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

UNIDROIT COMMITTEE OF GOVERNMENTAL EXPERTS FOR THE PREPARATION OF A DRAFT CONVENTION ON SUBSTANTIVE RULES REGARDING INTERMEDIATED SECURITIES
Fourth session
Rome, 21/25 May 2007

UNIDROIT 2007
Study LXXVIII – Doc. 76
Original: English
April 2007

COMMENTS BY GOVERNMENTS AND INTERNATIONAL ORGANISATIONS

(submitted by the European Banking Federation)

A. Introduction

The European Banking Federation (EBF) would like to congratulate UNIDROIT for the further progress achieved in drafting the future Convention on substantive rules regarding intermediated securities, presented in Doc. 57 as the result of the last inter-governmental session held in Rome in November 2006.

We welcome this new draft that, in our view, has globally improved namely thanks to the structure in chapters and some new and clearer definitions.

We reckon the recourse to the functional approach that has been at the origin of a number of amendments with a view of permitting to build consensus over several provisions so that the Convention can be translated into very different legal systems in and outside the EU.

The EBF encourages UNIDROIT to finalize the Convention in a short period of time and not to loose the focus on the goal to achieve, namely a lasting harmonisation of substantive rules on intermediated securities. As a matter of fact we believe that further discussions on technical details will not be of added value to the Convention and that the focus should be on clarification.

We also believe that the text of the draft Convention will greatly benefit from the addition of a revised Explanatory Notes for the clarification of some provisions.

This new version of the Convention has also not resolved the question of whether, for the purposes of adopting it, the system of ratification by the individual States should be adopted – which seems to be the prevailing trend – or whether it would be easier to use different legal instruments, such as the preparation of a model law, as proposed by some parties. We therefore expect that such an important issue and the impact thereof on national legislations will be tackled as soon as possible, preferably at the end of the May 2007 talks when the delegations should meet for the last session before the Diplomatic Conference to decide definitively on the method chosen to implement the Convention.

On this general premise, we welcome the opportunity to provide further detailed comments on Doc. 57 as follows.

B. Specific comments

Definitions (Article 1)

Article 1.a: While we find the amended definition of securities now greatly improved, we would advise UNIDROIT to further clarify the terms 'financial instruments' in order to avoid mismatches in the implementation at national level. Within the European Union such definition has been harmonised by the Directive on Markets in Financial Instruments (MiFID) which will be soon implemented by the 27 EU Member States. It is thus crucial, in our opinion, to ensure that such a fundamental definition does not leave doubts about the scope of application of the future Convention.

Article 1b: We welcome the new definition of intermediated securities.

Article 1.f: The definition of "account agreement" now defined as an "*agreement between the account holder and the relevant intermediary*," has improved and corresponds better to the effective structure of the agreement existing between the intermediary and customer.

Former Article 1h "Disposition" and 1i "Adverse claim": The definitions of "Disposition" and "Adverse claim" have been deleted in the new draft Convention, consistent with was subsequently stipulated in the text of the convention. It could be appropriate however to analyse the possible effects of that modification.

Article 1k "control agreement": The new definition seems less understandable and might compromise the legal certainty of the system above all with respect to the enforceability towards third parties. As a matter of fact, the term "another person" in place of the former "collateral taker" is no longer in accordance with the directive on financial collateral, which has a legal meaning. We therefore believe that readopting the definition of the previous version of the Convention (doc. 42), would be more appropriate since it meets the regulatory criteria already in effect in both the EU Member States to identify an individual third-party guarantor.

Secondly, we propose to reintroduce the possibility of applying such agreement only where it was allowed under the internal regulations of the State in question, as stated in the previous version, for the sake of certainty.

Finally, from our point of view the part "of which notice is given to the relevant intermediary" could rather refer to the effect of such an agreement. For instance, it could be placed in Article 8 of the draft Convention.

Article 1.n and 1.o: We welcome the clearer definitions presented now under Article 1.n and 1.o that better mirror the different systems in place in the various markets at global level. As a matter of clarification, however, it would be worthwhile to differentiate.

Article 1.m: the suppression of the criterion of "*domestic non convention law*" and its replacement by "*non convention law*" read in conjunction with article 2 raised concerns to some EBF members. However this opinion is not shared by others. Therefore the EBF is not in a position to comment further those provisions. Further clarifications on the impact of this modification would anyway be welcome.

Central Securities Depositories (Article 3)

New Article 3 stipulates that the UNIDROIT Convention is not applicable to the "*creation, recording or reconciliation of securities*, if made by the central depositary or the issuing individuals.

Principles of interpretations (Article 4)

Since the debate is progressing, we would reiterate the need to ensure that the final text does not leave the Convention's purposes a self-referring statement, since we still believe it useful to have them spelled out for the sake of clarity when interpreting the Convention and implementing it at national level. This would also allow verifying that such purposes are not in conflict with domestic legislation of the Contracting States ('[domestic] non-Convention law').

Intermediated securities (Article 5)

We welcome the new draft of Article 5 which better clarifies the principle according to which the exercise of rights belongs to the investor (accountholder) and not to the intermediary (except if the latter does act on its own behalf, as the owner of the securities).

Yet, the issue of the procedures to be followed by the account holder in order to participate in the issuer's corporate affairs (participation in general meetings, receiving dividends) should be better clarified in the draft Convention by referring to the application of the non-Convention law. Also the person responsible, in a chain of intermediaries, for verifying who the true *beneficial owner* is still needs to be clarified.

Measures to enable account holders to receive and exercise rights (Article 6)

In paragraph 1, the term "appropriate measures" which need to be taken by an intermediary is relatively open and vague and hence some clarification might be needed (e.g. in the Explanatory Notes) as to what measures need to be taken.

Acquisition and disposition of intermediated securities (Article 7)

We welcome the progress made in the new version which provides the transfer of securities deposited by a credit on account, without the need of any other formality – repealing any other domestic law – in order for the transfer made to be enforceable against third parties.

Additionally, some clarification on the relationship between Art. 7(2) and Art. 10 might be helpful.

Grant of interest in intermediated securities by other methods (Article 8)

The new provision introduces a complex mechanism that does not appear to be consistent with the rules of some domestic systems and therefore is likely to create specific difficulty in establishing and managing interests on securities, which constitute one of the most delicate areas of the system.

On the other hand the new provision introduces a series of concepts creating a very fragmented and difficult-to-predict context, with consequences for the intermediaries, who could be forced to manage types of interests on securities used in different jurisdictions.

It would therefore appear useful to recall the principles stipulated for securities interests according to the formulation of the prior (see doc. 42) Article 5.

Otherwise, it should be made clear that the requirement in paragraph 1 (a) to enter "into an agreement" will not create a formal requirement to that effect; it is not uncommon that a pledge document on the face of it is a unilateral document (by the collateral provider) whilst the agreement between the collateral provider and the collateral taker is implied.

Invalidity and reversal (Article 11)

The relation between paragraph 1 and 2 is somewhat confusing since paragraph 1 relates to invalid entries and paragraph 2 (a) states that the validity of a debit, credit, or designating entry is determined by non-Convention law.

Acquisition by an innocent person of intermediated securities (Article 12)

We understand that the term "innocent person" is the result of the functional approach. However, we still consider more relevant to refer to the commonly accepted wording of 'good faith' which would avoid any misinterpretation in the two linguistic versions of the Convention and would prevent any unintended link with criminal law at the level of implementation of the future Convention.

The provision contained in paragraph 4, B (ii) introduces a criteria for "a person [who] has knowledge of facts sufficient to indicate that there is a significant probability (…)". Some clarifications - if necessary in the explanatory notes – on the cases in which the criteria of probability is deemed fulfilled would in our opinion be opportune.

Priority among competing interests (Article 13) and Priority of interest granted by an intermediary (Article 14)

The provisions establish the priorities within the framework of competing rights on interests, which with respect to the text contained in the prior version of the Convention, appear better articulated.

However, Article 13 determines, according to paragraph 1, the priority between interests effective under Article 8. Paragraph 2 of Article 13 deals nevertheless, with the priority between interests effective under Article 8 and interests effective under non-Convention law. That fact should be reflected in paragraph 1.

Also, Article 14 relates to "interest granted by that intermediary that have become effective under Article 8". This leads to an unclear situation as interests granted under Article 8 should be granted by the account holder and not the intermediary. It would therefore be a benefit if Article 14 could be clarified.

In the absence of Explanatory Notes, the analysis of the provisions of Article 13 remains also partial and seems still ambiguous in certain aspect. It seems therefore important to evaluate the compatibility of these provisions with domestic rules applicable to the priority among guaranties (indeed, article 13 firstly confers the primacy of the guaranties established under Article 8 on any other guaranties established under different modalities, arising from domestic law that applies the criterion of *prior in tempore potior in iure)*

We consider necessary that such conventional principle is used only where mechanisms are stipulated in the interest of third parties, stipulating if necessary adequate forms of publicity, which makes the existence of agreements - modifying the order of priority - among the parties publicly known.

Nonetheless under the provisions of Article 13.6, the respective collateral takers may agree on derogation from the priorities stipulated by the preceding paragraphs. We welcome the fact that this provision now includes a clarification to the effect that any such agreement shall not affect the rights of third parties.

Prohibition of upper-tier attachment (Article 17)

Insofar as neither Article 17 nor the definition of relevant intermediary under Article 1g have been modified from the last draft, we would like to reiterate the importance of amending these provisions in order to make sure that any attachment of account held for third parties at the omnibus level is prevented.

Also it is maybe understood that the issuer may use a CSD or transfer agent for certain purposes, but it could be considered to include e.g. “or anyone acting on the issuer’s behalf” after “relevant securities”.

Instructions to the intermediary (Article 18)

We note that the provisions under Article 18 might overlap with some provisions of the MiFID as far as instructions (or orders) from the account holder to the intermediary are concerned.

We recommend that a close review of the consistency of the two sets of provisions is analysed before the conclusion of the drafting.

Also, with respect to direct holding systems, in which the CSD is the intermediary according to the Convention, the instructions may be provided by agents of the account holders [account operators]. Indeed it may be argued that this is facilitated by paragraph 2 (e), but to avoid uncertainty, paragraph 1 could be amended by inserting “or on its behalf” at the end of paragraph.

Requirement for the intermediary to hold sufficient securities (Article 19)

The term "[for account holders]" that was deleted from Article 19-1 should be reintroduced. A qualification of the intermediary's duty to hold sufficient cover assets only for those securities credited to securities account holders would, in theory, mean that the intermediary could continue to credit more securities for itself than it actually holds. Whilst this would anyway not incur any legal consequences, it also remains unclear what the point would be if the intermediary were to credit securities to accounts which it maintained for itself.

Limitations on obligations and liability of intermediaries (Article 20)

The restrictions of liability should in our view also be extended to intermediaries and not solely the operators of a securities settlement system. However, the question arises why such explicit wording is needed as the matter of obligations and extent of liability is referred to the non-Convention law generally.

Loss sharing in case of insolvency of the intermediary (Article 22)

The scope of Article 22 is limited to cases of insolvency of the intermediary and that it is expressed as an optional default rule (“unless otherwise provided by any conflicting rule applicable in that proceeding”). It would nevertheless be useful to clarify that the application of the rules is without prejudice to the allocation of shortfalls outside insolvency. This could be addressed by adding the following words at the end the first paragraph of Article 22.2: “after taking into account the rights

of the account holder as defined by the account agreement and, if applicable, by the non-Convention law.

Indeed, it must be avoided that the rules on shortfall allocation in case of insolvency interfere with, or unintentionally overrule any short-fall arrangements that the domestic non-Convention law or account agreement have put in place. The pro-rata allocation of a shortfall needs to be done not just by reference to the amount of securities standing to the credit of the account holder's account, but also taking into account arrangements that, for example, place the risk of the shortfall on a specific client.

Position of issuers in securities (Article 24)

We welcome the clarification under Article 24.1 that the law of the Contracting State permitting the intermediated custody of securities is without prejudice of the terms of issue of the securities, as this mirrors what we previously commented. For the sake of consistency with the legislative terminology used in the EU, we would suggest inserting in the same paragraph the terms '***admitted to trading*** *on an exchange or regulated market'*.

We would recommend that the revised Explanatory Notes clarify the kind of markets other than stock exchanges that are considered under the future Convention as "exchange" and "regulated market". Indeed, since the adoption of EC Directive 93/22 on investment services (ISD) and further confirmed by the above mentioned MiFID, a clear list of such markets, updated on an yearly basis, is regularly published by the EU Commission following the notification of each competent authority at national level. We would welcome a clarification in this sense in the future UNIDROIT Convention.

Chapter VI - Special provisions with respect to collateral transactions

It is our understanding that the regulatory scope of Chapter VI also covers those collateral rights where there is transfer of full ownership of the financial collateral. This results from its reference to Article 5-2: Pursuant to Article 5-2 intermediated securities assigned as collateral are deemed as "delivered to a collateral taker" if and when they have been credited to its securities account. Pursuant to Article 4-1, once these securities have been credited to its account, the collateral taker shall have acquired these securities. Hence, a transfer of full ownership of the financial collateral will have taken place.

"Collateral securities" (Article 26-2-e)

The term "collateral securities" introduced under Article 26-2.e is redundant. Hence, Article 28-1 could also read as follows: "… the collateral taker may realise the intermediated securities delivered under the collateral agreement: (a) by selling them … (b) by appropriating them as the collateral taker's own property …" Article 28-2 could then continue: "Intermediated securities may be realised under paragraph 1 …" Also in Article 29-1 the renunciation to the new term is unlikely to pose any problems: "(the collateral taker shall have the right to use and dispose of the intermediated securities as…"

Definition of "close-out netting" (Article 26-2-j)

Article 26-2-j adopts the definition of "close-out netting" contained in Article 2-1-n of the Financial Collateral Directive and we strongly welcome this approach.

Recognition of title transfer collateral agreement (Article 27)

Although the *opt-out* mechanism is better specified insofar as it concerns the operation of financial collateral, the article in question reasserts the principle by which the States adhering to the Convention could exercise a *opt out* repealing the part of the Convention related to guaranties in the presence of specific circumstances. In this regard, this provision establishes several exceptions which – where put in place – would make the international frame of reference difficult to understand, by compromising the principles of legal certainty which inspire the most recent legislative initiatives, both at EU and international level.

For the use of opt-out, we refer therefore to our more general comment under article 32.

Increase in the credit risk incurred by the collateral taker concerning the insolvency remoteness of agreements on top-ups of collateral (Article 31-1-a)

The recognition of any circumstances giving rise to an increase in the credit risk incurred by the collateral taker as contemplated by Article 31-1-a exceeds the provisions under the Financial Collateral Directive. The limited recognition of borrower related top-up entitlements under the provisions of the Financial Collateral Directive has already come under strong criticism. Hence, the initiative of the UNIDROIT reflected in Article 31-1-a is strongly welcome.

Declaration in Respect of Charter VI (Article 32)

Although the *opt out* mechanism is better specified insofar as it concerns Collateral Arrangements, Article 32 reasserts the principle by which the States adhering to the Convention could exercise an *opt out* of Chapter VI of the Convention stating special provisions with respect to collateral transactions.

In this regard, this provision establishes several exceptions which – where put in place – would make the international frame of reference difficult to understand, by compromising the principles of legal certainty which inspire the most recent legislative initiatives, both at EU and international level.

We understand that leaving the choice of using the *opt-out* clauses to the contracting State has the advantage of preserving the national regulatory structure, by allowing the application of the legal structure that is the closest to that stipulated in domestic regulations. However, that approach is certainly likely to weaken the overall level of uniformity of the Convention.

Likewise, from this problem raises the applicability of the criterion of *law of the contracting State*, which transfers to the legislation of the individual contracting States the application of some provisions contained in the text of the Convention, allowing a *de facto* non-uniform implementation thereof.

We would encourage therefore UNIDROIT to limit as far as possible the opt-out provisions. For instance, Paragraph 2 (a) could be limited to consumers.

Additional comment

We were wondering whether UNIDROIT could consider including an express provision in the Convention regarding an automatic creation of a security interest in situations where the intermediary has advanced funds on behalf of the account holder. We believe that a provision to this effect would make sense.