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INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW

**STUDY GROUP FOR THE PREPARATION OF HARMONISED
SUBSTANTIVE RULES ON TRANSACTIONS
ON TRANSNATIONAL AND CONNECTED CAPITAL MARKETS**

**Restricted Study Group on Item 1 of the Project: Harmonised Substantive
Rules regarding Securities Held with an Intermediary**

Summary Report
3rd Session
(13 – 16 November 2003)
(prepared by the Secretariat)

Rome, November 2003

1 INTRODUCTION

The Restricted Study Group for the Preparation of *Harmonised Substantive Rules Regarding Securities Held with an Intermediary*, set up pursuant to a decision taken by the UNIDROIT Governing Council at its 80th session, held in Rome from 17 to 19 September 2001¹ and endorsed by the General Assembly of the Organisation at its 55th session held on 7 December 2001,² met in Rome at the seat of UNIDROIT for its third session from 13 to 15 November 2003. The session was opened at 09:30 a.m. on 13 November by Mr Herbert Kronke, Secretary-General of UNIDROIT, on behalf of Mr Berardino Libonati, President of UNIDROIT and Mr B. Sen, member of the UNIDROIT Governing Council and Chairman of the Study Group who especially welcomed Ms Sandra Rocks as second co-ordinator of the private financial sector.

The meeting was attended by the experts and representatives set out in *Appendix 1*.

The materials set out in *Appendix 2* were submitted to the members of the Study Group.

2 Adoption of the agenda

The Study Group approved the draft agenda after amending the proposal made by the Secretariat as it is set out in *Appendix 3* to this Report.

3 Economic impact study

As to the feasibility and the need of an economic impact study, all Members of the Study Group agreed that subject of such a study should be a comparison of the economic impact of the current legal framework for securities held with an intermediary with an ideal situation arising after the adoption and implementation of the future UNIDROIT instrument. An exercise under such broad criteria was deemed to be most difficult. The Study Group decided therefore to postpone the decision as to in which area an economic impact study is necessary and feasible.

4 Intersessional work conducted since the last meeting

Mr Philipp Paech, Secretary to the Study Group, explained the process of drawing up the Study Group's position paper and the circle of addressees that the

¹ See UNIDROIT 2001, C.D. (80) 21.

² See UNIDROIT 2001, A.G. (55) 8.

Position Paper has been sent to. He thanked those members of the Study Group who were actively involved in the drafting process.

He then illustrated the ongoing fact finding exercise and stressed that such missions are most useful not only from the point of view of actual fact finding, but also as regards mobilising support for the project in the relevant countries. He drew the members' attention to UNIDROIT 2003 S78 Doc. 9, i.e. the summary of the fact finding missions in the United Kingdom, Switzerland and France. As to findings from the USA, they would be circulated together with findings from Canada later this year. A preliminary list of issues which were the main subject of deliberations in the USA was submitted to the Group (Appendix 4). Mr Hideki Kanda, Member of the Study Group, gave an overview on the talks in New York in which he had participated.

5 Comments on the Position Paper

As to comments on the Position Paper received from the public sector and the private financial sector, Mr Paech pointed to the Documents UNIDROIT 2003 S78 Doc. 10 and 10 add1., as well as to the Secretariat's comprehensive compilation of comments which follows the structure of the Position Paper, reproduced in Appendix 5. He proposed to come to detail as regards the comments in the appropriate context of the agenda.

6 Agenda of the project / further work

The Study Group discussed an outline of the agenda of future work that had been submitted by the Secretariat. A number of members felt that the project might require a 6th session of the Study Group and that a decision on this issue would only be possible at the next meeting in March 2004.

7 Scope of the Project

With respect to a comment submitted to the Study Group by Mr Mark Evans, Travers Smith Braiswaite, London, cf. UNIDROIT 2003 Doc. 10 No.1, a question was raised over which type of holding pattern the future UNIDROIT instrument will cover. The members took the view that the scope of the project regarding the form of intermediation should be as broad as possible, i.e. it should include all forms of intermediation (regardless of whether the investor's right took the form of direct ownership or of a derived right) and also the relationship between the issuer and the tier immediately below. The Group accepted the potential for direct holding of securities through an intermediary.

There was broad agreement that all patterns of intermediated securities holding face similar problems because they are all based on a book-entry system. In particular, it was agreed that tracing of individual holdings is nearly impossible under most models. There was no agreement as to whether modern techniques of securities clearing and settlement, such as multi-tier-netting and the right of intermediaries to use their clients' assets for own purposes ("right of use")

require that there be an independent right with respect to securities at each layer of the holding structure.

8 Review of the list of items to be covered

The Study Group decided to discuss the different items to be treated by the future instrument regardless of whether they were considered for being included in the mandatory or the non-mandatory part of the instrument. There was agreement that all items currently on the list, cf. sect. 3.1 – 3.10 of the *Position Paper*, should actually be dealt with.

As to additional items, the Study Group identified the following issues to be taken into consideration. In the area of clearing and settlement of securities, it was determined that netting and/or set-off, close-out and novation could be addressed, as well as bilateral and multilateral issues such as the potential for implementing Central Counter Parties (“CCPs”). Legal problems regarding depository receipts, nominees and voting rights should also be considered.

9 Mandatory rules and benchmarks

The Study Group divided the work regarding the rules included in the future instrument into three subgroups.

9.1 SUBGROUP 1

This subgroup dealt with issues regarding protection of an investor in the event of the insolvency of its intermediary, shortfall and excess credit and formulated the following principles:

1. *The rights of account holders constituted by credit balances on their securities accounts held with an intermediary are effective against the intermediary and third parties.*
2. *Paragraph 1 applies notwithstanding insolvency proceedings in respect to the intermediary. In particular –*
 - a. *the rights referred to in paragraph 1 are effective against the insolvency administrator and creditors in an insolvency;*
 - b. *securities held by the intermediary in respect of account holders' rights are not available for creditors in an insolvency.*
3. *Securities are to be regarded as held in respect of account holders' rights when*
 - a. *any securities which are segregated for account holders are held in respect of account holders' rights;*
 - b. *if there is no segregation, the securities of a given kind held by the intermediary shall first be treated as held in respect of account holders' rights, and only the excess (if any) over the aggregate securities of that kind credited to account holders is available to creditors in the insolvency;*

- c. if insufficient securities are segregated under a, the rule in b applies.*
- 4. If the securities of a given kind held in respect of account holders' rights under 3.) are less than the aggregate securities of that kind credited to account holders, such account holders bear the deficiency pro rata.*
 - 5. Subject to paragraphs 6, 7 and [rule on reversal of credits, if any], an intermediary must ensure that at all times it holds sufficient securities in respect of account holders' rights.*
 - 6. If an intermediary holds securities of a given kind in respect of account holders' rights with another intermediary and such securities cease to be available [in consequence of the failure or insolvency of that other intermediary], the resulting deficiency shall, subject to any agreement to the contrary between the intermediary and its account holders, be allocated pro rata to the account holders to whose accounts securities of that kind are credited.*
 - 7. By way of exception to paragraph 5, the law of a Contracting State may permit an intermediary to credit securities to the securities account of an account holder in reliance on a corresponding credit of securities to a securities account held by that intermediary with another intermediary in circumstances where that intermediary has received confirmation that the corresponding credit is to be made.*

9.2 SUBGROUP 2

This subgroup treated the issues of finality, irrevocability, reversible credits, good faith acquisition. The following principles were developed:

1) Good faith acquisition

It was suggested that good faith acquisition should be dealt with through rules on irreversibility of credits. This idea was challenged on the grounds that, first it cannot apply to non-book entry dispositions, for which good faith acquisition must nevertheless be possible and, secondly, notwithstanding the irreversibility of a book-entry, some sort of good faith acquisition might be necessary to bar adverse claims ("shield").

2) Irrevocability of transfer orders

A transfer order should be irrevocable, at each step of the transfer, when the securities have been credited to the account of the account holder (be it an intermediary or the ultimate recipient of the securities), or, as determined by the rules of the settlement system at this step.

3) Irreversibility of book-entries

Unless designated as reversible, a book-entry in a securities account must not be reversible. Claims to securities credited to an account must be claims against the account holder for restitution – in kind or in value. Their application must not result in unwinding either the transfer creating the book entry or any subsequent transfer, and they should apply at every tier.

The Subgroup determined that claims in restitution are outside the scope of the future instrument, although claims based on the transferor's insolvency have not yet been specifically considered.

3a) Special rule for clearing and settlement

As challenges to the validity of a transfer of securities do not cause unwinding, but are claims against accountholders (at any link in the chain), there is debate as to whether there should be an exemption from any such claim for intermediaries which have received securities only as the result of the operation of a clearing and settlement process.

3b) "Shield"

Notwithstanding the irreversibility of credits (see 3), any account holder remains subject to adverse claims in [restitution]. Most national laws provide a shield from such claims by various means. The Subgroup raised the issue of whether the instrument should reserve the shield applicable under the PRIMA law or whether it should provide such a rule of its own.

4) Reversible book-entries

Book entries must only be admissible to the extent provided for in the custody agreement and must be designated as such in the account. A reversal of a book-entry should result in the obligation of the account holder to restore any missing quantity of the corresponding securities. Reversal must not result in unwinding subsequent transfers of the securities

The Subgroup proposed a working definition for this process: a book-entry is reversible when it can be cancelled by the intermediary without any new instruction. In the discussion that followed, some members proposed that any book-entry be reversed when entered by mistake (i.e. book entry not in conformity with the instructions received by the intermediary). Some members suggested that "flagging" should not be the only basis for reversal and that reversal should also be possible in precise circumstances described in the custody agreement. Other members disagreed, suggesting that "unflagged" credits were subject to liens and realisation procedures, not to reversal.

9.3 SUBGROUP 3

This group treated the aspects of transfer, perfection and priorities. It set out the following principles:

The mandatory segment of the instrument should provide:

- 1) that national law must recognise as valid, between transferor and transferee, transfers that are made either by book entries or otherwise.*
- 2) that national law must provide appropriate means to perfect non-book entry dispositions. Such means may include agreement by the intermediary to accept instructions of the transferee regarding disposition of the collateral, notice to the intermediary, and earmarking of the account by the intermediary, or other appropriate means.*

- 3) *that national law must provide that non-book entry dispositions can be effected by agreement to transfer a securities account without necessarily identifying the securities in the account.*
- 4) *that national law must provide that non-book entry dispositions can be effected by agreement to transfer a securities account without necessarily identifying the securities in the account.*
- 5) *that national law must provide appropriate rules for determining the priority among transferees, including particularly the priority of the interest of a securities intermediary that extends credit to an account holder.*
- 6) *that national law must provide a mean for prompt and effective realisation of collateral by a collateral taker on default of a borrower, subject only to restriction such as a requirement that realisation made in a commercially reasonable manner.*
- 7) *that national law must provide appropriate priority rules that govern the interest for lenders who take collateral from a securities intermediary and the account holders of that intermediary.*
- 8) *that national law must provide that a book entry crediting an account is sufficient to create acquisition of a security and that a book entry debiting an account is sufficient to effect a disposition of a security and that these book entries are affective against the intermediary and third parties.*

10 Role and criteria of the benchmark instrument

The Study Group discussed the role and the criteria of the second – non-mandatory part – of the future instrument.

As to its scope, the first question was whether the non-mandatory part of the instrument should only address emerging capital markets or all legal systems. The Study Group took the view that there was no reason to limit the scope of the benchmark to certain countries. First, even developed markets might benefit from the provisions set out in such an instrument. Second, the distinction between developing and developed capital markets appeared for the present exercise nearly unfeasible and rather arbitrary.

Furthermore, the Study Group discussed the question of whether the non-mandatory part should provide for “best-practice” standards or take the form of a questionnaire aimed at assessing the legislation’s degree of sophistication.

Finally, there was the question regarding the type of international instrument the future benchmark provisions might eventually be presented in. Here the Study Group took the view that it could take the form of a protocol to a future convention.

As to the content of the benchmark instrument, the Study Group agreed that

- 1) there should be a rule promoting the implementation of the *Convention on the law applicable to certain rights with respect of securities held with an intermediary*, adopted under the auspices of the Hague Conference on Private International Law;

- 2) the benchmark instrument should promote the possibility to issue dematerialised securities;
- 3) the question of non-book entry collateral interests should be addressed;
- 4) the issue whether the intermediary or a collateral taker is allowed to use the assets in custody or subject to the collateral for own purposes (especially re-pledge) should be addressed; the respective rule should require the express consent of the investor regarding the use of his assets; by the same token, the investor should dispose of a right to terminate the agreement allowing the use; he should receive a proper remuneration with respect to the right of use and there should be a restriction as regards the circle of eligible clients for such agreement; and
- 5) there should be a rule addressing the issue of segregation of clients' assets from those of the intermediary at the upper tier of the holding structure. Clients' assets should be exempt from a lien with respect to the debts of the (lower-tier) intermediary.

11 Decision on industry observers

The Study Group recognized that the success of the project depends upon obtaining the advice and the support of representatives from industry, but concluded that the immediate work must go forward within the Study Group.

12 Decision on further work / drafting process

Mr B. Sen, Chairman of the Study Group, asked Mr Luc Thévenoz, Vice-Chairman of the Study Group, to prepare a consolidated text with respect to the findings of the present Study Group meeting, which should serve as basis for the discussion at the fourth meeting. Mr Thévenoz accepted and announced consultation in this regard with members of the Study Group representing different continents and legal traditions. There was broad agreement, that this process should be strictly confidential and that the report of the Vice Chairman should not be revealed to the members of the Study Group before its finalisation.

13 Next meeting

The next meeting will be held from 25 to 27 March 2004 at the invitation by the Swiss National Bank in Gerzensee, Switzerland. There will probably a seminar with Swiss legal experts held on 24 February in Berne, Switzerland.

Mr Guy MORTON	Partner Freshfields Bruckhaus Deringer London, United Kingdom
Mr Frédéric NIZARD	Direction juridique Crédit Agricole SA Paris, France
Mr Curtis R. REITZ	Professor of Law University of Pennsylvania Law School Pennsylvania, USA
Mr Luc THÉVENOZ	Professor of Law Centre for European Legal Studies University of Geneva Faculty of Law Switzerland
Mr WU Zhipan	Vice-President Peking University Beijing, P. R. China
Observers to the Study Group	
Mr Spiros V. BAZINAS	Senior Legal Officer International Trade Law Branch Office of Legal Affairs UNCITRAL Secretariat Vienna, Austria
Mr Antoine MAFFEI	Avocat à la Cour de Paris De Pardieu Brocas Maffei & Leygonie Paris, France
Ms Sandra M. ROCKS	Counsel Cleary, Gottlieb, Steen & Hamilton New York, NY, United States of America

APPENDIX 2

MATERIALS DISTRIBUTED TO THE STUDY GROUP

- Unidroit 2003 Study LXXVIII – Doc. 9 prov., *Securities holding and dispositions in the United Kingdom, France and Switzerland*, prepared by the Secretariat;
- Unidroit 2003 Study LXXVII – Doc. 10 and Doc. 10 add. 1, *Comments on the Position Paper 2003*, compiled by the Secretariat;
- *Comments on the Position Paper – Summarising compilation of additional aspects*, prepared by the Secretariat;
- *Comments on the Position Paper following the Consultation meeting held in New York*, by Mr Jack Wiener, DTCC;
- *Draft Timetable regarding future work of the Study Group*, prepared by the Secretariat;

APPENDIX 3

**DRAFT AGENDA FOR THE 3RD SESSION OF THE STUDY GROUP ON HARMONISED
SUBSTANTIVE RULES REGARDING SECURITIES HELD WITH AN INTERMEDIARY**

1. Welcome
2. Adoption of the agenda
3. Economic impact study
 - a. Need
 - b. Definition of criteria
4. Intersessional work conducted since the last meeting
5. Comments on the Position Paper from private and public sector
6. Agenda of the project / further work
7. Scope of the project /Approach
8. Mandatory rules
 - a. Review of the items already included
 - b. Discussion on further items to be included
 - c. Discussion on the content / Terms of reference for tentative draft
9. Benchmark
 - a. Review of the items already included
 - b. Discussion on further items to be included
 - c. Discussion on the content / Terms of reference for tentative draft
10. Role / criteria of the benchmark instrument
11. Decision on industry observers
12. Decision on further work / drafting process
13. Next meeting

**UNIDROIT STUDY GROUP ON INDIRECTLY HELD SECURITIES
3RD SESSION**

Comments by Mr Jack R. Wiener, Managing Director and Deputy General Counsel,
The Depository Trust & Clearing Corporation

(following the Consultation Meeting held in New York in September 2003)

I. Issues

Following up on our meeting yesterday, if the proposed UNIDROIT Convention were to address the following issues, in addition to other good issues such as bankruptcy issues that are already under consideration, I believe that the convention would remove some troubling obstacles from cross-border clearance and settlement.

1. Applicable laws both permitting and relating to nominee holdings of securities should be clarified and harmonized.

Examples of this are in the areas of bankruptcy (there have been problems in casting bifurcated votes as nominee in China); voting rights generally (there have been problems in Switzerland); and ownership and reporting (there have been issues in this regard in France).

2. Applicable laws should be harmonized to clarify that securities may be held outside of their domestic markets.

Examples of this are problems that formerly existed in both Peru and in South Korea. In both instances, after significant discussion the countries agreed to effect a change in their domestic law.

3. Applicable laws should be harmonized to clarify that securities accounts at CSDs may be held by entities other than the beneficial owners themselves.

This has been a problem in Malaysia. Unlike the other issues, which are old problems that reflect a tension between old laws and new realities, this is a new problem that was recently introduced by the government in Malaysia.

4. Laws should allow for the existence of a central counterparty.

Central counterparties dramatically reduce risk and costs. The legal basis for the netting arrangements required in such a system should be sound and transparent.

5. Laws should allow dematerialized systems of holdings of securities.

Dematerialized systems of holding of securities, and to a large extent book-entry-only systems of holdings of securities, allow for much greater safety (individual certificates will not be lost), lesser cost (e.g., the costs to print certificates, ship them, and insure them), and speed of transfer than do fully certificated systems of holdings of securities.

6. Applicable withholding tax laws should be harmonized to simplify the process of cross-border withholding at source.

While DTC has entered into one-on-one agreements with foreign tax authorities to address this problem in certain jurisdictions, this would benefit from broad support. This recommendation directly yields tangible immediate monetary benefits to industry members.

7. Laws relating to the taxation of the transfer of securities, such as stamp duty taxes and stamp duty reserve taxes, should be reviewed with an eye as to whether they unnecessarily impede the efficiency of the capital markets and the raising of capital by issuers.

If this issue is to be discussed in other than solely domestic forums such as those of the UK and some of its former colonies, this would seem to be a forum that would be well situated to address the issue.

II. Legal Opinion Issues

In addition, when DTC establishes a cross-border link by opening an account at a non-U.S. depository, we engage counsel in the CSD's jurisdiction and ask them to answer a short series of simple questions via a legal opinion. The answers to those questions are a starting point in our attempt to flush out any possible legal problems, and impact the level of our enthusiasm in doing business in that jurisdiction.

In the event that the list may be of some interest, in that it may signal to us some issues we might cover in a possible UNIDROIT convention, the list of questions is as follows:

Legal Opinion:

The opinion will relate to the laws of the _____ (the "foreign law"), and their interplay with U.S. laws. DTC would like the opinion to cover the following matters at a minimum.

- 1) Is the delivery of the foreign security to, and the registration of the foreign security certificate in the name of, DTC's nominee valid under the foreign law?

- 2) Are subsequent book-entry transfers of interests in such securities on DTC's books and records valid under foreign law?
- 3) Are pledges in DTC's system valid under the foreign law?
- 4) Under the foreign law, will DTC (and DTC's Participants, Pledgors, and Pledgees) retain the same ownership interest in the foreign security held by a foreign custodian that it would have a U.S. security held by a U.S. custodian?
- 5) Does the foreign law require that DTC ensure that the beneficial owners of the foreign securities be limited to a class of owners that have certain characteristics (*c.f.* U.S. restrictions on communications and maritime issues, restricted securities, etc.)?
- 6) Does the foreign law require that DTC supply either the foreign issuer or a foreign regulator with trade or investor information?
- 7) Are distributions to and by DTC of monies and interests related to the foreign securities, in the manner in which such distributions are effected to and by DTC, valid under the foreign law?
- 8) What adverse tax consequences, if any, will DTC, or a U.S. beneficial owner holding through DTC, become subject to under the foreign law?
- 9) What is the effect of foreign law upon a bankruptcy of a DTC Participant or Pledgor that has an interest in such foreign securities?
- 10) What is the effect of the foreign law upon title to the custodied securities in the event of the bankruptcy or other failure of the Custodian?
- 11) In the event of a conflict of laws, will U.S. law govern?

The list could no doubt be expanded upon, and I would be interested in others had other questions they thought appropriate for such a list.

III. Proxy Issues.

The attached report commissioned by the International Corporate Governance Network highlights some problems in cross-border proxy voting. The study tracked the transmission of proxy materials and voting instructions between issuers from the US, UK, Germany, Japan, and Italy, and took note of problems where they arose. Among the problems that were noted in issuers from some of the countries were the length of time between receipt of proxy materials and the voting deadline, share-blocking, and voting on a show of hands.

If these and other identified problems could be addressed by the UNIDROIT convention, that would be a boon to cross-border securities holdings and transactions.

**WORKING PAPER REGARDING
COMMENTS ON THE POSITION PAPER (CF. DOC 10)
– SUMMARISING COMPILATION OF ADDITIONAL ASPECTS –
(prepared by the Secretariat)**

1. Usefulness of the project for developing countries

1.1 "It may be noted that the Indian legal system is very inadequate [with regard to indirectly held securities]. It is attempted here to see in what direction India is required to formulate legal relations, ... Objective of the exercise of UNIDROIT drafting a position paper is to help developing national position on the subject and then to harmonize the national position with international guiding policies and principles" (Reserve Bank of India, pp. 3 et seq., 8 et seq, see also pp. 13 et seq., 16, 19 et seq. ,).

1.2 "The ten topics mentioned in the Position Paper of the *UNIDROIT Study Group* is the problems which should been solved in indirect holding systems as soon as possible. It is a significant effort to make a thorough study on those legal issues and then promote an standard international practice on them. I think the effort made by *UNIDROIT Study Group* will better the registration and settlement practice in many countries, and will promote the cross border securities settlement activities." (SD&C)

2. Approach

2.1 "In seeking to narrow the scope of the USTA, we found that creating a sound legal basis for cross-border clearing and settlement requires a relatively narrow set of uniform commercial law rules, and that the key distinction is between

those things that *must* be technically uniform in order to legally enable cross-border transactions involving interests held through the indirect holding system,

and

areas where technical uniformity is not legally necessary to enable cross-border transactions (thus accommodating differences between national laws and market practices), but where functional consistency is necessary to provide the soundness and efficiency desired in such transactions.

We suggest that category #1 comprises only two things: conflict-of-law rules, and the description of the interest that a person holds through the indirect holding system." (Spink/Paré, p. 6)

2.2 "The legal framework for securities clearing and settlement must integrate with regulatory law in a manner that accommodates different regulatory mechanisms." (Spink/Paré)

"In the opinion of the EFMLG, any proposed reform should not affect prudential rules for participants' conduct of business in the securities markets. Furthermore, it should not advocate a specific infrastructure for the securities markets. An harmonisation of rules should be pursued to the extent that they are necessary to reduce legal or systemic risk or to promote market efficiency. It should be safeguarded that the project continues working on a functional approach." (EFMLG, p. 3)

2.3 The future instrument should apply to indirect holding systems, but not to systems as *CREST* in the UK, where a central unit plays (from its economic functions) the role of a CSD but in fact has no title to the securities. Those systems of direct holding through book-entries are most sophisticated and legally sound. Any association with indirect holding in a future instrument would therefore decrease legal certainty. (Evans)

2.4 "Since we must anticipate that market practices will continue to evolve and improve, the legal framework must accommodate and not impede such changes" (Spink/Paré, p. 4)

3. Needs of market participants as guidelines

3.1 It is impossible to protect the investor from every exposure to intermediary risk (Rogers)

3.2 "Achieving those objectives may not require all the uniform rules described. This view is consistent with much of the analysis in section 3 of the Position Paper, which recognises that most of the functional objectives described in the list of uniform rules may be achieved more simply or by alternate means, depending upon the precise nature of the interest constituted by a credit of securities to an account." (Spink/Paré, p. 6)

3.3 "The Position Paper is not very outspoken on the issue of investor protection. However, from a regulatory point of view, this is a critical point, which might merit further reflection in the document, to ensure consistency of the proposed approach with existing regulatory standards. For example, the CESR-ESCB standards for securities settlement systems which are currently being finalised might merit a reflection in the Position Paper, as they are the result of a

lengthy and in-depth discussion between the European regulators and reflect the minimum common standards required from a European perspective." (ECB, p. 3)

3.4 "Certain structures are being proposed which are only practical for a few global players (e.g. automatic securities lending to settle securities transactions). This might pose problems for smaller institutions holding deposit accounts for their customers." (ECB, p. 3)

4. Scope of uniform requirements

4.1 Additional issues which could be included

4.1.1 Interface

The UNIDROIT project should at least create an "interface" between the world of physical and dematerialised securities. (UBS)

4.1.2 Intermediary's collateral out of the custody agreement

We suggest to consider uniform rules including the terms of the intermediary's right of retention or lien for claims arising out of a custody arrangement. Even though harmonisation may not be necessary it would certainly contribute to a smooth functioning of the system. (UBS)

4.1.3 Intermediary's liability

To support soundness and efficiency of the clearing and settlement system we would deem it useful to agree on uniform rules on the intermediary's liability for its own failures and the failures of the upper tier intermediary in connection with the book-entries effected (or not effected) by them. (UBS)

5. Content of rules (Convention)

5.1 Upper tier attachment

5.1.1 "The rule precluding upper-tier attachment should not lead to a compulsory segregation of client assets and proprietary assets of the lower tier intermediary" (UBS)

5.1.2 Furthermore, to the extent that the Position Paper asks for an exclusion of any upper tier attachment, the conclusion that also issuers registers should be covered is fully shared by the ECB.

5.1.3 “[In connection to upper-tier attachment], the Position Paper suggests that the use of omnibus accounts is the prevailing solution in the market. Yet, as confirmed by the findings of the EFMLG, segregation of accounts between the intermediary’s own assets and customers’ assets is a quite commonly used technique in the markets. (ECB, p. 4)

5.2 Book entry accounts / informal dispositions

5.2.1 “In a system which distinguishes between the obligation to transfer and the transfer of title as such we hardly see a need for “informal” dispositions, although the Swiss proposal for a new Securities Custody Act does not exclude “informal” dispositions (assignment in written form)”. (UBS)

5.2.2 “The issue of ‘the role of book-entries into a securities account’ is the core issue and departing point that leads to all other listed issues. It must inevitably deal with the role that certificated securities will play once book-entries become legally relevant in countries such as Switzerland. This will of course relate directly to a variety of issues such as good faith acquisition or loss allocation. ...” (Witmer)

5.2.3 Informal disposition by account holders, which are not effected by book entry transfer nor recorded in accordance with applicable rules, should be devoid of any effect. (SD&C)

5.2.4 The Position Paper is not expressly taking a position on the legal nature of a book entry. Yet, quite a number of the conceptual problems identified in the paper are directly depending on the answer to the question whether a book entry right is constituting ownership (right in rem), just evidencing ownership or just representing a claim, should be emphasised stronger. Thus, the consequences of the different approaches should be clearly assessed and spelled out rather than in the future proposing a solution which is (silently) based on just one of those concepts. In the view of the ECB, it is necessary to ensure that holders of book entry securities have a property right, which is effective *erga omnes* in the case of default of a counterparty. We would encourage the Study Group to study and provide recommendations regarding the creation and the enforceability of rights *in rem* on indirectly held book-entry securities.” (ECB, p. 3)

5.2.5 "Section 3.2 on transfer formalities gives relevance exclusively to book-entries. This is in line with the approach taken in the Collateral Directive and also with the proposals of the EFMLG report. However, to the ECB, the Position Paper is not entirely clear as to what kind of right is being transferred. Whilst section 3.2 refers to 'property interests', it leaves the qualification open (ownership or mere claim). Another issue that is left open by the paper is the question of the moment of time when a transfer takes place (cf. the rule established by the Settlement Finality Directive) and whether a debit and a credit are to be seen as separate or as a single act (the first alternative would open the door to the creation of excess securities, see below). In a tiered system, the exact moment when a right passes from the transferor to the transferee is crucially important" (ECB, pp. 4 et seq.)

5.2.6 "In the ECB's understanding, this section suggests that dispositions not involving book entries should be possible, but ranking below book entry dispositions. This question is linked to the legal nature of a book entry (constitutive or just evidential). As a result, the ECB would suggest not to pursue this aspect further at this point in time." (ECB, p. 5)

5.2.7 The effects of book-entries in securities accounts would need to have certain harmonised characteristics. In particular, a high degree of harmonisation is required for the exact nature and extent of an investor's right as evidenced by a book-entry (which, in the view of the EFMLG should be based on ownership principles), the protection of investors' rights to the maximum extent possible, even in the case of insolvency of the intermediary, the full tradability of rights in securities as evidenced by book-entries, including the protection of acquirers in good faith, and the safeguarding a system of holdings of securities by book-entries by double entry bookkeeping and clear rules for movements of securities on accounts. (EFMLG, p. 3)

5.2.8 "Point b) in par. 2.4 and par. 3.4 state there will be the need for a rule for the so called "informal disposition" over securities. This is defined as a disposition made otherwise than a book entry in accounts. Considering that the structure envisaged by the Study Group is based on disposition via book entries, we have some problems in identifying the hypothesis of informal disposition. We would appreciate further clarification on this subject." (ECSDA, p. 7)

5.3 Good faith acquisition

5.3.1 "The Position Paper suggests a general rule that good faith acquirers should be protected. However, the paper questions whether one would have to look at both sides of a transaction or whether it would be sufficient to only focus on the acquirer's account. In our view, there is a specific problem in relation to the concept of good faith used in the Position Paper. In traditional, Roman law

based jurisdictions, acquiring ownership in good faith is based on the understanding that a *bona fida* acquirer is acquiring an ownership right to the detriment of another party who is losing its right by virtue of the *bona fida* concept. Contrary to that, the principle in the Position Paper seems to be based on the idea that acquiring in good faith leads to the creation of excess securities. However, to the extent that ownership rights are subject to a book entry transfer, this principle should not apply. If a property right is non-existent, then there is no possibility of good faith acquiring, thus no creation of a windfall. Indeed, one of the greatest risks concerning indirectly held dematerialised securities is the creation of new securities inadvertently during transfers through the chain of intermediaries. This is against the interest of systemic stability, the integrity of an issue and the protection of transferability. Consequently, the legal framework should focus on prohibiting and making impossible the creation of excess securities by legal and operational safeguards. The basic rule, as also stressed by the ESCB and the CESR-ESCB standards is that no excess is to occur and the legal and operational framework should ensure that this should not happen (the ESCB User Standard 3 on custody risk requires systems to put in place adequate procedures to check that the total amount of securities in participants' accounts is equal to the total amount of securities deposited by the issuer in the SSS). This is the principle of ensuring the integrity of the issuance. From our perspective, the Study Group should rather focus on adequate legal techniques regarding the protection of securities holders and collateral takers from any unauthorised or mistaken entry in securities accounts held in a chain of intermediaries, and not on risk management, to ensure the integrity of the issue. In the same vein, on page 15, we would suggest adding a sub-section (d) in the section dealing with account holders, raising the integrity of the issue to a general legal principle in order to ensure the holder's proprietary rights." ECB, pp. 5 et seq.)

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5.4.1 "We wish to add that it may be useful to analyse in this context the requirements set out by tax laws (taxation of change of beneficial ownership) and stock exchange regulations (change of ownership by market put through). (UBS)

5.4.2 "To the extent that the document states that there might be a need for a rule regarding net settlement (so that book-entries made by an intermediary may reflect the net overall change in the adequate balance of its account holders taken together), such a rule might conflict with rules of transparency and certainty deriving from an understanding of book-entries evidencing proprietary rights and not just claims against an intermediary." (ECB, p. 4)

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relevance of the question whether a book entry right is constituting ownership (right in rem), evidencing ownership or just representing a claim should be emphasised stronger. Many of the issues raised depend on a clear answer to this question." (ECB, p. 6)

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5.6.1 This section deals with the core of what was regulated by the Settlement Finality Directive. Yet, a novelty of the Position Paper seems to be to apply similar concepts to all intermediaries, not just to systems. In addition, the Position Paper uses quite extensively references to systemic risk, also in cases where existing procedures might just be cumbersome, but do not necessarily lead to systemic implications. To the extent that the paper refers to the possibility of reversals of transactions due to suspect periods, in our view, this is opening up the possibility to allow for unwinding, provided that further acquirers remain protected (if in good faith). This is not fully in line with the need to protect the settlement of net systems and opens up the possibility to create excess securities (with resulting losses that would have to be borne by the generality of holders of those securities). Again, the considerations that led to the abolition of reversals due to an insolvency in the Settlement Finality Directive might be of interest to the Study Group. (ECB, p. 6)

5.6.2 "Paragraph 3.7 focuses on finality and irrevocability in order to create certainty on the effected credit on an account and to protect from the risk of reversal. As the Study Group clearly states, all the issues presented in the abovementioned paragraph are included in the Settlement Finality Directive at the EU level. Maybe a good approach could be that of including the SDF solution in the future Convention. This would surely help intermediaries to reach certainty. We believe that a provision of the same contents at the level of a Convention could help intermediaries who effect book entry credits to be confident against the risk of reversal from a particular moment." (ECSDA, p. 7)

5.7 Provisional Credits

5.7.1 "Provisions on this issue should be flexible enough to cover various models". (UBS)

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repurchase operations or securities lending facilities. These arrangements are commonly used in modern settlement systems and permit to avoid any danger of artificial creation of securities." (Banque de France)

5.7.4 Whereas the Position Paper focuses on the treatment of the consequences if such excess arises, the aim of any international initiative focus should rather be on the prohibition of the creation of excess securities as such concept is fundamentally in contrast with the principles of systemic stability, the integrity of an issue and the protection of investors. In the same vein, the possibility of provisional credit is not desirable in the ECB's opinion. (ECB, p. 4)

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5.7.6 Accepting that the instrument would have a global reach, we have certain reservations in allowing provisional credits or over-crediting, let alone in establishing them as a general rule. We are aware of the considerable risks, even of systemic nature, associated with such practice. The instrument should not impose provisional credits as a standard or endorse the practice. Rather, as envisaged by the Study Group, the errors and problems which arise in practice should be dealt with in a way that tries to limit the risks. (ECSDA, p. 7)

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5.8.1 Based on the assumption that no deliberate creation of a shortfall, except for shortfalls resulting from provisional credit, is allowed, we agree to the Study Group's conclusion that the account holder's (lead) intermediary should be obliged to bear the risk. There is no need for further harmonisation except for the case that such intermediary cannot replace the securities because of its insolvency. Whilst we appreciate the difficulties of tracking a shortfall we should mention that a rule setting out that a shortfall should be borne by the account holders in proportion to the holdings of the relevant securities might discourage even from tracking clear cases in the books and records of such intermediary. Therefore, the proportional allocation of loss should only apply if it is not reasonable to trace a particular account. (UBS)

5.8.2 "Personally, I am not for excess credits. As for the excess credits resulting from fraud, and inadvertence or accident the relevant intermediary is obliged to bear the risk; when the intermediary is insolvent, the account holder's could

claim the securities in proportion to the holding of the relevant securities; as for the account holders who still suffer loss after that, it can participate the allocation of intermediary own assets. In other words, I suggest that in the case of bankruptcy, the shortfall be borne by the account holders in proportion to the holdings of the relevant securities. In the end, I think we should promote the establishment of Investors Guarantee funds, which can act as a last resort to compensate the loss to some limits, and therefore increase the confidence of investors". (SD&C)

5.8.3 "The general rule suggested in section 3.9 is accepted in the securities industry and also supported by the EFMLG report. Yet, the section might be somewhat misleading by putting too much emphasis on the occurrence of shortfalls due to the creation of excess securities. This is against the basic rule, mentioned above, that no excess is to occur and the legal and operational framework should ensure that this should not happen. Consequently, the paper should limit its attention on shortfalls to due errors or fraud on the side of the intermediary." (ECB, p. 7)

6. Benchmark instrument

6.1 Right of use

6.1.1 "To the extent that section 3.10 alludes to a possibility of an intermediary to use the securities of a client, it should be stressed that this should only be possible with the express consent of the client." (ECB, p. 7)

6.1.2 "Finally, the protection of the final investors might also require uniform rules to address the rights of use of customers' assets by intermediaries, at least stating the minimum requirement under which such use is allowed. This seemed to be the original intention expressed by the Study Group in its Second Session Report." (ECSDA, p. 7)

6.2 Insolvency of the Intermediary

6.2.1 "Regarding the contemplated legal instruments, we support the approach based on a mandatory convention with a restrictive scope of harmonisation combined with attached non mandatory standards. As a matter of fact, we feel that technical issues such as the question of a statutory dematerialisation, the bearer/registered form of the securities, or the rules for the organisation of the securities infrastructure (see for instance the segregation of accounts) as well as some sensitive matters (such as property laws and the definition of the nature of

rights on the securities) could be addressed in the non mandatory annex.” (Banque de France)

6.2.2 « The Position Paper might benefit from the considerations underlying the insolvency ring-fencing of systems in the Settlement Finality Directive and the disapplication of certain insolvency effects as provided for in the Collateral Directive. Through these Directives, a careful and effective approach to balance the interests of the community of creditors and the interests of the functioning of securities settlement systems and securities markets has been achieved. To the extent that section 3.10 intends to go beyond these principles, in our view, the document should not address insolvency issues, as this is a very specialised field of law, and perhaps just refer to the UNICTRAL draft legislative guide on insolvency. As a result, Section 3.10 becomes redundant.” (ECB, p. 7)

“We suggest that the Study Group includes *“protection of the client’s assets against the claim of general creditors of the insolvent intermediary”* in the mandatory instrument and not merely in the benchmark criteria. We wish to point out that such protection requirement is already a part of the CPSS-IOSCO Recommendations (Recommendation 12 “Protection of customers’ securities”). Priority should be given to the protection of the investor as the Study Group itself states when addressing the issue of internal soundness (par. 2.1): investor protection seems to be regarded as a benchmark for evaluating a system as sound. Confining this issue into a *“non mandatory annex to the convention”* would probably fail to meet the goal because of the non-binding nature of the instrument. To our mind, dealing with the other issues such as good faith acquisition and finality would lose relevance if this fundamental issue is not addressed. Of course there may be different solutions in the different laws to provide for the protection of the final investors’ assets but we deem that according to the importance of the issue, uniformity should be reached also as regards the manner in which protection of the final investor is achieved. We believe that this would grant the same level of protection everywhere the future Convention applies.” (ECSDA, p. 6)

7. Usefulness of the project for developing countries

7.1 “It may be noted that the Indian legal system is very inadequate [with regard to indirectly held securities]. It is attempted here to see in what direction India is required to formulate legal relations, ... Objective of the exercise of UNIDROIT drafting a position paper is to help developing national position on the subject and then to harmonize the national position with international guiding policies and principles” (Reserve Bank of India, pp. 3 et seq., 8 et seq, see also pp. 13 et seq., 16, 19 et seq. ,).

7.2 "The ten topics mentioned in the Position Paper of the *UNIDROIT Study Group* is the problems which should be solved in indirect holding systems as soon as possible. It is a significant effort to make a thorough study on those legal issues and then promote an standard international practice on them. I think the effort made by *UNIDROIT Study Group* will better the registration and settlement practice in many countries, and will promote the cross border securities settlement activities." (SD&C)

8. Approach

8.1 "In seeking to narrow the scope of the USTA, we found that creating a sound legal basis for cross-border clearing and settlement requires a relatively narrow set of uniform commercial law rules, and that the key distinction is between

those things that *must* be technically uniform in order to legally enable cross-border transactions involving interests held through the indirect holding system,

and

areas where technical uniformity is not legally necessary to enable cross-border transactions (thus accommodating differences between national laws and market practices), but where functional consistency is necessary to provide the soundness and efficiency desired in such transactions.

We suggest that category #1 comprises only two things: conflict-of-law rules, and the description of the interest that a person holds through the indirect holding system." (Spink/Paré, p. 6)

8.2 "The legal framework for securities clearing and settlement must integrate with regulatory law in a manner that accommodates different regulatory mechanisms." (Spink/Paré)

8.3 "In the opinion of the EFMLG, any proposed reform should not affect prudential rules for participants' conduct of business in the securities markets. Furthermore, it should not advocate a specific infrastructure for the securities markets. An harmonisation of rules should be pursued to the extent that they are necessary to reduce legal or systemic risk or to promote market efficiency. It should be safeguarded that the project continues working on a functional approach." (EFMLG, p. 3)

8.4 The future instrument should apply to indirect holding systems, but not to systems as *CREST* in the UK, where a central unit plays (from its economic functions) the role of a CSD but in fact has no title to the securities. Those systems of direct holding through book-entries are most sophisticated and legally sound. Any association with indirect holding in a future instrument would therefore decrease legal certainty. (Evans)

8.5 "Since we must anticipate that market practices will continue to evolve and improve, the legal framework must accommodate and not impede such changes" (Spink/Paré, p. 4)

9. Needs of market participants as guidelines

9.1 It is impossible to protect the investor from every exposure to intermediary risk (Rogers)

9.2 "Achieving those objectives may not require all the uniform rules described. This view is consistent with much of the analysis in section 3 of the Position Paper, which recognises that most of the functional objectives described in the list of uniform rules may be achieved more simply or by alternate means, depending upon the precise nature of the interest constituted by a credit of securities to an account." (Spink/Paré, p. 6)

9.3 "The Position Paper is not very outspoken on the issue of investor protection. However, from a regulatory point of view, this is a critical point, which might merit further reflection in the document, to ensure consistency of the proposed approach with existing regulatory standards. For example, the CESR-ESCB standards for securities settlement systems which are currently being finalised might merit a reflection in the Position Paper, as they are the result of a lengthy and in-depth discussion between the European regulators and reflect the minimum common standards required from a European perspective." (ECB, p. 3)

9.4 "Certain structures are being proposed which are only practical for a few global players (e.g. automatic securities lending to settle securities transactions). This might pose problems for smaller institutions holding deposit accounts for their customers." (ECB, p. 3)

10. Scope of uniform requirements

10.1 Additional issues which could be included

10.1.1 Interface

The UNIDROIT project should at least create an "interface" between the world of physical and dematerialised securities. (UBS)

10.1.2 Intermediary's collateral out of the custody agreement

We suggest to consider uniform rules including the terms of the intermediary's right of retention or lien for claims arising out of a custody arrangement. Even though harmonisation may not be necessary it would certainly contribute to a smooth functioning of the system. (UBS)

10.1.3 Intermediary's liability

To support soundness and efficiency of the clearing and settlement system we would deem it useful to agree on uniform rules on the intermediary's liability for its own failures and the failures of the upper tier intermediary in connection with the book-entries effected (or not effected) by them. (UBS)

11. Content of rules (Convention)

11.1 Upper tier attachment

11.1.1 "The rule precluding upper-tier attachment should not lead to a compulsory segregation of client assets and proprietary assets of the lower tier intermediary" (UBS)

11.1.2 Furthermore, to the extent that the Position Paper asks for an exclusion of any upper tier attachment, the conclusion that also issuers registers should be covered is fully shared by the ECB.

11.1.3 "[In connection to upper-tier attachment], the Position Paper suggests that the use of omnibus accounts is the prevailing solution in the market. Yet, as confirmed by the findings of the EFMLG, segregation of accounts between the intermediary's own assets and customers' assets is a quite commonly used technique in the markets. (ECB, p. 4)

11.2 Book entry accounts / informal dispositions

11.2.1 "In a system which distinguishes between the obligation to transfer and the transfer of title as such we hardly see a need for "informal" dispositions, although the Swiss proposal for a new Securities Custody Act does not exclude "informal" dispositions (assignment in written form)". (UBS)

11.2.2 "The issue of 'the role of book-entries into a securities account' is the core issue and departing point that leads to all other listed issues. It must

inevitably deal with the role that certificated securities will play once book-entries become legally relevant in countries such as Switzerland. This will of course relate directly to a variety of issues such as good faith acquisition or loss allocation. ..." (Witmer)

11.2.3 Informal disposition by account holders, which are not effected by book entry transfer nor recorded in accordance with applicable rules, should be devoid of any effect. (SD&C)

11.2.4 The Position Paper is not expressly taking a position on the legal nature of a book entry. Yet, quite a number of the conceptual problems identified in the paper are directly depending on the answer to the question whether a book entry right is constituting ownership (right in rem), just evidencing ownership or just representing a claim, should be emphasised stronger. Thus, the consequences of the different approaches should be clearly assessed and spelled out rather than in the future proposing a solution which is (silently) based on just one of those concepts. In the view of the ECB, it is necessary to ensure that holders of book entry securities have a property right, which is effective *erga omnes* in the case of default of a counterparty. We would encourage the Study Group to study and provide recommendations regarding the creation and the enforceability of rights *in rem* on indirectly held book-entry securities." (ECB, p. 3)

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12.2 Insolvency of the Intermediary

12.2.1 "Regarding the contemplated legal instruments, we support the approach based on a mandatory convention with a restrictive scope of harmonisation combined with attached non mandatory standards. As a matter of fact, we feel that technical issues such as the question of a statutory dematerialisation, the bearer/registered form of the securities, or the rules for the organisation of the securities infrastructure (see for instance the segregation of accounts) as well as some sensitive matters (such as property laws and the definition of the nature of rights on the securities) could be addressed in the non mandatory annex." (Banque de France)

12.2.2 « The Position Paper might benefit from the considerations underlying the insolvency ring-fencing of systems in the Settlement Finality Directive and the disapplication of certain insolvency effects as provided for in the Collateral Directive. Through these Directives, a careful and effective approach to balance the interests of the community of creditors and the interests of the functioning of securities settlement systems and securities markets has been achieved. To the extent that section 3.10 intends to go beyond these principles, in our view, the document should not address insolvency issues, as this is a very specialised field of law, and perhaps just refer to the UNICTRAL draft legislative guide on insolvency. As a result, Section 3.10 becomes redundant." (ECB, p. 7)

"We suggest that the Study Group includes *"protection of the client's assets against the claim of general creditors of the insolvent intermediary"* in the mandatory instrument and not merely in the benchmark criteria. We wish to point out that such protection requirement is already a part of the CPSS-IOSCO Recommendations (Recommendation 12 "Protection of customers' securities"). Priority should be given to the protection of the investor as the Study Group itself states when addressing the issue of internal soundness

(par. 2.1): investor protection seems to be regarded as a benchmark for evaluating a system as sound. Confining this issue into a "*non mandatory annex to the convention*" would probably fail to meet the goal because of the non-binding nature of the instrument. To our mind, dealing with the other issues such as good faith acquisition and finality would lose relevance if this fundamental issue is not addressed. Of course there may be different solutions in the different laws to provide for the protection of the final investors' assets but we deem that according to the importance of the issue, uniformity should be reached also as regards the manner in which protection of the final investor is achieved. We believe that this would grant the same level of protection everywhere the future Convention applies." (ECSDA, p. 6)