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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**

**4<sup>th</sup> Session**

**(24-27 March 2004)**

*(prepared by the Secretariat)*

Rome, April 2004

## **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 80<sup>th</sup> session, held in Rome from 17 to 19 September 2001<sup>1</sup> and endorsed by the General Assembly of the Organisation at its 55<sup>th</sup> session held on 7 December 2001,<sup>2</sup> met in Gerzensee near Bern, Switzerland, at the invitation by the Swiss National Bank for its fourth session from 24-27 March 2004. The session was opened at 2:00 p.m. on 24 March by Mr Herbert Kronke, Secretary-General of UNIDROIT, on behalf of Mr Bernardino Libonati, President of UNIDROIT and Mr B. Sen, member of the UNIDROIT Governing Council and Chairman of the Study Group. Mr. Hans Kuhn provided welcome remarks on behalf of the Swiss National Bank, sponsor of the session.

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 Intersessional work conducted since the last meeting**

Philipp Paech, secretary to the Study Group, explained the development of the current draft instrument. After the 3<sup>rd</sup> session of the Study Group held in November 2003, Mr Guy Morton produced a first draft of an instrument in December 2003. It was discussed by the members of the reporter's group (Messrs Dupont, Jelonche, Kanda, Morton, Reitz, Thévenoz) in mid January by teleconference. The outcome of the discussions was the draft document that was provided for circulation for this meeting as Document 13.

He noted that the recent fact finding mission to Canada that took place in December 2003 was particularly successful in drawing support for the project. The mission was comprised of two meetings that took place in Montreal and Toronto, that was hosted by McCarthy Thetrault LLP and attended by Michel Dechamps, Dorothee Einsele and Philipp Paech. At these meetings, the particular nature of Canada's provincial and federal system and the absence of a uniform commercial code was found to raise complex interjurisdictional issues for the transfer and holding of securities even within Canada. A recent legislative initiative was currently underway to adopt a Uniform Securities Transfer Act in all provinces to address these issues. The need for ongoing co-operation with UNIDROIT to ensure the compatibility of this legislation with international initiatives was emphasised by all participants.

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<sup>1</sup> See UNIDROIT 2001, C.D. (80) 21.

<sup>2</sup> See UNIDROIT 2001, A.G. (55) 8.

Philipp Paech then discussed the meeting with representatives of the European Central Bank that was attended by Sandra Rocks, Luc Thévenoz and himself in mid January. The outcome was of a less technical nature but that the draft was presented in terms of its functional and neutral approach and the Bank reaffirmed its support for the project.

He also described UNIDROIT'S contacts with the Commission of the European Union with a view to coordinating the Institute's work in the area of clearing and settlement of securities with the efforts of the European Union in this field, especially taking in consideration that the Commissions relevant communication as response to the so called second *Giovannini Report* will be released at the end of April 2004.

Sandra Rocks reported on an Latin American initiative by the Centre of Inter-American Law Studies in Tuscon, USA in co-operation with the International Swaps and Derivatives Association (ISDA). After a recent meeting in New York sponsored by ISDA, it was decided to go forward with a model Law in this area that would be designed specifically for Latin American countries. The project is scheduled to be launched in July. Although there are funding issues involved, the hope is that ISDA members will be interested in pushing the project forward to open up markets in Latin American and that there would be synergy with the UNIDROIT project.

#### **4 Structure of the Instrument**

The Study Group discussed the Working Document that was produced by the Secretariat as regards the division of issues (see Appendix 4). A decision was made to treat even politically sensitive and legally challenging questions within a single text, leaving the decision to put aside certain issues for the intergovernmental negotiation phase. Where issues are included that the group has not been able to resolve, an explanation referring to different alternatives should be given.

#### **5 Discussion of the draft**

The Study Group began with a discussion on how to proceed with an assessment of the current draft. The Secretariat provided a working document on the status of the draft as set out in Appendix 5. It was proposed first to treat the issues that were not yet addressed by the text of the draft. However, the Study Group decided to proceed with a discussion article by article, and to consider the gaps that were missing afterwards. It was agreed to skip a preliminary review of the definitions under Article 1 as a discussion of these definitions would arise under each Article thereafter.

As for the **scope of the instrument**, the Study Group discussed whether the future instrument should apply only to international transactions or also to purely domestic transactions. They determined that the text needed to apply to both, because the distinction between domestic and international transactions in this area was often blurred and it would be difficult to have provisions applying to international transactions that were different from provisions applying to domestic ones.

There were some **general considerations**:

- As regards contracting out of the provisions of the convention, as it is allowed here and there in the draft text, it was not clear if this was also possible in other cases without express permission.
- It was advocated not to differentiate in the draft between different kinds of intermediaries, especially that special protection of CSDs should be left to the contracting states.

## 5.1 Discussion Article by Article

As regards **Article 2**,

- the question was raised whether para. 1(a) and para. 1(b) required separate provisions as they appeared similar in content.
- As regards para. (1)(c) and (d), one must retain that there are a variety of holding systems in place and none of them should be displaced by the indirect holding system. Therefore, a neutrality principle should be stated expressly.
- As regards para. (1)(e) and 2(2), there was a concern over the creation of a kind of hybrid system where, account holders maintain ownership with their direct intermediary but at the same time, they also had a direct relationship with an issuer. This point raised the issue of how far the convention should encroach on issues of corporate law. However, there was agreement that the instrument should not intend to deprive an account holder of rights that are conferred upon it by the corporate law of the issuer. Such systems occurred, for example, in France, where registered securities were maintained in the books of the issuer as well as with the intermediary because it is through the intermediary that the securities were being traded.
- With respect to para. (3), there was a question about the text in the square brackets. It was intended to recognize the policy decision that there are systems purely based on contractual relations between intermediaries and account holders where the account holders only rely on their intermediaries for protection of their rights and that it should not be the function of the convention to disallow these systems. There was support for the view that future convention should also apply to such systems. There was agreement that, as a drafting point, the text in square brackets should be included immediately before the words "against third parties".
- It was noted that para. (3) and (4) appear to state opposite principles, but that they are nevertheless essential because it need to be stated clearly that the account holder has a right that is good against everybody but nevertheless, in normal circumstances can only be asserted from a procedural perspective against the direct intermediary.
- With respect to para. (4), it was stated that it is the first of several appearances of the absence of any upper tier attachment. With possible exceptions, the account holder could enforce rights only against the intermediary and not against a higher tier intermediary. Subparagraph (a) linked with Article 5(2) into the insolvency of the intermediary and barred any remedy that occurred in that tier. The difficulty therefore was that account holders may be left without proper protection.

With respect to **Article 3**,

- it was stated that the underlying policy decision in para. (4) was questionable, and it was suggested that every account holder only bear the risk of one intermediary. However, others stressed that there needed to be a balance between expectations of investors and systemic risk issues.
- Special considerations should apply where an intermediary has no choice as regards the other intermediaries through which a certain type of securities are held. They could also apply in cases where crediting to customers' accounts for good reasons is allowed, as for example under Belgian legislation regarding the delivery of public debt instruments. Also for ICSDs, a special rule might be needed because at their level, systemic risk issues have already been given particular consideration.
- Furthermore, there was a question as to who else may possibly be liable, assuming that the intermediary is liable. (for example, all intermediaries, jointly and severally as is the case under Japanese law).

- In addition, it was noted that under para. (4) the customer has no recourse against the intermediary and that elsewhere in the draft, it is stated that there is no recourse against other intermediaries. The concern was that this would result in nobody being liable.
- As regards para. 5 (a), it was questioned whether the rule also applies to intermediaries that are on the top tier.
- As regards para. 5 (b), it should be clearly stated that the convention does not impose any obligation to segregate.

In relation to **Article 4 and 5**,

- it was asked if the prerequisite "deficiency as result of a failure by the intermediary" (art. 4 para. 2) aims at the situation of a wrongdoing that goes beyond the pure fact of creating a deficiency.
- Also regarding art. 4 para. 2, the Group's attention was drawn to the impact of this rule under a holding system based on trust principles. In general, a trustee is held to segregate and to fill a discrepancy by using his own assets. This result can, however, be countered by the attachment of his assets by a judgment creditor, who will take precedence in this situation. It would be good if para. 2 changed this general principle. However, if this was understood as if the draft stated implicitly that segregation is not necessary, one should keep in mind that segregation in most countries is a regulatory matter and that generally speaking, the principle of segregation under a trust system is regarded as most useful. But, if investor protection depends on segregation being carried out properly, and it is not, such a rule could have the opposite effect.
- It was noted that only the opening of an insolvency procedure would give rise to the need to allocate the shortfall (art. 4 para. 3) to the account holders, because as long as there is a functioning intermediary, the allocation of shortfalls does not make sense. Other members were inclined to accept other situations, such as where a deficiency occurs without an insolvency of the intermediary, or where the duty to maintain and acquire sufficient securities is defeated for some reason or another, but this has not clearly been identified.
- Furthermore, in the event of a judgment creditor seizing the portfolio to the extent necessary to satisfy the judgement, not the rule on loss allocation (article 4) but the obligation to hold sufficient securities (article 3) should apply.
- It was admitted that to a judgment creditor, without segregation, it was difficult to determine whether the attached securities belong to the intermediary or to the investor. Another solution would be to allow only attachment of securities that exceed the number of the aggregated account holders' assets. As this is in practice very difficult, too, one could take into consideration the possibility of prohibiting attachment in respect of certain intermediaries at all. However, attachment was a purely procedural question which should perhaps be left to contracting states to address.
- In the context of loss allocation (art. 4 para. 3), it was questioned whether this rule as such was enough – the loss allocation could only be done collectively and not by each account holder himself. On the other hand, it could go too far to attribute the role of loss sharing to a specific person or body, e.g. an insolvency administrator. This could encroach too much on national legislation.
- On the same point, it was said that with respect to securities lending arrangements, the loss sharing rule should not apply to lenders. In contrary, they should bear the full risk taken over by the lending arrangement. Consequently, art. 4 para. 3 should be open for contractual modifications. Other members replied, that, as a lender was no longer owner of the securities, i.e. there was no mismatch, this question would not arise. This however required that there are corresponding debit entries in the lenders account, which might not be the case e.g. in Switzerland,

where a drawing from the pool was possible without debiting the securities in the lender's account. A complete debiting also had the disadvantage that dividends under a lending arrangement must still be passed on to the owner/lender.

- Consideration was given to treat the delivery of "materialised" securities into an indirect holding system differently from the general rule of loss allocation, in the event that those securities are stolen or counterfeited. Then the loss should be allocated to the account holder who delivered the certificates.

With respect to **Article 6**,

- it was stated that art. 2 and 12 should be merged and then art. 6 should refer to the "rights in art.", not "the securities".

- With respect to **Article 7**,

- it was questioned whether the division between para. (a) and (b) was necessary and should not be eliminated. However, others stated that under certain systems a disposition just on the basis of a debit-instruction was not possible.

- There was agreement that the drafting of para. (a) and (b) does not aim to prohibit netting.

- It was noted that the division of (a) and (b), when looked at them in isolation, does not make much sense because of the possibility to dispose of the securities in any manner provided by the applicable law. Therefore, this division makes only sense when looking to the provisions on priorities and perfection.

- As regards the meaning of "applicable law" in para. (d), the Group still has to determine whether this rule refers to the law determined under the Hague Convention.

With respect to **Article 8**,

- A question was raised whether there was any part of the draft text where the different concepts of control as set out in para. 3 make any difference except for the priorities section.

- Another member proposed only to retain the concept of positive control (para. 3(a)(i)).

- There was agreement that the draft text should cover collateral interests along the lines of article 8 UCC.

- Consideration was given the question whether the term control is too technical or should be avoided because of potential secondary meanings.

- There was agreement that the provision should provide for a collateral mechanism which prevails over other forms of collateral but that states would still be free to adopt alternative mechanisms and that this would most probably entail a partial overriding of domestic law on secured transactions.

- In the context of **Article 9**,

- there was the suggestion to replace the notion "disposition" by "transfer of an interest in the account".

As regards **Article 10**,

- It should be made clear what is meant by "applicable law" in para. (2).

- There was agreement that the term "perfection", though bearing difficulties, should be retained as it is also used in the Hague Convention.

- The question was raised whether there should be the possibility for an insolvency administrator of the transferor to upset a transfer under para. (1).

With respect to **Article 11**,

- Again, the members felt that the term “applicable law” should be defined more specifically.
- There was also the question whether the text should apply the work “priority”, as the priority concept required an existing property interest.

As regards **Article 12**,

- It was stated that para. (3) contradicts with art. 11 para. (7)
- Furthermore, it was suggested to draft para. (3) in a more abstract way to make a reservation to the entire article like “except as otherwise agreed or as ordered by a court”.

With respect to **Article 13**,

- It was noted that under art. 2 para. 4 there should be no right to enforce and it was questioned whether this made art. 13 redundant. Others were of the opinion that: First, the court is not necessarily the same court that deals with the own property right of the claimant. Second, there was agreement that the preclusion of upper tier attachment needed to be expressly stated.

In context of **Article 14**,

- It was noted that the concept of collusion (para. 2) should not be used in the international context as its perception is different in different legal traditions.
- It was suggested to apply the “notice” concept instead of innocence, as innocence is more difficult to define.

With respect to **Article 15**,

- the term “for value” was questioned because it might be possible to receive securities free of payment. At any rate, the term should be defined because the concept does not necessarily exist in civil law countries.
- The members agreed that this rule might entail changes to the domestic law, as in some civil law countries a bona fide acquisition required tracing from where the security comes.

There were no comments as regards **Article 16**.

With respect to **Article 17**, a question was raised as to how transfers which are made outside the control concept of this convention would be treated. It was made clear, however, that there will still be dispositions outside the convention which then will also follow domestic bona fide rules.

As regards **Article 18**,

- there was agreement that para. 2 should better read “an issuer of securities which are held with an intermediary is not bound or compelled to recognise the securities of the person other than the immediate holder”.
- There was a discussion on how far this draft should encroach with corporate law with respect to para. (2). Corporate law should at least be sufficiently flexible to enable the passing on of the benefits and voting rights as well as other corporate rights to the investors. How this goal were achieved was not important.
- It was noted however, in the context of para. (2), that present tendencies go towards more transparency and that issuers wanted to know who their shareholders are.

As relates to **Article 19**,

- it was stated that this does not operate to the benefit of the account holder who is itself acting as an intermediary, although the article in its present form does not state this.

- Some members suggested that the draft should not touch the area of set-off, because in practical terms, rights to set-off could cause systemic problems and that under certain jurisdictions, rights arising from bond issues are collective rights that have to be exercised collectively, or they would violate the principle of equality among bondholders. On the other hand, there was the possibility of an exit from the indirect holding system of a bondholder who wants to have the possibility to set-off. Others were of the opinion that there is no reason to deviate for indirect holding from the result that would occur if there were a paper certificate. Others emphasised, that in practical terms, there was a great need for set-off in indirect holding systems, because banks assess their credit-exposure vis-à-vis issuers on the basis that they are bondholders. The reason why this need is not put forward more often is that banks are not aware of the fact that there is a doubt over mutuality as soon as bonds are held with an intermediary. There was a proposal to formulate the provision not positively, but negatively, in the sense that existing rights of set off are not taken away by rules of the instrument saying that rights are only enforceable against the direct intermediary.

## **5.2 Discussion on further points to be treated**

As regards the topic of collateral, the Study Group declined to make a determination as to the steps required for the collateral take to enforce its securities. It was noted that while there was no consensus among the group on negative control, the group concluded that an agreement in addition to a book entry should be sufficient as regards the priorities under article 11. It was stressed that the priorities rules needed to be set out very clearly. Some members of the group suggested that if an interest is created and is enforceable against an insolvency administrator before it is perfected, this should be said explicitly in the draft. However, rather than used the word "perfection" which had different connotations in different jurisdictions, one member suggested that the functional result of a transfer when certain events occur should be described instead. This could be done within the priorities rules by using the terms "it is subordinate to" or "has priority over".

In respect of settlement finality and netting, some members suggested that the finality of debit entries should be for each contracting state to decide and left out of the convention. However, others emphasised that it was important to address finality and netting systems in the event of an insolvency. Nonetheless, the group could not agree on whether to delineate the point at which the investor protection should be ensured in the event of improper instruction or improper execution of its securities interests. Some members expressed concern that the issue was more difficult than what was addressed by the EU Settlement and Finality Directive. It was decided that as regards netting, a rule was needed saying that debits and credits are not rendered ineffective because it is not possible to identify a matching credit or debit anywhere else. A rule was also need to state that dispositions across securities accounts could be effected on a net basis.

With respect to provisional credits, the Study Group agreed there should be no specific time designation for over-crediting under the Convention. They considered that enough flexibility should be allowed for ordinary, processing of business over-credits, and that the convention should not be drafted to be more restrictive than currently existing regulations that allow for excess credits for valid reasons. In order to avoid encroaching upon regulatory matters, it was suggested that the Convention make reference to existing market practices that might govern the availability of excess credits. It was agreed that the provision under article needs to be included, but that the Convention should not address enforcement.

The Study group then turned to the issue of reversibility of credits. Some argued that it might be best for the convention to be silent on reversals, However, other said that it was important to address it at least in the context of the general framework. It was suggested that Article 6 might allow for the reversal of some dispositions. There was also a suggestion that the Convention refer to general principles on which the Convention is based, and as a fallback, the problem could be addressed by national law.



As regards the liability of intermediaries to each other, the Group decided that on a balance, the allocation of risk should be that the intermediary is responsible to its customer for the loss of assets it was holding for its customer. However, they agreed that there might be a need to limit liability or exempt it in some circumstances, such as in respect of CSD's. The question of the extent to which intermediaries could contract out of liability was also raised. It was suggested that the notion of contracting out should be drafted very generally, as in "unless otherwise agreed".

In respect of revocation, there was disagreement as to whether it should be included in the draft. While some members argued that revocation was beyond the scope of the Study Group, others members argued that it was an exceptional opportunity to try and include provisions to allow for the development of a more harmonised system. The Group considered that if there are provisions on revocation included in the convention, there should not be a special rule about revocation by reason of insolvency. Moreover, they determined that any provisions on revocation should be drafted in a way so as to allow for opting out. Other suggested that such provisions should apply only to central securities depositories.

As regards the issue of insolvency, one member asserted that there was not enough protection in the draft against the insolvency of the intermediary. A rule of recognition might be required to suggest that once a disposition is perfected, a mere declaration of insolvency will not concern the intermediaries' holdings for account holders. The Group agreed that set-off should be provided for but only in the event of an insolvency.

#### **6 Further work**

The Study Group agreed to aim at finalising its proposal by November of 2004, so that the draft could be presented to the Governing Council of UNIDROIT in December 2004.

#### **7 Next meeting**

The next meeting will take place from 18 September 2004 (14:00) to 22 September 2004 (13:00).