



**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. 95  
Original: English  
August 2007

## **REPORT**

### **Introductory Matters**

1. From 21 to 25 May 2007, 36 Member States, 1 non-Member State and 9 observers, with a total of 113 delegates (*cf.* Appendix 3) convened in Rome for the fourth session of the UNIDROIT Committee of Governmental Experts for the preparation of a draft Convention on Substantive Rules regarding Intermediated Securities (hereinafter the 'Committee' or the 'CGE'). The basic working documents were:

- the preliminary draft Convention on Substantive Rules regarding Intermediated Securities, as adopted by the Committee at its third session, held in Rome from 6-15 November 2006 (UNIDROIT 2006, Study LXXVIII, Doc. 57; hereinafter the 'draft Convention');
- in relation to the Working Group on so-called 'Transparent Systems': a Working Paper and a (draft) Report prepared by the Chairs of the Working Group (UNIDROIT 2007, Study LXXVIII, Docs. 60, 70, 88); comments submitted by the Government of the Czech Republic (UNIDROIT 2007, Study LXXVIII, Doc. 61), the Government of the Federative Republic of Brazil (UNIDROIT 2007, Study LXXVIII, Docs. 62, 85), the Government of Greece (UNIDROIT 2007, Study LXXVIII, Docs. 63, 77), the Government of the United Kingdom (UNIDROIT 2007, Study LXXVIII, Doc. 64), the Government of the People's Republic of China (UNIDROIT 2007, Study LXXVIII, Doc. 65), the Government of France (UNIDROIT 2007, Study LXXVIII, Doc. 66), the Government of Switzerland (UNIDROIT 2007, Study LXXVIII, Doc. 67), the Government of South Africa (UNIDROIT 2007, Study LXXVIII, Doc. 71), the Government of Argentina (UNIDROIT 2007, Study LXXVIII, Doc. 78), the Government of Malta (UNIDROIT 2007, Study LXXVIII, Doc. 81), the delegation of the United States of America (UNIDROIT 2007, Study LXXVIII, Doc. 91); and a supplementary Working Paper prepared by the Secretariat (UNIDROIT 2007, Study LXXVIII, Doc. 44 Add.);

- in relation to the topic of transitional rules: a Working Paper and a Report, prepared by the delegation of Switzerland (UNIDROIT 2007, Study LXXVIII, Docs. 59, 84); comments submitted by the delegation of the United States of America (UNIDROIT 2007, Study LXXVIII, Doc. 68), the delegation of Finland (UNIDROIT 2007, Study LXXVIII, Doc. 69), the delegation of the Czech Republic (UNIDROIT 2007, Study LXXVIII, Doc. 73), and the delegation of the Republic of Korea (UNIDROIT 2007, Study LXXVIII, Doc. 87);
- general comments in respect of the draft Convention, submitted by the International Swaps and Derivatives Association, Inc. (UNIDROIT 2007, Study LXXVIII, Doc. 72), the delegation of the United States of America (UNIDROIT 2007, Study LXXVIII, Docs. 74, 83), the delegation of Denmark (UNIDROIT 2007, Study LXXVIII, Doc. 75), the European Banking Federation (UNIDROIT 2007, Study LXXVIII, Doc. 76), the Government of the Republic of Latvia (UNIDROIT 2007, Study LXXVIII, Doc. 79), the Government of the Republic of Turkey (UNIDROIT 2007, Study LXXVIII, Doc. 80), the Government of Poland (UNIDROIT 2007, Study LXXVIII, Doc. 82), the Government of France (UNIDROIT 2007, Study LXXVIII, Doc. 86), the Government of the United Kingdom (UNIDROIT 2007, Study LXXVIII, Doc. 89), the delegation of Austria (UNIDROIT 2007, Study LXXVIII, Doc. 90), the delegation of the Czech Republic (UNIDROIT 2007, Study LXXVIII, Doc. 92), and the Government of Italy (UNIDROIT 2007, Study LXXVIII, Doc. 93); and
- various working and informal papers that were submitted during the session (cf. the table in Appendix 1 and Appendices 4 to 9).

2. The Chairman of the Committee, Mr Hans Kuhn (Switzerland), opened the session at 10 a.m. and welcomed all delegates. He indicated that one of the main topics to be discussed on the basis of inter-sessional work was how so-called transparent systems could be covered by the draft Convention. He thanked delegates for their contributions in this respect, which had resulted in a Report of excellent quality.

3. The Plenary adopted a detailed Order of Business (see Appendix 2).

4. The Secretary-General introduced the new Secretary to the Committee, Mr Thomas Keijser, as well as Ms Aurelia Piacitelli, who would provide assistance in respect of the French documentation.

5. The Chairman of the Committee proposed to leave the Drafting Committee unchanged, apart from including Finland and Colombia in the light of the discussion on so-called transparent systems. The Drafting Committee would therefore be chaired by Mr Hideki Kanda (Japan), co-chaired by Mr Guy Morton (United Kingdom) and Mr Michel Deschamps (Canada), and include representatives of Belgium, Colombia (on behalf of Latin-American States), Finland (on behalf of the Nordic States), France, Germany, Luxembourg, Switzerland and the United States of America, as well as any observer invited to attend by the Chairman of the Drafting Committee.

### **Transparent systems: general**

6. The Chairman of the Committee invited the Co-chairs of the Working Group on Transparent Systems to present the inter-sessional work on this topic (for the background materials on transparent systems, see paragraph 1 above). The Co-chairs thanked all those delegations and observers which had actively participated in the work on transparent systems, which had resulted in the Report on the topic (Doc. 88), and expressed their hope that a satisfactory solution could be reached for the inclusion of this important category of systems in the scope of the Convention. They indicated that a pre-meeting of the Working Group had taken place prior to the session, and

that its outcome was that those present had expressed great interest in establishing a declaration mechanism in respect of those features of transparent systems that could not be covered in the text of the Convention itself. An outline of the presentation by the Co-chairs can be found in Appendix 9. After an introduction (slides 1-4), a description was given of different types of transparent system (slides 5-9). Subsequently, the following three substantive issues were addressed: 1) the roles and functions of intermediaries in transparent systems (slides 10-22); 2) the position of the top CSD (slides 23-28); 3) Articles 7(5) and 24 of the Convention (slides 29-30).

7. The Chairman of the Committee and delegates thanked the Working Group on Transparent Systems, and its Chairs in particular, for the excellent inter-sessional work. The Chairman then opened the floor for comments on national specifics, and also for comments relating to the general approach to be taken in respect of transparent systems.

8. The Secretariat announced that an additional document (Doc. 44 Add.) had been prepared with information about the systems in China and the United Kingdom.

9. One observer noted that there were essentially two ways to solve the issue of transparent systems: 1) a general provision combined with a declaration mechanism; or 2) a more fragmented approach by adjusting each and every provision of the draft Convention, if required.

10. Another delegation outlined a possible solution set out in Doc. 91, under which a Contracting State could file a declaration in which it could explain how the Convention applied in that State. It was submitted that such declarations should be targeted and specific, and should be monitored when filed for the sake of consistency. Several delegations and one observer supported a general recognition of the possibility to share functions, as well as the declaration mechanism proposed in Doc. 91. Arguments presented in favour of a declaration mechanism with reference to non-Convention law, over an article-by-article adaptation of the text of the draft Convention, included time constraints, and the fact that there were different types of transparent systems, while these systems were also evolving and new varieties of systems could appear.

11. The Chairman of the Committee concluded that there were two basic approaches to taking into account transparent systems, either by way of a declaration mechanism, or by a more fragmented, article-by-article approach.

### **Transparent systems: I. roles and functions of CSDs**

12. The Secretariat submitted that, in the light of the discussion on transparent systems, two subject matter areas had been put on the agenda. The first one, which might also have relevance for non-transparent systems, related to the roles and functions of CSDs, and was subdivided into three sub-items: 1) Can a CSD qualify as an intermediary?; 2) How do Articles 19, 21 and 22 apply to a CSD and what is the role of issuer accounts in this respect?; 3) Should the rules of CSDs be mentioned in the draft Convention like rules relating to securities clearing and settlement systems?

#### **I.1 The CSD as intermediary**

13. As far as the inclusion of provisions along the lines of the Articles 1(3), (4) and (5) of the Hague Securities Convention was concerned (see Doc. 91), a number of delegations were of the view that CSDs could be intermediaries under the draft Convention and expressed support for a more explicit recognition of CSDs. One delegation recalled that the carve-out in Article 3 had been inserted under the assumption that CSDs could be, and generally were, intermediaries. Several delegations shared this interpretation and suggested that a reference to CSDs in a positive fashion

could be added to the Convention along the lines of the Articles 1(3), (4) and (5) of the Hague Securities Convention, either in Article 1 and/or in Article 3 of the draft Convention.

14. One delegation pointed out that a clarification of the position of a CSD along the lines of the Hague Securities Convention could certainly be helpful, but that it should be taken into account that the UNIDROIT draft Convention did not contain conflict of laws rules but substantive rules.

15. One delegation shared the view that the current negative formulation in Article 3 did not preclude CSDs from being intermediaries. It also stated, however, that in its system the CSD did not qualify as an intermediary. This delegation was, for this reason, not in favour of a positive reference to CSDs in the text of the draft Convention.

16. The Chairman of the Committee concluded that the majority of the Plenary had expressed the view that CSDs might qualify as an intermediary, and asked the Drafting Committee to take this into account when the language of Article 1 and/or 3 of the draft Convention was reviewed.

## **I.2 'Issuer accounts'**

17. One delegation emphasised that issuer accounts were not securities accounts. In an issuer account, for example, no credit or debit entries or designating entries could be made, and it was also unsuitable for segregation. It proposed, however, that under a functional approach Article 19 could be relevant for an issuer account, if this provision would apply to the top level.

18. One delegation stated that in its system issuer accounts were not necessarily kept by the CSD, but could be kept by any intermediary. It supported the view that Article 19 could be applied to issuer accounts. Even if issuer accounts were not securities accounts, under Article 19 an intermediary such as a CSD was obliged to make sure that it did not credit more securities to securities accounts than its actual holdings of securities, while an imbalance had to be corrected in one way or another. It considered that it would be useful to clarify in the text of the draft Convention or in the Explanatory Report that Article 19 did apply to an intermediary, including a CSD, which did not hold securities properly, but acted as the registrar for an issuer.

19. There was general support for the view that a clear distinction should be made between an issuer account and a securities account. In respect of the view that Article 19 should apply to the top level, one delegation took the position that the focus should be on the intermediate links of the chain, excluding the top level. This position, however, was contested by a number of other delegations. They argued that Article 19 should also apply to a CSD or another intermediary when that intermediary did not hold physical securities or securities with another intermediary, yet was the registrar of the issue. In order to guarantee the integrity of the system, the number of securities registered on an issuer account should in their view be matched with the number of securities registered on securities accounts of participants.

20. One delegation pointed out that confusion might be caused by the wording of Article 19, stating that an intermediary must 'hold' securities. To some the concept of 'holding' might not include registration activities relating to an issuer account registered by, for example, a CSD. It proposed to ask the Drafting Committee to find appropriate language to reflect the generally supported idea that registrations on account holders' accounts and in the issuer's books were supposed to match. Two delegations supported the view that the 'holding' terminology should be reconsidered.

21. The Chairman of the Committee concluded that, while issuer accounts and securities accounts should be clearly distinguished, the prevailing view was that Articles 19, 21 and 22 could apply to a top level, such as a CSD. The issue was referred to the Drafting Committee.

### I.3 Rules of CSDs

22. In respect of the question of whether the rules of CSDs should be mentioned in the draft Convention, like rules relating to securities clearing and settlement systems, one of the Co-chairs of the Working Group on Transparent Systems noted that there might be circumstances in which a CSD did not act as a clearing or settlement system.

23. One delegation expressed the view that the rules of CSDs could be covered by the draft Convention in the same way as had been decided with respect to the uniform rules of securities clearing and settlement systems, but subject to conditions comparable to those that applied to the recognition of the uniform rules of securities clearing and settlement systems (i.e. the system involved should be subject to some form of oversight by a governmental body, and the relevant rules should be accessible publicly). This view was supported by two other delegations.

24. Two observers proposed careful examination of the consequences of a reference to the rules of CSDs in addition to the reference to the rules of securities settlement systems. They also questioned whether it was wise to engage in an attempt to define the term CSD, which had been tried earlier but had proven to be very difficult in practice.

25. Two delegations proposed to take a functional approach and suggested that the focus should not be on entities, such as CSDs, but on functions. They pointed out that, under such a functional approach, it would not be necessary to define a CSD.

26. Several delegations wondered whether any additional functions of CSDs or relevant references to rules of CSDs could be identified, which had not yet been covered by the current text of the draft Convention. It was argued that the securities settlement function was, in any case, sufficiently covered by the reference to the rules of securities settlement systems.

27. One delegation posed the question of whether the rule set out in Article 18(2)(e) should not also be applied to corporate law functions exercised by CSDs. In this respect, the Chairman of the Drafting Committee remarked that in his understanding the draft Convention dealt primarily with the holding, transfer and pledging of securities, and not with corporate law issues.

28. One delegation tentatively put forward two other examples in which CSD rules could come into play: 1) an issuer reduces its share capital and thereby creates a shortfall, which is proportionally allocated among account holders on the basis of CSD rules; 2) an issuer prematurely redeems bonds, which redemption is allocated among account holders on the basis of CSD rules. Two delegations, however, were of the view that these two examples related to issues of corporate law and that national rules determining the relationship between the issuer and account holders should not be affected.

29. One delegation, while acknowledging that defining a CSD was a difficult task, nonetheless raised its concern with a strictly functional approach. It referred to the loss sharing rules of Article 22 and pointed out that in this case a CSD would have to determine in which cases it acted in the capacity of a CSD and when it did not act in that capacity. It cautioned that such distinctions within the same entity might prove to be an extremely difficult task in practice.

30. Another delegation was of the view that the text of the draft Convention could be left unchanged.

31. One delegation asked for time for a review of the text of the draft Convention and presented a document attached to this Report as Appendix 5 at a later moment during the session.

32. The Chairman of the Committee concluded that no specific CSD function had been identified that had not yet been covered by the current definitions relating to clearing and settlement, and that the text of the draft Convention would therefore be left unchanged for the time being, with the understanding that the issue could be revisited on the basis of a review.

## **Transparent systems: II. sharing of functions regarding the 'maintaining of a securities account' and status of 'account operators'**

### **Introduction**

33. The Secretariat introduced subject matter area II, relating to the question of the sharing of functions regarding the maintenance of a securities account and to the status of account operators. On the basis of the Report prepared by the Co-chairs of the Working Group on Transparent Systems, several provisions of the draft Convention had been identified in which this issue played a role. The Secretariat proposed to discuss these provisions with a view to arriving at the best possible solution for accommodating transparent systems (e.g. by way of a declaration mechanism or an article-by-article revision).

34. The Chairman of the Committee opened the floor for general comments before going through the provisions listed on the Agenda.

35. The exchange of views on the general approach to be taken was continued. One delegation was in favour of a provision somewhere in the draft Convention stating that the maintenance of a securities account required a number of different actions, which could be allocated to different entities under non-Convention law. It did not consider desirable the approach of determining article-by-article whether functions could be shared, because under this approach there was the risk that not all systems would be covered and that provisions would become illegible.

36. Another delegation agreed with these comments and stated that draft Article 20bis in Doc. 91 had in mind a general provision recognising a sharing of duties. It also submitted that the main goal of the declaration mechanism was to inform others of how the Convention applied within a jurisdiction in respect of which a declaration was made (e.g. that certain duties of the relevant intermediary were under the non-Convention law carried out by certain other entities).

37. One delegation took the view that the sharing of tasks between different entities in transparent systems should indeed be possible and would have no disrupting effect on the draft Convention, but that it was crucial that there be one securities account in respect of which core actions, such as a credit, a debit, a designating entry or an attachment could be carried out. If there were more than one account, it would not be clear on which account such a credit, debit, designating entry or attachment would be effective.

38. In respect of the discussion about the role of intermediaries and accounts (or book-entries) in the draft Convention, the Chairman of the Drafting Committee remarked that, in his view, it was crucial to determine the relevant book-entry (e.g. a credit, debit or designating entry) having legal effect. This might be different in different systems. For example, in a system such as that of Japan, an investor could have accounts for Toyota shares with two different immediate intermediaries (e.g. two securities houses), and the relevant book-entry could be with either of those intermediaries, depending on the choice of the investor. In transparent systems, the relevant book-entry might occur at the higher CSD level. He submitted that in all cases, there should be just one relevant book-entry that had legal effect.

39. Another delegation pointed out that having two intermediaries for the same account should be avoided. The fact that two or more persons might carry out functions in respect of an account did not, in its view, mean that there were two intermediaries.

40. Several other delegations and one observer supported a provision envisaging a sharing of functions. There was general support for the view that the drafting should not result in having two intermediaries for the same account holder and that there should always be one relevant account.

41. One delegation posed the question whether non-Convention law could permit the division of duties and liabilities as well. Another delegation answered that, in its view, it should be possible to determine under the non-Convention law what the consequences of the sharing of functions were for the liability of the entities concerned. If an intermediary outsourced a function to another entity, the non-Convention law would determine whether the intermediary was liable or whether the outsourcing also entailed a transfer of liability to that other entity. It considered this approach prudent in the light of the differences in allocation of responsibilities in different systems and in the light of currently unforeseeable developments in the future. Moreover, it was of the view that the approach was in line with that of Article 20 of the draft Convention, which left wide discretion to non-Convention law to deal with responsibilities and liabilities of intermediaries. Another delegation agreed with the observation that Article 20(1) with respect to liabilities and duties mainly referred to the non-Convention law. Likewise, another delegation expressed the view that the issue of liability should be determined under non-Convention law.

42. One observer proposed to make a clear distinction between the legal and the technical maintenance of an account. It noted that this issue was alluded to in the Hague Securities Convention but might need reconsideration in the light of technical developments. The observer stressed the importance, both for accommodating transparent systems and for future technical developments, of 1) the concept of the sharing of functions, and 2) pinpointing middle entities. The draft Convention should, in its view, not apply to certain entities that were not part of the holding chain, such as an entity which only fulfilled a support function on the level of the relevant intermediary that contributed to the carrying out of functions by that intermediary (e.g. technical IT support functions). It considered that such support functions were not part of the holding chain but rather an internal arrangement between an intermediary and the provider of support. It submitted that if an intermediary had entered into an account agreement with an account holder but had outsourced all of the functions to a third party, while there was no legal relationship between the account holder and the third party whatsoever, the third party should under no circumstances be qualified as an intermediary.

43. The Chairman of the Committee concluded that the clearly prevailing view was that a general rule should be inserted providing that the non-Convention law might allow that different functions could be carried out by different entities in maintaining a securities account. This rule could be combined with a declaration mechanism to permit Contracting States to clearly describe the functions of those persons. Moreover, he asked the Drafting Committee to take into account that it had been agreed that there could only be one relevant account and only one relevant intermediary.

## **Article 5**

44. In respect of the question of how the concept of sharing the maintenance of a securities account would work in the context of Article 5, one delegation indicated that in many systems instructions to make debit or credit entries were given to account operators instead of directly to the relevant intermediary. The Chairman of the Committee concluded that, if there would be a general rule on the sharing of functions, no amendment to Article 5 was needed.

**Article 6**

45. In respect of the functioning of Article 6 in a sharing context, one delegation noted that Articles 5 and 6 were closely related and that in respect of both provisions the sharing of functions should be possible. The Chairman of the Committee concluded that, if there was a general rule, no specific amendments had to be made to Article 6.

**Article 7**

46. In respect of the issue of netting under Article 7(5), which was identified by the Working Group on Transparent Systems, one delegation suggested a clarification (see Doc. 91, p. 2) in order to make clear that this was not intended to be a mandatory provision. Several delegations supported this clarification. The Chairman of the Committee concluded that Article 7(5) would be amended to make clear that this rule was not mandatory.

**Article 8**

47. One delegation pointed out that a general rule envisaging shared functions raised a question in respect of Article 8(2)(a). Should self-perfection only be available to create an interest in favour of the relevant intermediary or also in favour of all the other entities carrying out functions for the relevant intermediary? It gave the example of a 'category-one' system as distinguished in the Report of the Working Group on Transparent Systems, in which an account operator instead of the CSD (the relevant intermediary) financed the acquisition of securities for account holders.

48. The debate that followed centred around the generally supported idea that the rationale for self-perfection, i.e. control, should be guiding. One delegation expressed the view that Article 8(2)(a) referred to a security interest established in favour of the person who maintained the account and envisaged automatic perfection, exactly because the person who maintained the account also had control thereof. It considered that the meaning of 'relevant intermediary' should not be extended, because this would imply that more than one person could be the relevant intermediary. Another delegation confirmed that the relevant function in the context of Article 8(2)(a) was closely linked to the rationale for self-perfection, i.e. that the relevant intermediary controlled entries on the account by virtue of its function of operator of the account. A declaration should reflect that the key function related to this provision was deciding whether entries, such as debit and credit entries and the entries referred to in Article 8, were to be made on a particular account. Another delegation also called for caution in relation to the issue of Article 8(2)(a) in the context of shared functions, because systems could differ, e.g. in relation to the duties shared and the relationship between the parties. Moreover, two delegations argued that an account operator which financed a position of account holders, could avail itself of other methods to establish a security interest.

49. One observer drew attention to an outsourcing context, in which one entity had control of the technical features internally, but in which the outsourcing entity still had control from the point of view of the outside world. One delegation replied that where one had outsourcing without a shift of legal responsibility, the person who was legally responsible for carrying out the function should remain the person referred to in the draft Convention.

50. One delegation concluded that Article 8(2)(a) should be confined to the relevant intermediary and should not be extended to account operators. It was of the view that the provision could remain unchanged.



51. The Chairman of the Committee concluded that Article 8 would remain unchanged and that, in the case of a system in which functions were shared, it should be made clear by way of a declaration mechanism who the relevant intermediary was.

#### **Article 11**

52. In respect of the functioning of Article 11 in a sharing context, one delegation remarked that the point seemed to be covered as Article 11(1)(b) and Article 11(2) already referred to non-Convention law. The Chairman of the Committee concluded that Article 11 could be left unchanged.

#### **Article 17**

53. Several delegations explained how attachments were made in their respective systems. One delegation raised a concern in relation to the prohibition of upper-tier attachment, because in its system the relevant intermediary was a middle entity, while an attachment had to be made at the CSD level. It was in favour of a declaration mechanism that would make it possible to state that an attachment could be made at the level of the CSD. Another delegation explained that in its system three levels could be distinguished: the CSD, the account operator and the real beneficial owner. In its view it should be possible to attach securities of the real beneficial owner also if these securities were in the hands of a third person, notably the CSD or the account operator. A third delegation pointed out that in the practice of its transparent system an attachment (like designating entries or transaction orders) was made at the middle entity and subsequently reported to the CSD. It expressed its concern and hope that a declaration mechanism would leave the issue of attachment to the non-Convention law.

54. One delegation clarified that the proposal for a new Article 17(3) as contained in Doc. 91, Annex A, envisaged the situation of a CSD acting as the entity where an attachment is made (sub 3b), and also the situation where an attachment is made with both the relevant intermediary and the CSD (sub 3a). It pointed out that there was also a country where the CSD was the relevant intermediary, but where an attachment had to be made at the level of the account operator. In this situation, a declaration could state that the function of the CSD to receive the attachment order was being performed on its behalf by the account operator. In its view, given the great variety of systems, a public declaration providing clarity would be extremely useful.

55. One delegation drew attention to two important policy reasons behind the prohibition of upper-tier attachment. The first reason for a prohibition of upper-tier attachment in non-transparent systems was that an attachment should not be permitted in circumstances where it undermined the ability of an intermediary to perform its functions. In its view, an attachment order should not prejudice other account holders who had nothing to do with the subject matter of the attachment. It argued that the Report of the Working Group on Transparent Systems showed why, in principle, upper-tier attachment could be allowed in transparent systems. The second reason was that upper-tier attachment undermined the ability of an account holder or someone dealing with an account holder at a lower level in the holding chain to rely on the position as it was apparently stated on the account. If an account at a lower level appeared to show the ability of the account holder to transfer or pledge securities registered on that account, then, if in fact these securities were encumbered by an attachment order at a higher tier (without being indicated at the account on the lower level), the account holder or people dealing with the account holder could be misled. This delegation made the point that a declaration mechanism allowing upper-tier attachment in transparent systems should try to ensure that people were not misled at the level of the account of the relevant intermediary about the existence of an attachment order over the securities.

56. One delegation stated that, in its transparent system, attachment at a higher level was considered acceptable because the account holder concerned could always be traced. Another delegation expressed support for the view that an upper-tier attachment should be allowed if the CSD could identify securities, even if the CSD was not the relevant intermediary.

57. Another delegation referred to the policy concerns identified in respect of upper-tier attachment in non-transparent systems, such as uncertainty, market risk, and the like. It proposed to follow the principle that a Contracting State could under its non-Convention law have an exception to attachment at the level of the relevant intermediary, if there was adequate assurance provided that all of the policy concerns raised by upper-tier attachment were solved (e.g. by way of communication or notice).

58. One delegation argued that, conceptually, an attachment could be made at both levels in the case of a sharing of functions by the CSD and the middle entity (even if there was only one account and one relevant intermediary). In respect of the policy issues underlying the prohibition of upper-tier attachment, this delegation stated that upper-tier attachment should generally not be permitted in a jurisdiction envisaging lower-level attachment. In respect of a 'category-one' transparent system, however, where the CSD was the relevant intermediary, it expressed the view that the issue of whether attachment should be possible also at the level of the middle entity could be referred to non-Convention law. It pointed out that in this situation the policy concerns were not that strong.

59. One delegation identified two core issues: 1) attachment in the securities account of which the debtor is the account holder; 2) which entity receives the attachment order? This delegation underlined that there was always one account against which an attachment should be directed and highlighted the importance of identifying the right securities account. Once this account had been identified, the non-Convention law of a transparent system, in which the functions of the relevant intermediary were shared, could in its view determine with which entity an attachment should be served. If, for example, in a 'category-one' system, the account was with the CSD, the attachment order should be directed against this account, while the entity where the attachment was filed could be either the CSD or the account operator as determined under the non-Convention law.

60. One delegation stated that the approach focussing on the account seemed attractive, but expressed the concern that in practice attachment orders as a procedural matter were often made in the form of orders against particular entities. It was of the view that the current drafting of Article 17, which talked about attachment being made against certain categories of entity, was more cautious and that a reformulation with a central role of the account might not be in line with the way in which court procedures actually worked.

61. One delegation pointed out that in some States attachment might have to be made against the debtor (i.e. the account holder), in other States at the level of the intermediary that had control and maybe in yet other States against the account. In its view, Article 17 should accommodate all these different procedural traditions.

62. One delegation expressed the view that a revision of Article 17, stating that an attachment should be made against the account rather than against the intermediary, might not be advisable because an account did not constitute tangible property that could be actually seized. In the case of intangible property, legal systems normally provided that an attachment had to be made through a court order or other form of order addressed to a person. This delegation failed to see how this person could be an entity other than the intermediary. It suggested that Article 17 should remain unchanged, and that national law could determine that an attachment order served on an entity that performed certain functions of the intermediary was binding upon the intermediary. Another delegation, likewise, proposed 1) to maintain Article 17 and the role of the relevant

intermediary, and 2) to insert a general provision in the draft Convention providing that persons other than the relevant intermediary could under the non-Convention law of a Contracting State serve some functions in the process of receiving and acting on attachment. This could be coupled with a declaration mechanism to identify such other persons. This approach was generally supported. In line herewith, one delegation proposed that the phrase ‘against any intermediary other than the relevant intermediary’ in Article 17(1) should be replaced by ‘against any person other than the relevant intermediary’.

63. Several delegations addressed the moment when an attachment became effective and suggested that this issue should be considered in the drafting (so that it would be clear, for example, whether an attachment prevailed over debits and credits made).

64. One observer concluded that, in deviation from the general principle that an attachment was only to be made against the relevant intermediary, an exception was now contemplated for attachment against another entity in accordance with the non-Convention law. It submitted that, if such an exception was not provided for under non-Convention law and declared or made transparent, it should be specified clearly in the draft Convention that an attachment should be possible only against the legally responsible relevant intermediary, but not against the issuer, any intermediary other than the relevant intermediary or against any other entity involved in the technical operation of an account. This point of view, i.e. that purely technical account operators should be covered and protected by the prohibition of upper-tier attachment, was supported by one delegation.

65. The Chairman of the Committee concluded that there was broad support for the approach that the general principle remained that an attachment had to be made against the relevant intermediary, but that the non-Convention law could provide that an attachment order served on an entity or person other than the relevant intermediary could be effective and that such rules of non-Convention law should be made transparent by way of a declaration mechanism. The matter was referred to the Drafting Committee, which was also asked to consider remarks made relating to the timing issue and technical account operators which had found some support.

#### **Article 18**

66. One delegation expressed the view that a general provision would be sufficient and that no special amendment to Article 18 was necessary. The Chairman of the Committee ruled accordingly.

#### **Article 20**

67. In the absence of comments, the Chairman of the Committee concluded that a general provision was sufficient and that no special amendment was needed to Article 20.

#### **Article 24**

68. In respect of Article 24(2) the Chairman of the Committee concluded that, in line with Doc. 88, p. 22, no change to the text of the draft Convention was needed.

## Transparent systems: definitions and Article 7(5)

### Definitions

69. The Chairman of the Committee indicated that the discussion on the sharing of functions would, if necessary, be reflected in the definitions and asked the Drafting Committee to come up with a first draft.

### Article 7(5)

70. In respect of Article 7(5) the Chairman of the Committee recalled that it had already been decided that netting was not mandatory.

### Nature of the instrument

71. The Chairman of the Committee opened the discussion on the nature of the instrument. He recalled that the Committee and before that the restricted Study Group had always worked based on the assumption that there would be a binding international law instrument. He also indicated that there had been a discussion on the direct or non-direct applicability of the instrument during the second session of the Committee, but that a full-fledged discussion on the nature of the instrument had not yet taken place.

72. There was general consensus on the view that until now work had been carried out by all persons involved on the assumption that there would be a Convention.

73. One delegation confirmed that work had indeed been carried out on the assumption that there would be a Convention, but that no decision in this respect had yet been taken and that a discussion was therefore necessary during this session. It pointed out that essentially two alternatives were available, a Convention or a document stating (general) Principles, and presented a number of arguments *pro* and *con* these alternatives. The following arguments were in favour of Principles: 1) the numerous references to non-Convention law undermined the objectives of harmonisation and legal certainty, while they also made the implementation of the draft Convention into domestic law more difficult, and 2) Principles meant a lesser impact on systems of national law, were consistent with the functional approach taken by the Committee from the outset, and would make it easier to reach consensus. Besides the circumstance that work had until now been carried out with a Convention in mind, the following substantive arguments were presented in favour of a Convention: 1) it was too late to change from a Convention-type text to a Principles-type text (even if modifications might be marginal); 2) a precise and detailed text was necessary to guarantee interconnectivity between different systems; and 3) only a precise and detailed text could offer the legal certainty required by market participants. This delegation underlined that it strived for a useful text, irrespective of its nature, which could be signed by all delegations. Another delegation expressed a preference for a non-binding instrument and stated that the translation of a Convention into national law might pose too many difficulties and that there was no high level of harmonisation in the light of the high number of references to non-Convention law.

74. In the wide-ranging and detailed discussion that followed there was a very clear and broadly supported preference for a binding law instrument, i.e. a Convention.

75. One delegation firmly supported a Convention and addressed the arguments *pro* and *con*. 1) It refuted the argument that it would be too late as a practical matter to change to a non-binding instrument. In the light of the negotiation history it would be late, but not too late to make such a

change, if indeed necessary. There was, however, in that delegation's view no such necessity. 2) The level of detail in the Convention was considered necessary to allow interconnectivity between systems in different jurisdictions. Only by way of a binding instrument could the goal of legal certainty be reached. In the view of that delegation, a move to a non-binding instrument would remove the benefits of the instrument for financial markets, as it would lead to an exponential increase in uncertainty and the level of legal due diligence required. 3) In respect of the argument relating to the number of references to non-Convention law, it was noted that a number of issues, in respect of which harmonisation was considered desirable but not indispensable, had indeed been left to non-Convention law. This might not be ideal, but it was considered a strange logic to say that, because no optimal harmonisation had been achieved, no harmonisation should be achieved at all, even in core areas. 4) As far as the difficulty of incorporating the Convention into national law was concerned, it was confirmed that national law might have to be amended and that this might not always be an easy task, but it was also stated that the undertaking would be worth it in the light of the subject matter and the desirability of achieving core harmonisation at an international level. 5) In respect of the argument that a non-binding instrument would entail a lesser upheaval for national systems, it was stated that this might be correct, but that the price would be the removal of the certainty the Convention tried to achieve, which was considered too high a price. 6) In respect of the argument that a non-binding instrument was more consistent with the functional approach, it was stated that this was difficult to understand, because in the case of a non-binding instrument States would be inclined to follow the conceptual approach of their own law to a greater extent than if they were to adopt the functional and neutral approach taken in the Convention. 7) In respect of the argument that it might be easier to achieve consensus in the case of a non-binding instrument, it was remarked that consensus on key issues was crucial. This delegation concluded that the Convention was the proper approach and appealed to identify any substantive issues that currently stood in the way so that these could be discussed and brought to a satisfactory resolution.

76. One delegation stated that consultations with the international financial community in between sessions had shown that only an instrument in the form of a treaty, providing clarity and legal predictability, could have value. It underlined that Principles might have value in certain areas of the law, but not in this case in view of the level of certainty and predictability required in international financial practice. It stressed that Principles in model law form or any other form did not serve any function in this field of the law. It stated that the draft Convention, including the balanced mechanism of references to non-Convention law and declarations, was a step forward in enhancing certainty and predictability for legal systems and transacting parties around the world. It was of the firm view that a Convention would enhance the overall liquidity of the financial markets, a goal that could not be reached by any other instrument. Two observers representing participants in the financial markets firmly supported this position. They pointed out that Principles had no legal robustness and were therefore of zero value to market participants in this field of the law, and stated that from the perspective of market participants a Convention carried much more weight than any other non-binding instrument.

77. Some debate took place in respect of the question of whether Principles were suitable at all to address issues of property law. Several delegations stated that general Principles could well be used to address matters of contract law, but that issues of property law, which dealt with the enforceability of rights against third parties, could hardly be guaranteed by Principles. Other delegations pointed out that there were hardly any examples of binding or non-binding international instruments addressing issues of property law and stated that they could well imagine Principles addressed to legislators in this field.

78. A further exchange of views took place in relation to the references to non-Convention law and declarations in the draft Convention. One delegation mentioned that it had found 28 references to non-Convention law in the text of the draft Convention. It raised the question of whether this

enhanced legal certainty and predictability. Another delegation challenged the argument that too low a level of harmonisation and legal certainty would be reached in the light of references to non-Convention law, and stated that the current text met the objectives set out in the Position Paper of August 2003. It explained that, at that time, it had already been realised that full harmonisation would not be possible, but that it was possible to attain the application of certain general principles under a so-called functional approach. References to non-Convention law guaranteed an interface with national law, and the approach that national law regulated certain issues in accordance with the general principles under the functional approach by no means threatened but, on the contrary, enhanced legal certainty. Another delegation remarked that declarations had the positive effect of disclosure. Yet another delegation clarified that references to non-Convention law often had a very limited scope. It gave the examples of the rules on priorities and 'good faith' acquisition in the draft Convention, which contained a general principle or rule, and only referred to non-Convention law in respect of a limited number of aspects.

79. Several delegations and observers expressed support for a binding instrument, arguing that a non-binding approach would lead to a tendency to maintain the status quo of inconsistent national regimes. They pointed out that, in spite of references to non-Convention law and declarations, significant substantive progress had been made in respect of a number of core issues. As examples they mentioned the legal recognition of credits, the modernisation of rules relating to innocent acquirers, the trumping of non-Convention interests, and legal certainty in respect of transfers of securities. It was also submitted that by way of Principles it was not possible to ensure that clients' assets did not fall in the estate of the intermediary in insolvency or that a transfer of rights in securities was enforceable against third parties. Generally, it was considered that even a limited number of points in respect of which harmonisation took place, was a step forward, and that investor protection and the connectivity between systems could only be reached by way of a binding instrument.

80. One observer considered a Convention the appropriate instrument for the sake of global interconnectivity. This observer pointed out that its task was 1) to ensure that there were no discrepancies with the European 'acquis communautaire', which in its view was not the case apart from some possible last difficulties that could be eliminated, and 2) to take future developments into account, in particular in view of efforts regarding the harmonisation of the financial markets of the European Union. In respect of this second issue, too, it expressed the view that it did not see or expect major incompatibilities at this moment. It supported the view that substantive problems and difficulties existing at this moment should be identified and addressed.

81. Another observer drew attention to an additional aspect of the discussion, i.e. the circumstance that financial markets and the market infrastructure were clearly characterised by innovation and evolution. It pleaded for an element of flexibility in the Convention so as to make it capable of taking new developments into account, in the form of a mechanism for revision and amendment. Several delegations supported the view that there should be an adequate revision mechanism to take into account developments in the financial markets. One delegation pointed out that flexibility was achieved within the current text of the draft Convention by the careful set of references to non-Convention law and the declaration mechanism. Moreover, it assumed that for the sake of flexibility the final provisions of the draft Convention would, like the Cape Town Convention, contain a mechanism for making adjustments to the Convention, as well as a process of regular reports on its implementation and needs for adjustment.

82. The Chairman of the Committee concluded that the clearly prevailing view was that a binding instrument, i.e. a Convention, was the preferable type of instrument for the subject matter. He noted that concerns regarding the openness of the instrument for future evolvement of the financial markets should be taken into account in future work.

### **Transitional provisions**

83. The Chair of the informal Working Group on Transitional Provisions, the delegate from Switzerland, was invited to present a Report on this issue (for the background materials on transitional provisions, see paragraph 1 above). He clarified that it had been considered that the issue of competing interests was complicated and deserved attention prior to the Diplomatic Conference. He referred to a paper presented in October 2006 (Doc. 49), which had been briefly discussed during the third session of the CGE in November of that year, and which had given rise to the inter-sessional work to be discussed.

84. In addition to addressing the issue of competing interests and priority, the inter-sessional work had been intended to identify other transitional issues. Only one such other issue had been identified, i.e. in relation to making, withdrawing or changing declarations. This issue remained open and other transitional issues could still be identified.

85. In respect of the core issue of priority conflicts, the Chair of the informal Working Group remarked that this issue has been addressed in Article 16 of the Hague Securities Convention. He outlined the three methods set out in Article 8 for granting an interest in intermediated securities: 1) designating entry, 2) control agreement, 3) no formality if the taker of the interest is the relevant intermediary, i.e. the self-perfection mechanism. Article 9, in addition, explicitly recognised other methods under non-Convention law for establishing interests. He indicated that Article 13 on priorities made clear that, if there were two competing interests, one that had been established under Article 8 and another that had been established under non-Convention law, the interest established under Article 8 would prevail irrespective of the time it was created. In the case of two Article 8 interests, a traditional first in time rule would apply.

86. The Chair of the informal Working Group indicated that transitional issue arose from the fact that interests might have been established before the effective date of the Convention in a particular country ('pre-Convention interests'). The relation between these interests and the Convention needed to be regulated. In the absence of a transitional rule, the result would be that the respective priorities of pre-Convention interests could be disrupted because of the precedence given by Article 13 to Article 8 interests. This change of priorities could mean an infringement upon rights of holders of pre-Convention interests.

87. How could this transitional issue be solved? From the point of view of holders of pre-Convention interests, it would be desirable that their interest and priority would not be modified by the Convention, and for them a full grandfathering clause would therefore be optimal. However, takers of interests after the effective date of the Convention would wish to take a priority when establishing an interest under Article 8. To them it would be cumbersome to have to take into account the pre-Convention law and interests established thereunder for an indefinite time period after the effective date. From the perspective of takers of new interests, who require legal certainty, only a short grace period would therefore be acceptable.

88. The Chair of the informal Working Group indicated that three policy options were available to balance these interests: 1) full grandfathering, i.e. pre-Convention interests would retain their priority in all cases; under this approach takers of new interests would always have to investigate the existence of pre-Convention interests; 2) grandfathering limited in time, meaning that short term pre-Convention interests would retain their priority during that period of time, whereas pre-Convention interests extending after the grace period might be affected by new Article 8 interests if they were not reperfected; under this approach the takers of new interests were sure that Article 8 interests would take priority after the grace period has elapsed; 3) a reference to non-Convention law. The limited number of comments received showed no clear preference for any of these options.

89. The Chair of the informal Working Group ended his presentation with an example of a negative effect of an unlimited grandfathering clause. If there was no cut-off date, takers of new interests would tend to rely on credits under Article 7 rather than on Article 8 methods. This would mean a disincentive to apply Article 8 and its priority rules, and would be an incentive for parties to rely on Article 7 and good faith or innocent acquisition rules.

90. The Chairman of the Committee and delegates thanked the Chair of the informal Working Group for drafting the clarifying Report on transitional issues.

91. There were several delegations and one observer that supported a full grandfathering clause. An argument in favour of this position was that the industry would not have to spend money to renew interests. Another argument was that a partial grandfathering clause could lead to difficulties for a collateral taker if a collateral provider was not in a position to renew an interest. Moreover, the concern was raised that the option of a grace period could give rise to a 'race' in relation to reperfecting old interests: would the one who reperfected first have priority irrespective of the former situation?

92. There were also several delegations and one observer that supported a partial grandfathering clause with a grace period, after which the Convention priority rules would apply. An argument in favour of this view was that the continuous worry to market participants that Convention interests might be subject to pre-Convention interests outweighed the cost associated with reperfecting of interests. Moreover, it was argued that the number of short-term interests would be much higher than that of longer-term interests that would need to be reperfected.

93. In respect of the argument that the full grandfathering option would reduce costs, one delegation remarked that there was no evidence of what the cost and the impact on the market would be. What, for example, would be the cost of a shift from cheap Article 8 transactions to Article 7 transactions? Another delegation remarked that in the case of partial grandfathering there might not be that many extra costs, as pre-Convention interests that were perfected in accordance with a Convention-method (e.g. a designating entry) would not have to be perfected again upon the entry into force of the Convention.

94. One delegation posed the question of whether the innocent acquisition rule, a form of a priority rule in connection with Article 7, would take effect immediately upon the effective date of the Convention and would apply against pre-Convention interests. There was general consensus between a number of delegations that this should be the case. One of them noted in this respect that good faith acquisition rules could function as an alternative to market participants and ease concerns about a full grandfathering clause.

95. One delegation submitted a request to those arguing for a full grandfathering clause to indicate the methods of establishing priority in interests in their jurisdictions under their current law, e.g. by way of credits or 'secret', non-public arrangements between the parties. One observer supported the view that it would be helpful to know the nature of pre-Convention interests, such as secret or non-public interests, because the industry could in this case rely on the innocent acquisition rule. Likewise, the Chair of the informal Working Group pointed out that the level of grandfathering was closely related to the pre-Convention methods for establishing interests. In the case pre-Convention methods coincided with Convention methods (e.g. self-perfection for intermediary or control agreement) there would be no need for reperfecting and thus no transitional issue or a need for grandfathering. There might be a need for limited grandfathering if interests were established by entries in a public register, in which case there would be costs involved with checking that register, or in the case of non-public entries that could not be checked at all.



96. The Chair of the informal Working Group referred to the issue raised in Doc. 73. Should the priority status of additional securities provided by way of a designating entry be established by old or new law? In view of the Chair, the date when interests were actually made effective was decisive, i.e. the additional securities would in this case take priority in accordance with the Convention. The implication for the collateral taker would be that different parts of the collateral provided might be subject to different regimes as far as priority was concerned. This could be an argument for a limited grace period.

97. The Chairman of the Committee concluded that no consensus had yet been reached on the issue, but that a very useful discussion had taken place.

### **Co-ordination with the work of UNCITRAL on a Legislative Guide on Secured Transactions**

98. The Chairman of the Committee indicated that in the UNCITRAL Secretariat's Note on a Draft Legislative Guide on Secured Transactions (the 'Guide') of November 2006<sup>1</sup>, the question was raised whether 'directly held' securities should be covered by the Guide, as opposed to 'indirectly held', or better 'intermediated' securities<sup>2</sup>. In the light of UNIDROIT's work on the draft Convention, it was considered appropriate to exchange views during the fourth session of the CGE, in order to guarantee an optimal co-ordination of work.

99. The observer from UNCITRAL stated that security interests in securities had been excluded from UNCITRAL's Guide from the outset in order to prevent any overlap with the work by UNIDROIT. He explained, however, that it had been brought to the attention of UNCITRAL's Working Group on Security Interests, that an outright exclusion of all types of securities from the Guide would leave a gap, as the UNIDROIT draft Convention related to securities held with an intermediary only. In order to prevent any overlap, it had been suggested to exclude all intermediated securities, as defined in the UNIDROIT draft Convention, from the Guide. The result would be that the Guide would only cover e.g. non-tradable non-intermediated securities. He posed the question whether it occurred to the Committee that such an approach would indeed prevent overlap, and if it had views on how non-intermediated securities should be addressed. He explained that the Guide would be discussed during UNCITRAL's fortieth session from 25 June – 2 July 2007. These observations raised the following questions and remarks.

100. It was remarked that there was a difference between covering 'directly held securities' as mentioned in the document of November 2006 and excluding 'intermediated securities' (as defined in the draft Convention). It was also noted that the new approach of a carve-out for intermediated securities from the Guide should be considered as an UNCITRAL Secretariat proposal, which still had to be considered by the Working Group and the Commission.

101. It was observed that the UNCITRAL and UNIDROIT instruments covered different assets and therefore adopted different approaches and provided different solutions. The introduction of directly held securities, as opposed to indirectly held or intermediated securities, within the scope of the Guide therefore raised concerns. It was stated that the demarcation lines between different categories of securities, such as directly held and intermediated securities, were difficult to establish in practice. This had become apparent in the discussion on so-called transparent systems. For example, would securities in direct holding systems qualify as non-intermediated securities because of the strong link with the issuer?

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<sup>1</sup> Document A/CN.9/WG.VI/WP.31/Add.1.

<sup>2</sup> See in particular section 44 of the document of November 2006, which also refers to document A/CN.9/WG.VI/WP.29.

102. Moreover, the question was raised whether the approach of the UNCITRAL Guide was compatible with the UNIDROIT approach with regards to the issue of collateral arrangements, e.g. as far as the recognition of title transfer arrangements was concerned.

103. In relation to the gap regarding non-intermediated securities, it was asked whether the new UNCITRAL approach was to cover both tradable and non-tradable non-intermediated securities. If only non-tradable non-intermediated securities were to be covered, there would still be a gap in relation to tradable non-intermediated securities. Generally, different legal regimes in respect of different types of securities were not considered beneficial to legal certainty.

104. Several delegations and one observer shared the view that securities had deliberately and for good reasons been excluded from the scope of the Guide for the first four years of the work of the UNCITRAL Working Group. There was general support for the view that a last-minute inclusion of securities into the scope of the Guide during the UNCITRAL meeting in June was not desirable. Rather, the preferred option was to leave this issue for later work on the level of Working Groups, in which the options could be tested against market practices with a view to identifying the right solutions that would ensure compatibility with the UNIDROIT draft Convention and other – not least regional - legislative initiatives.

105. The Chairman of the Committee concluded that there was a strong preference for exclusion of securities from the Guide at this point and asked the Secretary-General to communicate this opinion during the forthcoming UNCITRAL session.

## **Comments submitted by Governments and observers on various provisions**

### **Introduction**

106. The Chairman of the Committee proposed that drafting issues would be referred directly to the Drafting Committee, that requests for clarification could be discussed in the Plenary or dealt with in the Explanatory Report, and that issues of substance could be discussed in the Plenary, but that at this late stage, sufficient support was needed for change or amendment of the text of the draft Convention. He proposed to consider only points that would be presented in the Plenary.

### **Article 1**

107. One delegation outlined the proposal set out in Doc. 89 to clarify the definition of 'uniform rules' in Article 1(p). One delegation supported this proposal and pointed out that, in its recollection, the intent of the Working Group on Securities Clearing and Settlement Systems had been to include rules established by legislation. One observer shared this recollection and also supported the proposal. The Chairman of the Drafting Committee concluded that the definition of 'uniform rules' would be amended accordingly by the Drafting Committee.

108. One delegation outlined the proposal to insert a definition of 'segregation arrangement', as set out in Doc. 89. There was not sufficient support for the amendment, upon which the proposal was withdrawn.

109. One observer suggested a modification to the definition of 'securities settlement system' in Article 1(n)(iii). It pointed out that the law governing the rules of the system could be another law than that applicable to the system and proposed to alter the definition so that it would refer to the law applicable to the system. One delegation supported this suggestion and referred to the Irish securities system. Irish law governed the proprietary and other legal aspects of settlement of Irish securities, however, the governing rules in accordance with the current text of Article 1(n)(iii)

would be those of the CREST system, which was governed by English law. The change envisaged would make Ireland the Contracting State to notify under Article 1(n)(iii). Another delegation called for a careful analysis of this new proposal and suggested that the issue be deferred. Yet another delegation asked for clarification on the motivation of this subtle change and the reason why only Article 1(n)(iii) and not Article 1(o)(iii) should be changed. The observer that had submitted the proposal agreed that the issue should be further discussed. The Chairman of the Committee concluded that the issue would be deferred.

### **Article 1(m) and Article 2**

110. Delegations presented comments in respect of the definition of 'non-Convention law' in Article 1(m) and the sphere of application in Article 2, as set out in Doc. 90 and INF. 3 [Appendix 8].

111. One delegation explained the background of the current text. At an early stage, it was realised that a reference to domestic law was necessary, because the rules in a particular State relating to securities accounts and the rights arising from securities accounts would consist of both Convention and domestic rules. The wording 'domestic non-Convention law' was changed to 'non-Convention law' in November 2006. The Secretary-General pointed out that the policy underlying Article 2 had at an early stage already been determined when the Study Group drafted the Explanatory Notes (Doc. 19) for the first session.

112. In respect of the relationship between Article 1(m) and Article 2, one delegation remarked that the draft Convention was not intended to provide any rule of conflict, but presupposed that there were rules of conflict. Another delegation confirmed that the draft Convention did not contain conflict of laws rules. The identification of the non-Convention law should in its view remain a matter for private international law rules which fell outside the scope of the draft Convention.

113. One delegation was in favour of the deletion of Article 2. In its view, a substantive law instrument, such as the civil code of a civil law country or the UCC, would not state when it was applicable. The applicable law should be determined on the basis of the existing conflict of laws rules of the enacting State. As a fall-back, it proposed the removal of Article 2(b), which led to the same result as Article 2(a). Another delegation supported the view that Article 2, or at least Article 2(b), could be deleted. One other delegation was of the view that Article 2(b) might well be unnecessary.

114. More delegations, however, considered that a substantive provision on the sphere of application was needed. Several of them pointed out that Article 2(a) was intended to relate to international transactions and Article 2(b) to domestic transactions. In their view the provision as such should be maintained, even if its wording could be changed.

115. There was debate about the reference to 'forum state' in Article 2. Several delegations were of the view that this should be reconsidered. One delegation remarked that the question of the law applicable was raised, even if there was no litigation or court yet. It wondered, however, whether there were international law instruments that used terms other than the forum State in order to determine the applicable law. It was of the view that the reference to 'forum state' in Article 2(b) could be deleted, because this provision had been written for purely domestic and not for conflict of laws situations. The Secretary-General confirmed that the word 'forum' was unhelpful and could be misleading, because this provision did not necessarily only apply to situations involving litigation and therefore a court. What was needed was an analysis of the applicable law, irrespective of whether it would be related to a court or the desk of a contract drafter. Another delegation was of the view that, in the light of the absence of universal conflict of laws rules, the 'forum state'

terminology could not be avoided and that it was often the *possible, future* forum, envisaged when drafting a contract, which was relevant.

116. One delegation pointed out that the phrasing of references to non-Convention law differed in quite a number of instances. It had made a list of the different formulations, which it presented to the Secretariat so that the Drafting Committee could take it into consideration. Another delegation supported the request to the Drafting Committee to reconsider the different references to non-Convention law throughout the draft Convention.

117. The Chairman of the Committee concluded that there was not sufficient support to remove Article 2 or Article 2(b) entirely. He kindly asked the Drafting Committee to revisit the wording of Article 2, as well as the references to non-Convention law throughout the draft Convention.

### **Article 3**

118. No points were raised in respect of Article 3.

### **Article 4**

119. One observer presented the point made in respect of Article 4 in Doc. 76. One delegation was of the view that the issue was addressed in the preamble drafted by the Preamble Working Group (Doc. 58, Appendix 10).

### **Article 5**

120. The discussion on points made in respect of Article 5 in Doc. 93 was deferred to the discussion about Articles 7 and 8.

### **Article 6**

121. One observer presented a point made in respect of Article 6(1) in Doc. 76. The Chairman of the Committee concluded that this issue could be clarified in the Explanatory Report.

122. One delegation presented a request for clarification made in respect of Article 6(1) in Doc. 79. One delegation clarified that Article 6 meant that an intermediary should act upon instructions from its account holder so that the account holder could dispose of the securities, but that this did not go so far so as to require the intermediary to open an account with another intermediary.

123. One delegation presented a point made in relation to Article 6(1) in Doc. 90. Upon its request, the Chairman of the Committee decided that the issue would be clarified in the Explanatory Report.

124. One delegation presented the point made in INF. 3 [Appendix 8]) in respect of Article 6(2). Two delegations supported the proposal. One of them argued that the relationship between account holders and issuers was, in its view, mainly a matter of company law, with which the draft Convention should not interfere. In this respect, it pointed out that the reference to 'This Article' in Article 6(2) could, *a contrario*, be understood in a very restrictive way. Two other delegations, however, called for caution and proposed that the effects of the new wording of Article 6(2) should be investigated carefully. The Chairman of the Drafting Committee clarified the current drafting of Article 6(2). He explained that the draft Convention did not intend to cover corporate matters, and that Article 6(2) had been drafted and should be read in close connection with Article 6(1). The intention had been to ensure that the circumstance that an intermediary must take appropriate

measures in line with Article 6(1) would not affect any direct rights of the account holder against the issuer in the property law sense (but not in the corporate law sense). The Chairman of the Committee concluded that there was sufficient support to refer the matter to the Drafting Committee and asked the Drafting Committee to take a cautious approach.

### **First Report by the Chairman of the Drafting Committee**

125. The Chairman of the Drafting Committee pointed out that the issues regarding transparent systems had been discussed by the Drafting Committee and that DC/WP. 1 [Appendix 6] was a preliminary draft document subject to further change, which reflected only part of these discussions.

126. In respect of the new, general provision Article X, he made four general statements: 1) the provision would probably be located in Chapter I; 2) the scope of this provision was not limited to CSDs or CSD-related situations, but was written to apply to all intermediaries or intermediary-related situations, including CSDs and CSD-related situations; 3) the provision was intended to cover the sharing of functions, but not outsourcing; 4) the provision did not speak of liabilities of the intermediary or the relevant intermediary, which issue was dealt with in Article 20.

127. The Chairman of the Drafting Committee stated that the amendment to Article 7(5) was intended to clarify that this provision was not mandatory.

128. In respect of the new text of Article 17 he made two general comments: 1) Article 17 stood independently from the general provision in Article X; 2) the approach had been to protect the operations of systems, by envisaging that the attachment order might arrive to entities other than the relevant intermediary. He pointed out that the formula 'where the law of that Contracting State is the non-Convention law' in Article 17(3), was intended to express that States could only make declarations in respect of their own jurisdiction and that States could not export their rules.

### **Reactions**

129. The Chairman of the Committee and delegates expressed their gratitude to the Drafting Committee and its Chairman for the excellent work done.

130. One delegation addressed Article 17(3), Article X(1) and Article 2. It pointed out that the draft Convention was supposed to contain substantive rules and was not intended to incorporate private international law rules. It was of the view that a declaration could only apply to the law of the Contracting State making that declaration, and that references to the non-Convention law were superfluous in such a case. In its view, Article 2 should not be a conflict of laws rule, but should be limited to a geographic expression of the scope of application, stating that the draft Convention would apply when the law of a Contracting State applied. The current references in Article 17(3) and Article X(1) would be covered by such a rule. Another delegation asked for a clarification about the relationship between Article 17(3) ('where the law of that Contracting State is the non-Convention law') and Article X [Applicability of Declarations] in Chapter VII.

131. In respect of Article 17, one delegation remarked that it was drafted in the light of States where attachments were issued against the intermediary. It pointed out that in its legal system attachment orders were served against the account holder who owed the money, after which the attachment would be served and notified to the intermediary. In particular the wording in the last sentence of Article 17(3) relating to the effectiveness 'against the relevant intermediary' raised concerns as under its system the attachment was effective against the assets of the account holder. This delegation requested the Drafting Committee to investigate whether more neutral

wording could be found. Another delegation pointed out that also in its system an attachment of assets of an account holder was not directed against an intermediary and supported the invitation to the Drafting Committee to find a different wording to cover this concern. A third delegation supported the view that Article 17 should govern different systems with different procedural rules.

132. One delegation asked to address the difference in wording in Article 17(1) ('granted or made') and Article 17(3) ('made').

133. Two delegations expressed their satisfaction with the document presented by the Chairman of the Drafting Committee and stated that Articles X, 7 and 17 were a very good basis for integrating transparent systems in the draft Convention.

### **Articles 7 and 8**

134. One delegation presented points made in Doc. 93 in respect of Articles 7 and 8, and, in connection therewith, in respect of Article 5(3). Moreover, it proposed to make clear that Article 7(4) would only apply to Contracting States that opted for the possibility of establishing limited interests by way of a credit through a declaration mechanism.

135. One delegation expressed some sympathy for the argument made in respect of Article 8(1). Another delegation expressed sympathy for the points raised in Doc. 93 in relation to Articles 7(4) and 8(2).

136. One delegation expressed the view that a universal perfection mechanism of security interests by way of credit should be available, but also stated that the core provision of Article 7 would maintain its value, if no consensus could be reached on this issue. It argued that a key objective of the draft Convention was that the inter-operability of systems should not be affected by extraneous rights not known to the parties. It stated that it was fundamental that, irrespective of the view one took on the possibility of establishing a security interest by way of a credit, if a party that had obtained a credit effected an onward transfer to a third party, the third party transferee would under all circumstances be protected on the basis of the good faith purchaser rule.

137. One delegation found appealing the interpretation that a Contracting State could for policy or technical reasons determine that a security or other limited interest could not be established by way of a credit, but that this should, if a credit was nonetheless made, for reasons of legal certainty, have no effect on the rights of third parties.

138. One delegation opposed the view that Article 7(4) did not oblige Contracting States to recognise the vesting of a limited interest by way of a credit. It argued that a core goal of the draft Convention was to make methods for the disposition of intermediated securities available across borders among all Contracting States. In its view, the debit and credit method should be available in all Contracting States, whereas other methods could be made available by declaration (Article 8) and by the non-Convention law (Article 9). In its view, if Article 7(4) were made subject to non-Convention law, one of the core goals of the draft Convention would not be reached. The types of limited interests that could be established by way of a credit under Article 7(4) were, however, determined by non-Convention law.

139. One observer stated that in its view the intent of Article 7(4) was that a credit would be recognised in all Contracting States as a method to enforce a limited interest against third parties, just as a credit would make an outright transfer enforceable against third parties. A different approach would lead to the unfortunate situation that a recipient of a transfer could be told that a

sale was in fact merely a limited interest which was void under the applicable non-Convention law. It took the view that it should not be necessary to make a distinction between an outright transfer and a limited interest in terms of the mechanics available for rendering an interest enforceable against third parties.

140. One delegation concurred with the view that it should not be possible, after a credit had been made, to prove that the underlying interest between two parties was somehow limited resulting in a void credit or the non-applicability of the draft Convention to that credit. In its understanding, Article 5(3), referring to the non-Convention law, was supposed to say that a limited interest effective against third parties had been established, but that non-Convention law could regulate and limit the kind of rights one would receive under Article 5 with respect to that interest.

141. One delegation supported the position that the credit and debit mechanism should be universal in relation to both outright transfers and security interests, and that Article 8 should contain a declaration mechanism.

142. One observer remarked that there were circumstances when a party to a transaction could not be assured of the characterisation of that transaction at the time it was entered into, for example, in the case of a repurchase transaction. It remarked that, if a credit was not available as a universal method for establishing a security interest, market participants could be faced with the difficult choice of how to transfer securities under a repo, which choice could be complicated even further in the light of possible different jurisdictions applicable in a case. In its view, many of the benefits of the draft Convention would, if such an interpretation were adopted, be lost in relation to a great number of market transactions.

143. In the light of re-characterisation risk, one delegation supported the view that a credit should be a general way of getting an interest. It pointed out that in the European Union perfection by way of a credit had been envisaged in the Financial Collateral Directive.

144. One delegation pointed out that it had never been under debate that a security interest could be established by way of a credit and was surprised that the issue was now brought up. It had been envisaged that also other limited interests could be made effective against third parties.

145. Another delegation confirmed that as of the very first draft of the Convention the assumption had been that credits were capable of conveying a limited interest. It supported the view that the draft Convention did not infringe upon the different types and the content of security interests and other interests in intermediated securities available under the non-Convention law. It stated that it would be a significant move to make Article 7(4) subject to non-Convention law.

146. One observer and one delegation supported maintaining the current approach. The observer underlined that title transfer based arrangements, such as collateral under an ISDA Credit Support Annex, a repo or a stock loan, would, in any case in the European market, typically be effected by debits and credits in securities accounts and fall within Articles 7(1), (2) and (3). It confirmed that Article 7(4) had no relevance to such arrangements. It pointed out that there were also situations in which the methods set out in Article 8 were for practical reasons applied to repos, such as in the case of short-term, overnight repos.

147. One delegation proposed to transfer Article 7(4) to Article 8, so that all cases where a limited interest was granted would be dealt with in one single provision. Likewise, another delegation proposed to make a distinction between Article 7, which should relate to a transfer of legal title and Article 8, which should relate to cases where a limited interest was granted. These suggestions were refuted by a number of other delegations. One delegation clarified that during the third session it had been realised that the draft Convention followed a functional approach and did not

impose on non-Convention law any legal characterisation of the right that an account holder derived from a credit of securities. It had been envisaged that one should be able to create the same types of rights, irrespective of whether one applied Article 7 or Article 8 methods. Article 7 was not limited to transfers of full ownership and Article 8 was not restricted to limited interests. Another delegation pointed out that during the third session it had been determined that the non-Convention law could establish different types of limited interests, but that the methods set out in the draft Convention were capable of conveying any type of full or limited interest. I.e., both under Article 7 (applicable in all States) and 8 (applicable after declaration), any full or limited interest could be established. In its view this approach was crucial, in particular in the light of recharacterisation risk, and should not easily be left. Likewise, another delegation remarked that in its perception Article 7 was intended to cover both full and limited interests, and that, if the interest was not a full interest, Article 5(3) was to invoke the non-Convention law for any necessary protections of the transferor, for example. It saw also Article 8 as a vehicle for conveying both limited and full interests. One more delegation confirmed that during the third session, all credit provisions had been put in current Article 7 and all non-credit provisions in Article 8.

148. One delegation wondered whether the rights arising from Article 5 applied only in the case of a credit under Article 7 and not in the case of, for example, a designating entry under Article 8. Another delegation supported the view that the connection between Articles 5 and 8 should be clarified because the draft Convention did not make entirely clear which rights were conferred by a security interest under Article 8, and in this respect it suggested the insertion of a reference to Article 8 in Article 5(3). One delegation took the position that Article 5 had been deliberately and correctly phrased so that the rights mentioned therein were indeed conferred only by the credit of securities to the securities account. It stated that under non-Convention law similar or the same rights could be conferred by other arrangements such as a designating entry. In relation to the relationship between Article 5(3) and Article 8, the Chairman of the Drafting Committee recalled that Article 5 only defined the rights arising from a credit book-entry and that Article 5(3) therefore only referred to Article 7(4) and not to Article 8.

149. The Chairman of the Committee concluded that there was not sufficient support to change Article 7 or Article 8.

150. The Chairman of the Drafting Committee pointed out that the provisions concerned had been reshuffled many times in order to reflect the functional approach as best as possible, and that the current text reflected many earlier, lengthy discussions.

151. One delegation presented a point in respect of a repetition in Article 5 and Article 7 set out in Doc. 90. The Chairman of the Committee referred this drafting matter to the Drafting Committee.

152. One delegation presented a proposal made in Doc. 75 in respect of Article 8(4). Two delegations and one observer supported the proposal. The Chairman of the Committee concluded that there was sufficient support and referred the issue to the Drafting Committee.

153. One delegation presented the point made in INF. 3 [Appendix 8] in respect of Article 8(3)(b). It was aware of the mechanism set out in Article 8(4)(d), but pointed out that it might nonetheless be wise to delete the reference to 'proportion or value' in Article 8(3)(b) because it seemed unlikely that this would have value in any country. Another delegation confirmed that, in the case of a traditional security interest or pledge, the value of the interest was measured by the obligation secured, but noted that the proposal missed the point that Article 8 did not relate to security interests only, but also to other limited interests. It argued that the reference to 'proportion or value' could in this case indeed serve a function. One observer remarked that sales of participations in pools of assets credited to securities accounts, i.e. an additional example where a



proportional interest is conveyed, were very common in the market. The Chairman of the Committee concluded that there was not sufficient support for this amendment.

154. One delegation presented the point made in Doc. 92 in respect of Article 8. One delegation clarified that, if an interest in favour of the relevant intermediary arose automatically by operation of law and without any act or formality to be performed by the intermediary or the account holder, this was a typical non-consensual interest. In its view, the draft Convention did not regulate such non-consensual interests, but allowed them and recognised the priority that they were given by the non-Convention law. The Chairman of the Drafting Committee pointed out that Article 8(5) related to non-consensual interests.

155. One delegation raised a new question in respect of Article 8(4). It asked whether the declaration foreseen in Article 8(1)(b) was mandatory or not. It argued that the words ‘and the relevant Contracting State has made a declaration in respect of that condition under paragraph 4’ could be deleted, if the declaration would not be mandatory. Another delegation remarked that, for reasons of achieving a good level of transparency, a declaration was a necessary precondition of any of the specified methods set out in Article 8(2) applying. One other delegation took the position that transparency would also be reached if a declaration would not be mandatory, because if no declaration was made all three methods envisaged could be applied. It only saw a need for a declaration if a Contracting State wished to apply less than the three methods. The Chairman of the Committee referred this issue to the Drafting Committee on the basis of the comments made.

156. One observer asked for a clarification in respect of Article 8(2). It suggested that attention be given to the fact pattern in which a collateral provider established a right of pledge for the benefit of a collateral taker and notified the system of the pledge between them. The system took the securities from the account of the collateral provider and transferred them to a different pledge account of the collateral provider. The system was not allowed to move the securities any further, unless it received instructions from the collateral taker. It wondered whether this fact pattern was covered by the three methods set out in Article 8(2). One delegation remarked that, in its view, the fact pattern described was in fact a specialised form of designating entry. The Chairman of the Committee referred the matter to the Drafting Committee for consideration.

## **Article 10**

157. One observer asked whether Article 10 applied to evidential requirements relating to collateral agreements (in writing or a comparable way), control agreements and the identification of financial collateral. There was general support for the view that evidential requirements were covered by the non-Conventional law. One delegation raised the additional question of whether provisions of non-Convention law, entailing that the absence of a written document would lead to invalidity of an interest established, were compatible with the purpose of the conjunction of Articles 7, 8 and 10. Two delegations replied that in their view, besides evidential requirements, matters of formal validity (formalities) ought also to be covered by the non-Convention law. The Chairman of the Committee suggested that the issue could on this basis be further clarified in the Explanatory Report.

## **Article 11**

158. No points were presented in respect of Article 11.

## Article 12

159. One delegation outlined the argument set out in W.P. 3 [Appendix 4] in respect of the good faith concept in Article 12 of the draft Convention and proposed that this provision be reconsidered. The debate was reopened. One delegation supported the third option presented in W.P. 3 [Appendix 4].

160. Another delegation shared the view that the test for wrongful knowledge was a core principle that was important for legal certainty and in the interest of the financial markets. It reiterated the view that, in the light of the special nature of the securities markets, the standard should be one in the area of misconduct, not one related to due or reasonable care. It refuted the suggestion that the 'wilful blindness test', which is also set out in Article 8 UCC, would not be neutral. It pointed out that this was not a common law test, but a test that had been specifically devised having in mind the modern securities markets, in which a party should make a phone call when it faced suspicious circumstances even if this meant a deal would not go through. This delegation was open to further discussions regarding possible tests and language, but it urged the Committee not to abandon this issue to national law. Another delegation also stressed the importance of achieving harmonisation by developing a list of conventional criteria, because in its experience traditional, rather broad-brush concepts were not well adapted to modern securities markets.

161. Another delegation confirmed the view that the issue concerned was crucial for legal certainty and mentioned the example of the Maxwell affair, in which legal procedures took place in different jurisdictions. It was satisfied with the specific test for intermediated securities, with concrete criteria, currently set out in the draft Convention, but was open to further discussions, also post-sessionally. It considered it undesirable to leave the issue entirely to national law. It took the view that it was crucial to formulate a test that as many countries as possible could adhere to, even if it was a compromise solution with an opt-out possibility.

162. One delegation stated that, in its view, the matter should not be referred to non-Convention law and that the objective of post-sessional work should be to further develop conventional criteria in order to promote international co-operation. Another delegation, likewise, supported the goal of an international test but noted that, in its view, in line with its domestic legislation relating to intermediated securities, this test should not imply any duty whatsoever for an intermediary to make any inquiry.

163. One delegation suggested the possible compromise of first stating the general principle that a *bona fide* acquirer could obtain title, and of then setting out a minimum list of circumstances in which an acquirer was in any case considered *bona fide*. Another delegation suggested that the draft Convention could contain two different solutions pointing in different directions.

164. The Chairman of the Committee proposed to put Articles 12(4)(b) and (c) in square brackets and to continue the discussion in the context of an informal Working Group after the session, which Working Group should present a Report with possible solutions. There was general support for this proposal.

165. In respect of the comments made in respect of Article 12 in Doc. 74, which were supported by one delegation, it was decided that these would be taken into consideration during the post-sessional work. The Chairman of the Committee proposed to also take the comments made in Doc. 76, Doc. 89 and INF. 3 [Appendix 8] into account during the post-sessional work.

166. One delegation pointed out that the French text of Article 12(1) stated 'sur ces titres ou sur ces titres intermédies', whereas the English text contained the formula 'in securities or intermediated securities' (but not 'in *such* securities or *such* intermediated securities'). It was of

the view that traceability had not been intended and that the text should be revised accordingly. The Chairman of the Committee referred this matter to the Drafting Committee.

### **Article 13**

167. The point raised in relation to Article 13 in INF. 3 [Appendix 8] was withdrawn.

### **Article 14**

168. One delegation presented the point made in respect of Article 14 in Doc. 75. A number of delegations expressed support for the proposal. One of them suggested the deletion of 'ought to have known' from the language proposed, because this would avoid a duty to inquire. Another delegation also supported the general idea behind the proposal, but called for careful drafting in the light of the general discussion on 'good faith', because it was not sure that 'ought to have known' should be deleted, and because the meaning of 'omnibus account' could differ from jurisdiction to jurisdiction.

169. Two delegations highlighted the necessity of protecting account holders of omnibus accounts, in particular in the light of intermediary risk. One of them drew attention to the circumstance that the protection of account holders in insolvency under Article 15 seemed greater than the protection outside insolvency under Article 14.

170. The Chairman of the Committee concluded that there was sufficient support for the idea behind the proposal set out in Doc. 75 and he referred the matter to the Drafting Committee.

### **Article 15**

171. One delegation presented the point made in relation to Article 15 in Doc. 83. One delegation supported the proposal set out in Doc. 83 and expressed a preference for the suggestion to add a new paragraph (b). The Chairman of the Committee concluded that there was sufficient support and referred the matter to the Drafting Committee.

### **Article 16**

172. One delegation presented the point made in respect of Article 16 in Doc. 89. In addition, it observed that it did not appear to be appropriate that Article 31 should necessarily take precedence over insolvency law relating to a preference or fraud of creditors, because there might be occasions where insolvency law should be able to strike down the provision of top-up collateral as a preference or a fraud of creditors.

173. Two delegations expressed concerns in respect of the proposal. One of them argued that the general approach of the draft Convention was to protect interests in intermediated securities, which should be effective in insolvency proceedings. It was, however, recognised that such an interest needed to yield to certain types of avoiding powers. It considered the deference to insolvency law in Articles 16(a) and (b) appropriate. Moreover, it stated that Article 16 was correctly made subject to the insolvency rules set out in Article 23. It remarked that the goal of Article 31 was to override insolvency law and to prevent the avoidance of the provision of top-up collateral, and that this provision was optional. The other delegation added that it failed to see how a line could be drawn between top-up provisions that should be immune from national rules on preference and transfer in fraud, and top-up provisions that might be subject to those rules, without emptying Article 31 of its content.

174. In relation to top-up collateral, one delegation pointed out that the European Collateral Directive protected top-up collateral against certain forms of insolvency stay and invalidation (e.g. a zero hour rule), but not against preference rules.

175. The Chairman of the Committee concluded that there was not sufficient support to include the proposal discussed.

176. One observer reserved its position on this point.

#### **Article 17**

177. No points were presented in respect of Article 17.

#### **Article 18**

178. One delegation presented the point made in respect of Article 18 in Doc. 92. There was support for the suggestion to defer this issue to post-session work in the context of a Working Group on Securities Clearing and Settlement Systems. The Chairman of the Committee deferred the issue accordingly.

#### **Article 19**

179. One delegation presented a point made in respect of Article 19 in Doc. 79. One delegation clarified that it believed that Article 19 did not allocate liability, but stated which intermediary should hold sufficient securities (including holdings with other intermediaries) in respect of the credits it had given to its account holders. It was up to the intermediary that did not have enough securities to make sure it did have enough. Another delegation added that many intermediaries held balances of customers' securities with other higher-tier intermediaries. It explained that, if those other intermediaries lost the securities, became insolvent or for some other reason were unable to produce the securities, Article 19 came into play and obliged the customer's intermediary to make up the difference in some way. The draft Convention, in order to prevent contagion into the system, imposed the duty to correct an imbalance as soon as possible, but, under Article 19(3), the allocation of costs involved was a matter of non-Convention law.

#### **Article 20**

180. One delegation presented the point made in respect of Article 20 in Doc. 74. Taking a different position, another delegation presented the point made in respect of Article 20 in Doc. 93.

181. One delegation supported the position that Article 20(2) should be deleted, that the rest of the provision should be amended accordingly, and that no extended immunity should be provided for. It argued that an immunity of intermediaries was not compatible with its national law and, moreover, that it would not enhance the confidence of investors. Likewise, another delegation expressed the view that this major policy issue of a regulatory nature should not be dealt with in the draft Convention and that other tools were available to reach the goal of stability. Another delegation also supported the view that the issue should be left to the non-Convention law. It stated that the proposed level of immunity would go contrary to its domestic law, which intended to guarantee stability and the protection of account holders by taking the opposite approach of increasing the liability of intermediaries.

182. Yet another delegation recognised the importance attached to the smooth and rapid operation of securities settlement systems and noted that tortious liability could have the contrary effect. However, it stated that some intermediaries were a great deal more systemic than others

and that a blank immunity was quite a dramatic way of addressing the issue. It concurred with the view that the issue of how systemic stability should in this respect be obtained, should be left to national policy.

183. One delegation stated that it found Article 20 in its current form very helpful for the practical reason that it provided clear guidelines as to what to do when a phone call or a fax was received from a third party, which, for example, wished to attach an account. Moreover, it remarked that its law defined circumstances in which legal process was entirely excluded in the context of intermediated securities, and it expressed the view that Article 20(2)(a) should not override such provisions of domestic law.

184. Another delegation expressed general support for the proposal concerning immunity for intermediaries, but was sensitive to the other arguments made. It proposed not to refer the matter entirely to non-Convention law, but to identify the intermediaries that were important to systemic risk and needed the kind of immunity suggested.

185. One observer argued that securities settlement systems could be given immunity, but that this immunity should not be extended to other intermediaries. It stated that it would not mind if the whole issue were referred to non-Convention law. Another observer noted that usually liability issues did not feature as a traditional method to attain financial stability, but that this goal could be attained by a wide range of technical measures.

186. It was discussed whether, if Article 20(2) was deleted, Articles 20(3) and (4) should also be deleted. Two delegations remarked that Articles 20(2) and (4) could hardly be separated. Another delegation remarked that Articles 20(2), (3) and (4) were closely connected and should all be deleted. One other delegation said that the Drafting Committee could decide how the deletion of Article 20(2) would affect the rest of Article 20.

187. Two delegations took the view that Article 20(1) should be retained, because it served an important function in the framework of the Convention apart from Articles 20(2), (3) and (4) (i.e. it was closely linked with affirmative provisions elsewhere in the draft Convention and determined what would happen if something went wrong in the discharge of the functions which the draft Convention imposed on an intermediary).

188. The Chairman of the Committee concluded that the clearly prevailing view was that the issue should be left to non-Convention law. He asked the Drafting Committee to delete Article 20(2) and to consider, in connection therewith, whether paragraphs 3 and 4 should also be deleted. He also concluded that Article 20(1) would be retained.

189. One delegation presented the proposal for an additional provision to Article 20(1) set out in Doc. 91. It stated that the draft Convention contained a number of references to compliance by an intermediary with the non-Convention law, which was stated in Article 20(1) in broad but general terms. It indicated that with the clarification proposed, a number of provisions scattered throughout the draft Convention could possibly be covered in one place. The substance of the proposal was that, when the draft Convention stated the substance of an obligation of an intermediary and if that obligation was the subject of a provision of the non-Convention law, compliance with the non-Convention law would satisfy that obligation. It mentioned the obligation under Article 19 to hold sufficient securities, which was stated in quite general terms, because jurisdictions had very detailed and specific laws and regulations on maintaining securities for customers. The suggested addition would mean that an intermediary could comply with those laws and regulations and not worry about having a double standard where one would also have to meet the standard of the draft Convention. It suggested that further examination of the draft Convention at a later stage in the light of the proposed precision might allow for the shortening of a number of

provisions. Two delegations supported the proposed addition to Article 20(1). The Chairman of the Committee concluded that there was support for the inclusion of the addition to Article 20(1) in the draft Convention.

### **Articles 21 and 22**

190. One delegation presented a point in respect of Articles 21 and 22, set out in INF. 3 [Appendix 8]. One delegation expressed sympathy for the proposal set out in INF. 3 [Appendix 8] and, in particular, supported the view that Article 22 should not apply in insolvency proceedings only.

191. A number of other delegations, however, saw no reason to make material, substantive changes to Articles 21 and 22.

192. One delegation stated that if some mistake was made somewhere resulting in a shortfall, usually the mistake could be corrected by tracing it back to particular securities accounts and by restoring the balance. In its view, there was always a risk, though, that a mistake could not be traced back. Therefore, rules of securities settlement systems usually contained, besides provisions on allocation and correction of mistakes, provisions on shortfall that applied when an imbalance remained after all other correction mechanisms had been applied. Consequently, it argued that, besides the allocation mechanisms allowed under Article 21(3), there was a need for a provision on shortfalls that could not be corrected by other mechanisms, i.e. Article 19.

193. Another delegation addressed the question of whether Article 19 allowed different ways of correcting an imbalance, notably by an increase of securities or by a reduction of the number of securities credited on accounts. It took the view that Article 19 indeed allowed different methods of compliance, and that this policy issue was correctly left to the non-Convention law. It remarked that Article 19(2) could be tidied up a bit, in particular in relation to the expression 'sufficient securities' which was no longer a defined term. In addition, it took the view that Article 22 had correctly been confined to insolvency situations. It argued that this mandatory provision was needed, because Article 19 provided a solution in any other situation, but did not relate to insolvency situations in which there was nobody capable of complying with Article 19. One delegation supported these views. It noted that the background of the limitation of this provision to insolvency situations was that outside insolvency many jurisdictions had problems with the concept that those with securities credited to their accounts could only have fractional, proportionate interests.

194. One delegation indicated that the change made earlier to Article 14 had been a hasty one and that it had not yet been persuaded by the soundness of this change. It pointed out that the change also had an effect under Article 21(2), because the priority given to the secured creditors over the account holders of the intermediary under Article 14 would also apply in insolvency cases. Another delegation supported the view that the Drafting Committee should carefully consider whether Article 21(2) had the same meaning after the changes that had been made to Article 14.

195. Three delegations opposed the deletion of Article 21(5).

196. The Chairman of the Committee concluded that there was not sufficient support to make changes to Articles 21 and 22, but asked the Drafting Committee to look into Article 22(2) in relation with Article 14.

197. One delegation remarked that the issue of attachments of accounts by creditors of account holders had been solved earlier during the session. It addressed the additional issue of attachments by creditors of the relevant intermediary (of client assets held at an upper-tier in an

omnibus account). It pointed out that Article 21(2) stated that client assets were not available to creditors of the intermediary for distribution or realisation, but did not state that these assets could not be attached. This delegation proposed to add a sentence to Article 21(2), making it clear that creditors of a relevant intermediary could not attach holdings of that intermediary with an upper-tier intermediary which were flagged as an omnibus or a clients' account, because this would block the upper-tier holding for a long time and affect the rights of the account holders of the relevant intermediary. Other delegations supported the position that omnibus and clients' accounts at an upper-tier should not be subject to attachment. Some debate took place in respect of the question whether the issue should be addressed in Article 21(2) or in Article 17. The Chairman of the Committee concluded that the Report should reflect the discussion and that the issue would be taken up again at the next stage.

### **Article 23**

198. No points were presented in respect of Article 23.

### **Article 24**

199. One delegation presented a point made in INF. 3 [Appendix 8] in respect of Article 24.

200. Several delegations supported the proposal to delete the words 'in his own name' from Article 24(2). Several other delegations proposed, however, to take a cautious approach in this respect. Two delegations expressed the concern that the result of the deletion might not be flexibility but a narrowing of the scope of the provision. Another delegation argued that the words 'in his own name' should be retained, because they reflected the specific and unusual situation where an intermediary acted in his own name and on behalf of another person. Another delegation saw no harm in broadening Article 24(2) by deleting 'in its own name', but it raised the concern that this could be misconstrued and lead to a loss of meaning, because it would not be clear anymore that this provision related to nominee situations.

201. The discussion about the formula 'in his own name' resulted in a more general exchange of views in respect of Article 24(2). One delegation wondered whether this provision meant that existing legislation relating to voting rights in internal holding chains had to be changed, or whether the provision was optional. One observer, likewise, asked whether the word 'recognise' in Article 24(2) meant that one system had to recognise the effect of the acceptance of nominees in another system and allow interconnectivity, or that every system had to allow a nominee within its own borders. One delegation answered that in its view not every system would need to have a nominee system. If, however, a system did have a nominee system and an intermediary maintained an account in another country's securities settlement system and was acting in the capacity of a nominee, there should be some limited recognition of that intermediary to act on behalf of its account holders in order to allow its account holders to effectively obtain the rights under Article 5 of the draft Convention. Three delegations supported the interpretation that Article 24(2) did not impose a nominee system upon Contracting States. Moreover, there was general support for the view that this provision was crucial for interconnectivity, i.e. for facilitating the interoperability of different systems. One observer noted that some systems recognised nominee holdings, whereas others did not. In order to guarantee interconnectivity of systems, the policy choice made in the European Union was not to impose one solution, i.e. recognition or not of nominee holdings, but the mutual recognition of systems. Two delegations argued that Article 24(2) struck a good balance between the fundamental need to guarantee some kind of interconnectivity between systems and national corporate legislation, and was crucial to the effective functioning of the intermediated system. Two other delegations indicated that the provision was 'corporate law neutral'. One delegation submitted that the approach of the draft Convention was to encroach as little as possible upon corporate law. Article 24(2), however,

contained one such small but significant encroachment, with the purport that systems in which nominees did not exist would recognise systems in which nominees did exist. One delegation confirmed that the goal of interconnectivity should be reached on the basis of the principle of neutrality, i.e. that it was left to Contracting States to craft the means of realising this goal in a way which did not unnecessarily intrude upon their corporate law and the rest of their general law. Many delegations supported the view that this provision should not be optional. Several delegations proposed to clarify the wording of Article 24(2).

202. One observer proposed to change the wording 'permitted to be traded' in Article 24(1) to 'admitted to trading'. In this context it also referred to Article 32. One delegation stated that this proposal might have the effect of narrowing the provision and that this should be carefully considered.

203. In respect of 'the conditions under which such a person is authorised to exercise such rights' in Article 24(2), one observer remarked that it understood such conditions to be, among other things, formal or disclosure requirements, such as a requirement under the non-Convention law for a nominee to identify the client for whom voting rights were exercised or to indicate the number of shares in respect of which voting rights were exercised, or a requirement relating to voting instructions. One delegation agreed that the disclosure of beneficial holders could be a condition in the sense of Article 24(2).

204. In respect of Article 24(3), one observer took the view that 'the holder of securities' was the shareholder. One delegation suggested the use of the term 'shareholder' or 'stakeholder' in Article 24(3). Three delegations did not support the proposal to use 'shareholder' or 'stakeholder' in Article 24(3), because in some circumstances a 'holder of securities' could be a bondholder, because 'stakeholder' was not a corporate law term, and because the functional approach should be maintained. In respect of the words 'holder of securities' in Article 24(3), one delegation remarked that these had a property law connotation, and it proposed to add wording to Article 24(3) to express clearly that this provision related to the exercise of corporate rights. Another delegation supported this proposal.

205. The Chairman of the Committee concluded that further work in respect of Article 24 was needed, but that at this moment there was no clear language that could be inserted into the draft Convention.

## **Chapter VI**

206. In respect of Chapter VI, one observer remarked that, as a matter of drafting, two policy choices made in Chapter III should be maintained: 1) there should be no formal requirements under non-Convention law to render effective collateral agreements and interests arising thereunder; 2) evidential requirements in relation to these issues should be determined under the non-Convention law. The Chairman of the Committee suggested that these remarks would be reflected in the Report on the session.

207. One observer proposed to add 'contingent obligations' to the definition of 'relevant obligations' in Article 26(2)(d). One delegation supported this proposal. The Chairman of the Committee concluded that there was no dissent and only support.

208. One delegation pointed out that a number of provisions of Chapter VI related to the collateral agreement but dealt with property rights. In such instances it argued that it would be more appropriate to speak of 'collateral transactions', as in the heading of Chapter VI, instead of using the narrower term 'collateral agreement' or 'contrat de garantie'. Another delegation remarked that



collateral agreements could by their terms convey property interests and that any drafting issues in this respect could be further addressed.

209. One delegation stated that there was a mismatch between the definition of 'close-out netting provision' in Article 26(2)(j)(i) in the English and French texts. Where the English text spoke about obligations being accelerated, it did not state how such acceleration would take place. The French text, however, seemed to imply that someone must declare that acceleration would take place. It proposed to opt for the broader English approach and to redraft the French text by stating 'la déchéance du terme ... intervient'.

210. One delegation suggested the deletion of Article 26(1). Another delegation remarked that Article 26(1) should not be deleted, but expanded, so as to cover both arrangements that were now included in Chapter VI, instead of only referring to granting security interests. It was submitted that Article 26(1) should be conformed generally to Article 26(2), but the Plenary did not approve the precise language to do so.

211. Because no further meetings of the Drafting Committee would be held, one observer indicated that it would present further remarks in respect of Chapter VI at a later stage. One delegation indicated that the point raised in respect of Article 28 in Doc. 65 could be discussed at a later point in time.

### **Proposals for further work**

212. One observer reminded that it had withheld its position in respect of Article 16. It stated that this provision related to insolvency law and that it touched upon a number of sensitive issues and important Articles, such as Articles 23 and 31. It proposed to consider the interrelation of the draft Convention with insolvency law in the post-sessional period.

213. One delegation remarked in respect of the earlier discussion in relation to Articles 12 and 20, that it believed that the content of these provisions, in particular that of Article 12, was fundamental to the economic strength that could be achieved by the draft Convention. It believed that the right way forward would be to have an opt in or an opt out possibility in respect of a provision containing a higher economic standard. Economic strength should not be reduced by agreeing on a lower common denominator. In its view an optional standard such as the one that had been proposed in Article 12 was crucial. It pointed out that the approach of an optional higher economic standard had also been applied successfully in the Cape Town Convention. It proposed further work in relation to Article 12 in the post-sessional period.

214. One delegation proposed to carry out post-sessional work in respect of the rules of CSDs.

### **Report by the Chairman of the Drafting Committee**

215. On the basis of DC/W.P. 2 [Appendix 7] the Chairman of the Drafting Committee explained further changes made by the Drafting Committee in Chapters I-IV.

216. In respect of the addition to Article 1(d) he remarked that this should be read in connection with the new Article 1bis and Article 3. The aim was to incorporate the substance, but not the language, of Articles 1(3), (4) and (5) of the Hague Securities Convention.

217. The change to Article 1(k) was made to make consistent the references to the non-Convention law. Likewise, the amendment of Article 1(m) was minor and not of substance. The addition to Article 1(p) followed from the proposal set out in Doc. 89 as approved by the Plenary.

218. The new Article 1bis should be read in connection with Article 1(d) and Article 3, and provided a declaration mechanism. He stated that it contained an opt-out possibility, with the effect, if applied, that a person who was the operator of a system, including a CSD, would not be an intermediary for the purposes of the draft Convention. He pointed out that the thinking behind Articles 1(3) and (4) of the Hague Securities Convention had been incorporated in Article 1(d) of the UNIDROIT draft Convention, and the thinking behind Article 1(5) of the Hague Securities Convention in Article 1bis of the draft Convention.

219. In respect of Article 2 he mentioned that, in accordance with the instructions from the Plenary, references to 'forum state' had been deleted, both in paragraphs (a) and (b).

220. Article 3bis was a more developed version of Article X set out in DC/W.P. 1 [Appendix 6]. He pointed out that the phrase 'for which the law of that Contracting State is the non-Convention law' in Article 3bis(1) had been deleted, in the light of Article X concerning the Applicability of Declarations in Chapter VII. He indicated that comparable changes had been made in other instances, unless a repetition was needed for clarification, or in the case of an exception to Article X in Chapter VII. Moreover, he referred to a minor change in Article 3bis(2)(a), which made it clear that it could be said for the purpose of function-sharing, that this related to all securities, all government securities, certain shares, a certain type of securities account, etc. He indicated that the square brackets in Article 3bis(3) had been deleted.

221. In respect of Article 5 he pointed out that no change had been made, and that Article 8 was not mentioned in this provision, because Article 5 was limited to credits, with which Article 8 was not concerned.

222. In Article 6(2), the word 'Article' had been replaced by 'Chapter', in line with the view that this provision should not be broadened so as to cover the entire draft Convention.

223. In respect of Article 7(4) he remarked that no change had been made as there had been no clear instruction to this end from the Plenary. In respect of Article 7(5), this was the version set out in DC/W.P. 1 [Appendix 6].

224. He indicated that a small change had been made to Article 8(1)(a) for reasons of accuracy. In respect of the change to Article 8(4) he gave the example of country X, in which the methods set out in Article 8 (e.g. a control agreement) were not recognised under non-Convention law as a means for creating a security interest. He stated that this country could nonetheless make a declaration and recognise one or more of these methods. Conceptually, therefore, 'its law' meant both non-Convention law and Convention law. The changes to Articles 8(5) and (6) resulted from the approved proposal set out in Doc. 75.

225. He pointed out that Article 11(2)(a) had been made subject to Article 11(1)(a). On the basis of the discussion in the Plenary, Articles 12(4)(b) and (c) had been put in square brackets. Moreover, some small changes had been made to Articles 13(1), (2) and (5).

226. He indicated that the new Article 14(2) was the result of an approved proposal set out in Doc. 75 and had to be refined on the basis of future discussions on Article 12.

227. In Article 15, the title had been simplified, while there had been additions to paragraphs (1) and (2) in respect of transparent systems and in accordance with instructions from the Plenary.

228. In Article 17, a number of changes had been made to the version set out in DC/W.P. 1 [Appendix 6]. The changes in paragraph (1) reflected the discussion on the procedural aspects of attachment, e.g. whether notice should be given to a debtor/account holder, the relevant intermediary or the CSD. An attempt had been made to accommodate all varieties in a neutral way. The Chairman of the Drafting Committee pointed out that Article 17(1) set out the principle that upper-tier attachment was not permitted, whereas Article 17(3) contained an exception. Some minor adjustments had been made to Articles 17(2) and (3).

229. The change in Article 19 addressed the issue in relation to the word 'hold', by using the wording 'hold or have available for the benefit of its account holders other than itself' in paragraph (1), and by listing a variety of ways to do so in a neutral manner in paragraph (2). Article 19(3) had been simplified. Article 19(4) contained a small change.

230. It had been considered that Article 20 should be relocated to the end of Chapter IV, after Article 23. In accordance with the instructions from the Plenary paragraph (2) had been deleted, and, consequently, paragraphs (3) and (4).

231. Article 21(1) had been made consistent with new Article 19, and, as a result, the words 'intermediated securities' had been added to Articles 21(2), (4) and (5). The words 'subject to Article 14' in Article 21(2) had not been changed.

232. A member of the Drafting Committee made a number of additional remarks in respect of the new French version of the text of the draft Convention set out in DC/W.P. 2 [Appendix 7]. He highlighted the following issues: 1) he explained that Article 1bis essentially reflected the substance and language of provisions of the Hague Securities Convention, but pointed out that the terminology used in the new provision had not yet been fully aligned with that used in the rest of the draft Convention (e.g. the term 'opérateur d'un système' from the Hague Securities Convention was not consistent with the term 'gestionnaire' used elsewhere in the UNIDROIT draft Convention); 2) in respect of Article 7(5) he stated that this might not yet be the ideal wording, but that the expression 'sur une base nette compensée' had been chosen to reflect with greatest clarity what had been meant; 3) in respect of references to 'droit non conventionnel' he remarked that these had been systematically reviewed throughout the draft Convention, that differences in wording conveyed a meaning and that the new English and French versions were compatible.

233. In respect of the French version, another member of the Drafting Committee made two additional remarks. He stated that 1) the addition to the definition in Article 1(p) had not yet been clearly formulated and needed to be improved; 2) the new wording of Article 7(5) contained redundant elements, in particular when speaking of 'nette compensée', and should be reconsidered.

## Reactions

234. The Chairman of the Committee expressed his gratitude and deepest respect to all members of the Drafting Committee, and the Chairman of the Drafting Committee in particular, for the valuable and indispensable work undertaken. Moreover, he announced that the Chairman of the Committee, the Chairman of the Drafting Committee and the Secretary-General would jointly ensure that a formal review of the draft Convention would be carried out, limited to renumbering and the correction of clerical errors. In respect of proposals discussed during the last day of the session he stated that, taking into account that no further meetings of the Drafting Committee would take place, amendments to the substance would only be made if solid conclusions had been drawn on the basis of the discussion in the Plenary, which was usually the case if there had not been too much discussion.

235. One delegation asked for clarification on the relationship between Article 1(d) and Article 1bis. The Chairman of the Drafting Committee clarified that Article 1(d) contained a definition of 'intermediary' and also clarified when a CSD would be an intermediary, while Article 1bis contained a declaration mechanism to exclude an entity, including a CSD, from the definition of intermediary for the purpose of the draft Convention.

236. One delegation stated that Article 1bis seemed to imply that a person who merely acted as a registrar or a transfer agent for an issuer of securities would be an intermediary for the purposes of the draft Convention, unless a Contracting State declared that it was not. In the view of this delegation, it should not be necessary to declare that a person who merely acted as a transfer agent or a registrar was not an intermediary. It proposed a clarification along the lines of Article 1(3)(a) of the Hague Securities Convention. Another delegation supported this proposal. The Chairman of the Drafting Committee concurred with the view that a person who merely acted as a transfer agent or a registrar should not be an intermediary under Article 1(d) and that any ambiguity in this respect in the light of Article 1bis should be addressed.

237. One delegation remarked that it found the new drafting of Article 2 unsatisfactory and intended to elaborate a further proposal in this respect. Moreover, in its view Article X in Chapter VII was superfluous and should be deleted, because it was clear that no State could make a declaration that would affect the law of any other State. Another delegation supported the doubts expressed about Articles 2 and X. In respect of the proposed deletion of Article X the Chairman of the Drafting Committee remarked that it should be reviewed article-by-article in which cases this provision was needed. He stated that by making a declaration one should not be permitted to export one's law to another jurisdiction.

238. One delegation proposed to make Article 3bis(1) more precise as follows: '[...] a person *or persons* other than the relevant intermediary is *or are* [...]'. The Chairman of the Drafting Committee agreed that it would be better to say 'person or persons' in Article 3bis(1), i.e. the same language used in Article 3bis(2)(iii).

239. One delegation highlighted a problem relating to Articles 14(2) and 21(2). It wondered whether the principle of investor protection had been relinquished too far in favour of the protection of systemic stability. It posed the question whether there would be 'good faith' under Article 14(2), if it was unclear whether an interest was granted in an omnibus account or an intermediary's own account. In this respect it also referred to the duty for intermediaries set out in Article 13(7) of the European 'MiFID' Directive to protect clients' assets. Another delegation shared the concern that Article 14(2) was not yet sufficiently clear. It pointed out that references in the proposal set out in Doc. 75, notably to 'an omnibus account, a nominee account or an account maintained for others than the account holder', were not reflected in the new text of Article 14(2), which only contained the general text in square brackets in the light of ongoing discussions on Article 12. The Chairman of the Drafting Committee agreed that the point relating to omnibus accounts, etc., should be clarified at a later stage.

240. One more delegation reiterated its position that new Article 14(2) was unacceptable. It stated that during the third session, in the course of the extensive discussion on Article 21 (previously Article 19), it had been decided that the draft Convention would not contain a priority rule in favour of either account holders or the secured creditors of the intermediary, but that this issue would be left to the non-Convention law, and that there had only been a very short discussion during the fourth session. It was not convinced that the argument – that the creditors of the intermediary had no possibility of finding out whether an account was an omnibus account or not – was sufficient reason to favour the creditors of the intermediary over the intermediary's account holders. Another delegation supported the concerns raised in respect of Article 14(2) by other delegations. In its view investors should, in this case, always be protected.

241. One observer remarked in relation to the methods listed in the new Article 19(2) that in its view such methods were or were not available in a certain jurisdiction and that, therefore, this provision should be subject to non-Convention law. It referred to the role of national securities regulations in this context. Moreover, it suggested introducing a declaration mechanism in respect of Article 19(2) in order to identify the methods available in a Contracting State, in particular the methods available, if any, under Article 19(2)(e). One delegation shared the interpretation that not all methods set out in Article 19(2) were necessarily available to an intermediary and that this provision contained an open-ended list, in particular in the light of Article 19(2)(e). In its view, however, Article 19(2) was not necessarily subject to national law, but could also be subject to the law under which the securities had been issued, the law of the issuer, or other rules. In addition, it did not consider a declaration mechanism necessary in this instance. It was of the view that not all cases where the draft Convention established a link with non-Convention law would require a declaration, because extensive declarations would restrict transparency. The Chairman of the Drafting Committee proposed to continue working on Article 19(2).

242. One delegation asked for clarification on whether the sharing of functions also entailed liability. The Chairman of the Drafting Committee clarified that Article 3bis only said that an intermediary's functions could be shared, but was silent about liabilities. The issue of the liability of the intermediary was addressed in Article 20, which essentially relegated the issue of liability to non-Convention law. He indicated that some further work on Article 20 might be needed in the context of transparent systems.

243. Delegates congratulated the Drafting Committee and its Chairman for the excellent work done and expressed their satisfaction with the solid basis that had been laid for the inclusion of transparent systems in the scope of the draft Convention.

244. The Chairman of the Committee concluded that the draft Convention, as presented by the Chairman of the Drafting Committee, was adopted as a basis for further work.

### **Future work**

245. The Chairman of the Committee concluded that there was still work to do, but that the text of the draft Convention was sufficiently mature to be put before a Diplomatic Conference for adoption. He indicated that post-session work would take place in the run-up to the Diplomatic Conference.

246. The Secretary-General outlined the procedure leading up to the Diplomatic Conference. He explained that under UNIDROIT rules and practices, the Governing Council would examine the draft Convention as it stood, as well as the Report on the fourth session, and would, on that basis, decide whether it shared the view of the Committee of Governmental Experts that the text was ready to be laid before a Diplomatic Conference. At that time, the Governing Council would also need to be assured that there was a Government that was prepared to host the Diplomatic Conference for the adoption of the draft Convention. Then the Secretariat would organise, in co-operation and co-ordination with the host Government, the invitation and the supporting documentation, primarily consisting of the current draft Convention and the Explanatory Report, six months before the envisaged Diplomatic Conference.

247. The Swiss delegation confirmed that there was openness and willingness to host the Diplomatic Conference in Geneva. It indicated that, as a preparatory measure, reservations had been made in 2008. On the basis of the progress made during the fourth session, in particular in relation to transparent systems, the Swiss delegation would recommend to its Government to host the Diplomatic Conference, subject to the approval by the UNIDROIT Governing Council.

248. The Chairman of the Committee indicated that post-session work would be conducted in three Working Groups: 1) a Working Group dealing with the good faith / innocent acquirer issue, to be chaired by Spain; 2) a Working Group dealing with issues relating to securities clearing and securities settlement systems, including uniform rules of CSD, to be co-chaired by the United States of America and the European Commission; 3) a Working Group dealing with insolvency related issues, to be chaired by the United Kingdom. He indicated that these informal Working Groups were open to all delegations and observers and that the UNIDROIT Secretariat would send out invitations to participate.

249. One delegation asked whether the final clauses could reflect the existence of multi-unit States. The Secretary-General confirmed that the Secretariat would draft the technical and usual set of final clauses and indicated that these would be sent out together with the invitation for the Diplomatic Conference.

250. Delegates thanked all who had facilitated the current work and in particular the Chairman of the Committee.

251. The Chairman of the Committee closed the session.

**LIST OF DISTRIBUTED DOCUMENTS  
AND INDEX OF APPENDICES**

- References:** UNIDROIT Study LXXVIII (not reproduced in this report; available on <http://www.unidroit.org/english/workprogramme/study078/item1/main.htm>)
- Doc. 57, Preliminary draft Convention on substantive rules regarding intermediated securities as adopted by the Committee of Governmental Experts at its third session, Rome, November 2006
  - Doc. 58, Report on the third session of the UNIDROIT Committee of governmental experts for the preparation of a draft Convention on substantive rules regarding intermediated securities, Rome, November 2006
  - Doc. 44 Add., Supplementary Working paper regarding so-called "Transparent Systems", prepared by the Secretariat on the basis of contributions submitted by delegations, Rome, May 2007
  - Doc. 59, Working Paper on Transitional Rules, prepared by the delegation of Switzerland, Rome, February 2007 (English only)
  - Doc. 60, Working Paper regarding "Transparent Systems", prepared by Chairs of the Working Group, Rome, February, 2007 (English only)
  - Doc. 61, Working Group on so-called "Transparent Systems" – Intersessional Work, Examination of the draft Convention vis-à-vis the Czech Legal Order, submitted by the Government of the Czech Republic, Rome, March 2007 (English only)
  - Doc. 62, Working Group on so-called "Transparent Systems" – Intersessional Work, Comments of the Brazilian delegation to the Working Group on so-called Transparent Systems, submitted by the Government of the Federative Republic of Brazil, Rome, March 2007 (English only)
  - Doc. 63, Working Group on so-called "Transparent Systems" – Intersessional Work, The Greek Holding System, Synoptic presentation, submitted by the Government of Greece, Rome, March 2007 (English only)
  - Doc. 64, Working Group on so-called "Transparent Systems" – Intersessional Work, Comments of the United Kingdom representative on the draft Working Paper on Transparent Systems, submitted by the Government of the United Kingdom, Rome, March 2007 (English only)
  - Doc. 65, Working Group on so-called "Transparent Systems" – Intersessional Work, Comments of the People's Republic of China representative on the draft Working Paper on Transparent Systems, submitted by the Government of the People's Republic of China, Rome, March 2007 (English only)
  - Doc. 66, Working Group on so-called "Transparent Systems" – Intersessional Work, Comments of the French delegation on the draft Working Paper on Transparent Systems, submitted by the Government of France, Rome, March 2007 (English only)
  - Doc. 67, Working Group on so-called "Transparent Systems" – Intersessional Work, Comments of the Swiss delegation on the draft Working Paper on Transparent Systems, submitted by the Government of Switzerland, Rome, March 2007 (English only)

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- Doc. 68, Observations on Transition Provisions, submitted by the delegation of the United States of America, Rome, March 2007 (English only)
  - Doc. 69, Observations on Transitional Rules, submitted by the delegation of Finland, Rome, March 2007 (English only)
  - Doc. 70, Draft Report of the Transparent Systems Working Group, prepared by Chairs of the Working Group, Rome, April 2007 (English only)
  - Doc. 71, Working Group on so-called "Transparent Systems" – Intersessional Work, Comments of the delegation of South Africa on the draft Working Paper on Transparent Systems, submitted by the Government of South Africa, Rome, April 2007 (English only)
  - Doc. 72, Comments on the draft Convention on Substantive Rules regarding Intermediated Securities, submitted by the International Swaps and Derivatives Association, Inc., ISDA, Rome, April 2007
  - Doc. 73, Observations on Transitional Rules, submitted by the delegation of the Czech Republic, Rome, April 2007 (English only)
  - Doc. 74, Comments on the draft Convention on Substantive Rules regarding Intermediated Securities, submitted by the delegation of the United States of America, Rome, April 2007
  - Doc. 75, Comments on the draft Convention on Substantive Rules regarding Intermediated Securities, submitted by the delegation of Denmark, Rome, April 2007
  - Doc. 76, Comments on the draft Convention on Substantive Rules regarding Intermediated Securities, submitted by the European Banking Federation, Rome, April 2007
  - Doc. 77, Working Group on so-called "Transparent Systems" – Intersessional Work, Comments of the delegation of Greece on the draft Working Paper on Transparent Systems, submitted by the Government of Greece, Rome, May 2007 (English only)
  - Doc. 78, Working Group on so-called "Transparent Systems" – Intersessional Work, Comments of the delegation of Argentina on the draft Working Paper on Transparent Systems, submitted by the Government of Argentina, Rome, May 2007 (English only)
  - Doc. 79, Comments on the draft Convention on Substantive Rules regarding Intermediated Securities, submitted by the Government of the Republic of Latvia, Rome, May 2007
  - Doc. 80, Comments on the draft Convention on Substantive Rules regarding Intermediated Securities, submitted by the Government of the Republic of Turkey, Rome, May 2007
  - Doc. 81, Working Group on so-called "Transparent Systems" – Intersessional Work, Comments of Maltese representative on the draft Working Paper on Transparent Systems, submitted by the Government of Malta, Rome, May 2007 (English only)
  - Doc. 82, Comments on the draft Convention on Substantive Rules regarding Intermediated Securities, submitted by the Government of Poland, Rome, May, 2007
  - Doc. 83, Comments on the draft Convention on Substantive Rules regarding Intermediated Securities, Observations on Article 15, submitted by the delegation of the United States of America, Rome, May, 2007
  - Doc. 84, Report on Transitional Rules, prepared by the delegation of Switzerland, Rome, May 2007
  - Doc. 85, Working Group on so-called "Transparent Systems" – Intersessional Work, Comments of the delegation of Brazil on the draft Working Paper on Transparent Systems, submitted by the Government of the Federative Republic of Brazil, Rome, May 2007 (English only)



- Doc. 86, Comments on the draft Convention on Substantive Rules regarding Intermediated Securities, submitted by the Government of France, Rome, May 2007
- Doc. 87, Observations on Transitional Rules, submitted by the delegation of the Republic of Korea, Rome, May 2007 (English only)
- Doc. 88, Report on the Transparent Systems Working Group, prepared by Chairs of the Working Group, Rome, May 2007 (English only)
- Doc. 89, Comments on the draft Convention on Substantive Rules regarding Intermediated Securities, submitted by the Government of the United Kingdom, Rome, May 2007
- Doc. 90, Comments on the draft Convention on Substantive Rules regarding Intermediated Securities, submitted by the delegation of Austria, Rome, May 2007
- Doc. 91, Working Group on so-called "Transparent Systems" – Intersessional Work, Comments of the delegation of the United States of America on the draft Working Paper on Transparent Systems, submitted by the delegation of the United States of America, Rome, May 2007
- Doc. 92, Comments on the draft Convention on Substantive Rules regarding Intermediated Securities, submitted by the delegation of the Czech Republic, Rome, May 2007
- Doc. 93, Comments on the draft Convention on Substantive Rules regarding Intermediated Securities, submitted by the Government of Italy, Rome, May 2007

**References:** CGE/Securities/4

- W.P.1 rev (2), *Detailed Order of Business* (reproduced as [Appendix 2](#))
- W.P.2, *Daily Report*, Plenary session, 21 May 2007 (not reproduced)
- W.P.3, *Working Paper on the good faith concept in the UNIDROIT project*, submitted by the delegation of France (reproduced as [Appendix 4](#))
- W.P.4, *Daily Report*, Plenary session, 22 May 2007 (not reproduced)
- W.P.5, *Working Paper on Uniform Rules of CSDs – Transparent Systems*, submitted by the delegation of the Federative Republic of Brazil, (reproduced as [Appendix 5](#))
- W.P.6, *Daily Report*, Plenary session, 23 May 2007 (not reproduced)
- W.P.7, *Daily Report*, Plenary session, 25 May 2007 (not reproduced)
- DC/W.P.1, Preliminary draft report, prepared by the Chairman of the Drafting Committee (reproduced as [Appendix 6](#))
- DC/W.P.2, *Text of the preliminary draft Convention*, submitted by the Drafting Committee (reproduced as [Appendix 7](#), now edited by the Secretariat and released as Doc. 94)
- INF. 1, *List of participants* (reproduced as [Appendix 3](#))
- INF. 2, *FAO facilities* (not reproduced)
- INF. 3, *Comments submitted by Zentraler Kreditausschuss and Bundesverband Investment und Asset Management* (reproduced as [Appendix 8](#)) (English only)
- INF. 4, *Report of the Transparent Systems Working Group*, prepared by the Chairs of the Working Group (reproduced as [Appendix 9](#)) (English only)

*All papers having the identifier "Doc." or "W.P." are official documents and therefore available in English and French (unless indicated otherwise). Papers identified as "Inf." are informal and only available in the language in which they were submitted.*

## Appendix 2

### **DETAILED ORDER OF BUSINESS**

*(prepared by the Secretariat)*

#### **Monday, 21 May**

- 8:30 a.m. Registration at FAO; Issue of security-badges (from 8:30 a.m.)
- 10:00 a.m. *Morning session (Plenary)*  
Opening address  
Adoption of the order of business  
Organisation of work
- 10:10 – 10:40 a.m. General report on the inter-sessional work of the Working Group on so-called Transparent Systems (Docs. 60, 70, 88)
- 11:00 – 12:00 a.m. Opportunity for members of the Working Group to briefly comment on national specifics (Docs. 61, 62, 63, 64, 65, 66, 67, 71, 77, 78, 80 (par. 3, 5), 81, 85, 91)
- 12:00 – 12:30 p.m. Subject-matter area I: Roles and functions of CSD's – 1) The CSD as intermediary; 2) 'Issuer accounts'; 3) Rules of CSD's  
I.1 The CSD as intermediary
  - Article 3
- 2:00 p.m. *Afternoon session (Plenary)*  
Subject-matter area I continued:  
I.2 'Issuer accounts'
  - Article 3
  - Article 19
  - Article 21
  - Article 22I.3 Rules of CSD's
  - Article 11
  - Article 19
  - Article 20
  - Article 22
- 4.30 p.m. Subject-matter area II: Sharing of 'maintaining a securities account' – Functions and status of 'account operators'
  - Article 5
- 7:00 p.m. Cocktails offered by UNIDROIT, Villa Aldobrandini, Via Panisperna, 28

**Tuesday, 22 May**

9:30 a.m.

*Morning session (Plenary)*

Subject-matter area II continued:

- Article 5 continued
- Article 6
- Article 7
- Article 8
- Article 11
- Article 17

2:00 p.m.

*Afternoon session (Plenary)*

Subject-matter area II continued:

- Article 18
- Article 20

So-called Transparent Systems, general:

- Definitions: Article 1(c), (d), (f), (g), (l)
- Clarification of Article 7(5)

4:30 p.m.

Nature of the instrument (Docs. 76 (par. A), 86, 93 (p. 3-4))

**Wednesday, 23 May**

9:30 a.m.

*Morning session (Plenary)*

Transitional provisions (Docs. 59, 68, 69, 73, 84, 87, 93 (p. 4), INF. 3 (p. 3-4))

11:00 a.m.

Coordination with UNCITRAL's work on a Legislative Guide on Secured Transactions

11:30 a.m.

Comments submitted by Governments and Observers on various provisions (Docs. 65 (par. 2c-e), 72, 74, 75, 76, 79, 80, 82, 83, 89, 90, 92, INF. 3):

## Chapter I

- Article 1 (Doc. 76, p. 2; Doc. 79, par. 1; Doc. 80, par. 1, 2; Doc. 82, par. I, II; Doc. 89, par. 1, 2; Doc. 90, par. 1)
- Article 2 (Doc. 90, par. 1; Doc. INF. 3, p. 1)
- Article 3 (Doc. 76, p. 3)
- Article 4 (Doc. 76, p. 3)

## Chapter II

- Article 5 (Doc. 76, p. 3; Doc. 79, par. 9; Doc. 90, par. 2; Doc. 93, p. 1)
- Article 6 (Doc. 76, p. 3; Doc. 79, par. 2; Doc. 90, par. 2; Doc. INF. 3, p. 1-2)

## Chapter III

- Article 7 (Doc. 76, p. 3; Doc. 90, par. 2; Doc. 93, p. 1-2; Doc. INF. 3, p. 2)
- Article 8 (Doc. 75, par. 1; Doc. 76, p. 3-4; Doc. 92, par. I; Doc. 93, p. 1-2; Doc. INF. 3, p. 2-3)

2:00 p.m.

*Afternoon session (Plenary)*

Comments on various provisions continued:

- Article 11 (Doc. 76, p. 4; Doc. 82, par. III)
- Article 12 (Doc. 74, par. 2-5; Doc. 76, p. 4; Doc. 89, par. 3, 4; Doc. INF. 3, p. 3)
- Article 13 (Doc. 76, p. 4-5; Doc. INF. 3, p. 3-4)
- Article 14 (Doc. 75, par. 2; Doc. 76, p. 4-5)

## Chapter IV

- Article 15 (Doc. 83)
- Article 16 (Doc. 89, p. 3-4)
- Article 17 (Doc. 76, p. 5)
- Article 18 (Doc. 76, p. 5; Doc. 79, par. 3; Doc. 82, par. IV; Doc. 92, par. II)
- Article 19 (Doc. 76, p. 5; Doc. 79, par. 4; Doc. INF. 3, p. 4)
- Article 20 (Doc. 74, par. 1; Doc. 76, p. 5; Doc. 79, par. 5; Doc. 91, p. 2; Doc. 93, p. 2-3; Doc. INF. 3, p. 5)
- Article 21 (Doc. INF. 3, p. 5-7)
- Article 22 (Doc. 65, par. 14; Doc. 76, p. 5-6; Doc. 79, par. 5-7; Doc. 82, par. V; Doc. INF. 3, p. 5-7)
- Article 23 (Doc. 79, par. 5)

## Chapter V

- Article 24 (Doc. 76, p. 6; Doc. 79, par. 8; Doc. 93, p. 3; Doc. INF. 3, p. 7)

**Thursday, 24 May***No Plenary*, all day Drafting Committee**Friday, 25 May**

9:30 a.m.

Distribution of the report of the Drafting Committee

10:15 a.m.

*Morning session (Plenary)*

Comments on various provisions continued:

## Chapter VI

- Article 26 (Doc. 76, p. 6)
- Article 27 (Doc. 76, p. 7)
- Article 28 (Doc. 65, par. 17-19)
- Article 31(1)(a) (Doc. 76, p. 7)
- Article 32 (Doc. 76, p. 7; Doc. 92, par. III)

## Chapter VII

## Preamble

2:00 p.m.

*Afternoon session (Plenary)*

Report by the Chairman of the Drafting Committee

4:00 p.m.

*Closing*

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**WORKING PAPER ON THE GOOD FAITH CONCEPT IN THE UNIDROIT PROJECT**

*(submitted by the delegation of France)*

Protection of the good faith acquirer of intermediated securities has since the inception of the proposed UNIDROIT Convention on Intermediated securities always been a key concern.

**A. Bona Fide purchaser protection is a key internal soundness criteria**

This concern was expressed as early as August 2003 in the Position Paper of the UNIDROIT Study Group on Harmonised Substantive Rules Regarding Indirectly Held Securities. Such position paper ranks good faith acquisition protection among the key features which a structure for the holding and transfer of securities through intermediaries must possess if it is to be regarded as sound, taking into account in particular objectives of investor protection and efficiency.

The report further stated that the question is whether indirect holders of securities can be confident that their interests are robust and can be dealt with under simple clear rules and procedures for acquisition, holding, transfer and realisation.

In achieving those purposes the study group concluded that it should adopt a functional approach – that is one which uses language which is as neutral as possible and formulates rules by reference to their results.

**B. Approach of the proposed UNIDROIT Convention**

The proposed draft Convention addresses those issues in its current Article 12 which in substance reads as follow:

*"1.- where securities are credited to the securities account of an accountholder at a time when the accountholder does not know that another person has an interest in securities or intermediated securities and that the credit violates the rights of that other person with respect to that interest:*

- a) *the account holder is not subject to the interest of that other person.*  
(...)

- 4. *For the purposes of this article*  
(...)

- b) *a person knows of an interest or fact if that person:*

- i) *has **actual knowledge of the interest or fact**, or*

*ii) has knowledge of **facts sufficient to indicate that there is a significant probability** that the interest or fact exists and deliberately avoids information that would establish that this is the case, and*

*c) when the person referred to in b) is an organization, it knows of an interest or fact from the time when the interest or fact is **or ought reasonably to have been** brought to the attention of the individual responsible for the matter to which the interest or fact is relevant".*

This proposed language has been modified during the November 2006 meeting of government experts. Such draft has been improved to the extent that the concepts of "facts or interest" have been substituted to the concept of "adverse claim" which was used in the previous drafts.

The current draft maintains its focus on the knowledge of interest or facts by the accountholder at the time of a credit of securities to the securities account. Such knowledge is susceptible of invalidating the credit entry. This knowledge concept is extended to situations where there is a significant probability that the interest or fact exist from the time when the interest or fact is or ought reasonably to have been brought to the attention of the relevant individual responsible for the matter to which the interest or fact is relevant.

### C. Concerns raised by the proposed approach

France is concerned that the proposed approach may lead to a substantial level of uncertainty and may further be inconsistent with the functional approach which is being advocated.

#### 1) The proposed approach is source of uncertainty

Major legal systems protect the bona fide acquirer of goods in particular in the context of movable assets including *inter alia* merchandise.

The traditional civil law approach tends to establish principles which courts are expected to apply and interpret with the required flexibility. Absence of knowledge may be used as a guidance<sup>1</sup>.

Other systems while establishing in one fashion or the other the principle of good faith whether or not based on knowledge tend to establish tests which while justified in their system may not fit in the way courts of other countries operate. Introducing such tests in civil law countries may be a source of new uncertainty for those countries.

The French civil code protects the bona fide acquirer under the old principle "*en fait de meubles la possession vaut titre*" or in respect of movables possession vests title. This principle is enshrined in Article 2279 of the French civil code.

This article establishes the principle of ownership based on good faith which is presumed. This applies even under circumstances where the possessor has acquired the goods "a non domino". This is a rebuttable presumption but the burden of proof lies on a third party or original owner seeking to reclaim such goods.

However protection is based on the title concept and possession allows to receive good title over the original owner if the acquirer is acting in good faith. Introducing test such as a significant probability of knowledge may be a source of dispute and may be perceived as being subjective. Per se such criteria may not constitute a test sufficient to challenge or preserve ownership based on possession. The concept of sufficient facts may also be perceived as subjective.

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<sup>1</sup> This is the approach taken by the Italian civil code (Article 1147) which provides that: "Is considered as a good faith possessor of a good such person in possession of a good while ignoring that such possession is depriving the rights of another person. Such person will not benefit from good faith protection if such ignorance is due to its [willfull misconduct-gross negligence]. Good faith is assumed and it is sufficient that it exists at the time of the acquisition of the relevant goods." "*E' possessore di buona fede chi possiede ignorando di ledere l'altrui diritto (535). La buona fede non giova se l'ignoranza dipende da colpa grave. La buona fede e presunta e basta che vi sia stata al tempo dell'acquisto*". Article 1153 of the Italian Civil code further provides that: "Such person who has acquired a movable good of a person who is not the owner, will become the owner of such goods through possession, provided possession was acquired in good faith at the time of delivery of the relevant good and that possession resulted from an appropriate title to transfer property". "*Colui al quale sono alienati beni mobili da parte di chi non ne è proprietario, ne acquista la proprietà mediante il possesso, purché sia in buona fede al momento della consegna e sussista un titolo idoneo al trasferimento della proprietà. La proprietà si acquista libera da diritti altrui sulla cosa, se questi non risultano dal titolo e vi è la buona fede dell'acquirente. Nello stesso modo si acquistano diritti di usufrutto, di uso e di pegno*".

Like in other legal systems<sup>2</sup> the application of the civil or common law good faith acquirer protection rule to financial instruments is debated. The debate is based on the fact that good faith acquisition protection applies to tangible assets while there is a question as to whether book-entry securities in a fully mandatory dematerialising system such as the French system should benefit from the Article 2279 protection similar to what Article 2279 of the French Civil Code is offering. The better approach is that under French law holders of financial instruments should be so protected.

In this respect, **in France**, to remove any uncertainty, the Legal Committee of Paris Europlace (a group of legal experts and practitioners) has proposed a reform provides in a proposed new article L.431-2 of the French Monetary and Financial Code:

*"A Financial Security over which title has been acquired in good faith cannot be reclaimed on any ground whatsoever."*

Other civil law countries have adopted similar approaches offering various levels of protection.

Under the heading "Protection of the good faith purchaser" Article 29 of the **Swiss** law related to intermediated securities stipulates that:

*"Whoever in good faith and for a consideration acquires intermediated securities or interest in intermediated securities under the provisions of art. 24, 25 or 26 is protected as regards its purchase even if:*

- the transferor/vendor did not have the power to dispose of the intermediated securities,*
- the bonus on the intermediated securities has been reversed into the initiator's account".*

Under Article 10 of the **Belgian** Royal Decree (Coordinated Royal Decree 62 relative to the deposit of fungible financial instruments and to the liquidation of transactions on these instruments):

*"The Clearing house, the members and any other person in good faith owning a financial instrument subject now or in the past to the fungibility regime are not bound to return it to the person who claims that it has been involuntarily dispossessed thereof before delivery of such instrument to the clearing house and who, before that time, has not sought publication of an opposition";*

Common law countries have adopted rules protecting good faith acquirers.

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<sup>2</sup> FMLC does insist on the need to organize the bona fide purchaser's protection and suggests the creation of a new principle for such purposes.

"6.8 Protection of purchaser in good faith

Because of the speed with which financial transactions take place, there is no possibility for purchasers of financial assets to investigate the vendor's title prior to trading. Purchasers of debt instruments have traditionally been protected by the rules of mercantile law, which protects the good faith purchaser of negotiable instruments. However, it is highly unlikely that these rules extend to electronic assets such as contemporary intermediated securities. As a result, a purchaser of the interest in, say, bonds (unlike a purchaser of a physical bond) is not protected by the rule that a holder in due course of a negotiable instrument takes free of any prior claims and is unaffected by any flaw in the title (for example, where the bond was stolen) of the transferor. Equity protects a person who in good faith acquires legal title without notice of any adverse claims, but this protection cannot apply if the purchaser only acquires an equitable interest in the securities. The distinction between legal and equitable rights should be irrelevant in this context. There should be a clear rule in favour of the bona fide purchaser for value without notice. This is the solution provided by Principle 7(e): FLMC – ISSUE 3 – PROPERTY INTERESTS IN INVESTMENT SECURITIES, Analysis of the need for and nature of legislation relating to property interests in indirectly held investment securities, with a statement of principles for an investment securities statute, July 2004."

While in the United States the UCC<sup>4</sup> contemplates that a person with voidable title has power to transfer good title to a good faith purchaser for value a specific rule<sup>5</sup> has been introduced in the UCC covering acquisition of securities. Such rule is based on notice of an adverse claim.

The United Kingdom also provides statutory protection to holders of debt instruments but like in France it is not free from doubt whether such protection extends to book-entry securities. Such protection being sought for the bona fide purchaser is also based on notice.

2) The proposed approach may be inconsistent with the functional approach

The provisions of the proposed Article 12 of the draft UNIDROIT Convention is based on language that is close to being a blueprint of Article 8-105 of the UCC which provides that :

*"A person has notice of an adverse claim if:*

- (1) the person knows of the adverse claim;*
- (2) the person is aware 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".*

Adopting such a blueprint drafting approach may be at odds with the functional, neutral approach advocated by the drafters of the proposed convention to address diversity of traditions and conceptual frameworks. At the inception of the exercise experts were in favour of the use of a "language as neutral as possible relative to the various legal traditions involved" and of the wording of rules "by reference to results to facilitate a reconciliation of different legal concepts in different States"<sup>6</sup>. Good faith was in fact given as the archetype of this approach.

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<sup>4</sup> Art § 2-403 UCC.

<sup>5</sup> Art § 8-105 UCC which reads:

- (a) A person has notice of an adverse claim if:
  - (1) the person knows of the adverse claim;
  - (2) the person is aware 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; or
  - (3) the person has a duty, imposed by statute or regulation, to investigate whether an adverse claim exists, and the investigation so required would establish the existence of the adverse claim.
- (b) Having knowledge that a financial asset or interest therein is or has been transferred by a representative imposes no duty of inquiry into the rightfulness of a transaction and is not notice of an adverse claim. However, a person who knows that a representative has transferred a financial asset or interest therein in a transaction that is, or whose proceeds are being used, for the individual benefit of the representative or otherwise in breach of duty has notice of an adverse claim.
- (c) An act or event that creates a right to immediate performance of the principal obligation represented by a security certificate or sets a date on or after which the certificate is to be presented or surrendered for redemption or exchange does not itself constitute notice of an adverse claim except in the case of a transfer more than:
  - (1) one year after a date set for presentment or surrender for redemption or exchange; or
  - (2) six months after a date set for payment of money against presentation or surrender of the certificate, if money was available for payment on that date.
- (d) A purchaser of a certificated security has notice of an adverse claim if the security certificate:
  - (1) whether in bearer or registered form, has been indorsed "for collection" or "for surrender" or for some other purpose not involving transfer; or
  - (2) is in bearer form and has on it an unambiguous statement that it is the property of a person other than the transferor, but the mere writing of a name on the certificate is not such a statement.
- (e) Filing of a financing statement under Article 9 is not notice of an adverse claim to a financial asset.

<sup>6</sup> Explanatory notes, Doc. 19 - Study LXXVIII, p. 19.

#### D. Available options

Good faith is among the key concepts of the law of property and of the law of contracts. Its introduction in the law of financial markets coupled with a series of tests which may be perceived as too subjective along the lines of what is currently being envisaged may disturb legal systems unfamiliar with the concepts being used.

During the last session, several delegations expressed concern about their expected inability to integrate without prejudice in their legal system an approach which is so remote from their traditional concepts.

This difficulty leads France to invite reconsidering this aspect of the project.

Three options are available:

- to maintain the draft conventions as it is,
- using a neutral language, avoiding the good faith and adverse claim concepts,
- reverting to the good faith concept without explaining its content.

The first concept is not neutral. It is directly inspired from the UCC. Moreover, we are not convinced that it is better from a technical standpoint, at least for legal systems which for reasons described above do not share the UCC approach.

The second option is ambitious, but experience of previous sessions has shown the difficulty and above all the limits of meeting a neutral terminology and even a common conceptual approach of which the language is only a reflection, in such a manner so as to reconcile the several different legal systems. This option which may involve spending a considerable amount of time, does not appear reasonable or even appropriate particularly as in the diversity of Europe's legal environment, the harmonization of the law of property is currently in its early stages. Taking an option on a fundamental aspect of the law of property outside the context of European law and internal discussions amongst the EU member states seems fraught with danger.

Remains the third option which seems to us to be the easiest to implement. The expression "good faith" appears indeed as the several delegations' lowest common denominator<sup>7</sup>. A reference to "good faith" with a cross reference to domestic non conventional law to determine the content of the concept, would preserve both the internal consistency of the legal systems and the requirement for the security of cross border transactions which the convention is seeking to protect. Under such approach a general reference to knowledge may be considered but without cross-reference to general subjective test which may be perceived as too subjective.

This is the preferred option of the French delegation.

Draft proposal:

12.4 *"For the purposes of this article*

*(...)*

*b) a person knows of an interest or fact as required by the non convention law".*

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<sup>7</sup> US law was using it until UCC article 8 was amended. According to the explanatory notes of article 8-303 the term "protected holder", which replaces the term "bona fide purchaser" used in the prior version of Article 8, is derived from the term "protected holder" used in the United Nations Convention on International Bills of Exchange and International Promissory Notes (UNCITRAL).

## Appendix 5

### **WORKING PAPER ON UNIFORM RULES OF CSDS – TRANSPARENT SYSTEMS**

*(submitted by the delegation of the Federative Republic of Brazil)*

The current text of the draft Convention defines several situations in which the enforcement of its provisions will not interfere in the uniform rules of securities settlement system. Nevertheless, it does not establish the same exception for uniform rules issued by CSDs, which have the same relevance.

The lack of such an exception would undermine procedures adopted by these entities and would attempt against the legal certainty of their own systems.

In this paper, we intend to list some examples of rules issued by CSDs which could be affected. It is to be pointed out that this is not an extensive list.

1) One example that could be mentioned are the typical rules of CSDs which describe all necessary operational arrangements (methods, systems, codes, etc) in order to make registries and entries to be valid at the CSD level. The CSD participants (intermediaries or not) will need to fulfill to these methods/arrangements in order to be guaranteed of all the rights flowing from securities deposited at the CSD.

2) Another example of rules adopted by CSDs regards to procedures on exercise of corporate actions, such as preemptive rights for subscription of new securities.

In the Brazilian system, an account holder may wish to have different segregated securities accounts (which are fully identifiable by the CSD).

At the same time, the CSD can establish some conditions for the entitlement and execution of account holder rights according to article 5.1.a of the Convention, which are technically relevant conditions that may clearly affect the completion of these rights. The rule itself does not avoid the complete exercise of rights on securities, it only sets up a condition of aggregation or segregation of securities on a single (or) separate accounts for the protection of the whole system.

3) Other common rule related to CSD activities is the one that provides which are the eligible securities that could be deposited therein. For instance, the rule could restrict as eligible securities only those that are permitted to be traded on an exchange or regulated market. This would mean that if the issuer of this type of securities for any reason is delisted from a regulated market, the securities should need to be held otherwise than through a securities account in the CSD's environment. This rule seem to affect the mention made in article 5.1.c of the Convention.

4) The next situation deals with the right to withdraw securities which are maintained through the CSD environment. As per the Brazilian CSD rules, this right of withdrawal can be restricted to intermediaries / CSD participants in specific situations, *e.g.*, if there are discrepancies with the amount of securities informed by the CSD participant and the amount registered at the CSD (and conciliated with issuers); or, still, if there is any kind of restriction for disposition on the relevant securities. The reasons of the restrictions for withdrawal are immediately informed to the



intermediary but that situation also seems to affect the right mentioned in article 5.1.c of the Convention.

For all reasons mentioned above, it would be important that the uniform rules of CSDs should prevail.

As a practical approach, it would be advisable that all articles of the Convention where there is a reference to the rules of a securities settlement system (Articles 5.1, 11.2, 12.5, 18.2.e, 19.3, 20.1 and 21.3) could be expanded so as to cover the uniform rules of CSDs.

Moreover, it would also be very important to consider:

- other situations or examples related to evolution of technological infra-structure of CSDs and their requirements on participants / intermediaries, that would clearly demand similar treatment; and
- a regulatory driver that could make the settlement securities systems to be separated from the CSD activities, in which case it would be useful that the CSD rules could be used irrespective of the entries eventually made during a settlement.

Finally, on the debates held at the plenary, there was a position expressing that, if the rules of the CSD were to be mentioned in the Convention, it would be important that they were common to a group of participants and publicly accessible, as well as that the CSD itself should be subject to oversight by a governmental or public authority in respect of its rules. The Brazilian delegation fully agrees with this position and believes these are precedent characteristics for the purposes of the legal certainty that is to be achieved with its reference in the Convention text.

**PRELIMINARY DRAFT REPORT**

*(prepared by the Chairman of the Drafting Committee)*

*Article 7*

*[Acquisition and disposition by debit and credit]*

5. - Nothing in this Convention limits the effectiveness of debits and credits to securities accounts which are effected on a net basis in respect of securities of the same description ~~may be effected on a net basis.~~

*Article 17*

*[Prohibition of upper-tier attachment]*

1. - Subject to paragraph 3, nNo attachment of or in respect of intermediated securities of an account holder shall be granted or made against the issuer of the relevant securities or against any ~~person~~intermediary other than the relevant intermediary.

2. - In this Article "*attachment*" means any judicial, administrative or other act or process for enforcing or satisfying a judgment, award or other judicial, arbitral, administrative or other decision against or in respect of the account holder or for freezing, restricting or impounding property of the account holder in order to ensure its availability to enforce or satisfy any future such judgment, award or decision.

3. - A Contracting State may declare that, where the law of that Contracting State is the non-Convention law, an attachment made against a person other than the relevant intermediary has effect against the relevant intermediary. Any such declaration shall identify that other person by name or description and shall specify the time at which an attachment made against that other person becomes effective against the relevant intermediary.

*Article X*

1.- A Contracting State may declare that, in respect of securities accounts, or securities accounts of any category or description, for which the law of that Contracting State is the non-Convention law, a person other than the relevant intermediary is responsible for the performance of a function or functions (but not all functions) of the relevant intermediary under this Convention.

2. - A declaration under this Article shall:

- (a) specify the securities accounts or category or description of securities accounts to which the declaration applies;
- (b) identify, by name or description, the relevant intermediary for such securities accounts or category or description of securities accounts;
- (c) identify, by name or description, the person or persons other than the relevant intermediary who is or are responsible as described in paragraph 1; and
- (d) specify, with respect to each such person, the functions for which it is so responsible and the relevant securities accounts or category or description of securities accounts.

3.- [Subject to any express provision to the contrary,] in any case where a declaration under this Article applies, references in any provision in this Convention to an intermediary or the relevant intermediary are to the person responsible for performing the function to which that provision applies.

**PRELIMINARY DRAFT CONVENTION ON SUBSTANTIVE RULES REGARDING  
INTERMEDIATED SECURITIES**

**CHAPTER I - DEFINITIONS, SCOPE OF APPLICATION AND INTERPRETATION**

*Article 1*  
*[Definitions]*

In this Convention:

(a) *“securities”* means any shares, bonds or other financial instruments or financial assets (other than cash) which are capable of being credited to a securities account and of being acquired and disposed of in accordance with the provisions of this Convention;

(b) *“intermediated securities”* means securities credited to a securities account or rights or interests in securities resulting from the credit of securities to a securities account;

(c) *“securities account”* means an account maintained by an intermediary to which securities may be credited or debited;

(d) *“intermediary”* means a person that in the course of a business or other regular activity maintains securities accounts for others or both for others and for its own account and is acting in that capacity and includes a central securities depository if and to the extent that it acts in that capacity;

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

(f) *“account agreement”* means, in relation to a securities account, the agreement between the account holder and the relevant intermediary governing that securities account;

(g) *“relevant intermediary”* means, with respect to a securities account, the intermediary that maintains the securities account for the account holder;

(h) *“insolvency proceeding”* means a collective judicial or administrative proceeding, including an interim proceeding, in which the assets and affairs of the debtor are subject to control or supervision by a court or other competent authority for the purpose of reorganisation or liquidation;

(i) *“insolvency administrator”* means a person (including a debtor in possession where applicable) authorised to administer an insolvency proceeding, including one authorised on an interim basis;

(j) securities are *“of the same description”* as other securities if they are issued by the same issuer and:

(i) they are of the same class of shares or stock; or

(ii) in the case of securities other than shares or stock, they are of the same currency and denomination and are treated as forming part of the same issue;

(k) “*control agreement*” means an agreement between an account holder, the relevant intermediary and another person, or, if so ~~permitted~~ provided by the non-Convention law, an agreement between an account holder and another person of which notice is given to the relevant intermediary, which relates to intermediated securities and includes either or both of the following provisions –

(i) that the relevant intermediary is not permitted to comply with any instructions given by the account holder in respect of the intermediated securities to which the agreement relates without having received the consent of that other person;

(ii) that the relevant intermediary is obliged to comply with any instructions given by that other person in respect of the intermediated securities to which the agreement relates in such circumstances and as to such matters as may be provided by the agreement or the non-Convention law, without any further consent of the account holder;

(l) “*designating entry*” means an entry in a securities account made in favour of a person other than the account holder in respect of intermediated securities, which, under the account agreement, a control agreement, the uniform rules of a securities settlement system or the non-Convention law, has either or both of the following effects –

(i) that the relevant intermediary is not permitted to comply with any instructions given by the account holder in respect of the intermediated securities in relation to which the entry is made without having received the consent of that other person;

(ii) that the relevant intermediary is obliged to comply with any instructions given by that other person in respect of the intermediated securities in respect of which the entry is made in such circumstances and as to such matters as may be provided by the account agreement, a control agreement, the uniform rules of a securities settlement system or the non-Convention law, without any further consent of the account holder;

(m) “*non-Convention law*” means the ~~provisions of~~ law in force in the State whose law is applicable under Article 2, other than the provisions of ~~use provided in~~ this Convention;

(n) “*securities settlement system*” means a system which-

(i) settles, or clears and settles, securities transactions;

(ii) is operated by a central bank or central banks or is subject to regulation, supervision or oversight by a governmental or public authority in respect of its rules; and

(iii) has been notified, on the ground of the reduction of risk to the stability of the financial system, as a securities settlement system in a declaration by the Contracting State the law of which governs the rules of the system;

(o) “*securities clearing system*” means a system which -

(i) clears, but does not settle, securities transactions through a central counterparty or otherwise;

(ii) is operated by a central bank or central banks or is subject to regulation, supervision or oversight by a governmental or public authority in respect of its rules; and

(iii) has been notified, on the ground of the reduction of risk to the stability of the financial system, as a securities clearing system in a declaration by the Contracting State the law of which governs the rules of the system;

(p) “*uniform rules*” means, in relation to a securities settlement system or securities clearing system, rules of that system (including system rules constituted by the non-Convention law) which are common to the participants or to a class of participants and are publicly accessible.

*Article 1bis**[Declaration concerning certain system operators]*

A Contracting State may declare that a person who is the operator of a system for the holding and transfer of securities on records of the issuer or other records which constitute the primary record of entitlement to them as against the issuer is not an intermediary for the purposes of this Convention.

*Article 2**[Sphere of application]*

This Convention applies where –

- (a) ~~the applicable conflict of laws rules of the forum state~~ designate the law in force in a Contracting State as the applicable law; or
- (b) the circumstances do not involve a choice in favour of any law other than the law ~~of in force in the forum state and the forum state is~~ a Contracting State.

*Article 3**[Central Securities Depositories]*

—This Convention does not apply to the activity of creation, recording or reconciliation of securities conducted by central securities depositories or other persons *vis-à-vis* the issuer of those securities.

*Article 3 bis**[Performance of functions of intermediaries by other persons]*

~~1. - A Contracting State may declare that under its non-Convention law, in respect of securities accounts, or securities accounts of any category or description, for which the law of that Contracting State is the non-Convention law, a person other than the relevant intermediary is responsible for the performance of a function or functions (but not all functions) of the relevant intermediary under this Convention, either generally or in respect of intermediated securities, or securities accounts, of any category or description.~~

~~2. - A declaration under this Article shall~~

~~(a) specify, if applicable, the securities accounts or the category or description of intermediated securities or securities accounts, to which the declaration relates applies;~~

~~(b) identify, by name or description~~

~~i) the relevant intermediary;~~

~~ii) the parties to the account agreement for such securities accounts or category or description of securities accounts; and~~

~~iii) e. identify, by name or description, the person or persons other than the relevant intermediary who is or are responsible as described in paragraph 1; and~~

\_\_\_\_\_ (d) specify, with respect to each such person, the functions for which it is so responsible and, if applicable, the relevant ~~securities accounts or~~ category or description of intermediated securities or securities accounts.

\_\_\_\_\_ 3. - ~~{Subject to any express provision to the contrary,} in any case~~ where a declaration under this Article applies, references in any provision in this Convention to an intermediary or the relevant intermediary are to the person responsible for performing the function to which that provision applies.

#### *Article 4*

#### *[Principles of interpretation]*

In the implementation, interpretation and application of this Convention, regard is to be had to its purposes, to the general principles on which it is based, to its international character and to the need to promote uniformity and predictability in its application.

### **CHAPTER II – RIGHTS OF THE ACCOUNT HOLDER**

#### *Article 5*

#### *[Intermediated securities]*

1. - The credit of securities to a securities account confers on the account holder:
  - (a) the right to receive and exercise the rights attached to the securities, including in particular dividends, other distributions and voting rights
    - (i) where the account holder is not an intermediary or is an intermediary acting for its own account; and,
    - (ii) in any other case, if provided by the non-Convention law ~~so provides~~;
  - (b) the right, by instructions to the relevant intermediary, to effect a disposition under Article 7 or grant an interest under Article 8;
  - (c) the right, by instructions to the relevant intermediary, to cause the securities to be held otherwise than through a securities account, to the extent permitted ~~by under~~ the law under which the securities are constituted, the terms of the securities, the non-Convention law and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system;
  - (d) unless otherwise provided in this Convention, such other rights, including rights and interests in securities, as may be conferred by the non-Convention law.
2. - Unless otherwise provided in this Convention,
  - (a) the rights referred to in paragraph 1 are effective against third parties;
  - (b) the rights referred to in paragraph 1(a) may be exercised against the relevant intermediary or the issuer of the securities, or both, in accordance with this Convention, the terms of the securities and the law under which the securities are constituted;
  - (c) the rights referred to in paragraph 1(b) and 1(c) may be exercised only against the relevant intermediary.

3. - Where an account holder has acquired a security interest, or a limited interest other than a security interest, by credit of securities to its securities account under Article 7(4), the non-Convention law determines any limits on the rights described in paragraph 1.

*Article 6*

*[Measures to enable account holders to receive and exercise rights]*

1. - An intermediary must take appropriate measures to enable its account holders to receive and exercise the rights specified in Article 5(1), but this obligation does not require the relevant intermediary to take any action that is not within its power or to establish a securities account with another intermediary.

2. - This ~~Chapter Article~~ Article does not affect any right of the account holder against the issuer of the securities.

**CHAPTER III – TRANSFER OF INTERMEDIATED SECURITIES**

*Article 7*

*[Acquisition and disposition by debit and credit]*

1. - Subject to Article 11, intermediated securities are acquired by an account holder by the credit of securities to that account holder's securities account.

2. - No further step is necessary, or may be required by the non-Convention law, to render the acquisition of intermediated securities effective against third parties.

3. - Subject to Article 11, intermediated securities are disposed of by an account holder by the debit of securities to that account holder's securities account.

4. - A security interest, or a limited interest other than a security interest, in intermediated securities may be acquired and disposed of by debit and credit of securities to securities accounts under this Article.

5. - Nothing in this Convention limits the effectiveness of debits and credits to securities accounts which are effected on a net basis in respect of securities of the same description.

*Article 8*

*[Grant of interests in intermediated securities by other methods]*

1. - An account holder grants an interest in intermediated securities, including a security interest or a limited interest other than a security interest, to another person so as to be effective against third parties if -

(a) the account holder enters into an agreement with or in favour of that person;  
and



(b) one of the conditions specified in paragraph 2 applies and the relevant Contracting State has made a declaration in respect of that condition under paragraph 4; and no further step is necessary, or may be required by the non-Convention law, to render the interest effective against third parties.

2. - The conditions referred to in paragraph 1(b) are as follows -

- (a) that the person to whom the interest is granted is the relevant intermediary;
- (b) that a designating entry in favour of that person has been made;
- (c) that a control agreement in favour of that person applies.

3. - An interest in intermediated securities may be granted under this Article so as to be effective against third parties –

(a) in respect of a securities account (and such an interest extends to all intermediated securities from time to time standing to the credit of the relevant securities account);

(b) in respect of a specified category, quantity, proportion or value of the intermediated securities from time to time standing to the credit of a securities account.

4. - A Contracting State may declare that under its ~~non-Convention~~ law –

(a) the condition specified in any one or more of sub-paragraphs (a) to (c) of paragraph 2 is sufficient to render an interest effective against third parties;

(b) this Article shall not apply in relation to interests in intermediated securities granted by or to parties falling within such categories as may be specified in the declaration;

(c) paragraph 3, or either sub-paragraph of paragraph 3, does not apply;

(d) paragraph 3(b) applies with such modifications as may be specified in the declaration.

5. - A declaration in respect of Paragraph 2(b) shall specify whether a designating entry has the effect described in Article 1(l)(i) or Article 1(l)(ii) or both.

6. - A declaration in respect of Paragraph 2(c) shall specify whether a control agreement must include the provision described in Article 1(k)(i) or Article 1(k)(ii) or both.

~~7~~5. - The non-Convention law determines in what circumstances a non-consensual security interest in intermediated securities may arise and become effective against third parties.

#### *Article 9*

#### *[Other methods under non-Convention law]*

This Convention does not preclude any method provided by the non-Convention law –

(a) for the acquisition or disposition of intermediated securities or of an interest in intermediated securities;

(b) for the creation of an interest in intermediated securities and for making such an interest effective against third parties;

other than the methods provided by Articles 7 and 8.

*Article 10*  
*[Evidential requirements]*

The non-Convention law determines the evidential requirements in respect of the matters referred to in Articles 7 and 8.

*Article 11*  
*[Invalidity and reversal]*

1. - A debit of securities to a securities account or a designating entry is invalid if the relevant intermediary is not authorised to make that debit or designating entry:

(a) by the account holder and, in the case of a debit or designating entry that relates to intermediated securities which are subject to an interest granted under Article 8, by the person to whom that interest is granted; or

(b) by the non-Convention law.

2. - Subject to Article[s] 12 [and 13], the non-Convention law and, to the extent permitted by the non-Convention law, an account agreement or the uniform rules of a securities settlement system determine –

(a) subject to paragraph 1(a), the validity of a debit, credit or designating entry;

(b) whether a debit, credit or designating entry is liable to be reversed;

(c) where a debit, credit or designating entry is liable to be reversed, its effect (if any) against third parties and the consequences of reversal;

(d) whether and in what circumstances a debit, credit or designating entry may be made subject to a condition; and

(e) where a debit, credit or designating entry is made subject to a condition, its effect (if any) against third parties before the condition is fulfilled and the consequences of the fulfilment or non-fulfilment of the condition.

*Article 12*  
*[Acquisition by an innocent person of intermediated securities]*

1. - Where securities are credited to the securities account of an account holder at a time when the account holder does not know that another person has an interest in securities or intermediated securities and that the credit violates the rights of that other person with respect to that interest -

(a) the account holder is not subject to the interest of that other person;

(b) the account holder is not liable to that other person; and

(c) the credit is not invalid or liable to be reversed on the ground that the interest or rights of that other person invalidate any previous debit or credit made to another securities account.

\_\_\_\_2. - Where securities are credited to the securities account of an account holder, or an interest becomes effective against third parties under Article 8, at a time when the account holder or the person to whom the interest is granted does not know of an earlier defective entry –

(a) the credit or interest is not rendered invalid, ineffective against third parties or liable to be reversed as a result of that defective entry; and

(b) the account holder, or the person to whom the interest is granted, is not liable to anyone who would benefit from the invalidity or reversal of that defective entry.

3. - Paragraphs 1 and 2 do not apply in respect of an acquisition of securities, other than the grant of a security interest, made by way of gift or otherwise gratuitously.

4. - For the purposes of this Article –

(a) “*defective entry*” means a credit of securities or designating entry which is invalid or liable to be reversed, including a conditional credit or designating entry which becomes invalid or liable to be reversed by reason of the operation or non-fulfilment of the condition;

[(b) a person knows of an interest or fact if that person –

(i) has actual knowledge of the interest or fact; or

(ii) has knowledge of facts sufficient to indicate that there is a significant probability that the interest or fact exists and deliberately avoids information that would establish that this is the case; and

(c) when the person referred to in (b) is an organisation, it knows of an interest or fact from the time when the interest or fact is or ought reasonably to have been brought to the attention of the individual responsible for the matter to which the interest or fact is relevant.]

5. - To the extent permitted by the non-Convention law, paragraph 2 is subject to any provision of the uniform rules of a securities settlement system or of the account agreement.

#### Article 13

##### *[Priority among competing interests]*

1. - This Article determines priority between interests in the same intermediated securities which become effective against third parties under Article 8 or Article 9.

2. - Subject to paragraph 5 and Article 14, interests that become effective against third parties under Article 8 have priority over any interest that becomes effective against third parties by any other method provided permitted by the non-Convention law.

3. - Interests that become effective against third parties under Article 8 rank among themselves according to the time of occurrence of the following events –

(a) if the relevant intermediary is itself the holder of the interest, when the agreement granting the interest is entered into;

(b) when a designating entry is made;

(c) when a control agreement is entered into, or, if applicable, a notice is given to the relevant intermediary.

4. - Where an intermediary has an interest that has become effective against third parties under Article 8 and makes a designation or enters into a control agreement with the consequence that an interest of another person becomes effective against third parties, the interest of that other person has priority over the interest of the intermediary unless that other person and the intermediary expressly agree otherwise.

5. - A non-consensual security interest in intermediated securities arising or recognised under any provision ~~rule~~ of the non-Convention law has such priority as is afforded to it by that law.

6. - As between persons entitled to any interests referred to in paragraphs 2, 3 and 4 and, to the extent permitted by the non-Convention law, paragraph 5, the priorities provided by this Article may be varied by agreement between those persons, but any such agreement does not affect third parties.

*Article 14*

*[Priority of interests granted by an intermediary]*

1. - Except as provided by paragraph 2, this Convention does not determine the priority or the relative rights and interests between the rights of account holders of an intermediary and interests granted by that intermediary that have become effective so as to be effective against third parties under Article 8.

2. - An interest in intermediated securities granted by an intermediary so as to become effective against third parties under Article 8 has priority over the rights of account holders of that intermediary if at the time the interest becomes so effective [the test in Article 12 is satisfied].

**CHAPTER IV – INTEGRITY OF THE INTERMEDIATED HOLDING SYSTEM**

*Article 15*

*[Effectiveness of rights in insolvency proceedings Rights of account holders in case of insolvency of intermediary]*

1. - The rights of an account holder under Article 5(1), and an interest that has become effective against third parties under Article 8, are effective against the insolvency administrator and creditors in any insolvency proceeding in respect of the relevant intermediary or in respect of any other person responsible for the performance of a function of the relevant intermediary under Article 3bis.

2. - Nothing in this Convention impairs the effectiveness of an interest in intermediated securities against the insolvency administrator and creditors in any insolvency proceeding where that interest is effective under the non-Convention law.

*Article 16*

*[Effects of insolvency]*

Subject to Article 23 and Article 31, nothing in this Convention affects:

- (a) any rules of law applicable in insolvency proceedings relating to the avoidance of a transaction as a preference or a transfer in fraud of creditors; or
- (b) any rules of procedure relating to the enforcement of rights to property which is under the control or supervision of an insolvency administrator.

*Article 17*  
*[Prohibition of upper-tier attachment]*

1. - Subject to paragraph 3, no attachment of intermediated securities of an account holder shall be made against, or so as to affect –

- a) a securities account of any person other than that account holder;
- b) the issuer of any securities credited to a securities account of that account holder; or
- c) a person other than the account holder and the relevant intermediary. ~~of or in respect of intermediated securities of an account holder shall be granted or made against the issuer of the relevant securities or against any person other than the relevant intermediary.~~

2. - In this Article "attachment of intermediated securities of an account holder" means any judicial, administrative or other act or process to freeze, restrict or impound intermediated securities of that account holder in order to enforce or satisfy ~~for enforcing or satisfying~~ a judgment, award or other judicial, arbitral, administrative or other decision against or in respect of that account holder or for freezing, restricting or impounding property of the account holder in order or in order to ensure the availability of such intermediated securities ~~to ensure its availability~~ to enforce or satisfy any future such judgment, award or decision.

~~3.~~ 3. - A Contracting State may declare that ~~where the law of that Contracting State is under its~~ the non-Convention law, an attachment of intermediated securities of an account holder made against ~~against or so as to affect~~ a person other than the relevant intermediary has effect also against the relevant intermediary. Any such declaration shall identify that other person by name or description and shall specify the time at which such an attachment ~~made against that other person~~ becomes effective against the relevant intermediary.

*Article 18*  
*[Instructions to the intermediary]*

1. - An intermediary is neither bound nor entitled to give effect to any instructions with respect to intermediated securities of an account holder given by any person other than that account holder.

2. - Paragraph 1 is subject to:

- (a) the provisions of the account agreement, any other agreement between the intermediary and the account holder or any other agreement entered into by the intermediary with the consent of the account holder;
- (b) the rights of any person (including the intermediary) who holds an interest that has become effective against third parties under Article 8;
- (c) subject to Article 17, any judgment, award, order or decision of a court, tribunal or other judicial or administrative authority of competent jurisdiction;
- (d) any applicable provision ~~rule~~ of the non-Convention law; and
- (e) where the intermediary is the operator of a securities settlement system, the uniform rules of that system.

*Article 19*

*[Requirement to hold Holding or availability of sufficient securities]*

1. - An intermediary must, for each description of securities, hold or have available for the benefit of its account holders other than itself ~~hold~~ securities and intermediated securities of an aggregate number ~~or an~~ amount equal to the aggregate number ~~or an~~ amount of securities of that description credited to securities accounts which it maintains for such account holders.

2. - An intermediary may comply with paragraph 1 -

(a) by procuring that securities are held on the register of the issuer in the name, or for the account, of its account holders;

(b) by holding securities as the registered holder on the register of the issuer;

(c) by possession of certificates or other documents of title;

(d) by holding intermediated securities with another intermediary; or

(e) by any other appropriate method.

~~32. - If at any time the requirements of paragraph 1 are not complied with, the intermediary must an intermediary does not hold sufficient securities and intermediated securities of any description in accordance with paragraph 1, it must within the time required provided by the non-Convention law take such action as is necessary to ensure that it holds sufficient securities and intermediated securities of that description~~ compliance with those requirements.

~~43. - The preceding paragraphs do~~ This Article does not affect any provision of the non-Convention law, or, to the extent permitted by the non-Convention law, any provision of the uniform rules of a securities settlement system or of an account agreement, relating to the method of complying with the requirements of ~~those paragraphs~~ this Article or the allocation of the cost of ensuring compliance with those requirements or otherwise relating to the consequences of failure to comply with those requirements.

*Article 20*

*[Limitations on obligations and liabilities of intermediaries Obligations and liability of intermediaries]*

**[to be relocated]**

~~1.-~~ The obligations of an intermediary under this Convention and the extent of the liability of an intermediary in respect of those obligations are subject to any applicable provision of the non-Convention law and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system.

~~2. - [An intermediary, including the] [The] operator of a securities settlement system, who makes a debit, credit, or designating entry (an "entry") to a securities account maintained by the [intermediary] [operator] for an account holder is not liable to a third party who has an interest in intermediated securities and whose rights are violated by the entry unless -~~

~~(a) the [intermediary] [operator] makes the entry after the [intermediary] [operator] has been served with legal process restraining it from doing so, issued by a court of~~

competent jurisdiction, and has had a reasonable opportunity to act on that legal process; or

~~———— (b) — the [intermediary] [operator] acts wrongfully and in concert with another person to violate the rights of that third party.~~

~~———— 3. — Paragraph 2 does not affect any liability of the [intermediary] [operator]—~~

~~———— (a) — to the account holder or a person to whom the account holder has granted an interest that has become effective against third parties under Article 8; or~~

~~———— (b) — that arises from an entry which the [intermediary] [operator] is not entitled to make under Article 18.~~

~~———— 4. — The operator of a securities settlement system or securities clearing system to whose securities account securities are credited and who authorises a matching debit of those securities to its securities account is not liable to a third party who has an interest in intermediated securities and whose rights are violated by that credit or debit unless—~~

~~———— (a) — the operator receives the credit or authorises the debit after the operator has been served with legal process restraining it from doing so, issued by a court of competent jurisdiction, and has had a reasonable opportunity to act on that legal process; or~~

~~———— (b) — the operator acts wrongfully and in concert with another person to violate the rights of that third party.~~

#### Article 21

##### *[Allocation of securities to account holders' rights]*

1. - Securities and intermediated securities of each description held by an intermediary as described in Article 19(2) ~~or credited to securities accounts held by an intermediary with another intermediary~~ shall be allocated to the rights of the account holders of ~~the former~~ that intermediary to the extent necessary to ensure compliance with Article 19(1). ~~that the aggregate number or amount of the securities of that description so allocated is equal to the aggregate number or amount of such securities credited to securities accounts maintained by the intermediary for account holders other than itself.~~

2. - Subject to Article 14, securities and intermediated securities allocated under paragraph 1 shall not form part of the property of the intermediary available for distribution among or realisation for the benefit of creditors of the intermediary.

3. - The allocation required by paragraph 1 shall be effected by the non-Convention law and, to the extent required or permitted by the non-Convention law, by arrangements made by the ~~relevant~~ intermediary.

4. - The arrangements referred to in paragraph 3 may include arrangements under which an intermediary holds securities and intermediated securities in segregated form –

(a) for the benefit of its account holders generally; or

(b) for the benefit of particular account holders or groups of account holders;

in such manner as to ensure that such securities and intermediated securities are allocated in accordance with paragraph 1.

5. - A Contracting State may declare that under its non-Convention law the allocation required by paragraph 1 applies only to securities and intermediated securities that are held by ~~the relevant~~ an intermediary in segregated form under arrangements such as are referred to in paragraph 4 and does not apply to securities and intermediated securities held by ~~the relevant~~ an intermediary for its own account.

[...]

**CHAPTER VII – FINAL CLAUSES***Article X*  
*[Applicability of Declarations]*

A declaration made by a Contracting State under any article of this Convention is applicable only if the law of that Contracting State is the non-Convention law.



**COMMENTS BY THE ZENTRALER KREDITAUSSCHUSS AND  
BUNDESVERBAND INVESTMENT UND ASSET MANAGEMENT**

**Chapter I**

**Sphere of application (Art. 2)**

The sphere of application of the Convention has been modified and supplemented by yet another case specified in letter (b). It is not clear, however, why the sphere of application is defined in such complicated terms. After all, letter (b) does not provide any new rule, but consistently leads to the same result as letter (a) in that in the absence of a choice in favour of any law other than that of the forum state and if the forum state is a Contracting State (i.e. the two criteria of letter (b)), the law of the latter shall be applicable. As, however, the same result is entailed by the application of the rule spelled out in letter (a), Art. 2 should remain confined to that rule.

<p><i>Article 2</i> [Sphere of application]</p> <p>This Convention applies where</p> <p style="padding-left: 40px;"><del>(a) — the conflict of laws rules of the forum state designate the law in force in a Contracting State as the applicable law; or</del></p> <p style="padding-left: 40px;"><del>(b) — the circumstances do not involve a choice in favour of any law other than the law in force in the forum state and the forum state is a Contracting State.</del></p>
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**Chapter II**

**Exercise of rights by the securities holder (Art. 6 para. 2)**

Art. 6 para. 2 provides that the provisions of Art. 6 do not affect the rights of the account holder against the issuer of the securities. We believe that this rule is too narrowly conceived. What it should rather say is that the *Convention* as such must not have an impact on those rights which a security, held by an intermediary pursuant to the Convention, confers to its holder against the issuer. After all, the intention is that neither the form nor the country of custody is to have any influence on the rights arising from the instrument in favour of the security holder against the issuer.

This also applies to the substantive company and securities law of every Contracting State. If, consequently, section 67 para. 2 of the German Stock Companies Act makes the status of a holder of registered shares vis-à-vis the issuer contingent on the holder's entry in a register, this must not be influenced by the Convention. That the terms and conditions of issue must not be affected by the Convention either is already provided for in Art. 24. We therefore suggest that Art. 6 para. 2 be re-worded to read as follows:

<p>2. This <del>Article</del> Convention does not affect any right of the account holder against the issuer of the securities or the terms and conditions concerning the securities set forth by the laws applicable to the creation of the securities.</p>
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### **Chapter III**

#### **Creation of a security by crediting securities to securities accounts (Art. 7 para. 4)**

The acquisition of a security interest pursuant to Art. 7 para. 4 involves the crediting of securities to securities accounts, so that as a matter of principle the rights specified in Art. 5 ("The credit of securities to a securities account confers to the account holder ...") are also acquired. With regard to the effect of a credit on a securities account by virtue of the creation of a security interest pursuant to Art. 7 para. 4, Art. 5 para. 3 makes reference to national law which may in particular limit the rights ensuing from Art. 5 para. 1. We welcome this possibility because this would continue to make it possible for liens to be created by transfer of the securities to a special account of the lienor. After all, the lienor does not have all of the rights listed in Art. 5 para. 1. In any event, it would be imperative, in the context of the implementation of the Convention, for national law to be unequivocal about the legal position of the collateral taker (both in case of transfer by way of security and the creation of liens).

#### **Creation of a security interest by designating entry (Art. 8 para. 2 (b))**

Prerequisites for the creation of a security interest by designating entry are an agreement between the securities account holder and the collateral taker (Art. 8 para. 1 (a)) and a designating entry in favour of the collateral taker (Art. 8 para. 2 (b)). The wording of Art. 8 para. 2 (b) could be interpreted to mean - albeit unintentionally - that as a prerequisite for the creation of a security interest the designating entry must be made prior to the agreement between the securities account holder and the collateral taker. Art. 8 para. 2 (b) should therefore be modified to read:

(b) that a designating entry in favour of that person <u>exists</u> <del>has been made</del> .
--

#### **Subject matter of a security interest acquired in any way other than by entry (Art. 8 para. 3).**

Art. 8 para. 3 (b) provides for the opportunity of giving rise to security interests also in respect of a quantity, a proportion or a value of securities. This flexibility is likely to contrast, in special scenarios, with the substantive principle of certainty applicable in Germany. The fact that the principle of certainty is also applicable under the Convention can be deduced from Art. 1 (k) and (l): Both in case of a control agreement (letter (k)) and a designating entry (letter (l)) it is permissible to withdraw from the securities account holder's control only part of the securities credited to the securities account. ("that the relevant intermediary is not permitted to comply with any instruction ... in respect of the intermediated securities to which the agreement relates" and "... in relation to which the entry is made").

A security interest in securities that is only defined in terms of value defies any determination of those securities that are encumbered with a security interest as the value may fluctuate. Therefore, both "proportion" and "value" should be deleted from Art. 8 para. 3:

(b) in respect of a specified category, <u>or</u> quantity, <del>proportion or value</del> of the intermediated securities from time to time standing to the credit of a securities account.
--

### **Acquisition by an innocent person (Art. 12)**

The new regulation on acquisition by an innocent person meets with our approval. As it has appeared difficult to reconcile the concept of adverse claim embodied in earlier drafts of the Convention as a loan from US law with the continental European legal tradition, the neutral approach now found is very much to be welcomed.

Likewise, the rule newly incorporated into the Draft (Art. 12 para. 2) to the effect that a credit made on the basis of earlier defective entries is not ineffective if the securities account holder of the subsequent credit was unaware of the preceding entry should be basically apt to maintain the current functioning of the clearing system for settling transactions in securities. The legal consequence of any acquisition pursuant to Art. 12 para. 2 is in our view that of course the party entitled to require the preceding defective entry to be reversed will lose that right to reversal following acquisition by a third party based on Art. 12 para. 2. This ensures at the same time that Art. 12 para. 2 does not entail a proliferation of securities, viz. of claims against the issuer.

Art. 12 para. 4 (b) (ii) („... deliberately avoids information that would establish that this [the existence of interests or fact] is the case“) must not be interpreted to mean that the collateral taker is obligated to make inquiries. The descriptive notes should therefore make it clear that the above wording of Art. 12 para. 4 does not give rise to any obligation to investigate.

The same applies to the assumption of knowledge within the "organisation" as this term may be construed so broadly as to justify even an attribution of knowledge to a group of affiliated companies, which is why we ask for a corresponding clarification in the descriptive notes on this point as well.

### **Priority among security interests – sphere of application of the rule (Art. 13)**

Art. 13 governs priority among such security interests in intermediated securities acquired pursuant to Art. 8, i.e. without entry on the securities account. However, the priority clause should be extended to include those security interests that were created by credit to the securities account (Art. 7 para. 4) as conflicts may arise among collateral takers in these cases, too. Moreover, it appears that the purpose of Art. 13 para. 2 is to give priority to all security interests created pursuant to the rules of the Convention, viz. both pursuant to Art. 7 para. 4 and pursuant to Art. 8, over other security interests created pursuant to the rules of national law. Therefore, in each paragraph of Art. 13, the words "under Article 8" should in every instance be replaced by the words "under Article 7 paragraph 4 or under Article 8".

Pursuant to Art. 13 para. 2, a security interest created under the Convention has priority over those security interests that become effective by any other method permitted by non-Convention law. In this context, we wish to comment on the working paper prepared by a sub working group chaired by the Swiss delegation, which dealt with the transitional problem relating to the order of priority of security interests in intermediated securities (Study LXXVIII - Doc. 59, annex). The sub working group examined ways of determining the ranking of security interests effectively created before entry into force of the Convention as against security interests created after that point in time. If the security interests created before entry into force of the Convention fail to satisfy the requirements of Art. 8 – because these were unknown at the point in time of their creation – while the security interests created after entry into force of the Convention do satisfy these requirements, the legal consequence of Art. 13 para. 2 appears to be that the first mentioned security interests have a lower priority than those mentioned last, which were acquired in pursuance with the Convention.

To solve this problem the sub working group submits two proposals:

- A transitional period during which collateral takers may subsequently satisfy in respect of "old" security interests the requirements of Art. 8 of the Convention in order to obtain the pertinent priority;
- A grandfathering clause pursuant to which "old" security interests would retain their priority also in relation to "new" security interests.

We oppose the option of a transitional period for the adjustment of "old" security interests. Such an arrangement is likely to produce ambiguous legal relationships if, on the one hand, the collateral taker of an "old" security interest has not made use as yet of the subsequent satisfaction of the Convention's requirements for the creation of security interests while, on the other, a "new" security interest has already been created pursuant to the Convention. Moreover, this would not only impose substantial expenses on both intermediaries and collateral takers, but would also produce inequitable results for those collateral takers which have not learnt about the transitional period and therefore missed the deadline. This is likely to affect in particular private individuals and small enterprises acting as collateral takers.

We therefore support the option of a grandfathering clause. In so doing, we understand Art. 13 para. 2 to mean on account of its wording („*have priority over any interest that becomes effective*“) that the lower priority is exclusively confined to security interests created pursuant to non-Convention law after the Convention entered into force in the given country while security interests already existing when the Convention enters into force are not, in our view, governed by Art. 13 para. 2. While, on this understanding, a grandfathering clause could be dispensable, a clarification in the descriptive notes might nevertheless be advisable.

## **Chapter IV**

### **The obligation of intermediaries to hold sufficient securities (Art. 19)**

At the end of Art. 19 para. 1 the words "for account holders" have been deleted, which is very much to be welcomed as otherwise it would not have been comprehensible why an intermediary should be permitted to credit securities to itself if it did not hold such securities for its own account in the first place. Now that the above words have been deleted it is clear that an intermediary is required to maintain sufficient cover for all credits to securities accounts it makes, including in its own favour.

Equally appropriate is the rule now embodied in Art. 19 para. 2 to the effect that the deadline by which the intermediary must hold sufficient securities is to be governed by national law given that this obligation is handled differently in each state as a result of the organically grown divergent structures in the settlement of securities transactions. Moreover, there are now as before no major systemic risks associated with the existence of different deadlines for the procurement of sufficient cover in various countries.

### **Limitation of the intermediary's liability (Art. 20 para. 2)**

What remains to be settled with regard to Art. 20 para. 2 is whether or not the limitation of liability provided for therein is to be confined to operators of securities settlement systems or rather to be extended to include intermediaries. We are strongly in favour of according the benefit of the limitation of liabilities also to those intermediaries which are not operators of securities settlement systems as this is a sine qua non for the proper functioning of the clearing system for settling transactions in securities. After all, it is the meaning and purpose of limiting liability to enable those

who are entrusted with the credit and debit of securities within the clearing system for settling transactions in securities to do so unimpaired by any potential civil liability for the benefit of the proper functioning of the securities settlement systems. This does not only apply to the operators of securities settlement systems, but in equal measure to the intermediaries making entries within such a system without being operators themselves.

### **Allocation of securities to account holders' rights and loss sharing in case of insolvency of the intermediary (Art. 21 and 22)**

Art. 21 obligates an intermediary to allocate all securities it holds or that are credited to securities accounts it holds with other intermediaries to the extent necessary to the credits it has allocated to its clients. Art. 22 provides for loss sharing if - in case of insolvency of the intermediary - the number of the intermediary's securities thus allocated is less than the number of securities the intermediary has credited to its clients.

To begin with, this gives rise to the question why Art. 22 should only be applicable in case of insolvency proceedings (Art. 22 para. 1). Lack of coverage may occur also outside insolvency proceedings for various reasons, so that a loss sharing rule should be available also in these cases which appear not to be properly taken care of in all respects by Art. 19 paras. 2 and 3.

What might be called for outside insolvency proceedings is the intermediary's liability in those cases where the loss was deliberately or negligently brought about by the latter (as provided for now in Art. 19 para. 2). Holding the intermediary liable for reasons for which it is not answerable, such as force majeure or measures of public authorities, would not only be inequitable but also apt to jeopardise the stability of the system, so that loss sharing among the securities account holders must be available as is, by the way, also the case under current German law.

Moreover, the system of rules on the allocation of securities and loss sharing as currently embodied in the Draft should be revised. Loss sharing pursuant to Art. 22 para. 2 presupposes that the intermediary has credited more securities to its account holders than it has allocated to them out of its own securities. So, if the intermediary had entirely neglected its allocating obligations pursuant to Art. 21, the account holders would not (in case of insolvency) receive any securities at all even if the intermediary, while possibly holding sufficient securities, simply failed to allocate them. However, the number of securities allocated or not allocated by the intermediary cannot be the decisive point.

The complementary rules on allocation (Art. 21) and loss sharing (Art. 22) should basically be designed differently:

Securities acquired by an intermediary through a transaction for its own account shall be directly allocated to it. Beyond that the intermediary may allocate to itself only such number out of the securities held by it that the remaining number of securities - i.e. those not allocated to the intermediary - does not fall short of the number credited by it to its clients.

This would reverse the rule currently embodied in Art. 21 in that the intermediary would allocate securities to itself rather than to its clients. As a result, different to Art. 21, all securities not allocated would be deemed to be client securities, thus serving to satisfy the clients.

With regard to loss sharing (Art. 22) this would be advantageous in that for the purpose of client satisfaction the decisive criterion would not be whether or not the intermediary had met its allocating obligation since all securities not so allocated shall be deemed to be client securities, which makes them unavailable for the satisfaction of the intermediary's creditors.

Art. 21 and 22 might read as follows:

*Article 21*

*[Allocation of securities to account holders' rights]*

1. - Securities of each description held by an intermediary or credited to securities accounts held by an intermediary with another intermediary ~~shall~~ are deemed to be allocated to the rights of the account holders of the former intermediary ~~to the extent necessary to ensure that the aggregate number or amount of the securities of that description so allocated is equal to the aggregate number or amount of such securities credited to securities accounts maintained by the intermediary for account holders other than itself.~~ unless

(a) the securities have been credited to an account of the intermediary held with another intermediary following an acquisition for the own account of the former intermediary, or

(b) the securities belong to the intermediary and have been so allocated by him.

2. - Subject to Article 14, securities allocated under paragraph 1 to the rights of the account holders shall not form part of the property of the intermediary available for distribution among or realisation for the benefit of the intermediary or be otherwise subject to claims of unsecured creditors of the intermediary.

3. The allocation required by paragraph 1 shall be effected pursuant to the domestic non-Convention law and to the extent required or permitted by the non-Convention law, by arrangements made by the relevant intermediary.

4. - The arrangements referred to in paragraph 3 may include arrangements under which an intermediary holds securities in segregated form –

(a) for the benefit of its account holders generally; or

(b) for the benefit of particular account holders or groups of account holders;

in such manner as to ensure that such securities are allocated in accordance with paragraph 1.

~~5. – A Contracting State may declare that under its non-Convention law the allocation required by paragraph 1 applies only to securities that are held by the relevant intermediary in segregated form under arrangements such as are referred to in paragraph and does not apply to securities held by the relevant intermediary for its own account.~~

*Article 22*

*[Loss sharing in case of insolvency of the intermediary]*

1. - This article applies at any time a loss in the holding of securities for the rights of account holders occurs other than by breach of duty by the relevant intermediary under Article 19. This article also applies in any insolvency proceeding in respect of an intermediary unless otherwise provided by any conflicting rule applicable in that proceeding.

2. - If the aggregate number or amount of securities of any description allocated under Article 21 to an account holder, a group of account holders or the intermediary's account holders generally is less than the aggregate number or amount of securities of that description credited to the securities accounts of that account holder, that group of account holders or the intermediary's account holders generally (as the case may be), the shortfall shall be borne –

(a) where securities have been allocated to a single account holder, by that account holder;

(b) in any other case, by the account holders to whom the relevant securities have been allocated, in proportion to the respective number or amount of securities of that description credited to their securities accounts.

3. - To the extent permitted by the non-Convention law, where the intermediary is the operator of a securities settlement system and the uniform rules of the system make provision in case of a shortfall, the shortfall shall be borne in the manner so provided.

## **Chapter V**

### **Position of issuers of securities (Art. 24)**

We welcome the changes made to Art. 24 to the effect that the obligation of the Contracting States to permit holding through intermediaries does not extend to the substance of the terms and conditions of issue. In these cases the possibility of certifying actual securities should be preserved. We also take a favourable view of the new paragraph 3 pursuant to which the Convention does not affect rules on whom an issuer is required to recognise as the holder of securities. Rather, the previous (national) rules will remain in force, which takes account of special types of securities, notably shares (registered shares).

However, as regards Art. 24 para. 2, we fear that the sphere of application is overly narrowed down by the words "in his own name" and that it consequently collides with Art. 13 of the planned EU Directive on the Exercise of Shareholders' Rights (COM(2005) 685). We therefore suggest deleting these words:

2. In particular, the law of a Contracting State shall recognise the holding of such securities by a person acting ~~in his own name~~ on behalf of another person or other persons and [...]

# 1. Report of the Transparent Systems Working Group

(prepared by the Chairs of the Working Group)

UNIDROIT CGE-4  
on Intermediated Securities,  
Rome, 21-25 May 2007

## 2. Tasks of the Working Group

- Deepen the analysis of Doc. 44 regarding transparent systems
- Examine what difficulties these systems have in application and interpretation of the draft Convention
- Examine how to deal with these difficulties in the draft Convention



### 3. Work of the Group

Steps taken:

- Working Paper (Doc. 60) in February
  - Contributions by participants
  - Draft Report (Doc. 70) in April
  - Comments by participants
  - Final report in May
- > the report is solely based on written material
- > meeting on 20 May

### 4. Structure of the report

Two parts:

- I. Presentations of different transparent systems
- II. Specific issues in relation to transparent systems
  - > Who is the relevant intermediary?
  - > Credits, debits and designating entry
  - > Prohibition of upper-tier attachment
  - > Questions relating to the CSD
  - > Others (netting, Article 24)

## 5. Part I: Descriptions of transparent systems

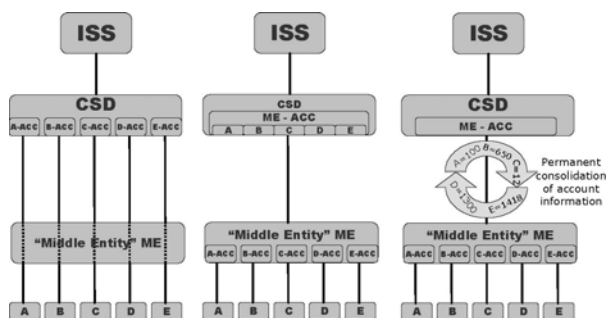
- Definition in Doc. 44

*“systems, where there are two or more entities involved in the holding chain (between the issuer and the investor) and where at the top level holdings of all lower tier account holder’s interest in intermediated securities are evidenced, in particular by means of maintaining accounts/sub-accounts for each of those lower tier account holders”.*

-> The account holder’s (investor’s) interest is recognised at the CSD level.

## 6. Various categories

Category 1      Category 2      Category 3

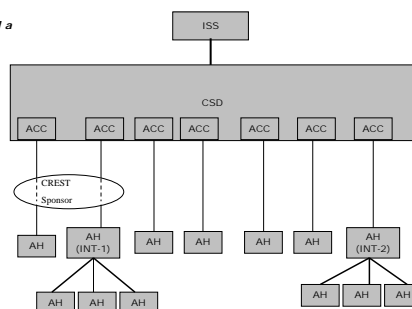


## 7. Main features

Category 1	Category 2	Category 3
The securities account is with the CSD in the name of the account holder (final investor)	The middle entity has a securities account with the CSD which is divided in sub-accounts for each account holder of the middle entity.	The middle entity has a securities account with the CSD. This account reflects the total amount of securities the middle entity holds on behalf of its account holders.
The middle entity operates the CSD accounts.	The middle entity keeps separate set of accounts in the name of account holders.	The middle entity keeps separate accounts for its account holders. Account information at both levels are regularly consolidated.

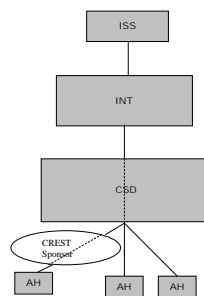
## 8. Category 4: UK domestic securities

Fig [ ] a



## 9. Category 4: UK international securities

Fig [ ] b



## 10. Part II: Issue 1- Intermediary

- What is the role of the CSD and the middle entity in various systems?
- Interpretation of the definitions of "*intermediary*" (in Article 1.d) and "*relevant intermediary*" (in Article 1.g)
- What "maintains a securities account for the account holder" means?

## 11. Interpretation by category 1

- The CSD maintains the securities account because the account is opened at the CSD in the name of the account holder. Thus, the CSD is the relevant intermediary.
- The middle entity is not an intermediary nor a relevant intermediary, because:
  - a. it merely operates the securities account of the account holder with the CSD and
  - b. it does not itself keep books/records for the account holder which would constitute a securities account (i.e. a transfer of securities cannot be effected across its books)

## 12. Proposals for category 1

- Clarifying the role of the CSD

The draft Convention should contain an explicit provision recognising that a CSD can be regarded as an intermediary. This could be made in a similar way to the HSC (Article 1.4):

*“A person shall be regarded as an intermediary for the purposes of this Convention in relation to securities which are credited to securities accounts which it maintains in the capacity of a central securities depository or which are otherwise transferable by book entry across securities accounts which it maintains.”*

## 13. Proposals for category 1

- Clarifying the role of the middle entity that is merely an account operator

The draft Convention should also contain a provision which makes it clear that a middle entity that merely operates the securities account maintained by the relevant intermediary and whose own records do not constitute a securities account is not to be regarded as an intermediary. This could be done in a similar way to the HSC (Article 1.3.b).

“A person shall not be considered an intermediary for the purposes of this Convention merely because –

a)...

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

## 14. Sharing of tasks of an intermediary in category 1

- |   |   |
|---|---|
| <ul style="list-style-type: none"> <li>• <b>CSD</b></li> <li>-&gt; “holds” securities, i.e. makes sure that securities are there for account holders</li> <li>-&gt; provides the securities accounts for account holders</li> <li>-&gt; may make entries in securities accounts, in particular in connection with settlement and corporate actions</li> <li>-&gt; may take care of the delivery of payments from the issuer to account holders</li> </ul> | <ul style="list-style-type: none"> <li>• <b>Middle entity – account operator</b></li> <li>-&gt; may act as a service interface between the CSD and the account holder</li> <li>-&gt; may make the actual entries in securities accounts at the CSD</li> <li>-&gt; may take care of delivery of payments from the issuer to the account holders</li> <li>-&gt; bears responsibility for errors and omissions in its obligations</li> </ul> |
|---|---|

## 15. Sharing of tasks of an intermediary in category 4

- **Entity**
  - > holds international securities
  - > issues depositary instruments (DI) to investors (account holders)
- **CREST**
  - > keeps records of DI for account holders

## 16. Account operators in category 1

- 1) Broad interpretation:
  - a. Account operator as an agent of the CSD.
  - b. Account operator as an agent of the account holder.
- 2) Explicit recognition:
  - a. Certain provisions of the draft Convention could be extended to account operators, if so provided by the NCL.

## 17. Common solution for sharing of tasks of an intermediary?

Sharing can occur between:

- a. The CSD and the account operator - in relation to maintaining of a securities account.
- b. The CSD maintaining securities account and another entity holding securities (issuing DI).

Proposal: Sharing of intermediary functions in above cases should be recognised in the draft Convention

## 18. Alternative interpretation of definitions of intermediary

- The middle entity is the relevant intermediary because it makes, on the basis of a mandate or an agreement with the account holder, the actual entries in securities accounts at the CSD.



## 19. Difficulties with credits and debits

- If the middle entity is the relevant intermediary, difficulties arise in relation to credits and debits as well as designating entry where the CSD has central registration activities.
- Proposals:
  - a. Each Contracting State could define how debits and credits are made to be effective against third parties.
  - b. Broad interpretation of the relevant provisions so that reflecting entries at the CSD level are possible.
  - c. Sharing model, i.e. though the middle entity is the relevant intermediary, the CSD can undertake registration functions.
- > Combined with a declaration mechanism, where relevant.

## 20. Difficulties with prohibition of upper-tier attachment

- If the middle entity is the relevant intermediary, difficulties arise in relation to the prohibition of upper-tier attachment (Article 17) where the CSD has central registration activities.
- Proposals:
  - a. Exception (that Article 17 does not apply to certain transparent systems / or upper-tier attachment is allowed in certain systems).
  - b. Opt-out possibility.
  - c. Broad application of Article 17 so that reflecting entries at the CSD level are possible.
  - d. Sharing model, i.e. though the middle entity is the relevant intermediary, the CSD can undertake registration functions.
- Combined with a declaration mechanism, where relevant.

## 21. Overview of interpretations and proposals based on them

- The CSD is the relevant intermediary because the securities account of the account holder is directly opened with the CSD
- Proposed clarifications:
  - a. CSD as intermediary;
  - b. Account operator not an intermediary;
  - c. Where the CSD is the relevant intermediary, intermediary functions can be shared with the account operator, if so permitted by NCL.
- The middle entity is the relevant intermediary because it makes the entries in securities accounts with the CSD on the basis of a mandate or agreement
- Proposals:
  - a. Effectiveness of credits, debits and designating entry dependent on NCL.
  - b. Exception from or opt-out as regards the prohibition of upper-tier attachment.

## 22. Coexistence of different interpretations

### Common solution 1:

- Possibility to choose (possibly by declaration) whether the CSD (systems 1) or the middle entity (systems 2) is an intermediary towards the investor.
- Systems 1 would still need clarifications as to the roles of the CSD and middle entity (HSC Articles 1.3.b and 1.4 + sharing of functions).
- Systems 2 would still need exceptions from the provisions on credits and debits (A 7) and prohibition of upper-tier attachment (A 17).

### Common solution 2:

- Clarifications that the CSD can be an intermediary (HSC A 1.4) and account operator not (HSC 1.3.b) for systems 1.
- Possibility to declare that the CSD is not an intermediary for systems 2 (HSC A 1.5).
- Otherwise as solution 2 (with respect to sharing of functions between the CSD and account operator and exceptions from A 7 and 17).

## 23. Issue 2: Questions relating to the top CSD (highest tier)

- Article 19: "An intermediary must,...., hold securities and intermediated securities...."
- Article 21: "Securities...held by an intermediary or credited to securities accounts held by an intermediary with another intermediary..."
- Application to the top CSD?
- -> physical securities
- -> dematerialised securities; use of issue account

## 24. Sufficient holding (A 19)

Ways of interpretation:

- a. Could and should be applied to the top CSD.
- b. Should not be applied to the CSD that is not holding securities or, in case of dematerialised securities, uses issue accounts.

## 25. Allocation of securities (A 21)

- Ways of interpretation:
  - a. Does not apply to the top CSD.
  - b. Does apply to the top CSD so that the requirements concern securities accounts with the CSD.
  - c. Does apply because an issue account corresponds to holding at the upper tier.

## 26. Loss sharing (A 22)

Close link with Article 21:

- a. If Article 21 did not apply to the top CSD, neither would Article 22.
- b. If Article 21 applied to the top CSD so that requirements would concern securities accounts with the CDS, Article 22 would be applied accordingly (A 22.2.a; segregated accounts).
- c. If Article 21 applied to an issue account at the top CSD, Article 22.2.b (pro rata) would apply.

## 27. Proposals: Clarifications

- Irrespective of which interpretation is approved as regards Articles 19, 21 and 22, the result should be clarified in the draft Convention.

## 28. CSDs (A 3)

### Negative scope

- The draft Convention does not apply to creation, recording or reconciliation of securities against the issuer.

Non-application of Articles 19, 21 and 22?

### Positive scope

- The CSD can be regarded as an intermediary
- Functions of an intermediary can be shared
- Rules of CSD
- Applicability of Articles 19, 21 and 22?

## 29. Netting (A 7.5)

- "May be effected on a net basis" raises concerns in transparent systems.
- Proposal: Make it clearer that the provision is not mandatory/subject to NCL.

## 30. Position of issuers (A 24)

- Article 24.1: "permit holding through intermediaries" should be interpreted as covering also transparent systems; also those where the securities account of the investor is directly with the CSD.
- Article 24.2: "person acting in his own name on behalf of another person" does not seem to apply in transparent systems where the securities account is directly with the CSD.

-> No incompatibilities.