financial instruments.
- ✓ The Explanatory Notes talk about a fluid system; Mr. Diaz proposes the word: **”elastic”**.
- ✓ Is it necessary to have a further core element for the definition (as Mr. Diaz suggested)? And what should it be?
- ✓ **Explanatory Notes:** The manner of issue of a financial instrument is irrelevant.

12

Bundesministerium der Justiz

Therefore it is negligible:

- where the securities are issued;
- whether the issue is certificated or not;
- in which form the certificate is constituted or (single, global, jumbo, or by mere registration);
- whether the securities can be withdrawn from the holding system and be held directly by the investor;
- whether or not the securities are listed on a stock exchange.

13

Bundesministerium der Justiz

5. Interests in Securities

The definition makes clear that also interests in securities are included.

- Not only full ownership of securities, but also rights deriving from it as possessory and non possessory security interests, and certain indirect holding positions (where the account holder is the beneficial owner, and the relevant intermediary, the legal owner) are included.
- Ownership and lesser forms.

14

Bundesministerium der Justiz

- This leads to the following observation (also Mr. Diaz made):

- If the owner of a share creates a security interest over it in benefit of a creditor, e.g. a bank,
  - there would be three "securities", in terms of the Draft Convention:
  - The certificated share, the ownership over or in that share and the created security interest.
  - **In Consequence:** the pledgee would not only be entitled to a right in rem (the pledge) but also would be the owner of a specific "security": the pledge he has in the share itself.

15

Bundesministerium der Justiz

6. Rights embodied in Securities

❖ Not included in the definition of securities is the question of what rights are embodied or - in the functional terms of the Draft Convention - "attached to" them.

❖ Article 4(1)(e) opens the field to the national law: **"subject to this Convention, such other rights as may be conferred by the domestic non-Convention law."**

16

Bundesministerium der Justiz

7. Capable of being intermediated

- **It remains relevant:** The securities must be capable of being credited to securities accounts; it must be possible to transfer them in an intermediated system.
- **Does this include the other dimension:** Must be all securities issued in the way that they are capable of being credited to securities accounts?

17

Bundesministerium der Justiz

IV. Observations made by delegations

- Definitions have not been discussed in the plenary, yet;
- **Two written statements of delegations:**
- European Banking Federation saying that the definition should be clarified to ensure that it encompasses not only bearer securities but also registered ones.
- **Germany:** the definition of “securities” should not be based on vested titles, but rather on technical features of securities, such a separateness, transport and legitimisation function.
- **The Second German remark was made in view of Article 19:** It should be avoided that the Convention covers shares in a partnership which are not or should not be conferred on the basis of book entries.

18

Bundesministerium der Justiz

→ No complete harmonisation with definitions of the Hague Convention possible? Would there really be a danger of a “Convention shopping”?

- Shouldn’t be the framework of definitions of a convention dealing with conflict of laws construed differently than one with the purpose of harmonising substantive rules?

19

Bundesministerium der Justiz

V. Conclusion:

- ✓ Draft Convention contains an open definition for “securities”;
- ✓ it explicitly avoids a conclusive list of existing instruments;
- ✓ the Draft Convention has the aim of harmonization;
- ✓ demands of competitive financial markets should not be limited or restricted;
- ✓ the Convention should lead to more integrated and flexible markets.

20

Bundesministerium
der Justiz

Questions may be discussed on the next committee of Governmental Experts:

1. Should it be more explicitly said by the Draft Convention that it does not apply on securities not held by an intermediary?
2. Are the contracting states able to uphold provisions allowing that securities may not be conferred on the basis of book entries (depending on the terms of the issuer or the legal form of it in case of a certain corporate entities [units of partnerships etc.])?
3. Should there be a further core element of the definition of securities? ...

21

Unidroit Seminar on intermediated securities
Paris January 31st, 2006

SEGREGATION : METHODS, PERTINENCY AND NECESSITY

Philippe GOUTAY
Gide Loyrette Nouel

Gide Loyrette Nouel

Introduction

- **Segregation means to separate or to distinguish assets which would not be otherwise distinguished (fungible assets)**
- **In a legal environment, segregation is implemented in order to apply different legal regimes to similar assets**
- **Segregation is particularly important in deposit or custody agreements (where no transfer of title occurs)**
- **This issue is fundamental when it deals with fungible assets (i.e. theory of regular or irregular deposit)**
- **With respect to dematerialised and fungible assets, segregation is a key-element contributing to the efficiency and safety of the legal regime of intermediated securities**

Gide Loyrette Nouel

Introduction

- Part 1 - Why implement segregation rules ?
- Part 2 - How to implement segregation rules with intermediated securities ?

Part 1 - Why implement segregation rules ?

- With respect to assets held in custody, segregation prevents from commingling assets not belonging to same persons
- Segregation is particularly important in custody agreements where no transfer of title is supposed to occur
- In many civil law countries, the deposit of fungible assets may lead to a transfer of title for the benefit of the custodian (irregular deposit)
- Indirectly held securities are fungible assets deposited or held in custody with a custodian : the custodian is not supposed to acquire any title on the securites deposited by its customers

1. Why implement segregation rules ?

- **First goal : Segregation allows to distinguish securities held by the custodian as to their beneficial owner (as it would be done also for materialised securities), in order to protect the rights of such beneficial owners.**
- **It shall prevent the commingling of securities in case of (i) insolvency of the custodian, (ii) attachment or seizure performed by creditors of the depositary or custodian, (iii) accidental misuse by the custodian.**
- **It is implemented in order to protect the rights of beneficial owners.**

1. Why implement segregation rules ?

- **Second goal : Segregation facilitates the supervision and auditing of account keepers and custodians as to their obligation of protection of the client's assets.**
- **Segregation may materialise and reveal in accounts a misuse by custodians of assets belonging to its clients.**
- **Segregation may also help to check at any moment the perfect accounting balance with respect to securities held on behalf of clients.**

Gide Loyrette Nouel

2. How to implement segregation ?

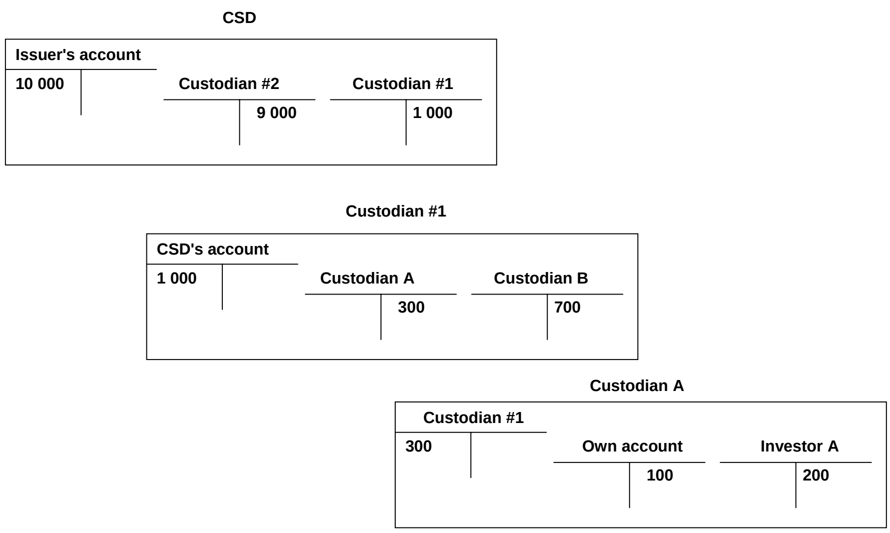
- Indirectly held securities involve at least two or more "account keepers" : issuer + custodian (i.e. financial intermediary); CSD + custodian; issuer or CSD + custodian # 1 + custodian # 2.

- An effective right (enforceable vis-a-vis the issuer) is acknowledged to a final investor if at any level of the chain of "account keeping", a number of securities is held on its behalf.

- Therefore, a strict equality of securities shall be respected at each level. This leads to the obligation of allocation of securities (art. 17 dated June 2005 doc. n° 24 of Unidroit).

Gide Loyrette Nouel

2. How to implement segregation ?



Gide Loyrette Nouel

2. How to implement segregation ?

- Segregation is aimed at enabling the control of such allocation , i.e. holding securities on behalf of third parties.

- Segregation is naturally performed by each custodian vis-a-vis its clients (by opening one or several accounts for each client). This allows not to acknowledge any transfer of title for the benefit of the custodian (regular deposit).

  It shall also be performed vis-a-vis its upper tier custodian. To which extent shall it be performed at the upper tier level ?

Page 9

Gide Loyrette Nouel

2. How to implement segregation ?

- The perfect solution would be to segregate securities at each level of the chain up to the CSD (identification in CSD's account of final investor). In an international environment, this may raise legal issues (banking secrecy), technical issues (possibility of such an accurate segregation at any level of the chain) and economic issues (loss of economy of scale which is notably based on omnibus accounts in international custody).

- The alternative solution for custodians may be to segregate with their upper tier intermediary in at least two accounts the assets held (i) for own account and (ii) for third parties' account. Such minimal segregation prevents from (i) any accidental misuse of securities of clients for custodian's own account, (ii) upper tier attachment and (iii) protection of assets in case of insolvency of custodians.

Page 10

Gide Loyrette Nouel

2. How to implement segregation ?

❖ Protection in case of accidental misuse

Custodian A issues an instruction to Custodian #1 for its own account to deliver to Custodian B 200 securities. What happens ?

No segregation

Custodian #1

CSD's account
1 000
Custodian A
300
Custodian B
700

Custodian A (after transfer)

Custodian #1
100
Own account
-100
Investor A
200

Such accounting situation may be considered as a lending of security by Investor A to Custodian A.

Segregation

Custodian #1

CDS's account
1 000
Custodian A own account
100
Custodian A Third account
200
Custodian B
700

Rejection of the instruction of Custodian A or partial execution. In no case the account of Custodian A / Third account shall be debited.

The assets of Investor A are protected.

Gide Loyrette Nouel

2. How to implement segregation ?

❖ Protection against upper tier attachment

Segregation

Custodian #1

CDS's account
1 000
Custodian A own account
100
Custodian A Third account
200
Custodian B
700

Rejection of attachement by creditor of Custodian A on account of Custodian A /Third account in Custodian #1.

The assets of Investor A are protected.

Gide Loyrette Nouel

2. How to implement segregation ?

- In case of an attempt by creditors of Custodian A to attach securities held with Custodian #1, securities credited on the Custodian's account dedicated to assets held for own account, shall only be so attached.

- France has newly implemented a rule prohibiting upper tier attachment, which is based on segregation obligations for custodians. Art. L. 211-4-1 of the Monetary and Financial Code provides that no attachment may be performed against an intermediary on assests held by the latter with another intermediary, where such assets are owned by third parties. Segregation allows to easily identify such securities in upper tier intermediary's books.

Gide Loyrette Nouel

2. How to implement segregation ?

- Protection against insolvency of custodians

- The protection of investors against the insolvency of their custodians is mainly provided by (i) legal provisions granting them a direct right on such securities and (ii) a strict segregation in the books of the custodian among the different holders (investors + the custodian). Such protection relies more on the general legal framework applicable to account keeping.

- Upper segregation may however raise an issue as to the right for an insolvent custodian to participate with its clients in the apportionment of the remaining securities (in case of deficit) if it has held securities for its own account.

Gide Loyrette Nouel

Contact

Philippe Goutay
Avocat à la Cour
Tél. +33 (0)1 40 75 36 59
goutay@gide.com

Alger
Belgrade
Bruxelles
Bucarest
Budapest
Casablanca
Hanoi
Istanbul
Londres
Moscou
New York
Paris
Pékin
Prague
Riyad
Shanghai
Tunis
Varsovie

Gide Loyrette Nouel
Association d'avocats
26, cours Albert 1er
75008 Paris - France
Tél. +33 (0)1 40 75 60 00
Fax +33 (0)1 43 59 37 79
E-mail : info@gide.com
www.gide.com

Gide Loyrette Nouel

THE CONCEPT OF GOOD FAITH IN INTERNATIONAL SECURITIES TRANSACTIONS

Hubert de Vauplane

UNIDROIT SEMINARE ON INTERMEDIATED SECURITIES

Paris, 30 January 2006

Introduction

- The need for legal certainty requires the implementation of a common rule that will protect the *Bona Fide* Acquirer in international securities transactions.
- Protection should be granted to an acquirer not aware of challenging action at the time he received the securities in his account.
- Acquirer should be in a position to clearly ascertain whether the conditions under which he received the securities were clear or challengeable.

3/21

I – Adverse possession

- *Good Faith Acquisition:* concepts of *limitation* and *statutory period*
- Doctrine of adverse possession:
  - the occupier of a land, not the true owner, acquires title to the land without consent from or compensation to the “true” owner.
  - after a period of time, not even the true owner may bring action to eject the unauthorized possessor.
  - places a statute of limitation on the owner’s right to bring action against the possessor.
- English common law, Statute of Limitations in 1632:
  - adverse possession: after a period of time a person in possession of a property, either rightfully or wrongfully, is to be protected from actions to recover possession of the property.
- in all US states:
  - adverse possession provides a person with a means to acquire title through possession according to law.

4/21

Adverse possession (cont.)

- The doctrine of adverse possession does not differ much under common law from civil law systems.
- Under French law, good faith:
  - is a mean to shorten the usual statutes of limitations on the acquisition of movable goods.
  - also referred to the performance of contracts in the civil code.
  - considered both under the view of truth and mistake, and as missing an intent to deceive.
- Differences between civil and common law systems refers to the distinction between good and bad faith possessors.
- Main difference between common law and civil law systems:
  - Civil law systems explicitly espouse and apply the principles of contractual good faith,
  - Common law systems, typically the English common law, have no recognition of a general doctrine of good faith.

5/21

II – Concept of Good Faith in some National Jurisdictions and International Conventions

- Broad concept of contractual good faith in acquisition deals.
- Doctrine often distinguishes:
  - *subjective* meaning of Good Faith (i.e. defence of justifiable ignorance in contexts of purchase and possession)
  - *objective* meaning in bilateral relationships, where one party takes no undue advantage of (an)other vulnerable party(ies).
  - In French, equivales to '*surprendre la bonne foi de quelqu'un*' and '*abuser de la bonne foi de quelqu'un*' as acting without an intent to deceive.

6/21

A - Common rules of Civil and Common Law Systems regarding Good Faith

- Two majors common rules:
  - a party may regain possession of its property;
  - a party may not be deprived of its property without consent.
- Two major ways to lose property possession without consent: theft and loss.
- Rule known as Nemo dat quid non habet:
  - one can transfer no better interest than one has,
  - in case of loss or theft, the intermediate party's title is void.
- Various jurisdictions diverge between two other categories of cases, where:
  - the intermediate party has voidable title, and
  - the owner entrusted the property to the intermediate party.
- Entrustment means that "trustee" received the property either as bailment or by contract, later held invalid.
  - Conflict arises when Owner A entrusts (or transfers possession of) his property to another Person B and Person B transfers property to innocent Third party C in exchange for valuable consideration.
  - Owner A may recover damages from Person B.
  - Owner A and Third party C are innocent, have socially protectable interests against B.

7/21

Anglo-American rules

- UCC §2-403:
  - If a party entrusts its property to a merchant who deals in the same sort of goods, a good-faith purchaser in ordinary course of business from such merchant, will prevail against the owner.
  - In consequence, a *Bona Fide* Purchaser (BFP) will prevail against the owner
  - Mere separation of ownership and possession will not amount to an entrustment or bailment situation.
  - Holder of the property must be a merchant who deals in goods of that kind.
  - A party with voidable title can pass good title i.e. Bona Fide Purcharser will prevail.
  - True for both real and personal property.
- English law, Sale of Goods Act, 1979 (§23):
  - quite similar: a party with voidable title can pass good title to a BFP.

8/21

Civil law rule

- Continental law: no such rules on entrustment, bailment or voidable title.
- Continental law: title is valid until declared invalid by court, thus a party with voidable title can pass good title to a BFP.
- French Civil Code on protection of the BFP: combinaison of:
  - Art. 2279 al 1 principle: « In matters of movables, possession is equivalent to a title. » = « En fait de meuble possession vaut titre.»
  - Statute of limitation rule: one may receive title by possession over a period of time.
  - Art. 1141: « Where a thing which one is bound to transfer or deliver to two persons successively is purely movable, the one of the two persons who has been put in **actual possession is preferred** and remains the owner, although his title is subsequent, provided however that the **possession is in good faith** ».

9/21

Civil law rule (cont.)

- French law: actual possession of a movable good has 2 key effects:
  - possessor acquired the movable good on a *non domino* basis,
  - is a good faith possessor (believes has good title or is true owner of a real property).
- Possession allows him to receive good title over original owner.
- Possession received from original owner gives a legal non-conclusive presumption of ownership, supposes good title.
- French law: not fixed upon the "title" but upon will and contract:
  - In case of theft or other crime by which party obtained property
  - same rule as under American jurisdiction: owner can recover, even from a subsequent bona fide purchaser.
  - Property possession did not pass according to owner's will, because contracts (or other juridical acts) declared invalid are invalid *ab initio*, from the moment of their formation.

10/21

Quebec

- Civil code §1714:
  - In case of personal property left for safekeeping or repair and forgotten.
  - After a period of time and upon notice to the owner, bailee may sell the property at auction or transfer it to charity.
  - The owner may "revendicate" the proceeds received by bailee minus bailee's expenses.
  - In case of immovable good sold in the ordinary course of business to a bona fide purchaser, owner may revendicate the property but must reimburse BFP of the purchase price.

11/21

For Value

- To be a Bona Fide Purchaser, a person must have obtained property for value,
  - i.e. has paid or promised to pay for it or given or promised to give some other thing or service of value in exchange for it.
- Under French law:
  - the BFP must have taken the property under onerous title, meaning must have exchanged something for it.

12/21

Successive Transfers

- Successive transfers do not change the situation.
- Under the American rule :
  - if a person with voidable title transfers it gratuitously to a third party, and third party transfers it onerously (for value), the owner prevails.
  - The first transfer that matters: if first transfer is not onerous, the owner prevails, even if subsequently the property goes through a number of onerous transfers.

13/21

Exception for Securities

- In all jurisdictions, one cannot recover certain types of property that are in the hands of a *bona fide purchaser*.
- Since money and securities are fungible goods and circulate, the law must protect the security of the acquisition above all. (i.e. Russian civil Code, § 302.3).

14/21

B – Does opposition between common law and civil law systems still have sense?

- Distinction between a civil law system v. a common law system is of limited value and purpose specific.
- Some doctrine argues:
  - concept of Good Faith is not common in all western countries.
- English contract law:
  - does not recognise a general concept of good faith.
  - traditionally regards good faith as "an invitation to judges to abandon the duty of legally reasoned decisions and produce unanalytical incantation of personal values"

15/21

B - Opposition between common law and civil law systems (cont.)

- Distinction even less definite once acknowledged that:
  - 'mixed' common law systems, such as US or Australian, with amalgams of civil codes and common law principles
  - some scholars (A. Farnsworth): the wide-ranging doctrine of *implied terms* functioning as a repository of principles of fairness, Good Faith, and 'reasonableness' at the heart of contract law.
- Significant developments worldwide point out:
  - the *ubiquity* of the principle of Good Faith (and fair dealing) in Western systems regardless of their characterisation as civil codes or common law,
  - its *essential* rationale when dealing with contracts.
- Harmonisation of contract law:
  - Principles of European Contract Law (PECL), Unidroit principles, UN Treaty on Sale of Goods,UN ConventioUS Uniform Commercial Code and the Restatement (Second) of Contracts, and UK Unfair Contract Terms in Consumer Contracts Regulations 1994 and 1999.

16/21

B - Opposition between common law and civil law systems (cont. 2)

- Both PECL, UN Convention on the Assignment of Receivables in International Trade and Unidroit Principles of International Commercial Contracts contained general provisions
  - "in exercising his rights and performing his duties each party must act with good faith and fair dealing".
  - "to the need to promote uniformity in its application and the observance of good faith in international trade".
- On the opposite, Unidroit Convention on International Interests on Mobile Equipment:
  - reference to good faith abandonned for causing uncertainty in operations dealing with important amounts of money,
  - incentive was rather put on the necessity to promote the forseeable use of the convention.
- A turning point in referring to good faith in international conventions ?
- The lack of reference to good faith is due to a misunderstanding of the good faith concept:
  - It is important to get back to the essentials of good faith acquision both in the civil and common law systems.

17/21

B - Opposition between common law and civil law systems (cont. 3)

- The difference between civil and common law systems, when understanding and developing the notion of Good Faith, is often illusory. Farnsworth makes two relevant and related points:
  - the widely accepted *Uniform Commercial Code* and *the Restatement Second,* function as a civil code within a common law jurisdiction,
  - the articulation of Good Faith contained in UCC Section 205: "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement", was effectively a transplanted version of the principle concept of the *Treu und Glauben* German civil code.
- Thus, distance between civil and common law systems reduced, closely connected and potential compatible.
- In civil law systems:
  - Good Faith governs the interpretation of law in contractual relations
  - Especially where there is a need for legal doctrine "to temper the deliberate pursuit of self interest in situations where the conscience is bound".

18/21

III - Limits to a neutral approach of Unidroit Project

- For a uniform application of the Convention provisions:
  - Most important principle of the Convention: "all references to traditional concepts should be avoided where possible".
  - Application of this principle by the Secretariat: the requirements "*need to be defined in as a plain wording as possible so to avoid recourse to traditional concepts. In the end, it was decided that the entire concept of what is traditionally known as a "*good faith acquisition*" should be replaced by a description*".
- The new Article 11 called (English version) "Acquisition by an innocent person of intermediated securities" provides that
  - "*A person who acquires intermediated securities by credit to a securities account under Article 5, or who acquires a security interest in such securities by an agreement or designation under Article 6, and who does not at the time of acquisition have knowledge of an adverse claim with respect to the securities is not subject to that adverse claim*".

19/21

III - Limits to a neutral approach of Unidroit Project (cont.)

- Knowledge of adverse claim: key principle to address the "good faith acquisition" rule.
- Article 11 of the draft convention indicates that
  - *"For the purposes of this Article a person acts with knowledge of an adverse claim if that person:*

    (a) has actual knowledge of the adverse claim; or

    (b) has knowledge of facts sufficient to indicate that there is a significant probability that the adverse claim exists and deliberately avoids information that would establish the existence of the adverse claim;

    and knowledge received by an organisation is effective for a particular transaction from the time when it is or ought reasonably to have been brought to the attention of the individual conducting that transaction."
- In Rome, several delegations viewed that "knowledge" as used in former Article 10(3) was unclear.
- One delegation concerned by a broad interpretation of 'knowledge' in dealings between intermediaries. I agree.

20/21

III - Limits to a neutral approach of Unidroit Project (cont. 2)

- No reason but neutral language to avoid references to the concept of Good faith. Although,
  1. Principle of neutral language in draft convention is flexible.

     - The secretariat recognizes: it "*is a clear desire to accommodate different legal concepts and to produce as unintrusive an instrument as possible by employing fact based-rules, however, this does not mean that intrusion can be avoided entirely*".

     - English and French draft versions differ (from "Acquisition by an innocent person" to good faith acquirer or "Aquisition par une personne de bonne foi") due to the difficulty to address similar views in both languages.
  2. Concept of Good faith is not so different from one jurisdiction to the other.
  3. Good faith acquisition rule is key to protect third parties.

     - It is clearly better to use a legal terminology known and used in various jurisdictions rather than to describe this rule with a doubt that judges may miss the real meaning of this unknown new rule.

     - Due to uncertainty in the scope of the concept of "knowledge of adverse claim", and to avoid a risk of requalification by judges, more important to put out the principle of neutral language and come back to concept of Good faith.

IBERCLEAR

GRUPO BME BOLSAS Y MERCADOS ESPAÑOLES

UNIDROIT

FEDERATION BANCAIRE FRANCAISE

AFTI

UNIDROIT SEMINAR ON INTERMEDIATED SECURITIES
Paris, from 31 January to 1 February 2006

The impact of intermediated holding on the relation between investor and issuer

Ignacio Gómez-Sancha (Head Legal Counsel, IBERCLEAR) February 1st, 2006

IBERCLEAR

GRUPO BME

The impact of intermediated holding on the relation between investor and issuer

IBERCLEAR BME

Back were it started (I)

❖The need for cheaper money in the origin of Securities Markets.

- **"Desintermediation" and a direct legal relationship between issuers and investors (investment banking vs. commercial banking)**
- **Three important aspects in a company (DMP, FOC, TS)**
- **Economically, a type of credit rights (satisfaction depends on debtor-issuer).**
- **Documented in paper certificates or Shareholder's Registry:**
  - ✓ **Good for issuers** **"I know who is my creditor"**

    "I only pay him if he shows the certificate that I issued or his name is in my Registry the certificate is with my Registrar"
  - ✓ **Good for investors** **"I can have liquidity without notice to my debtor-issuer"**

    "I can rest on legal protection granted by publicity of possession"

    "I don't fear shortfalls or my right being vitiated by previous relation of the transferor-issuer (i.e. set-off with debts of previous holders)".

3

IBERCLEAR BME

Back were it started (II)

- ❖ But "paperwork crunch"
  - **Incompatible with the growth pace of modern securities markets.**
  - **Inconsistent with foreign investment, as paper needs to be close to the issuer (presentation)**
- ❖ Common solution: allow for transfers documented through entries in an electronic book or record ➔ "book entry" or "electronic" securities
- ❖ How to keep advantages for issuers and investors while not "closing the eyes to reality"?
- ❖ In late XXth century Legislators adopted two kind of solutions:
  - Adapt Law to reality ➔ indirect (intermediated) holding systems
  - Adapt reality to the Law ➔ direct holding systems

4

IBERCLEAR

Characteristics of indirect (intermediated) holding systems

- Entitlement (bundle of rights) against the relevant intermediary:
  - New kind of "legal asset" A1
- No legal relationship with the issuer: Issuers may not know their names.
- Transfer of rights or attachments do not require intervention of the upper-tier CSD or intermediary.
- "Credits" and "debits" may occur by mere confirmation, and determine destruction / creation of securities each time
  - No need to look inside the "black-box"
- Insolvency: no traceability ➔ need for shortfall-allocation arrangements

5

IBERCLEAR

Characteristics of direct holding systems

- Law recognizes the account holder – investor as the legal counterpart of the issuer
- Intermediaries are mere book-keepers
  - No legal interest in the underlying asset ➔ only entitled to custody fees, etc.
  - Acts before the issuer "in the name" and "on behalf" the investor
- Issuer is "free" if it fulfils its obligations vis-à-vis the "direct holder", and has a way to know who this is
- Upper-tier attachments are seen as more protection
- A credit usually requires an effective entry in a concrete record / account / electronic cell, not a mere "confirmation" of the intermediary

6

IBERCLEAR BME

Characteristics of direct holding systems (II)

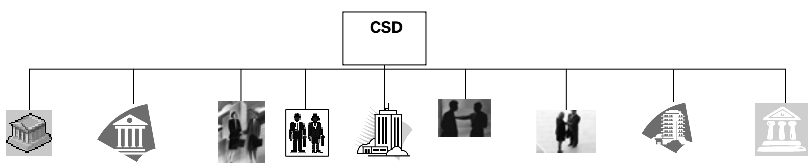
- But… this needs to be ensured by someone!!
  - An infinite "holding chain" is not easily compatible with a "direct holding" legal structure (meaning direct legal claim)

    ➔ issuers would be defenseless if nobody controls number of securities.
  - Someone must bear responsibility for:
    - Avoiding "creation of securities" through reconciliations
    - Maintaining the primary electronic records
    - Co-ordinate / facilitate exercise of rights
  - The vital role of CSDs: two possible realistic structures.

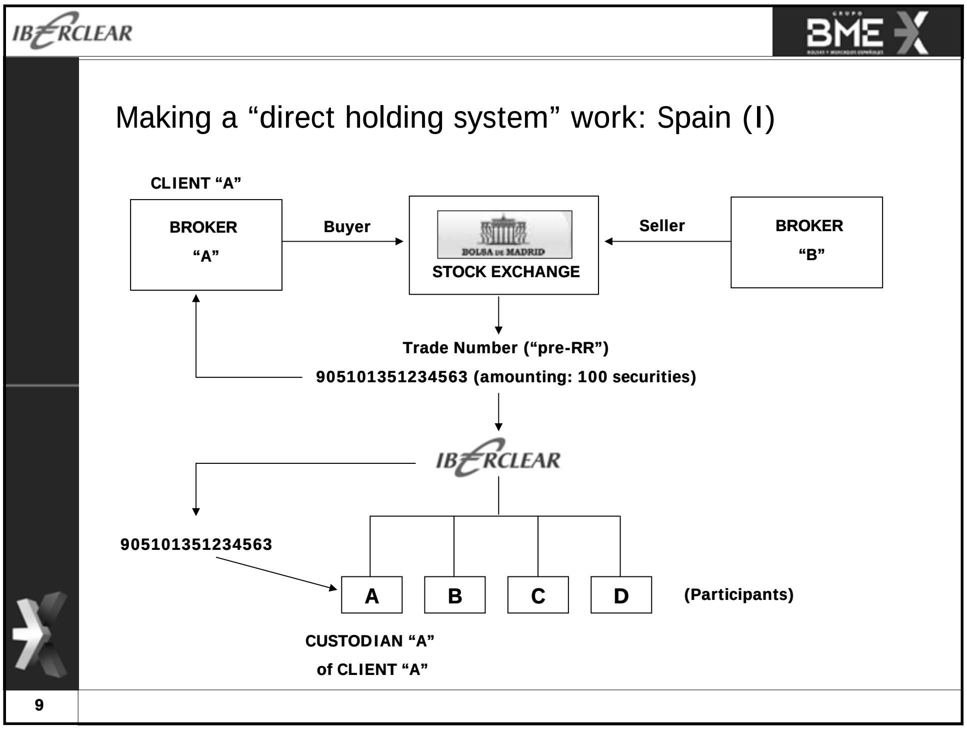
IBERCLEAR BME

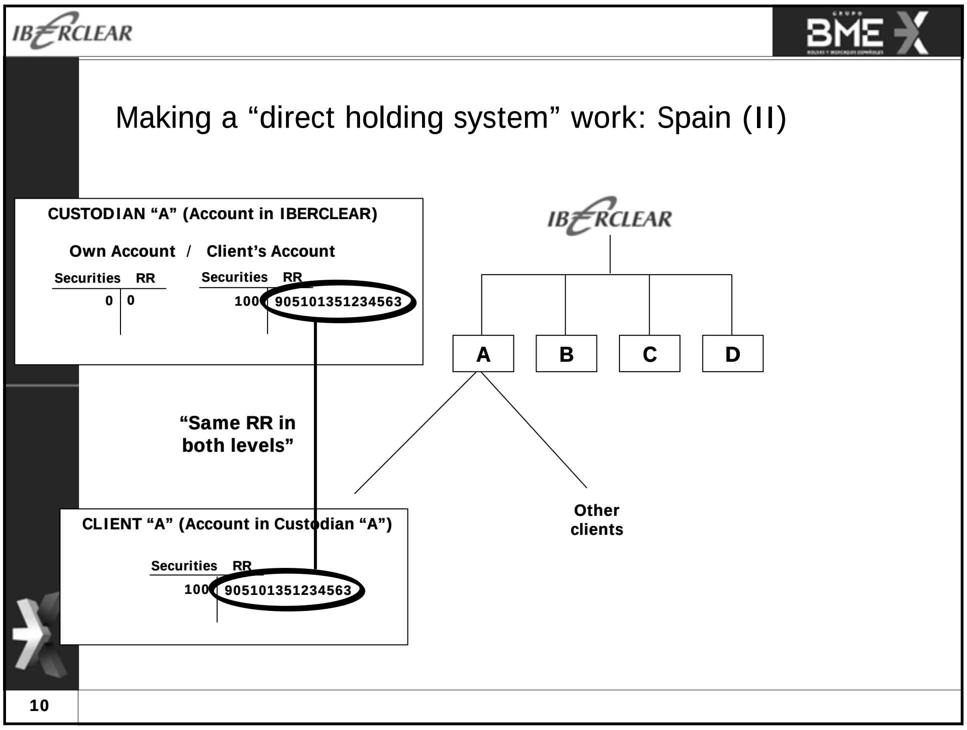
Two ways of organizing a direct holding system

- Single tier centralized registry system: Greece, Nordic, Brazilian CSDs



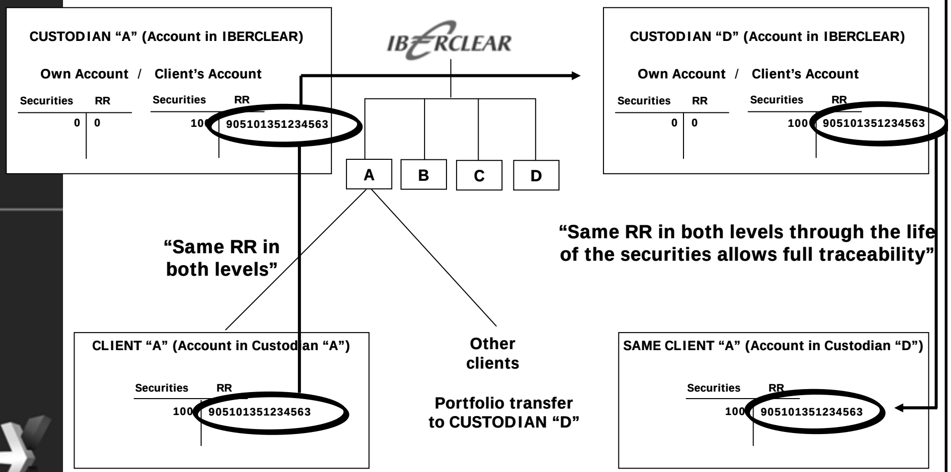
  - As many accounts as investors
  - "Indirect" investors (through trusts, nominees or omnibus accounts) are subject to potential legal contingencies
  - Compatible with custody industry: the CSD only maintains the "legal registry". The account is operated by a custodian bank
  - Issuers and supervisors are happy
- **Two tier centralized system: Spain full legal reform in 1992**


IBERCLEAR
BME
Making a "direct holding system" work: Spain (I)
CLIENT "A"
BROKER "A"
Buyer
BOLSA DE MADRID
STOCK EXCHANGE
Seller
BROKER "B"
Trade Number ("pre-RR")
905101351234563 (amounting: 100 securities)
IBERCLEAR
905101351234563
A
B
C
D
(Participants)
CUSTODIAN "A" of CLIENT "A"
9


IBERCLEAR
BME
Making a "direct holding system" work: Spain (II)
CUSTODIAN "A" (Account in IBERCLEAR)
Own Account / Client's Account
Securities RR
0 0
Securities RR
100 905101351234563
IBERCLEAR
A
B
C
D
"Same RR in both levels"
Other clients
CLIENT "A" (Account in Custodian "A")
Securities RR
100 905101351234563
10

IBERCLEAR BME

Making a “direct holding system” work: Spain (III)



11

IBERCLEAR BME

Structure of the RR (registry reference)

RR = 9/051013/5/123456/3

9	**Origin of the transaction (9: buy in Stock Exchange, 6: buy in Latibex Market)**
051013	**Date of transaction (yymmdd)**
5	**Detail of the origin of the transaction (5: buy in Bilbao Stock Exchange, 8: bilateral loan)**
123456	**Sequential number**
3	**Control digit**

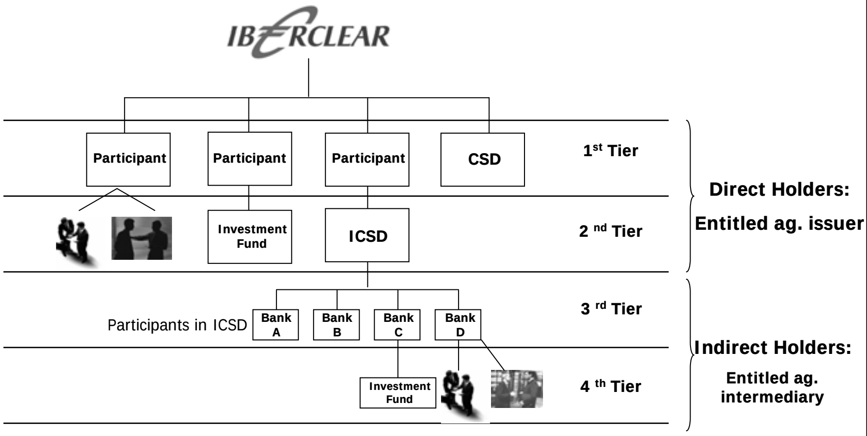
FUNCTIONS:

- ✓ Controls “naked short selling”: total prohibition (shortages covered with borrowed stock allowed)
- ✓ Allows control of “legal short selling” through stock lending
- ✓ Daily update of registry of shareholders (nominative shares)
- ✓ No “RR” means no property rights, only claim against the intermediary
- ✓ Allows traceability: Broker, Exchange, CSD, custodian investor share the same RR

12

IBERCLEAR

Scope of direct holding



13

IBERCLEAR

Practical implications: Pros and cons

Direct		Indirect	
Pros	**Cons**	**Pros**	**Cons**
As legally sound as old paper certificates	Created before the cross-border settlement era	Realistic path for cross border investment	Legally unsound in a long chain of holdings: more legal risk
Fully integrated with clearing and settlement processes in CSDs /less risk	Does not allow “internalised settlement”	Allows internalised settlement	Incompatible with foreign clearing and settlement arrangements / more risk
Designed to cater issuer’s needs	Does not facilitate distance voting/ divided voting / take over thresholds, etc.	Good flow of economic rights through the chain (cash distributions)	Burdensome/uncertain exercise of shareholder’s political rights.
Full protection in “direct” collateral taking	Uncertain indirect collateral taking (upper-tier attachments)	Allows cross border collateral taking	But uncertain enforceability / upper-tier shortfalls.
Traceability / good public supervision / transparency	Considers “owner” a mere nominee/trustee.	Right to choose place of custody.	No traceability / bad supervision, no transparency

13bis

IBERCLEAR BME

The impact of intermediated holding on the relation between investor and issuer

I.	Back were it started.
II.	Direct vs. indirect holdings.
III.	Making a direct holding system work.
IV.	The Issuer – Investor relationship (Static picture)
V.	Domestic solution in the electronic era (the Spanish case).
VI.	The *status quo* in the intermediated arena and its consequences for issuers, intermediaries, investors.
VII.	Transfer of corporate entitlement
VIII.	The EU Directive on Shareholders' rights.
IX.	Would issuers like the current UNIDROIT draft?

IBERCLEAR BME

The Issuer – Investor relationship: THE STATIC PICTURE

- SHAREHOLDER: complex "legally protected situation" composed of:
  - **Rights** (and sometimes, *obligations* –i.e. to vote: fund managers-) on the **Investor**. A2
  - **Obligations** (and sometimes *rights* –i.e. not fully paid up shares-) on the **Issuer**.
- Basic legal need: Identification
  - **for a Creditor: to know who is my debtor (Who do I sue?)**
  - **for a Debtor: to whom I have to satisfy to be free again!**
  - **This means: good documentation.**
- When shares were documented in papers: easy to handle, as explained.
  - **Could be papers (bearer shares): delivery, presentation.**
  - **Could be inscriptions in a shareholders' registry.....**

IBERCLEAR BME

Why identification of the counterparty is important

- From the active side: Investor- Shareholder:
  - (+) I am sure that I am entitled to my rights.
  - (–) I am obliged to fully pay-up shares / vote, etc.
- From the passive side: Issuer - Company
  - (+) I am free if a pay my shareholder / I can reclaim what its outstanding
  - (–) I cannot hide, provided that the <u>shareholder IS a shareholder</u>.

A3

IBERCLEAR BME

Why identification of the counterparty is important

- So the "Shareholder registry" has for the shares the same function that "notice to the debtor" has in an assignment of receivables.
- It protects the "*debitor non laedere*" principle.
- It is a **defensive tool** for the issuer: If I do not get notice of a transfer, I am free if I pay my current counterparty.

  (+,–) But, May I pay dividends, allow to vote, etc. to a non-shareholder?

  Please do not answer yet.....

- **FIRST**, How do I solve the "identification" issue in the electronic era?

<u>what about "electronic shares" (electronically documented relation)?.</u>

A4

IBERCLEAR

Domestic solutions in the electronica era (Spanish Case)

Two legitimation-entitlement solutions (bearer vs. registered)

A. **Bearer**: Art.22.2 RD116/92

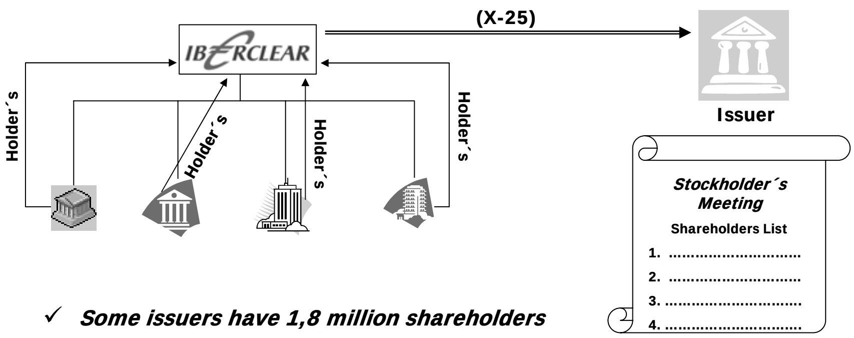
- Issuers may only obtain the list of shareholders when calling a GSM. With reference to D-5. (“The X-25”)
- Not time enough to issue it’s own shareholders “attendance cards”.
  - They are issued by participants
- Shareholder's “Attendance Cards” are not homogeneous (Standardized)
  - Homogenization cost.

17

IBERCLEAR

Bearer:

- ✓ ***Only when the G.S. meeting has been called***
- ✓ ***Referred to “record date” (in Spain, D-5)***



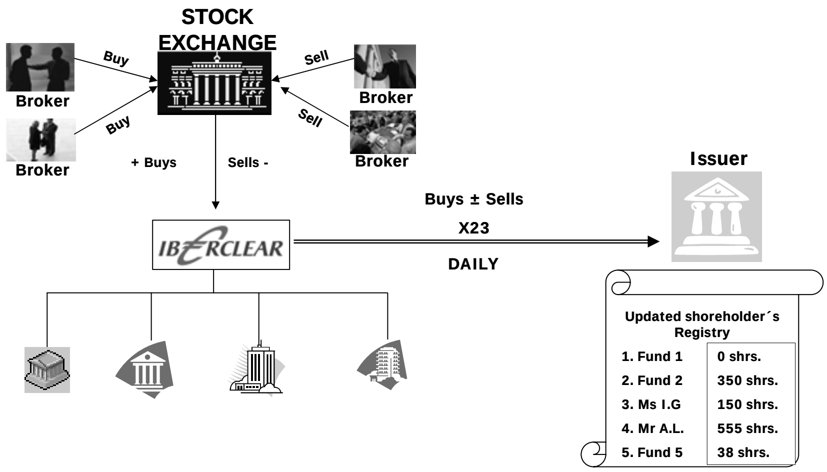
- ✓ ***Some issuers have 1,8 million shareholders***
- ✓ ***Problems with links between CSDs***

18

B. **Registered (Nominative)**: Art.22.1 RD116/92

- Intermediaries send the transactions to Iberclear daily.
- Iberclear elaborates the "Acta Múltiple de Transferencia" and send it to the issuers.
- Entities have a daily updated shareholder's registry.
- Which allows them to:
  i. Issue and send the cards within the publication of GSM announcement (D-30).
  ii. Do a valid cut D-5, refusing the shareholder's cards whose securities have been sold.

Registered (nominative): updated daily



IBERCLEAR BME

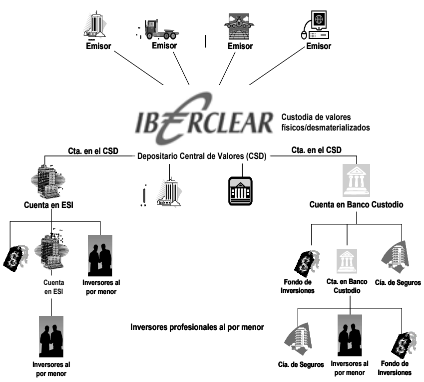
The impact of intermediated holding on the relation between investor and issuer

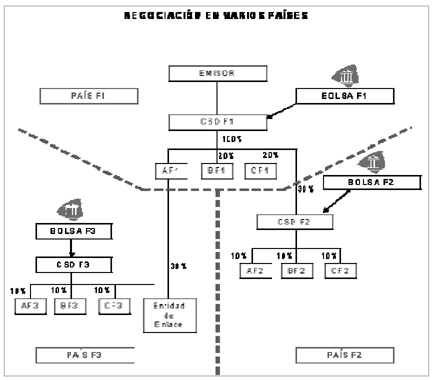
I. Back were it started.
II. Direct vs. indirect holdings.
III. Making a direct holding system work.
IV. The Issuer – Investor relationship (Static picture)
V. Domestic solution in the electronic era (the Spanish case).
VI. The *status quo* in the intermediated arena and its consequences for issuers, intermediaries, investors.
VII. Transfer of corporate entitlement
VIII. The EU Directive on Shareholders' rights.
IX. Would issuers like the current UNIDROIT draft?

IBERCLEAR BME

The status quo in the intermediated arena and its consequences for issuers, intermediaries, investors.

- Foreign investment flows through "intermediated chains"
- Issuers traded on several markets need link mechanisms between settlement systems





IBERCLEAR

GRUPO BME

The status quo in the intermediated arena and its consequences for issuers, intermediaries, investors.

- Corporate Law generally not adapted to this new reality
- Continue to consider “shareholder” the immediate accountholder:
  - ➔ “it’s the only name in my book”.
- **Consequences:**
  - Final investor seizes to exist for Corporate Law purposes.
  - Sometimes, formal prohibition to hold shares indirectly: which means prohibiting foreign investments.
  - They own a “right” over a share.
  - Nominees, custodians, omnibus accounts are major “shareholders”.

  Not a joke:
  - Filings with SEC’s of significant holdings,
  - Obliged to vote but incapable to process instructions because of impossibility to split votes.
  - Shareblockings impede cross-border settlement during GSM calls.
  - Even problems when crossing mandatory taker-over thresholds.

22

IBERCLEAR

GRUPO BME

The status quo in the intermediated arena and its consequences for issuers, intermediaries, investors.

- What do issuers think about this?
  - They need to communicate with the relevant holder:
    - ➔ To obtain sufficient quorum in G.S.M., delegated votes in proxy fights, etc.
  - Finding the “ultimate investor”, a “mission impossible”.
  - But still need to identify with certainty my counterparty for (+) effects.
  - How may I have a relationship with someone that I cannot identify?
  - ✓ So “Corporate schizophrenia” is born: Issuers want the “final investor” to be reachable, but without loosing the **(+)** effects of identification.
- Two important questions:
  - **How is this currently managed?**
  - **Is there a legal cure (i.e. a legally acceptable solution) without splitting legal/beneficial ownership?**

23

IBERCLEAR BME

1) How is this currently managed?

- Economic rights flow correctly. Is a minimum.
- Political rights are possible but more difficult (helped by rational apathy....)
  - **Timing problems (to little time to run up and down the chain)** A6
  - **Obstructive problems (need to block the shares)**
  - **Information problems (big reports, proxy statements difficult to send, etc.).**
  - **Execution problems.**

  ➔ **Issuers stick to the legal entitlement given by Corporate Law (*lex societatis)* to intermediaries to cast the vote, and forget about who controls the vote (as long as they vote).**
- ICSDs, Global Custodians and other intermediaries are frequent instructed voters, either directly or by proxy.
- Ultimate investor has a hurdle race to reach the GSM and vote etc.
- Proxy agents and Proxy advisors step into this arena.

24

IBERCLEAR BME

2) Is there a legal cure?: Yes

✓ **Transfer of corporate entitlement ("*legitimationübertragung*")**

- Issuers should accept that rights arising from "lex societatis" may be transferred if it is for the benefit of the life of the Company. A5
- Holding shares through intermediaries is unavoidable and good for foreign investment.
- They should allow the exercise of the (+) investor rights "through" intermediaries without limits, although not loosing the issuer (+) effects of identification.
- Intermediaries obligations (downstream and upstream) must be clearly defined (regulated).
- Then, Should intermediaries be subject to investor obligations vs. issuers?
  - ✓ **Corrective rule: ➔ Assigning burden of proving that a "transfer of corporate entitlement" has happened.**
  - ✓ **Intermediary may prove that is acting on behalf of someone else, although the burden of the prove should be on him.**
  - ✓ **Respectful with bank secrecy.**

25

IBERCLEAR

BME

The EU Proposed Directive on Shareholders' rights

- After years of work by several working groups.
- Objective: to remove key obstacles to the process of cross-border voting and exercise of rights in GSM, by minimum legal harmonisation. A8
- The "Where is Wally?" approach abandoned: Shareholder includes a person holding in its own name but on behalf of another. Is a type of "corrective rule", as is only "for the purposes of this directive".
- Establishes minimum standards for: GSM notice period and content, web-site info, right to add to the GSM agenda and to table resolutions (5% or 10M Sh. Cap.), no blocking, record date (30 dates), electronic attendance and voting (when technically feasible).
- Three types of non-resident voting:
  - **By appointing a Proxy holder: Proxies may be held from more than one Sh., and yes/no concurrent votes are allowed (and speeches?).**
  - **In absentia: postal or electronic means (authentication?)**
  - **Upon instructions: record of instructions for 1 year.**

26

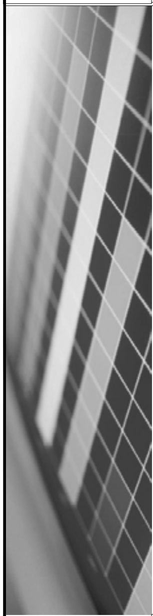
IBERCLEAR

BME

Would issuers like the current UNIDROIT draft?

- Again, corporate schizophrenia.
- Article 19 is potentially circular: A7
  - **a) Issuers are not bound to recognise as shareholder if according to corporate law they are not compelled to do so.**
  - **b) Corporate laws should be amended to oblige them to recognise that.**
  - **➔ It is a "lift the barriers" declaration (a "Directive"). Not the style of the rest of the text.**
  - **➔ Would be better to regulate the process of exercising the rights, and how intermediaries and issuers should behave.**
- Article 20 is difficult to accept in a "direct world". A corrective rule is needed. The burden of the prove of the intermediated holding (and that no shortfall is in place?) should be on the account holder.

27



Ignacio Gómez-Sancha
Head Legal Counsel
(IBERCLEAR)
Deputy Secretary to the Board
(BOLSAS Y MERCADOS ESPAÑOLES)

More Information
ignacio.gomez-sancha@iberclear.es
www.iberclear.es

Pedro Teixeira, 8 – 2ª plta.
28020 – MADRID

91 417 48 00

EUROPEAN CENTRAL BANK

Disposition of the right and transfer between accounts: Any links?

Klaus Löber
Principal Legal Counsel
klaus.loeber@ecb.int

Book-entry schemes - underlying philosophies

- Focus on protection of investor’s ownership status
- Focus on exercise of certain investor rights
- Focus on the integrity of the issue
- Focus on market efficiency

"Disposition of the right"

- What „right"?
- Who acquires the „right"?
- When and under which conditions?

Object of the disposition – Status quo

- "The securities"
- Direct ownership right in securities held with a CSD
- Co-ownership right in pool of identifiable securities
- Property right over securities
- *Sui generis* right
- Bundle of rights
- "Book-entry securities"
- Co-ownership in a fungible pool of assets held with an intermediary
- Beneficial ownership in securities

Who acquirers – Status quo

- Transferee acquirers all rights directly from transferee
- Transferee acquirers from intermediary
- Intermediary acquires all rights
- Intermediary acquires legal ownership

EUROPEAN CENTRAL BANK

Steps necessary for a valid disposition – Status quo

- Contract for effects inter partes and subsequent book-entry for third party effect
- Valid contract and completion by book-entry
- Agreement and delivery by non-book-entry means, book-entries only evidence a pre-established disposition
- Credit entry with lower tier intermediary
- Credit entry with CSD
- Joint credit entry with CSD and qualifying intermediary
- Corresponding credit and debit entry
- Chain of valid book-entries up to the CSD
- Chain of valid book-entries up to the CSD, but credit entry with lower tier intermediary may heal lack of valid chain

EUROPEAN CENTRAL BANK

Legal effect of book-entry – Status quo

- Creating autonomous legal effects
- Creating legal effects only derivative from corresponding acquisition by the intermediary
- Reflection of existing rights, not creation

- Disposition completed by credit book-entry
- Prima facie evidence for a disposition
- Essential for exercising the rights arising from accounts

EUROPEAN CENTRAL BANK

Thesis I: Transfer of rights and book-entries

Domestic situation – no conflict:

- If transfer is construed to be valid without book-entries, bookings tend to have the status of (rebuttable) evidence
- If not, bookings tend to be constitutive

Cross-border situation:

- Conflict between non-book entry transfers and constitutive book-entries may arise
- To avoid discrepancies: „Completion“ of non-book entry transfers should be made dependent on book-entries (see also Thesis IV)

EUROPEAN CENTRAL BANK

Thesis II: Autonomous vs. derivative book-entries

If book-entries create *autonomous* rights/positions:

- these should only be directed against the intermediary
- the intermediary should have a (prior?) backing position at the upper-tier reflecting the investors rights/positions

If book-entries create *derivative* rights/positions:

- the valid creation (and maintenance?) will depend on a (prior?) validly established position at the upper tier

EUROPEAN CENTRAL BANK

Thesis III: Conditional/contingent book-entries

If the validity of book-entries is *dependent*

- on a validly concluded contract between transferor and transferee and/or
- on validly established positions at the upper tier

⇒ as a minimum, information on the agreement and/or the creation of upper-tier positions need to be passed on with the transfer instruction and

⇒ the book-entry will have to be conditional/contingent upon the fulfilment of these conditions

EUROPEAN CENTRAL BANK

Thesis III: Conditional/contingent book-entries

The *conditionality/contingency* should:

- either be indicated by marking the book-entry as contingent/conditional
- or by introducing an additional element, such as a „finality stamp“ in the books indicating that a book-entry position has become unconditional (final)

Thesis IV: Content of transfer

For *derivative* book-entries (and autonomous book-entries provided that the entries with a CSD are constitutive and do not match lower tier entries):

- a lower-tier account holder cannot acquire more rights/positions than what arise at an upper-tier
- a lower-tier account holder may acquire less rights/positions than what arise at an upper-tier

⇒ To safeguard the investor position, the minimum content of the positions/rights to be passed on should be defined

Thesis IV: Content of transfer

For systems based on *autonomous* book-entries:

⇒ To safeguard the investor position, it should be ensured that the minimum content of the positions/rights are backed on through the whole chain of holdings

EUROPEAN CENTRAL BANK

Thesis V: Corresponding bookings

For transfers *within one* intermediary/CSD:

⇒ matching correspondent (simultaneous) credits and debits should be a matter of proper account keeping

For transfers involving *two or more* intermediaries:

⇒ the integrity of an issue should be safeguarded through the overall correspondence of all credit and debit positions within intermediaries and matching entries at the joint upper-tier intermediary

⇒ within one intermediary, investors‘ positions should be safeguarded by the requirement for the intermediary to have positions at an upper-tier intermediary at least equal to the aggregate credit entries of all investors

EUROPEAN CENTRAL BANK

Thesis VI: Moment of transfer

- Simultaneous credits and debits (individual or aggregate), where possible, provide certainty on the moment of transfer
- Credit occurs *before* a corresponding debit:
  - ⇒ (i) If credits are *contingent* (requiring prior/simultaneous debit or establishment of a matching upper-tier position), no problem can arise
  - ⇒ (ii) If credits are autonomous, temporal excess positions may occur (default/insolvency risk)

To limit risks, credit positions should (i) either be contingent or (ii) there should be a requirement for a prior acquisition of matching positions

Thesis VI: Moment of transfer

- Debit occurs long before a credit, thus creating an interim phase, where:
  - ⇒ (i) nobody holds the respective positions (non-allocated securities) credits or
  - ⇒ (ii) the intermediary holds the respective interim positions,

resulting in possible problems in a default/insolvency situation.

To avoid problems, (i) a presumption should be established that non-allocated positions remain with the transferor until the credit entry is made and (ii) furthermore, eventual interim positions of an intermediary should (a) be qualified as contingent or (b) be subjected to a presumption of belonging to the transferor until the credit is made

Relevance and implications of Unidroit draft Convention on Intermediated Securities for securities settlement systems

Unidroit Seminar

organised in Paris

January 31/February 1, 2006

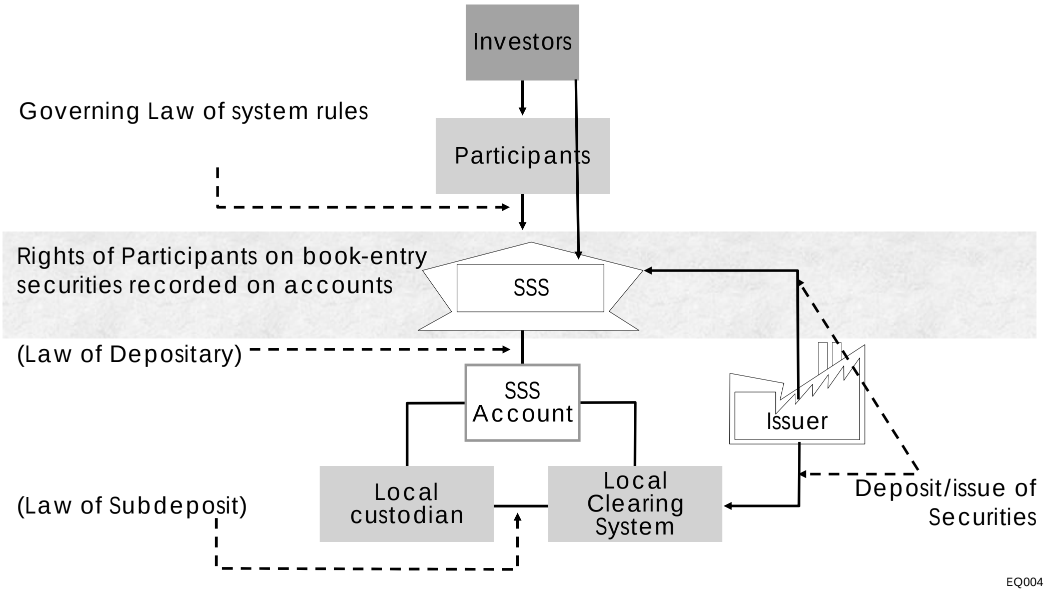
Diego Devos

euroclear

Agenda

- **SSS Holding Structure**
- **Some basic findings in relation to SSS substantive laws' issues**
- **What is a securities settlement system?**
- **Why SSSs should be covered by Unidroit Convention ?**
- **Do SSSs require specific treatment and exceptions to Unidroit Convention rules ?**
- **Conclusions**

1. SSS Holding Structure



2. Need for Unidroit Convention for SSS

Some basic findings in relation to SSS substantive laws' issues

1. SSSs hold , whether directly or indirectly, securities in book-entry form (immobilised bearer and/or registered securities; dematerialised securities)as intermediary between the investor and the issuer (even though investors may have direct rights/title against the issuer)
2. SSSs may hold both domestic and foreign securities, in this last case necessarily through local intermediaries/SSS;
3. SSSs may also have both domestic and foreign participants as well as issuers;
4. SSSs may receive collateral to secure the operation of the system and are anyway interested in the soundness of collateral transactions in their books between their participants

3. What is a securities settlement system?

- **No commonly agreed definition of this concept (nor of "central securities depositary" (CSD) for example) ;**
- **Definitions given in official regulatory publications such as BIS CPSS-IOSCO reports (also the "Red Book"); the ECB Blue Book, the ESCB-CESR standards on SSSs (on hold);**
- **At EU level, intense discussions on definitions (CESAME, ECB, etc) which may be reflected in a (possible but not decided yet) future Directive on C&S;**
- **Definition of a SSS is very complicated (see ECSDA exercise showing a huge variety of services to issuer and participants, depending on the country, the SSS in question and the type of instruments);**
- **Definition of securities also politically sensitive because of the debate on "functionnal approach" in Europe and on the scope of what should be regulated;**
- **A definition exercise by Unidroit would be stuck with the above difficulties and political debate which may endanger the project and in any event cause delays**
- **Recommendation: to refer to national Contracting States definitions**

4. Why SSSs should be covered by Unidroit Convention ?

On a world-wide basis:

1. Need to clarify and harmonise up to a minimal level, the basic regime for holding and transferring book-entry securities with a SSS, under national law.

2. Same for collateral transactions in a SSS (or in favour of a SSS operator).

More generally, even for jurisdictions which modernised their laws on SSSs and collateral recently (EU, USA, Japan, Canada, Switzerland, etc): need to enhance legal protection e.g. :

1. against upper tier attachment risks in other jurisdictions;

2. for good faith purchaser/transferee;

5. Why SSSs should be covered by Unidroit Convention ? (continued)

1. **Foreign participants in SSSs also require minimum level of legal consistency between legal regimes to avoid challenges abroad (especially in the insolvent participant's country) in relation to SSSs' operations, in spite of the local protection available under governing (SSS) law;**
2. **Each national SSS holding (by nature indirectly) foreign securities via another SSS/custodian in the primary place of deposit must be protected -as if it would be acting as any custodian-in relation to :**

   - **Legal risk under its national legislation regarding the nature of right granted to its participants (ex: no specific regime, different treatment depending on the type of foreign corresponding custodian (leading to either ownership or claim), etc);**
   - **Recognition of omnibus accounts to hold foreign securities on behalf of clients;**
   - **Recognition of nominee positions (the SSS acting in its name but on behalf of its participants, using or not a special (trust) vehicle (as available) especially for holding foreign registered securities on a fungible pooled basis;**

6. Do SSSs require specific treatment and exceptions to Unidroit Convention rules ?

- As a rule, SSSs do not require a specific treatment compared with securities intermediaries-they are just one category- since legal protection should apply equally (see f.i. art. 5.4 , 5.5 and 11 of the draft Convention);
- However, most SSSs may be regarded as playing a specific role at the top of the securities holdings' pyramid:
  - **Services to the issuer;**
  - **Accountable for the integrity of the issue *when* they have 100% of the issue in their books (dematerialised securities);**
  - **Specific protection granted by national legislation (see SFD in the EU);**
  - **Subject to regulatory standards (2001 CPSS-IOSCO recommendations);**
- The above situation may justify exceptions/specific treatment under Unidroit Convention: SSSs rules should prevail to the extent defined by the Convention (when justified by systemic reasons: yes but what does that mean?): see art. 7,12, 16.1 (a).

7. Conclusions

1. SSSs are a specific class of securities intermediaries as they hold in their books domestic and foreign securities;
2. As such , SSSs should be granted at least the same level of legal protection under the Convention;
3. SSSs play often a specific role at the top of the pyramid of domestic securities which may justify a special treatment/exceptions with the view to ensure overriding effect of their rules as currently foreseen in the draft Convention
4. Draft Convention should not be obstructed by neither “taboos” (“no negotiations of what is already organised at national/regional level”: cf. EU SFD- evolution should be possible) nor by political debate (SSS definition).
5. Unidroit Convention should also avoid to overlap with applicable regulatory standards and rules (debit balances, loss-sharing, duties of the operator, etc) to avoid confusion.

euroclear