



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

**UNIDROIT STUDY GROUP ON HARMONISED
SUBSTANTIVE RULES REGARDING SECURITIES HELD
WITH AN INTERMEDIARY**

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PRELIMINARY DRAFT CONVENTION ON HARMONISED SUBSTANTIVE RULES
REGARDING SECURITIES HELD WITH AN INTERMEDIARY

EXPLANATORY NOTES

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PART I: INTRODUCTION

1 HISTORY OF THE PROJECT

UNIDROIT commenced work on an instrument on *Harmonised Substantive Rules regarding Securities Held with an Intermediary* 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

Mr B. SEN, Senior Advocate at the Supreme Court of India, New Delhi, India and Member of the Governing Council of UNIDROIT, was appointed Chairman of the Study Group on *Harmonised Substantive Rules regarding Securities Held with an Intermediary*. The Members of the Study Group were Mr J. Michel DESCHAMPS, Partner, McCarthy Tétrault, Montreal, Canada; Mr Philippe DUPONT, Partner, Arendt & Medernach, Luxembourg, Luxembourg; Ms Dorothee EINSELE, Professor of Law, Christian-Albrechts-Universität zu Kiel, Kiel, Germany; Mr Edgar I. JELONCHE, Attorney-at-Law, Professor of Commercial Law, Buenos Aires University School of Law, Buenos Aires, Argentina; Mr Hideki KANDA, Professor of Law, University of Tokyo, Tokyo, Japan; Mr LI Rui Qiang, Law Manager, China Securities Depository and Clearing Co. Ltd., Beijing, P.R. China; Mr Guy MORTON, Partner, Freshfields Bruckhaus Deringer, London, United Kingdom (Reporter); Mr Frédéric NIZARD, Direction juridique, Crédit Agricole SA, Paris, France; Mr Richard POTOK, Potok & Co., Darlinghurst, New South Wales, Australia; Mr Curtis R. REITZ, Professor of Law, University of Pennsylvania Law School, Pennsylvania, United States of America; Mr Luc THÉVENOZ (Vice Chairman), Professor of Law, Centre for European Legal Studies, University of Geneva Faculty of Law, Switzerland; Mr WU Zhipan, Professor of Law, Vice-President of Peking University, Beijing, P.R. China.

The Secretariat invited Mr Antoine MAFFEI, Partner, De Pardieu Brocas Maffei, Paris, France and Ms Sandra ROCKS, Counsel, Cleary Gottlieb Steen & Hamilton, New York, USA, to attend as observers and serve as co-ordinators for the private financial sector in the project.

The *Hague Conference on Private International Law* (represented by Mr Christophe BERNASCONI) and the *United Nations Commission on International Trade Law* (represented by Mr Spiros BAZINAS) participated as observers in the work of the Study Group.

The Study Group used the first session³ to determine the scope of the future instrument⁴ and the fundamental strategy of its drafting approach. A first discussion paper⁵ was circulated, outlining that the resolution of the conflict-of-laws aspect with regard to securities held with an intermediary, though the first and fundamental achievement, was not sufficient in and of itself to eliminate legal risk in cross-border holding and disposition of securities. Rather, the internal soundness and the cross-border compatibility of all domestic laws would also need to be improved.

Following the second session of the Study Group,⁶ UNIDROIT published the *Position Paper on Harmonised Substantive Rules regarding Indirectly Held Securities* in August 2003.⁷ This report set out the Study Group's underlying thinking with regard to the future international instrument. The paper gave an overview on the background of the project as well as on the approach and potential solutions proposed by the Study Group. The Position Paper was communicated to all Governments of Member States and to

¹ See UNIDROIT 2001, C.D. (80) 21.

² See UNIDROIT 2001, A.G. (55) 8.

³ Held in Rome, Italy, 9 to 13 September 2002, UNIDROIT 2002 Study LXXVIII Doc. 5 (summary report 1st session).

⁴ Cf. UNIDROIT 2002 Study LXXVIII Doc. 1 (scope of the project).

⁵ Reproduced in the Annex of UNIDROIT 2002 Study LXXVIII Doc. 5 (summary report 1st session).

⁶ Held in Rome, Italy, 12 to 14 March 2003, UNIDROIT 2002 Study LXXVIII Doc. 7 (summary report 2nd session).

⁷ UNIDROIT 2003 Study LXXVIII Doc. 8 (Position Paper).

their central banks and regulatory authorities, to interested international governmental and non-governmental organisations as well as to market participants and the academia for comments.⁸

On the basis of the Position Paper, UNIDROIT invited Governments of Member States, their central banks, other interested national and international organisations as well as legal experts from the private financial sector to attend a seminar entitled "Legal Risk and Market Efficiency", held at the UNIDROIT headquarters in Rome on 12 November 2003.⁹ The purpose of the event was to shed light on some specific core aspects of the project. About 80 representatives from governmental and non-governmental organisations from twenty-four Member States and two non-Member States participated in this event.

At the occasion of the third session,¹⁰ the Study Group refined its thinking regarding the content of the future rules.

In 2003, the UNIDROIT Secretariat, along with Members of the Study Group, carried out a process of consultation and information in the United Kingdom,¹¹ France,¹² Switzerland,¹³ the United States¹⁴ and Canada.¹⁵

During an informal working process between the third and fourth session, Mr Hideki Kanda developed the first set of principles regarding harmonised substantive rules regarding securities held with an intermediary. On this basis, Mr Guy Morton prepared a tentative draft of the future instrument. Following a request by the Chairman, this draft was informally discussed by a committee of six Members of the Study Group which was chaired by Mr Luc Thévenoz.¹⁶ The outcome of this discussion¹⁷ was later submitted to the entire Group.

During its fourth session,¹⁸ the Study Group developed this draft further. The Chairman asked Mr Guy Morton to prepare an updated version. Mr Antoine Maffei prepared a first proposal for the French version of the future instrument.¹⁹

The project was introduced to the Members of the UNIDROIT Governing Council by the Chairman of the Study Group and Member of the Council, Mr B. Sen, and the UNIDROIT Secretariat at the 83rd session of the Council. The Council accepted the Chairman's proposal to review the draft after the last session of the

⁸ UNIDROIT 2003 Study LXXVIII Doc. 10 and 10 add.1 (Comments on the Position Paper).

⁹ The proceedings have been published as UNIDROIT 2003 Study LXXVIII Doc. 12.

¹⁰ Held in Rome, Italy, 13 to 15 November 2003, UNIDROIT 2003 Study LXXVIII Doc. 11 (summary report 3rd session).

¹¹ Held in London, United Kingdom, on 21 and 22 February 2003, hosted by *Freshfields Bruckhaus Deringer*. Messrs G. Morton and F. Nizard from the Study Group and the UNIDROIT Secretariat participated.

¹² Held in Paris, France, on 26 and 27 February 2003, hosted by *Crédit Agricole*. Messrs G. Morton and F. Nizard from the Study Group and the UNIDROIT Secretariat participated.

¹³ Held in Zurich, Switzerland, on 12 and 13 June 2003, hosted by the *Swiss National Bank*. Messrs Ph. Dupont and L. Thévenoz from the Study Group and the UNIDROIT Secretariat participated.

¹⁴ Held in New York, United States of America, on 15 and 16 September, hosted by the *Federal Reserve Bank of New York*. Messrs H. Kanda and C. Reitz from the Study Group and the UNIDROIT Secretariat participated.

¹⁵ Held in Montreal (Quebec), on 8 December 2003 and in Toronto (Ontario), on 10 December 2003, hosted by *McCarthy Tétrault*. Ms D. Einsele and Mr M. Deschamps from the Study Group and the UNIDROIT Secretariat participated.

¹⁶ The Members of this group were Messrs Ph. Dupont, E. Jelonche, H. Kanda, G. Morton, C. Reitz, L. Thévenoz.

¹⁷ UNIDROIT 2004 Study LXXVIII Doc. 13 prov. 1.

¹⁸ Held at the invitation of the *Swiss National Bank* in Gerzensee, Switzerland, 24 to 27 April 2004, UNIDROIT 2004 Study LXXVIII Doc. 14 (summary report 4th session).

¹⁹ UNIDROIT 2004 Study LXXVIII Doc. 13 prov. 2 (en), (fr).

Study Group and to decide by correspondence whether to proceed to the intergovernmental phase at the end of 2004.²⁰

The UNIDROIT Secretariat liaised with the competent authorities of the European Union and the United States of America in early 2004.²¹

The Co-ordinators of the Study Group for the private financial sector, Ms Sandra Rocks and Mr Antoine Maffei, along with the UNIDROIT Secretariat, organised seminars in Frankfurt,²² Paris,²³ New York²⁴ and London²⁵ in order to introduce the draft to major market participants and public authorities.

During the summer of 2004, the UNIDROIT Secretariat, in some cases along with Members of the Study Group or of the UNIDROIT Governing Council, carried out a process of consultation and information. Seminars and expert consultations were organised in Argentina,²⁶ Brazil,²⁷ Mexico,²⁸ Japan,²⁹ China,³⁰ India³¹ and Malaysia³². Later in 2004, consultations were held in Sweden,³³ Denmark³⁴ and Greece.³⁵

²⁰ UNIDROIT 2004 CD 83 (24), p. 24 *et seq.*

²¹ Meeting with the European Central Bank at its headquarters at Frankfurt, Germany, on 29 January 2003. Ms S. Rocks (co-ordinator of the private financial sector), Mr L. Thévenoz from the Study Group and the UNIDROIT Secretariat participated. Meeting between the UNIDROIT Secretariat and the EU Commission at its headquarters in Brussels, Belgium, on 16 June 2004. Meeting with US authorities and the *Depository Trust and Clearing Corporation* on 1 July 2004 at the Securities and Exchange Commission (SEC) in Washington, D.C.

²² At the invitation of *Bundesverband Deutscher Banken* (BdB) and *Deutsche Bank AG*, held at the latter's headquarters in Frankfurt, Germany, on 4 May 2004. Mr Antoine Maffei (co-chair), Ms Sandra Rocks (co-chair), and Mr Ph. Dupont, Ms Dorothee Einsele, Mr Guy Morton, Mr L. Thévenoz from the Study Group as well as the UNIDROIT Secretariat participated.

²³ At the invitation of the *Fédération Bancaire Française* (FBF) and *Association Française des Professionnels des Titres* (AFTI), held in Paris, France, on 9 June 2004. Mr Antoine Maffei (co-chair), Ms Sandra Rocks (co-chair) and Messrs Ph. Dupont, G. Morton and F. Nizard, Mr L. Thévenoz from the Study Group and the UNIDROIT Secretariat participated.

²⁴ At the invitation of *Cleary Gottlieb Steen & Hamilton*, held in New York, United States of America, on 11 May 2004. Mr A. Maffei (co-chair), Ms S. Rocks (co-chair) and Mr G. Morton from the Study Group and the UNIDROIT Secretariat participated.

²⁵ At the invitation of and organised by the *Financial Markets Law Committee* (FMLC), held in London, United Kingdom, on 7 July 2004. Mr A. Maffei (co-chair) and Mr Guy Morton for the Study Group participated.

²⁶ At the invitation of *Caja de Valores, Mercado de Valores* and *Comisión Nacional de Valores*, held in Buenos Aires, Argentina, on 7 July 2004. Mr E. Jelonche from the Study Group and the UNIDROIT Secretariat participated.²⁷ At the invitation of *CLBC*, held in Sao Paulo, Brazil, on 15 and 16 July 2004. Mr E. Jelonche from the Study Group and the UNIDROIT Secretariat participated.

²⁸ At the invitation of and organised by Mr Jorge Sánchez Cordero, Member of the UNIDROIT Governing Council, held in Mexico City, Mexico, on 21 and 22 July 2004; UNIDROIT was represented by the Secretariat.

²⁹ Informal meeting hosted by the Ministry of Foreign Affairs and the Ministry of Justice, on 26 July 2004. Mr H. Kanda from the Study Group and the UNIDROIT Secretariat participated.

³⁰ At the invitation of the *Renmin University*, Beijing, held in Beijing, China, on 28 July 2004; UNIDROIT was represented by the Secretariat. At the invitation of *Chinaclear*, held in Shanghai, China, on 30 July 2004. Mr Li Ruiqiang from the Study Group and the UNIDROIT Secretariat participated.

³¹ At the invitation of Mr B. Sen, Member of the UNIDROIT Governing Council, meetings were held at the Ministry of Foreign Affairs on 5 August 2004 and with the *India International Law Foundation*. Messrs B. Sen and G. Morton from the Study Group and the UNIDROIT Secretariat participated.

³² Meeting hosted by the *Securities Commission*; held in Kuala Lumpur, Malaysia, on 2 August 2004; UNIDROIT was represented by the Secretariat.

³³ At the invitation of the Swedish *Riksbank*, the *Nordic Council of Ministers' Working Group on Securities Market Cooperation* and *VPC*, held in Stockholm, Sweden, on 23 September 2004; UNIDROIT was represented by the Secretariat.

4.

The fifth session³⁶ of the Study Group was primarily aimed at re-assessing the draft against the background of the findings gathered since the last meeting. Additionally, the Secretariat invited four major Central Securities Depositories³⁷ to participate in the meeting for one day, with a view to giving the Study Group additional input from their perspective. The meeting was followed by a seminar with Hungarian experts.³⁸

The Chairman asked Mr Guy Morton to incorporate the outcome of the fifth session and the additional meeting into the draft.³⁹ Mr Antoine Maffei and the UNIDROIT Secretariat prepared a French version of the draft, which was then submitted to a Francophone working group on the occasion of a special meeting in Paris in which additional French practitioners participated.⁴⁰

Both texts were discussed and adopted by the Study Group during a final telephone conference call on 16 November 2004. Afterwards, at the request of the Chairman, Mr Guy Morton incorporated the last amendments into the text.

2 BACKGROUND OF THE FUTURE INSTRUMENT

The purpose of the future instrument is to promote legal certainty and economic efficiency with respect to the cross-border holding and disposition of securities held with an intermediary, by harmonising certain legal aspects in this regard. This has become a necessary venture due to the considerable change in market practices within the last 50 years, combined with an ever-increasing volume of cross-border activities in the capital markets. It has been widely recognised in recent years that these developments in the practice of holding and disposition of securities have, in a number of respects, outrun the traditional legal framework.⁴¹

The basic rules on the legal nature, transfer and collateral provision of securities were formulated in the days when securities were transferred individually by physical delivery of certificates representing them. Under these rules, there was always a direct relationship between issuers and holders. In the case of registered securities, the investor's name was always registered in the issuer's books. In the case of bearer securities, the mere possession of a securities certificate represented or evidenced the direct property interest. The tokens were either physically held by the investors or under their names by an

³⁴ At the invitation of *Danmarks Nationalbank*, held in Copenhagen, Denmark, on 7 October 2004; UNIDROIT was represented by Michael B. Elmer, Member of the UNIDROIT Governing Council and the UNIDROIT Secretariat.

³⁵ At the invitation of the Bar of Athens and the *Fondation d'Etudes Juridiques Internationales des Prof. Elias Krispis and Dr. Anastasia Samara Krispi*, held in Athens, Greece, on 11 November 2004. UNIDROIT was represented by Mr Ioannis Voulgaris, Member of the UNIDROIT Governing Council, the Secretary General and the Secretariat.

³⁶ Held with the support of the *Hungarian Foreign Trade Bank* in Budapest, Hungary, 18 to 22 September 2004.

³⁷ *Clearstream Banking*, Frankfurt, Germany; *The Depository Trust & Clearing Corporation*, New York, United States of America; *Euroclear Bank*, Brussels, Belgium; *Japan Securities Depository Center*, Tokyo, Japan.

³⁸ At the invitation of the *University of Budapest* and the *Hungarian Foreign Trade Bank*; UNIDROIT was represented by Mr Attila Harmathy and Mr B. Sen, Members of the UNIDROIT Governing Council, the Members of the Study Group and the Secretariat.

³⁹ UNIDROIT 2004 Study LXXVIII Doc. 17 (en).

⁴⁰ UNIDROIT 2004 Etude LXXVIII Doc. 17 (fr). Meeting hosted by *De Pardieu Brocas Maffei*, on 29 October 2004. Messrs A. Maffei and L. Thévenoz from the Study Group, as well as representatives from *BNP Paribas*, *Société Générale* and *Gide Loyrette Nouel*, and the UNIDROIT Secretariat participated.

⁴¹ A.O. AUSTEN-PETERS, *Custody of Investments*, Oxford University Press 2000, p. 21 *et seq.*; J. BENJAMIN / M. YATES, *The Law of Global Custody*, 2nd ed., Butterworths 2002, p. 13 *et seq.*; Chr. BERNASCONI, *The Law Applicable to Dispositions of Securities held through Indirect Holding Systems*, The Hague Conference of Private International Law, Nov. 2000; D. EINSELE, *Wertpapierrecht als Schuldrecht*, J.C.B. Mohr 1995, p. 7 *et seq.*; R. GUYNN, *Modernising Securities Ownership, Transfer and Pledging Laws*, Capital Markets Forum of the International Bar Association, 1996, p. 28 *et seq.*; R. Potok (ed.), *Cross-Border Collateral: Legal risk and conflict of laws*, Butterworths 2002, p. 7 *et seq.*; J.St. ROGERS, "Policy Perspectives on Revised U.C.C. Article 8", (1996) *U.C.L.A. L. Rev.*, pp. 1431, 1435 *et seq.*

agent, for example a bank or a broker. Any type of transfer of the securities involved a direct or indirect possessory transfer and sometimes entailed the physical transfer of the tokens from one vault to another.

This method of physical holding and disposition of securities worked adequately until a sharp increase in trading volumes overwhelmed the system, and the enormous amount of paper that had to be physically moved around the globe began to present grave logistical problems.

Consequently, considerations of speed, efficiency and economy of settlement led to the evolution of a sophisticated system of intermediaries, through which securities could be held and transferred in book-entry form, generally by computerised means.

2.1 Change towards modern practice of holding and disposition of securities

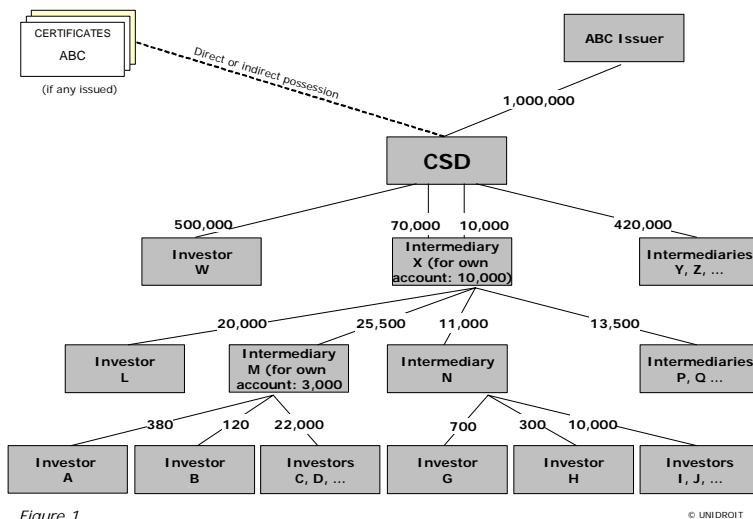


Figure 1

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A number of legal, regulatory and operational innovations to clearance and settlement systems led to the establishment of a system of holding with intermediaries.⁴²

One of the most important objectives of the restructured system was to immobilise the vast amount of paper, if not to eliminate it altogether. Today, most jurisdictions around the world have achieved this goal by adopting the principle of holding through intermediaries, although the details often vary. The following sections describe the basic characteristics of the modern system that depart considerably from the traditional holding system; however,

they are in reality far more complicated and vary considerably across jurisdictions. Details of specific systems, where relevant, are considered below.

2.1.1 Immobilisation and dematerialisation

With *immobilisation*, paper instruments or certificates can still exist, but they no longer move from person to person or from intermediary to intermediary in the secondary market. Instead, the securities are deposited in a Central Securities Depository (CSD), in the form of either single, "jumbo" or "global" certificates.⁴³

Frequently, in the context of an intermediated securities holding system, reference is made to the *dematerialisation* of securities, i.e. a process whereby physical certificates or documents of title representing or evidencing ownership of securities are eliminated. In dematerialised systems, securities

⁴² This system is often referred to as an "indirect holding system". However, "indirect" is understood as implying that the investor has an indirect interest in the securities in question, while the intermediary has a legal position over the securities from which the investor's "indirect" interest is derived. Current legal practice around the world provides for both solutions. There are: (1) systems where intermediaries retain an own legal position from which the investor's position is derived; and (2) systems where intermediaries only have the function of a book-keeper and have no interest at all in the underlying asset, i.e. investors having a direct interest though holding through intermediaries. As the preliminary draft Convention is intended to address both models, the term "indirect" should be avoided and replaced by "held with an intermediary" or "held through an intermediary" or similar.

⁴³ Jumbo-certificates represent or evidence blocks of securities of an issue, e.g. a block of 10,000. Global certificates represent or evidence all securities of an issue. Terminologically, a distinction should be made between "securities held in global form" and "globally registered shares". The latter refers to shares originated in a specific country and registered on various stock markets under foreign jurisdiction and regulation.

exist only as computer records. Dematerialised securities are by their nature held in systems of intermediaries, as a withdrawal from the system is technically impossible. At the top-level of the system, an initial electronic record represents the entire issue.

However, it is not necessary for securities to be dematerialised in order to be held through intermediaries. The decisive feature of an intermediated holding system is the immobilisation of the securities. Therefore, in the context of this project, the question whether securities are dematerialised need not be addressed.

CSDs maintain accounts and credit securities for their customers (often referred to as “participants”), who are primarily major financial intermediaries. These customers, in turn, may hold securities partly for their own account and partly for the account of their own customers for which they maintain an account to which the securities are credited, and so on.

In the above *Figure 1*, Intermediary X is a client, or “participant”, of the CSD. It holds securities for L, M, N, P, Q and others. M and N, for example, are intermediaries themselves and hold accounts for A – J and others.

The different levels of intermediaries in such a system are commonly referred to as “tiers” or “layers”, hence the frequent term “multi-tiered holding system”. There can be both intermediaries and investors on each layer. E.g. W, X, Y, Z and others are on the first layer. W is an investor, probably an institutional one, while the other participants X, Y and Z are intermediaries. L, M, N, P, Q and others are on the second tier, and so on.

2.1.2 Pooling

In most systems, an intermediary holds securities of the same issue for all of its account holders in a single fungible “omnibus account” with its own higher-tier intermediary. The securities are “pooled” (“commingled”), without any attribution of specific securities to identified account holders. Consequently, from the perspective of a higher level, individual investors located farther down the chain cannot be identified. In *Figure 1*, Intermediary N holds the securities of all its account holders in an omnibus account with Intermediary X. Because those securities are pooled into a single account, Intermediary X is unable to identify the account holders G, H, I, J and others.

In this context, reference is often made to segregated accounts. The expression most commonly indicates a segregation of the assets held by an intermediary on behalf of its clients (which are nevertheless pooled), from those held by the intermediary for its own account. Consequently, in such a scenario, an intermediary has two accounts with the upper-tier intermediary: an account for its clients’ assets and a separate account for its own assets.

In *Figure 1*, Intermediaries X and M hold both their own assets and their clients’ assets with the upper-tier intermediary. Intermediary M pools the assets of its clients A-D and others (22,500) with its own assets (3,000) to a total amount of 25,500 securities. Intermediary X holds its clients’ assets (70,000) in an omnibus account with the CSD. Securities that are held for its own account (10,000) are held in a separate account with the CSD.

There is another type of segregation that goes far beyond this. In so-called “transparent” systems, it is possible to attribute specific securities to account holders, mostly ultimate investors. In most cases, in a transparent system an intermediary’s account held with its higher-tier intermediary contains sub-accounts for each of its lower-tier customers. The functional makeup of those systems varies considerably across jurisdictions. For example, some transparent holding systems still pool clients’ securities; nevertheless the amount of securities that are attributed to each account holder is communicated to the higher-level. In other cases, clients’ assets might not even be pooled, but instead be segregated in every respect.

2.1.3 Acquisition and disposition of securities

The enormous gain in efficiency attributable to the advent of the multi-tiered holding systems is most apparent in the context of acquisitions and dispositions. These activities have undergone a substantial transformation from the traditional holding system regarding the possession of securities certificates.

In order to effect a disposition (e.g. on the basis of a security collateral or sales agreement) between two investors who are customers of a single intermediary in a multi-tiered holding system, it is sufficient to make entries in the books of that intermediary accordingly. Neither delivery of physical securities, nor entry on the issuer's register is required. Often, "net settlement" is allowed, and consequently no entries are made in the books of upper-tier intermediaries or those of the issuer.

In the case where the acquirer and the disposer are account holders of different intermediaries, account entries will change up to the layer where both the acquirer's and the disposer's "holding chains" meet. In *Figure 1*, if Investor A sells 150 ABC securities and Investor B acquires 100 and Investor G 50 securities, the following changes will occur: (1) 150 securities will be debited to A's account with M; (2) 100 securities will be credited to B's account with M; (3) 50 securities will be credited to G's account with N; (4) 50 securities will be debited to M's account with X; and, (5) 50 securities will be credited to N's account with X.

In the case where securities are disposed of by way of security, the physical delivery of the certificates into the "possession" or "control" of the secured party is unnecessary. The securities are either blocked on the security provider's account, or they are temporarily moved to the security taker's or specially designated account.

2.2 Repercussions of modernisation: increased legal risk and economic inefficiency

The modern system of multi-tiered holding and disposition of securities described above has greatly improved the efficiency of the securities clearing and settlement process. However, these significant changes in the commercial practice have developed autonomously and incrementally in various markets all over the world. The result has been a patchwork which is attributable to the lack of a homogenous concept, both as regards a parallel internal development of the relevant law and as regards the practice and law in different countries.

2.2.1 Legal risk

The first question is whether the departure of the standard commercial practice from the law increases legal risk. Legal risk commonly refers to a situation where the applicable law does not provide for a predictable and sound solution.

For example, legal risk might arise in scenarios where the relevant factual issue is not addressed by the law. Even where there were rules in place, these could be contradictory or give rise to different interpretations. In such a "gap" or "lack of clarity" situation, parties may enter a transaction without knowing about the specific risk they face, which they might then realise later. Or, parties may know the risk beforehand but then have to invest time and money in filling the gap or overcoming the lack of clarity by way of contractual agreements.

Legal risk might also refer to situations where the answer provided by the applicable law does not fit the market reality, or where the law unnecessarily complicates or burdens a transaction. Often, legal requirements that are rooted in traditional legal concepts and created to promote legal certainty lose their original purpose when applied to modern securities holding and transfer structures. The consequence of imposing requirements that complicate a transaction can be time-consuming and costly. Furthermore, a complicated procedure makes each process of perfection of a transaction specifically vulnerable to mistakes. On the other hand, in other cases, the law provides for legal concepts that make the use of specific kinds of transaction that are used in or requested by the practice impossible and thereby creates a barrier.

2.2.1.1 Why the risk is particularly high

In principle, the forms of legal risk described above in relation to the holding and disposition of securities are no different from the legal risk inherent in any commercial transaction. Legal risk is ubiquitous. Nevertheless, there are factors that elevate the legal risk with regard to the holding of securities through intermediaries to a critical point.

The structural and technological innovations that have made the modern securities holding system possible have not been universally matched by corresponding levels of legislative modernisation. This is not to say that the legal framework has not been carefully revised to date; but the legislation often used traditional concepts adapted from other contexts. This causes a conceptual problem which rests upon the attempt to comprehend the modern system of holding through intermediaries under the terms of custody or deposit of physical objects.

The reason for this is that, although securities were originally intangibles,⁴⁴ they subsequently became certificated, frequently in bearer form, and acquired the legal status of tangible assets. This status later remained unchanged in most jurisdictions, notwithstanding the fact that in modern computerised systems securities are (again) often not represented or evidenced by certificates, or even if they are, the certificates are immobilised and therefore not physically moved to the greatest extent. This leads, in many jurisdictions, to the following puzzling situation: a type of financial instrument, for example a debt security, that was intangible and rather a set of mutual obligations at its very origin, today is again in fact or practically intangible because it is immobilised and often even dematerialised and credited and debited to accounts in a way that bears small resemblance to the characteristics of physical objects. Nevertheless, it is governed by concepts which were created with respect to tangibles.

Consequently, the degree of risk in the above terms is significantly higher than in other areas of commercial law. In some countries, special legislation governs the holding and disposition of securities in multi-tiered systems. However, only a handful of these States have abandoned the traditional legal basis built on custody of physical objects. The legal framework in different countries could be classified into (a) countries with modern legislation in place; (b) countries dealing with modern holding under legislation which is built on traditional concepts; (c) countries without special legislation, but settled legal practice; and (d) countries with no sound legal framework in place.

It should be stressed that, in jurisdictions falling into groups (a), (b) and (c), legal risk materialises only under exceptional circumstances. Therefore, the present instrument is primarily designed for providing a sound framework in times of "stress", e.g. the insolvency of a major market participant.

2.2.1.2 Examples

Several examples illustrate the occurrence of legal risk stemming from the divergence between modern practice of multi-tiered holding and the law:

- (a) In some systems, the intermediaries in a holding chain retain a legal position with respect to the underlying assets (e.g. the position of a trustee) on each tier. All these legal positions relate, however, to the same underlying asset, at least economically. Each of these legally distinct interests can be the object of a security interest granted to a third person. These security interests technically do not compete with each other, as they relate to legally different objects. Therefore, as long as no clear priority rules are in place for this scenario, it

⁴⁴ Joanna BENJAMIN, *Interests in Securities*, 1.02.: "The meaning of the term "security" has varied over time. Originally the term was used to denote security interests (such as mortgages and charges) supporting the payment of a debt or other obligation. In the early modern period, companies and government agencies began to raise capital from the public by issuing transferable debt obligations; the repayment of these debt obligations was secured on the assets of the issuer. By a process of elision, these secured debt obligations came to be known as "securities". Since late medieval times, commercial companies have raised funds by issuing participations or shares. In the Victorian era, the transferability of these shares was put beyond doubt. As shares became more rapidly transferable, their functional likeness to debt securities became clearer, and both forms of investments became known as "securities". More recently, the term security has been extended to include units in investment funds and other forms of readily transferable investment. "

might be unclear who prevails in the event of (economically) conflicting security interests. This would probably be a secured creditor at a higher tier, which is closer to the underlying interest.

- (b) The secured party might face the risk of re-characterisation of its security interest in circumstances where it is unclear whether the security interest can be created over a fungible pool of securities with incoming and outgoing securities, for example a securities account. A court in a later proceeding might rule that the legal concept applied to the security interest by the parties in fact did not fit the characteristics of the transaction. Instead, the court might characterise the transaction as a different type of security interest, requiring different elements to be met in order to render it effective against third parties.
- (c) Certain types of transactions, especially the creation of a security interest, might require procedures of notification or filing with a public registry in order to achieve publicity of the security interest. This is an appropriate method as regards the creation of security interests over tangibles. As regards securities held with an intermediary, there are easier and maybe even more effective methods of making the security interest public, e.g. by earmarking of encumbered securities in the account statement. Filing in a public registry, to the contrary, creates additional costs and adds another point of entry for operational or legal mistakes.
- (d) Similarly, the realisation of a security interest over securities might become a burdensome and time-consuming task. This is the case especially where concepts created with regard to tangibles, like public auction, still apply. Very often, these requirements no longer serve their original purpose, i.e. to protect the security provider. In particular, the fact that there is often a clear market price attached to the assets taken as security would allow the security interest to be realised smoothly and quickly without prejudicing the security provider.
- (e) It might be unclear in some jurisdictions whether an investor's creditor who has obtained an attachment order with regard to the investor's assets held with an intermediary is in a position to attach the securities at an upper level of the holding system, i.e. at the level of an intermediary different from the investor's own intermediary. Such upper-tier attachment typically might occur at the CSD level, since traditional legal principles dictate that tangibles, as physical objects, generally must be attached where they are physically located. However, the account maintained with the upper-tier intermediary will today generally be an "omnibus" account. The fact that the higher-tier intermediary has no knowledge or record of interests other than the interest of its immediate account holder makes such attachment order particularly threatening for the integrity of the system. The higher-tier intermediary might have no alternative, pending clarification of the position, but to freeze the *entire* account, thereby interrupting transactions not only of the underlying investor who is party to the dispute, but of all the other account holders of the lower-tier intermediary.

2.2.2 Cross-border links

Apart from the legal risk caused by the departure of commercial practice from the law, the increasing number of cross-border securities and collateral holdings and transactions raises additional concerns. Securities can be held through multiple tiers of intermediaries, each of which may be situated in different countries, as well as investors and collateral takers.

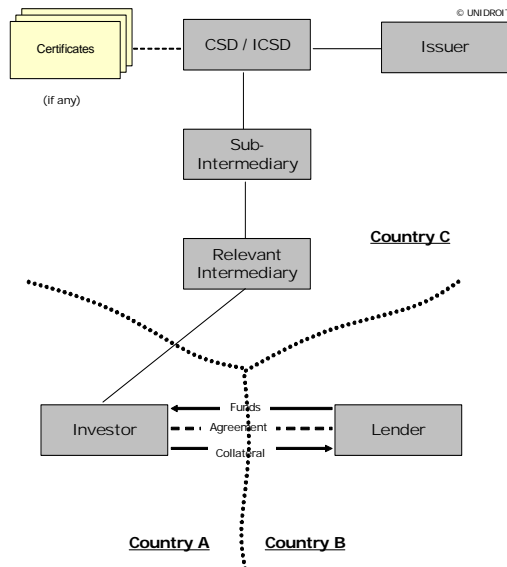


Figure 2

In a cross-border context, the first question is usually that regarding the applicable law. This matter is addressed by the *Hague Convention on the Law Applicable to Certain Rights in respect of Securities Held with an Intermediary*.⁴⁵ For purposes of the present report, the conflict-of-laws aspect will therefore be disregarded. Nevertheless, even in the presence of a clear and reliable conflict-of-laws rule, it is possible that the laws of two or more jurisdictions may govern the entirety of given situation. This is because the conflict-of-laws analysis will not necessarily provide for the same answer with respect to every single aspect of an overall context. Aspects of,

e.g., contractual, corporate, insolvency, property and securities law may or may not be subject to choice of law provisions, and the conflict-of-laws rules may point to different jurisdictions for certain aspects. This situation may already be quite complicated as such, but in general will not cause legal risk. However, certain previously unsuspected legislative gaps, lack of clarity, complications or barriers may impede a sound legal result, at least within a reasonable time. Deficiencies within one domestic legal framework may create difficulties regarding aspects governed by another law, etc. Thus, it may be said that cross-border holding and disposition are likely to multiply legal uncertainty.

In the above example, in *Figure 2*, the account agreement and the proprietary aspects regarding the securities may be governed by the law of the country of the relevant intermediary. The collateral arrangement may be governed by the law of the lender's jurisdiction. In the event of the investor's insolvency, the law of its own jurisdiction would apply to the insolvency procedure.

Apart from the above scenario which assumes a complex cross-border situation, there may be other situations where the laws are effectively incompatible between jurisdictions. For example, in some countries certain financial instruments, such as particular types of derivatives, are considered securities, whereas in others they are regarded as contractual rights. In the latter case, they therefore do not benefit from the special protection afforded securities. In the event of the insolvency of an intermediary situated in such a country, these interests are possibly less protected than they were in the investor's country.

To take another example, in some countries, the special statutory framework for investment securities applies only to securities that are held with the local CSD. In the event that securities that are held with a foreign CSD are traded or pledged in that country, the conflict-of-law rules, in particular the Hague Convention, might refer to the law of that country. However, the special statutory framework does not apply. Instead, a different legal framework governs the situation, either specially designed or forming part of the general private or commercial law. In order to avoid the co-existence of two systems within one jurisdiction, legislators need to be certain that under foreign systems, the securities are equally and as effectively protected as under the home system. However, this is impossible without a common international standard.

⁴⁵ *Convention on the Law Applicable to Certain Rights in respect of Securities Held with an Intermediary*, adopted under the auspices of The Hague Convention on Private International Law, The Hague, on 13 December 2002; see *infra*.

2.2.3 High economic risk

It is obvious that the legal risk described above may result in economic loss for the parties affected by a transaction. Although losses in commercial transactions are generally unavoidable, the potential economic damage can be exceptionally high in cases where legal risk is manifested in the context of intermediated securities holding. This risk of elevated damage is due to the insufficient legal framework and is further complicated by cross-border activities.

Securities worth 50 trillion euros are held through intermediaries world-wide. The volume of trade in collateral transactions in OECD Government and corporate securities, for example, has grown to \$2 trillion or more per day. This means that the volume of these transactions exceeds the world's total GDP (approximately \$32 trillion in 2002) every 15 trading days.⁴⁶ Consequently, the value at stake is enormous.

However, the potential for market participants to incur considerable economic loss is only one aspect of the damage that may result from a poorly constructed system. Apart from this micro-economic effect, the realisation of legal risk can affect the entire financial system, notably when it triggers systemic effects. Systemic risk is commonly described as "the risk that the inability of one institution to meet its obligations when due will cause other institutions to be unable to meet their obligations when due. Such a failure may cause significant liquidity or credit problems and, as a result, might threaten the stability of or confidence in markets".⁴⁷ In the worst case, a domino effect of insolvencies amongst linked market participants might ensue. However, legal risk may become systemic in a less destructive sense. Consider, for example, the scenario in which an entire market suddenly changes its behaviour because the participants become aware of a major legal problem inherent in a specific kind of transaction unsuspected until then. In order to avoid this risk, the market participants avoid entering into this type of transaction as long as the legal problem remains unresolved. Such a mass reaction, if not properly restrained, could seriously damage the market.

The realisation of systemic risk of one or the other kind can ultimately affect the macro-economy of an entire region of the world.

2.2.4 Economic inefficiency

Apart from the fact that legal risk in multi-tiered holding systems can result in extreme losses or even systemic effects, there is likely to be economic inefficiency in every single day-to-day transaction. The reason is that an important consequence of an unsound legal framework is increased transaction costs due to additional time and money spent on contractual agreements and operational measures to overcome legal uncertainty. This already applies to purely domestic situations, to face insufficiencies of the internal legal framework. When it comes to cross-border holding and transactions, additional problems stemming from the interaction of both domestic laws must be addressed. The most that can be done at present to remedy this deficiency is to construct "bridges" between the different national systems. Each bridge must be especially designed, taking into consideration the particular characteristics of the systems that it is trying to link. The resulting system would therefore be complex and costly.

This additional burden might deter market participants from entering securities transactions for whatever purpose, or devalue securities as objects of a security interest. This latter scenario could increase the cost of credit, or even, under specific circumstances, make credit unavailable.

⁴⁶ R. GOODE, H. KANDA, K. KREUZER, *Draft Explanatory Report on the Hague Securities Convention*, The Hague, 25 June 2004, p. 4.

⁴⁷ IOSCO/BIS, *Recommendations for securities settlement systems*, November 2001, p. 49; available at <http://www.bis.org/publ/cpss46.pdf>.

2.3 Remedies

As seen above, the current commercial practice of securities holding and disposition in multi-tiered holding systems has departed considerably from its underlying legal framework. As national legal measures that govern the holding of securities through intermediaries differ considerably, the resulting world-wide legislative situation is a “patchwork” of concepts. Consequently, the situation of purely domestic legal risk is further complicated by the ever-increasing volumes of cross-border holdings and dispositions. As soon as legal risk comes to the surface and is realised, enormous value can be lost and systemic risk could even be triggered. But even if the risk does not materialise, the uncertainty of the legal situation can influence confidence in the market. Additionally, an uncertain legal framework leads to economic disadvantages because time and money are invested in overcoming the legal risk, i.e. transactions are more costly than they needed to be and, in the worst case, participants will not enter into certain transactions simply because they are too risky or too costly.

Governments and international governmental and non-governmental organisations first realised this situation in the late 1980s. Since then, especially since the late 1990s, more and more initiatives have addressed the issue. The focus has also shifted over the past two decades from domestic law reform to the conflict-of-laws issue and, in recent times, to the cross-border harmonisation of substantive law.

2.3.1 Recommendations of non-governmental organisations

There have been several consultative initiatives accomplished by non-governmental organisations in recent years aimed at drawing the attention of Governments, the competent authorities, the private financial sector and the legal profession to the legal and systemic risk and insufficiencies arising from the current system. The most important such initiatives in the area of securities held with an intermediary was the recommendations by IOSCO/BIS and the G30.

In November 2001, the International Organization of Securities Commissions (IOSCO), together with the Bank for International Settlements (BIS), issued nineteen *Recommendations for Securities Settlement Systems*.⁴⁸ Among the purposes of these recommendations was to give guidance for the reduction of legal and systemic risk in clearing and securities settlement systems, as evidenced by the following excerpts:

- Recommendation 1: “Securities settlement systems should have a well founded, clear and transparent legal basis in the relevant jurisdictions”;
- Recommendation 12: “[...] It is essential that customers’ securities be protected against the claims of a custodian’s creditors” ;
- Recommendation 19: “CSDs that establish links to settle cross-border trades should design and operate such links to reduce effectively the risks associated with cross-border settlements”.

In January 2003, the G30 *Plan of Action*⁴⁹ concerning global clearing and settlement endorsed these proposals in its own Recommendations 14, 15 and 16. Particularly interesting is the fact that G30 identified the resolution of conflict-of-laws problems by the Hague Convention (see *infra*) as the first essential step towards increasing legal certainty regarding rights to securities. However, the report also urged national legislators to tackle matters of substantive law. While Recommendation 14 advocates strengthening the enforceability of contracts, Recommendation 16 encourages the promotion and accommodation of closeout netting arrangements by the domestic law.

G30 Recommendation 15 addresses the topic of legal certainty over securities, cash and collateral. Here, the following problem areas are enunciated: (a) the conflict-of-laws issue; (b) protection of the account

⁴⁸ IOSCO/BIS, *Recommendations for Securities Settlement Systems*, November 2001, available at www.bis.org/publ/cpss46.pdf.

⁴⁹ The Group of Thirty, *Global Clearing and Settlement – A Plan of Action*, 2003; cf. <http://www.group30.org>, in particular pp 109 *et seq.*

holders assets against intermediary insolvency; (c) development of sound and simple procedures for creating and realising security interests over assets; and, (d) finality of book-entries in securities accounts. The report calls on national legislators to undertake law reforms in this regard.

It is obvious that the UNIDROIT preliminary draft Convention covers (b)-(d), whereas the Hague Convention (see *infra*) addresses (a). It must be noted, however, that neither of these international efforts applies to cash transactions.

2.3.2 National law reform

At national level, some countries have in recent years revised the legal framework applicable to the indirect holding of securities in order to reflect the new market reality.

In the United States, Article 8 of the Uniform Commercial Code⁵⁰ underwent a fundamental revision in 1994 to address the realities and needs of market practices in the context of securities held through intermediaries, which had become by far the most common holding pattern. The previous version of U.C.C. Article 8 - although recognising intermediation - was nevertheless based on principles of direct ownership of interests in securities. Revision was prompted, in part, by the U.S. stock market crisis in 1987, which revealed the insufficiency of the existing rules. The central new features were the creation of the concept of a *security entitlement* – a *sui generis* combination of property interests and contract rights exercisable almost exclusively against his direct intermediary (to replace the traditional property right approach), the enhancement of adverse claim cut-off rules and the clarification of rules regarding the appropriate allocation of shortfalls.⁵¹

In Belgium,⁵² the investor's interest is defined as a co-ownership right of an intangible nature in a pool of fungible book-entry securities of the same type held by the intermediary for all its clients collectively (cf. Articles 2 and 6 of the Decree). The investor's title is the book entry and not the underlying physical or dematerialised security. The co-proprietary right is accompanied by personal rights against the intermediary. In the event of insolvency of the intermediary, the investor has a right of revendication, *i.e.* a claim for the return of property enforceable against the intermediary and the intermediary's creditors (cf. Articles 12 and 13 of the Decree).

In Luxemburg,⁵³ the law provides for a very similar framework. An investor, holding securities through an intermediary, has a right of (co-)ownership in a given pool of non-individually identified securities of the same type held by the intermediary on behalf of all owners of the same type of securities. This right of ownership can only be exercised against the direct intermediary. There is a right of revendication granted to investors in the event of insolvency of the intermediary. The law precludes the attachment of securities accounts at the level of securities settlement systems. Upper-tier attachments are equally precluded.

In France, securities were dematerialised in November 1984. Today, there are no longer any certificates and securities are evidenced by book-entries in accounts maintained by authorised financial intermediaries or by the issuer itself. Issuers and intermediaries in turn have an account with Euroclear France, in which issued securities are evidenced by book-entries. The number of securities appearing in the accounts maintained by issuers and intermediaries must correspond to the number of securities appearing in the accounts maintained by Euroclear France. If they did not, investors would lose any right to the securities that appeared in their account with the issuer or their intermediary. In other words,

⁵⁰ The American Law Institute/National Conference of Commissioners on Uniform State Laws, *Uniform Commercial Code, Official Text – 2000 With Comments, Revised Article 8* (1994 Revision), p. 651 *et seq.* (hereinafter: U.C.C. Article 8).

⁵¹ Cf. U.C.C. Art. 8, Part 5; J.S. ROGERS, Policy perspectives on revised U.C.C. Article 8, (1996) U.C.L.A. L. Rev. pp. 1431, 1456 *et seq.*

⁵² Cf. Belgian Royal Decree No. 62 on the deposit of fungible financial instruments and the settlement of transactions involving such instruments, as coordinated by Royal Decree of 27 January, 2004.

⁵³ Cf. Arts. 6, 7 and 15 of the Law of 1 August 2001 on the circulation of securities and other fungible instruments.

book-entries in the accounts maintained by Euroclear France prevail over book-entries in the accounts maintained by intermediaries.⁵⁴

Japan revised the legal framework applicable to shares, bonds and other debt securities, including government bonds, in 2002 and 2004. The financial instruments in question can now be dematerialised; however, the investor has the position of a proprietor. Neither an intermediary nor a CSD has any property right in the securities in question; they are merely responsible for making book-entries and maintaining accounts. The investor's right is determined by the book-entry in his account with the direct intermediary.

In addition, several law reform projects are currently underway in other countries.

The Uniform Law Conference of Canada approved, in August 2004, a draft uniform law on multi-tiered holding systems in Canada, entitled *Uniform Securities Transfer Act*.⁵⁵ This instrument is intended to harmonise Canadian legislation on this subject and to keep it closely aligned on the modernised framework in the United States. The draft law is currently being considered by the governmental authorities of the various Canadian provinces.

In Switzerland, a governmental commission was appointed to review private sector proposals for securities law reform in 2003. The commission delivered a report proposing a comprehensive reform of the law of intermediary-held securities. A draft statute will be published for consultations later this year, and a bill is expected to be submitted to the Swiss Parliament in 2005. Whereas the initial proposals focused on the codification of existing practices and the elimination of minor deficiencies, the current project envisages a more comprehensive reform and is aimed at creating a sound and transparent legal framework for both the custody and the transfer of intermediary-held securities.

In the United Kingdom, in 2002, the Financial Markets Law Committee (FMLC) considered legal uncertainties arising in the context of the intermediated securities markets. The FMLC formed a Working Group to design legislation to address legal risk in relation to intermediated investment securities. The Working Group presented the justification of the need for law reform and set out principles that legislation should exhibit.⁵⁶

2.3.3 International law reform

2.3.3.1 Hague Convention

Parties need to be sure which country's law governs the various legal issues relevant to their rights, and traditional conflict-of-laws rules do not always give a clear answer when applied to modern holding and transfer patterns.

The adoption, in December 2002, of the *Hague Convention on the Law Applicable to Certain Rights in respect of Securities Held with an Intermediary*⁵⁷ represented a huge step towards modernising and clarifying the law on the indirect holding and transfer of securities. This purpose is achieved by the creation of a uniform conflict-of-laws regime (Arts. 4, 5 and 6) that displaces any national conflict rules in

⁵⁴ Code Monétaire et Financier, Art. L. 431-2; cf. F. NIZARD, *Les titres négociables*, Economica 2003, p. 217 *et seq.*

⁵⁵ Cf. .E.T. SPINK, M. PARÉ, *The Uniform Securities Transfer Act: Globalized Commercial Law For Canada*, Banking and Finance Law Review 19 (2004), 321 *et seq.*

⁵⁶ *Analysis of the need for and nature of legislation relating to property interests in investment securities statute, with a statement of principles for an investment securities statute*, Financial Markets Law Committee, 2004, available www.fmlc.org.

⁵⁷ *Convention on the Law Applicable to Certain Rights in respect of Securities Held with an Intermediary*, adopted under the auspices of The Hague Convention on Private International Law, The Hague, on 13 December 2002; available at www.hcch.net. For a full discussion of the conflict-of-laws issues and the Convention, see Chr. BERNASCONI, *op. cit.*, p. 27 *et seq.*; R. GOODE, H. KANDA, K. KREUZER, *Draft Explanatory Report on the Hague Securities Convention*, The Hague, 25 June 2004; R. Potok (ed.), *op. cit.*, p. 48 *et seq.*

this matter and that provides the parties with the answer as to which substantive law is applicable in their specific situation.

The Hague Convention is a pure conflict-of-laws convention. Thus, it has no effect on the substantive law that will be applied once the applicable law has been determined.

The scope of the Convention is addressed in its Article 2. Accordingly, the (domestic) substantive law determined by application of the Hague Convention governs:

- the nature of the right of an account holder against its intermediary and third parties as well as the effects, against the intermediary and third parties, of a disposition of securities held with an intermediary;
- the question whether an interest extinguishes or has priority over another person's interest; it applies in particular to the priority between (i) a person who acquired an interest in securities in good faith, for value and without notice of an adverse claim; and (ii) an adverse claimant;
- the issue whether an intermediary has any duties to a person other than the account holder who asserts, in competition with the account holder or another person, an interest in securities held with that intermediary (this includes the question whether so-called upper-tier attachments are permissible).

Under the Hague Convention, the applicable law is determined following Articles 4 and 5. The primary rule of Article 4 states that the applicable law is determined on the basis of an *express law agreement between the account holder and the relevant intermediary*, if that agreement is articulated in either of two ways: if an account holder and its relevant intermediary expressly agree that the law of a particular State shall govern their account agreement, that law also governs all issues enumerated in Article 2(1); if, however, the account holder and its relevant intermediary expressly agree that the law of a particular State shall govern all the Article 2(1) issues, that law governs all these issues, whether or not there is also a choice of a separate law to govern the account agreement. The parties may expressly agree to have the law of one State govern all the Article 2(1) issues and that of a different State govern the account agreement. The law chosen by the parties to the account agreement applies only if the relevant intermediary has, at the time of the agreement on the governing law, an office in the State whose law is selected which meets certain factual criteria.

If the applicable law is not determined in this manner, there are certain fall-back provisions in Article 5 of the Convention. They result, ultimately, in the application of the law of the jurisdiction in which the intermediary is incorporated or otherwise organised. Article 6 sets forth a list of factors that must be disregarded when determining the applicable law under the Convention.⁵⁸

Being a pure conflicts convention, the Hague Convention has no effect on the substantive law that will be applied once the choice of law determination has been made. Therefore, even after the implementation of the Hague Convention, it remains the role of each jurisdiction's substantive law to provide for a sound legal framework regarding securities holding and dispositions that presents no gaps, uncertainties, burdensome complications or barriers. This also means that issues of cross-border compatibility of the substantive law, as set out above, cannot be addressed by the Hague Convention.

2.3.3.2 European Union

At the regional level, there have been several recent EU initiatives to improve the cross-border trading environment and to remove barriers to cross-border clearing and settlement in particular. The current

⁵⁸ The Convention also deals with a number of other important considerations. These include: (1) the protection of rights on change of the applicable law (Art. 7); (2) the role of the Convention in insolvency proceedings (Art. 8); (3) the determination of the applicable law for multi-unit States (Art. 12); and (4) certain transitional provisions for determining priorities between pre-Convention and post-Convention interests and for dealing with pre-Convention account agreements and securities accounts (Arts. 15 and 16).

legal framework addresses, in particular in the Settlement Finality Directive⁵⁹ and the Financial Collateral Directive.⁶⁰, several aspects that fall within the scope of the UNIDROIT preliminary draft Convention.

The Settlement Finality Directive minimises the disruptions caused to a settlement system by the opening of an insolvency proceeding by ensuring:

- that transfer orders and netting are legally enforceable and binding on third parties;
- that settled transactions cannot be unwound on the basis of the so-called "zero-hour-rule" sometimes incorporated in insolvency laws;
- that transfer orders are irrevocable after a point in time specified by the system; and
- that security provided to central banks or in connection with participation in a settlement system is insulated from the effects of insolvency law.

Furthermore, the Settlement Finality Directive, with respect to the last aspect, provides for a conflict-of-laws rule.

The Financial Collateral Directive, which is in the process of implementation by Member States of the EU, has a much broader scope of application since it covers a substantial part of the financial collateral transactions performed by systems and "financial intermediaries". The Directive:

- protects a security taker in the event of the insolvency of the security provider;
- reduces formal requirements for financial collateral agreements and protects their validity and irrevocability against certain insolvency provisions, such as "zero-hour" rules;
- under certain conditions, allows for the reuse of security interests;
- recognises closeout netting and set-off even when its enforcement is triggered by the commencement or the continuation of winding-up procedures or reorganisation measures; and
- provides for a conflict-of-laws rule relating to the legal nature and proprietary effects of book-entry security, the requirements for perfection and validity against third parties, the conflict of competing titles and the realisation of security interests.

The second report by the Giovannini Group⁶¹ of April 2003 expressed the view that the absence of a common framework for the treatment of interests in securities held with an intermediary constitutes a persistent legal barrier to the development of cross-border clearing and settlement in the EU.

Following the recommendations given in this report, the European Commission⁶² is about to set up a Group, by the end of 2004 or in early 2005, to develop a proposal for legislation regarding the following aspects:

⁵⁹ Directive 98/26/EC of 19 May 1998 on settlement finality in payment and securities settlement systems; available at http://europa.eu.int/eur-lex/en/lif/reg/en_register_1040.html.

⁶⁰ Cf. Arts. 4, 7 and 9 of Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements ("Collateral Directive"); available at http://europa.eu.int/eur-lex/en/lif/reg/en_register_1040.html. Cf. K. LÖBER, "Die EG-Richtlinie über Finanzsicherheiten", *Zeitschrift für Bank- und Kapitalmarktrecht* 2002, p. 601 *et seq.*

⁶¹ The Giovannini Group, *Second Report on EU Clearing and Settlement*, Brussels, April 2003; in this second report the group addresses the question of what actions should be undertaken to eliminate barriers to the integration of the European financial market identified in its first report: The Giovannini Group, *Cross-Border Clearing and Settlement Arrangements in the European Union*, Brussels, November 2001. Both reports are available at http://europa.eu.int/comm/economy_finance/giovannini_en.htm.

⁶² Communication from the Commission to the Council and the European Parliament, *Clearing and Settlement in the European Union – The way forward*, p. 22 *et seq.*; available at http://europa.eu.int/eur-lex/en/com/cnc/2004/com2004_0312en01.pdf.

- the nature of the investor's rights in relation to securities held in an account with an intermediary;
- the transfer of these rights;
- the finality of book-entry transfers;
- the treatment of upper-tier attachment;
- investor protection from insolvency of the intermediary;
- the acquisition of these rights in good faith by third parties;
- differences in the rules relating to the transfer of ownership for the purposes of corporate actions, to the extent that these differences are incorporated in national laws; and
- the choice of securities location.

2.4 Conclusion

During the last fifty years, the practice of holding and disposition of investment securities has changed considerably: departing from the traditional concept of custody or deposit of physical certificates, for reasons of efficiency, operational certainty and speed, a system of holding through intermediaries has been developed. In this system, the greatest part of securities is immobilised with a Central Securities Depository. The investor holds securities through a chain of intermediaries that are ultimately connected to the Central Securities Depository. Acquisition and disposition of securities, including the creation of security interests, are in practice effected on the basis of book entries to the accounts concerned. The securities themselves are no longer physically moved.

However, the legal framework which underlies this modern system of holding through intermediaries in many countries still relies on traditional legal concepts first developed for the traditional method of holding and disposition, i.e. for the physical custody of tangible assets. Because of this, the legal risk in the area of securities holding and disposition is particularly high. This legal uncertainty is multiplied by the fact that securities are increasingly held and transferred across borders, since domestic legal frameworks are not necessarily compatible with each other. Legal risk can, in times of "stress", even trigger systemic effects. Additionally, persistent legal risk affects the efficiency of the markets, as is easily illustrated by the example of increased transaction costs.

Only a few countries have tackled the issue of fundamentally modernising the legal framework for securities holding and transfer, naturally limited to their domestic legal framework. Cross-border holding and transfer of securities suffers from deficiencies regarding the internal soundness of domestic systems and, furthermore, from problems of compatibility between different legal frameworks that govern a given situation.

The issue of harmonising the legal framework regarding securities holding and disposition has been addressed by two international Organisations: the *Convention on the Law applicable to Certain Rights in respect of Securities held with an Intermediary* was adopted in December 2002 under the auspices of the Hague Conference on Private International Law. However, the Hague Convention cannot, by its nature, address issues of substantive law.

On a regional level, the Directives on Settlement Finality and Financial Collateral set in place a fragmented legal framework for securities holding and disposition in the European Union, with special emphasis on security transactions.

Consequently, a framework that comprehensively addresses issues of substantive law in the problem areas identified above is still needed, particularly on a global level. Such a framework would be a necessary complement to the Hague Convention and the EU harmonisation efforts.

The present UNIDROIT *preliminary draft Convention on Harmonised Substantive Rules regarding Securities Held with an Intermediary* is intended to fill this gap.

3 KEY FEATURES OF THE PRELIMINARY DRAFT CONVENTION

In determining the scope of the instrument, as a first step, the criteria that should govern the question of whether a particular matter needs to be addressed by a harmonised rule had to be defined. In this respect, a rigorous approach was adopted: a harmonised rule should be regarded as necessary if it is clearly required for the reduction of legal or systemic risk or for the promotion of market efficiency. This approach recognises that to achieve fully harmonised rules, however desirable in principle, is, in practice, a complex and difficult process requiring both technical and political consensus. The difficulty of achieving such harmonised rules, particularly within a reasonable timeframe, strongly supports this restrictive approach to the scope of harmonisation.

3.1 Internal soundness and compatibility

Against the background set out above and taking into consideration the crucial yet – by virtue of its nature as a conflict-of-laws instrument – limited remedy offered by the Hague Convention, the modernisation and harmonisation of the key aspects of substantive law require action from two angles.

First, the project must be considered from the point of view of promoting *internal soundness* within the domestic legal framework. This means that each system should be given a sound legal framework for the holding and transfer of securities through intermediaries, taking into account in particular objectives of investor protection and efficiency. Roughly, a legal framework meets these criteria when holders of securities through intermediaries can be confident that their interests are robust and can be dealt with under simple, clear rules and procedures for acquisition, holding, disposition (including both outright transfer and provision of security interests) and realisation.⁶³ Furthermore, it is clearly essential that the account holder's interest is not exposed to risks such as the insolvency of any intermediary or interference by unrelated parties.

However, the goal of internal soundness of each system alone would not justify the effort of global harmonisation by way of an international convention. It could be more easily achieved at a purely national level. But, as explained above, legal risk and economic inefficiency stem from both a lack of internal soundness *and* an unsatisfactory legal basis for cross-border holding and transaction. For example, it is possible for the rules of two systems of law, though each internally sound, to fail when combined and to produce an unclear or unsatisfactory result when they interact. It is therefore essential to promote the *compatibility* of national laws by a co-ordinated and harmonised effort with respect to the revision of domestic rules.

It should be stressed that it is hardly possible to classify issues included in the future instrument as exclusively addressing either internal soundness or compatibility. Both the internal soundness of a system, and its compatibility with other systems, can only be addressed in their entirety within a set of harmonised substantive rules.

3.2 Functional approach

The future Convention has to cope with several different traditions and conceptual frameworks of the different systems of law. For this reason, the preliminary draft instrument adopts a functional approach – that is, one that uses neutral language in consideration of the various legal traditions involved and formulates rules by reference to facts, with a view to facilitating the accommodation of the different legal concepts in place in different jurisdictions.

⁶³ Establishing the robustness of an interest in indirectly held securities is a process that involves both legal and operational issues. However, operational issues are beyond the scope of the future instrument.

3.2.1 Importance of the functional approach

In each jurisdiction, the law governing securities holding and transfer is embedded in national legislation and integrated within several different legal areas: commercial law, corporate law, tax law, insolvency law, etc., as well as through measures carried out by the regulatory authorities. Generally, provisions in an international instrument can be either intrusive with respect to domestic legislation, or seek solutions that are compatible with the law of all contracting countries, or at least with their legal tradition. The former solution would cause greater difficulty in terms of implementation, the latter would probably result in a huge number of national peculiarities that must be taken into consideration, overloading the drafting process and perhaps rendering it impossible. The preliminary draft Convention settles on an intermediate approach: it is not designed along the lines of domestic laws (and therefore “intrusive”), but aims at avoiding too much intrusion by formulating rules only by reference to facts. The means by which the required result is to be achieved in a concrete legal system are not decisive and remain within the national legislator’s discretion, provided there are compatible with the other rules of the preliminary draft Convention.

To take an example, the protection of the securities of an account holder in the event of its intermediary’s insolvency could be achieved by the following means: e.g. (a) by treating securities as “property”, with the result that since they belong to a person other than the insolvent party, such property does not, according to traditional legal principles, form part of the insolvency estate; or (b) by holding securities with an intermediary under a trust mechanism, with the effect that under the ruling law, the assets of the beneficiary (trustor) are not available to the creditors of the legal owner (trustee). Several other techniques are certainly possible.

To follow the functional approach means, in the context of this example, that a rule need not follow any of the above techniques, but settle exclusively on a description of the result: *The rights of an account holder constituted by the credit of securities to a securities account [...] are effective against the insolvency administrator and creditors in any insolvency proceeding in respect of the relevant intermediary* (cf. Art. 11 of the preliminary draft Convention).

3.2.2 Neutrality as to language

Drafters of other international instruments have found it unexpectedly difficult to use ostensibly common legal concepts such as “property” or “possession” in a manner which would be interpreted in the same sense in all legal systems. The preliminary draft Convention, therefore, seeks to avoid such terms and the related, unintentional, pre-determination of concepts and instead uses neutral language, employing plain and factual terms.

Thus, with a view to ensuring the uniform application of the provisions of the preliminary draft Convention, all references to traditional concepts should be avoided where possible. As regards, for example, a concept that is traditionally termed in many jurisdictions “good faith acquisition”, the requirements need to be defined in as plain a wording as possible so to avoid recourse to traditional concepts. In the end, it was decided that the entire concept of what is traditionally known as “good faith acquisition” should be replaced by a description: *A person who acquires securities held with an intermediary [...] who does not at the time of the acquisition have knowledge of an adverse claim with respect to the securities is not subject to that adverse claim. [...] [A] person acts with knowledge of the adverse claim if that person has actual knowledge of the adverse claim or has knowledge of facts sufficient to indicate that there is a significant probability that the adverse claim exists and deliberately avoids information that would establish the existence of the adverse claim. [...]* (cf. Art. 10 preliminary draft Convention).

3.2.3 Limits to the functional approach

There is a clear desire to accommodate different legal concepts and to produce as unintrusive an instrument as possible by employing fact-based rules. However, this does not mean that intrusion can be

avoided entirely. Where the purposes of the future Convention require a *uniform* practice, the respective provision of the preliminary draft Convention will be rather detailed and inflexible. In the consultation process that led to the adoption of the 2001 Cape Town Convention on International Interests in Mobile Equipment, this became known as a “rule based” as opposed to a “standard based” draft. Amendments of laws that have to date followed a different approach might be necessary, especially in the case where the purpose of compatibility of the legal frameworks is in the foreground. For example, in the context of the acquisition and disposition of securities, the preliminary draft Convention contemplates a regime that leaves little margin to national legislators: *securities held with an intermediary are acquired by an account holder by the credit of those securities to that securities account of that account holder* (cf. Art. 3 (1) of the preliminary draft Convention).

This conflict between the need for a uniform legal framework and the desire to create as unintrusive an instrument as possible results, with respect to several elements of holding and disposition of securities, in a two-fold strategy: on the one hand, the preliminary draft Convention provides for a uniform and relatively strict rule regarding a particular aspect of intermediated securities holding; on the other hand, the preliminary draft does not necessarily preclude other - traditional - legal concepts regarding this aspect, provided the uniform rule prevails. The preliminary draft pursues this strategy regarding acquisition and disposition of securities (including creation of security interests) by setting a sequence of priorities that puts interests created under the rules of the future Convention over interests created under traditional domestic rules.

Where issues do not directly relate to system stability and legal risk, e.g. the effective exercise of corporate rights (cf. Article 2(1)(a), (3)), the preliminary draft Convention limits itself to proposing a strictly result-based rule while entrusting to the national law with the task of establishing the particular concrete means of achieving that result.

3.3 Internationality

There has been some discussion whether the preliminary draft Convention should introduce a legal framework with respect only to holding and transactions that feature a cross-border element, or whether it should also address purely domestic contexts. The first solution, applying the future instrument only to situations including a cross-border element, is tempting because it would enable the regime for purely domestic situations to remain unchanged. However, this solution assumes, first, that there still exist purely domestic transactions and, second, that it would lead to a legal framework offering two alternatives: one for domestic situations, one for fact patterns which include a cross-border element. This would entail, in turn, that each transaction would need to be classified with a view to determining which alternative is applicable. This might be relatively difficult or even impossible. Therefore, the rules promoted by the preliminary draft Convention apply to both domestic transactions and those with a cross-border element.

3.4 The needs of market participants as guidelines

In seeking to identify the nature and extent of the harmonised rules that are desirable, it was useful to consider the needs of the principal participants against the background of criteria of legal and systemic risk and market efficiency in a domestic as well as in a cross-border context.

3.4.1 *Effective book-entries*

First and foremost, an account holder needs to be confident that securities in its account represent interests that are effective against its intermediary and third parties, even in the event of insolvency of the intermediary. This applies to an account holder at the bottom level of the holding chain (investor) as well as to account holders in the middle of the chain, i.e. intermediaries that hold through another (higher-tier) intermediary. An aspect closely related to the foregoing is that a reversal of book-entries should only be possible under previously clearly stated exceptions.

These aspects are addressed in Articles 1(d), 2(2)(a), 5, 11, 14 and 15.

3.4.2 *Fruits, voting rights, etc.*

An investor needs to be sure that the holding of securities through a multi-tiered holding system does not weaken its position regarding (a) receipt of dividends or other fruits of the investment; (b) exercise of voting and other corporate rights; and (c) exercise of set-off against a bond-issuer, which should not be precluded to an extent greater than under a direct holding system.

The preliminary draft Convention deals with these issues in Articles 2(1), (3) and 18.

3.4.3 *Clear and simple rules for transactions*

All parties to any kind of transaction (acquisition, disposal, creation of a security interest) need to rely on simple rules for such transaction. This means also that (1) the effectiveness of a transaction against third parties is clearly defined; (2) an acquirer of securities or a security interest should be protected against claims from a third party challenging the right, purporting to have a prior or prevailing interest, except in scenarios where the account holder knew about a previously existing interest over the asset in favour of that party; (3) there should be clear rules regarding priorities of competing dispositions.

The respective rules are addressed in Articles 3-6, 9 and 10.

3.4.4 *Integrity of the account holder / intermediary relationship*

An intermediary needs to be sure that it is only exposed to claims that build on the relationship with its own account holder and that it is protected from third party interference. Third parties may not have access to this relationship unless expressly granted, e.g. when providing security over securities to a third party. Consequently, an intermediary only has to recognise (1) interests of its *own* account holder with respect to the account; (2) security interests over assets credited to an account that it maintains for its *own* account holder; (3) orders to attach or freeze one of the foregoing interests in favour of a third party.

These issues are addressed in Articles 2(2)(b), 8 and 13.

3.4.5 *Instructions*

There should be a clear regime for instructions with a view to protecting the intermediary and the clearing and settlement system: (1) an intermediary needs to be perfectly sure whose instructions are binding (account holder and possibly a secured third party) and who is not entitled to instruct (third parties); (2) there should be limits to the possibility of revoking instructions.

Rules relating to instructions and their revocation are addressed in Article 13.

3.4.6 *Net settlement*

An intermediary should be entitled to effect a net settlement. That is, to the extent that there are matching debits and credits to accounts maintained by the intermediary for its account holders, there need not be precisely matching entries in the intermediary's accounts maintained with the upper-tier, but such entries should simply reflect the net overall change in the aggregate balances of its account holders taken together.

Net settlement is addressed in Article 3(5).

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3.4.7 Integrity of the issue

An issuer of securities needs to be sure that the rules regarding acquisition of securities do not lead to a situation where the aggregate number of securities of a certain description held through the system of intermediaries exceeds the number of securities originally issued (“inflation”).

This issue is dealt with in Article 16.

3.4.8 Realisation of security interests

There should be clear and simple rules regarding the realisation of a security interest over securities held with an intermediary. These rules should allow for rapid realisation without burdensome formal requirements once the substantive requirements authorising the enforcement have been fulfilled, in a manner that does not prejudice the interests of the security provider.

There are rules regarding the realisation of security interests in Article 20.

3.4.9 Right of use

A security provider needs to know clearly whether and to what extent the security taker may use the securities that it has under its control for further purposes, notably whether and under which conditions it is entitled to create another security interest over its interests in favour of a third person (re-collateralisation).

This point is dealt with in Article 21.

PART II: EXPLANATORY NOTES

The text of the preliminary draft Convention is to be found in the Appendix to this document.

ARTICLE 1 – DEFINITIONS AND INTERPRETATION

Paragraph (1)

In general, the UNIDROIT preliminary draft Convention uses the same definitions as are used in the Hague Convention, since these definitions are already the result of a consensus among a great number of countries. The use of identical definitions and concepts will promote interoperability between the two international instruments and facilitate implementation in domestic law.

Sub-paragraph (a): “securities”

The definition of securities is intentionally very broad, though marginally less so than the Hague Convention definition, since it restricts the residual category of financial instruments and financial assets to *transferable* financial instruments and financial assets. It includes all kinds of financial assets, other than cash. The commentators of the Hague Securities Convention describe it as a fluid definition, mainly based on the criterion of whether a financial instrument is capable of being credited to an account. The clear advantage of adopting this flexible approach, rather than subscribing to a fixed list of financial instruments that are considered as being securities, is that it can accommodate future development of new types of financial instruments.

The manner of issue of a financial instrument is irrelevant, therefore excluding considerations regarding:

- the market on which the securities are issued;
- whether the issue is certificated or not;

- the form of the certificate (single, global, jumbo), if any;
- whether the securities can be withdrawn from the holding system and be held directly by the investor;
- whether or not the securities are listed on a stock exchange;
- etc.

The phrase “or any interest therein” is necessary, because the future instrument should also cover positions of account holders which do not comprise full ownership, such as security interests in securities, and certain indirect holding positions, e.g. where the account holder is a beneficial owner and the intermediary legal owner of the securities. Against the same background, the definition makes clear that any interest an intermediary might have in the assets is equally included.

The restriction of “cash” from the definition of securities makes clear that the instrument is not intended to apply to money deposited or paid into a bank for whatever reason and to whatever account.

Sub-paragraph (b): “securities account”

The definition comprises, for the purposes of this Convention, accounts between all types of parties to a system of holding through intermediaries, i.e. investor/intermediary; lower-tier intermediary/higher-tier intermediary; intermediary/CSD. However, the CSD/issuer relationship is not included.

Sub-paragraph (c): “intermediary”

Intermediaries are typically banks or brokers, but may also be CSDs/ICSDs, clearing corporations, etc. Even Central Banks can fall within this definition. Consequently, the notion relates to all participants in a system of holding through intermediaries, except the ultimate account holder (“investor”) and the issuer (who should not even be regarded as participating in the system). Cf. comments on “account holder”.

Excluded from the scope of the text are other persons that assist in the holding and disposition of securities, such as agents, consultants, managers of an intermediary, etc.

Sub-paragraph (d): “account holder”

This broad definition encompasses the following persons within its scope:

- the ultimate account holder in the holding chain, whether it is, in economic terms, the investor itself or an agent for another person; and
- a lower-tier intermediary that holds securities through another higher-tier intermediary.

However, it excludes:

- a person entitled to give instructions without being the named holder of the account, e.g. a third person that acquired a security interest over the assets credited to that account; and
- the CSD with regard to the issuer.

Sub-paragraph (e): “account agreement”

The account agreement is the contract setting out the reciprocal rights and duties between the account holder and the intermediary. There are no formal requirements for the purposes of the future Convention.

Sub-paragraph (f): “securities held with an intermediary”

This definition is one of the central terms of the present draft, as it is used throughout to refer to the substantive legal position of the account holder. However, “securities held with an intermediary” is a generic term that has no content by itself and is not intended to define the nature of such right. The definition of the nature of the account holder’s legal position remains with the applicable domestic law (cf. Art. 2 (1) (e)). However, it is subject notably to Article 2 and must also be compatible with the other provisions of the preliminary draft Convention.

At the same time, the definition delimits the scope of the future Convention to securities held with and intermediary as opposed to securities that are not within the system of holding through intermediaries. Therefore, all situations in which investors hold physical certificates, either themselves or through an agent, or where investors are directly registered with the issuer, are excluded from the application of the future Convention.

In order to come within the scope of the future Convention, securities need to be credited to an account held with an intermediary. They exit the regime of this instrument from the moment that they are withdrawn from the system of holding through intermediaries.

It should be stressed that the decisive factor is the acquisition of the legal position by the credit of the securities to an account with an intermediary. Thus, it is irrelevant for the application of the Convention whether the intermediary itself retains any legal position in the securities. Consequently, securities are held with an intermediary even if, as is the case notably in jurisdictions following the proprietary legal concept, the intermediary has no position at all and the investor has the full right "in his hands". The future Convention will also apply in cases where a special register is maintained by the issuer for purposes of, e.g., identification of end-investors, especially with regard to payment of dividends and exercise of corporate rights. The rights are initially acquired through the account with the investor's intermediary.

Sub-paragraph (g): "relevant intermediary"

"Relevant intermediary" means, with respect to an account holder, the intermediary that directly maintains the securities account for the account holder. This definition is intended for determining the account holder's own intermediary as opposed to all other intermediaries that operate between the account holder and the issuer or the account holder and the counterparty of a transaction.

Sub-paragraph (h): "disposition"

Prior to the current draft, the term 'disposition' was, following the terminology in certain jurisdictions, sometimes used as an umbrella concept encompassing both 'acquisitions' and 'dispositions' in a narrower sense of 'giving up a right'. The square brackets are intended to remind that there is a slight tension created by the almost unperceivable change of perspective from, on the one hand, Article 1 (1)(h) where the perspective is exclusively the transferor's/seller's/security provider's - i.e. the 'losing party's' - to, on the other hand, Article 4 where one specific type of 'disposition' - which is at the same time and from the other party's perspective an 'acquisition' -, namely the creation of a security interest is described objectively and not from the perspective of only one of the parties. The square brackets could be deleted. In a similar vein, one might consider, for the sake of formal parallelism, inserting a definition of the term 'acquisition' in Article 1 (1).

Sub-paragraph (i): "adverse claim"

The term is used in the context of an innocent acquisition of securities that are subject to an adverse claim of a third person under the domestic law. Cf. Article 10.

Sub-paragraph (j): "insolvency proceeding"

The definition is taken from Article 5 of the 2001 *United Nations Convention on the Assignment of Receivables in International Trade*. It is as broad a definition as possible, and includes various types of proceedings as well as interim measures.

Sub-paragraph (k): "insolvency administrator"

"Insolvency administrator" means a person authorised to administer a reorganisation or liquidation, including one authorised on an interim basis, and includes a debtor in possession if permitted by the applicable insolvency law.

The definition is taken from Article 5 of the 2001 United Nations Convention on the Assignment of Receivables in International Trade and the 2001 UNIDROIT/ICAO Convention on International Interests in Mobile Equipment (Cape Town Convention).

Sub-paragraph (1): "securities of the same description"

In this definition, a distinction is drawn between shares and stock of a corporation and other types of securities, such as debt instruments. The reason for this is that shares and stocks of the same corporation can be issued in more than one instance, especially in the event of an increase of capital stock. However, these are fungible and are traded without taking into consideration whether they belong to the initial or a later issue. The case of debt securities is different: here, securities from different issues are not fungible.

Paragraph (2)

This provision is the standard interpretation principle, instructing to avoid the use of national legal concepts in interpreting the text. It is in essence adopted from Article 5 of the Cape Town Convention, as are Paragraphs (4) and (5). There is, however, no reference to the Preamble.

Paragraph (3)

This definition reflects the fact that the Convention was not drafted as a comprehensive code covering all substantive rules relevant to its subject matter, but as a set of key provisions to be incorporated by Contracting States into their existing laws, with whatever modifications of their existing laws are appropriate. As is made clear in various provisions of the Convention, the rules of the Convention must have priority.

Paragraph (4)

The general principles of the draft text referred to in Paragraph 4 are, for example: consideration of modern market practices, clarity and predictability, and primacy of book-entry dispositions.

Paragraph (5)

Where issues are not settled by the terms of the Convention, the domestic law of the State as determined by conflict-of-law rules of the forum applies. *Renvoi* is excluded. The law thus determined need not to be the law of a Contracting State.

ARTICLE 2 – RIGHTS RESULTING FROM THE CREDIT OF SECURITIES TO A SECURITIES ACCOUNT

This provision sets out basic characteristics of the rights that are conferred on the account holder by a credit to its securities account with the relevant intermediary.

Paragraph (1)

Paragraph (1) describes the features of the right that entitle the account holder to receive something or to act in a certain way. Sub-paragraph (a) covers the economic and other benefits flowing from the holding of securities. Sub-paragraphs (b), (c) and (d) deal with the transfer of securities held with an intermediary; in particular, they describe the right to move a holding to a different intermediary and the right to withdraw securities from the intermediated system where this is possible under the applicable corporate law and the terms of issue of the securities. Sub-paragraph (e) makes clear that (a)–(d) do not

exhaustively depict the nature of the rights stemming from the credit of securities to a securities account with an intermediary.

Sub-paragraph (a)

Sub-paragraph (a) recognises two principles. The first is that the system of holding through intermediaries should not distort the allocation of economic benefits that result from investing in securities.

The second notion is that not all participants within the system are entitled to those benefits. The ultimate account holders (investors or agents for investors) are clearly so entitled. However, all intermediaries not situated on the topmost tier of holding are also account holders (*vis-à-vis* their higher-tier intermediary), as is made clear in Article 1(1)(d). Therefore, this Sub-paragraph makes clear that intermediaries are only entitled to the fruits of ownership in as far as they are account holders for their own account, i.e. in so far as they do not act in their capacity of intermediary for their clients with respect to the securities in question.

Sub-paragraph (d)

The right to withdraw the securities from the system of holding through intermediaries means that the account holder claims delivery of paper certificates, whereby its securities exit the system (and the scope of this preliminary draft Convention). The possibility of withdrawing from the system may be excluded; for example, in systems where securities are generally dematerialised; or, where securities are represented or evidenced by global certificates or jumbo certificates.

Sub-paragraph (e)

As intended in the preliminary draft Convention, the characteristics enumerated in Article 2 are neither exhaustive nor comprehensive. In the interest of upholding the drafting principles of neutrality and functionality, and considering that the nature of the investor's right must fit into the framework of each domestic law, the draft confers upon the national legislator the task of defining the remaining rights conferred by a credit of securities, subject to the characteristics set out in Article 2 and to the other provisions and principles of the Convention.

Paragraph (2)

Most jurisdictions give an account holder's right the status of being generally effective against anybody, i.e. the intermediary and third parties. This is also one of the foremost objectives of this preliminary draft Convention. In keeping with the principle of neutrality, it is left to the national law to determine the means by which effectiveness against third parties is achieved.

As this effectiveness generally would entitle the account holder to defend and claim its legal position *vis-à-vis* anybody, an important clarification must be made with respect to a feature that is unique to the system of holding with intermediaries: with a view to avoiding disruptions in the system, under normal circumstances, an account holder may only *exercise* this right *vis-à-vis* its *direct, "relevant" intermediary*.

This means that although the securities may equally be held through an intermediary situated higher up along the "holding chain" than its relevant intermediary, an account holder may not exercise its right at the upper level because the account maintained with the upper-tier intermediary will generally be an "omnibus" account and the upper-tier intermediary has no knowledge or record of interests other than the interest of its immediate (own) account holders.

There are two means by which the draft text bars the exercise of the right at an upper tier. First, Paragraph (2)(b) states that the right is enforceable only against the relevant intermediary except as otherwise provided by the Convention, by the terms of issue or by the law under which the securities are constituted. Second, Article 13(1) provides that (subject to certain exceptions) an intermediary is neither bound nor entitled to give effect to any instructions with respect to securities credited to a securities account of an account holder given by any person other than that account holder.

Article 13(1) addresses this issue from a purely procedural angle. Article 2(2)(b) seems to limit the right as such. As to the nature of the right resulting from a credit of securities to a securities account, cf. Paragraph (1)(e); Paragraph (2)(b) has a greater impact than has Article 13(1). However, prohibiting the exercise of the right at an upper level effectively in all legal systems might require the farther-reaching rule of Paragraph (2)(b). The Study Group proposes to refer the question of whether Paragraph 2(b) is necessary to the Committee of Governmental Experts.

Paragraph (3)

Paragraph 3 makes clear that the purpose of Paragraph 1(a) is not to modify the duties of intermediaries with respect to assistance in receiving the fruits of ownership. The detailed scope of the intermediary's duties in assisting the ultimate account holder in receiving the fruits is left to the national law.

ARTICLE 3 – ACQUISITION AND DISPOSITION OF SECURITIES HELD WITH AN INTERMEDIARY BY DEBITS AND CREDITS TO SECURITIES ACCOUNTS

The rules contemplated by this Article follow two criteria: the regime for acquisition and disposition should be as clear and simple as possible, and it should be based on accepted commercial practice.

Paragraphs (1)-(4)

Paragraphs (1) and (2) establish the principle of sufficiency of book entry debits and credits by providing that securities held with an intermediary are acquired by a credit, and disposed of by a debit, to a securities account.

Securities held with an intermediary is a defined term and refers to the rights specified in Article 2. Thus, an acquisition or disposition of securities, as defined in Paragraphs (1) and (2) respectively, does not mean that the account holder acquires or loses the right to benefits of the investment, as set out in Article 2(1)(a).

Paragraph (3) reinforces the principle of sufficiency of book entries by providing that the effectiveness of a book entry acquisition or disposition does not depend on any additional prior or subsequent act, such as, for example, the conclusion of an underlying valid contract, any specific declarations, a possessory change with respect to the securities, correspondent acquisition of securities by the relevant or any upper tier intermediary, or similar actions.

However, the effectiveness of an acquisition or disposition is dependent upon the authorisation of the account holder, cf. Article 5.

Paragraph 4 precludes so-called "tracing"; in other words, the acquisition or disposition does not depend on whether a corresponding disposition or acquisition can be identified as taking place anywhere in the system. A "transfer" from one account holder to another is not a necessary condition for the acquisition or disposition of securities. However, the fact that a "transfer" actually takes place under the applicable rules of the system does not affect the application of Paragraph (1) or (2).

Paragraph (5)

To the extent that there are matching debits and credits to accounts maintained by the intermediary for its account holders, there need not be precisely matching entries in the intermediary's accounts maintained with the higher-tier, but such entries simply reflect the net overall change in the aggregate balances of its account holders.

Paragraph (6)

Paragraph 6 clarifies that under the Convention, security can be provided by means of an (as it is traditionally termed) outright transfer of the securities, accompanied by a contractual agreement stipulating the conditions of the security. The Convention does not intend any changes to such transactions except that the “transfer” is governed by Paragraphs (1)-(5).

Paragraph (7)

Paragraph (7) results from the application of the principle of neutrality *vis-à-vis* the national law. Therefore, the preliminary draft Convention does not preclude any other method provided by the applicable law for the acquisition or disposition of securities held with an intermediary.

In cross-border transactions, parties on both sides need to be in a position to rely on the acquisition and disposition of securities by book entry as having the same legal effects in all systems concerned by the transaction. Book entry dispositions would not have the desired qualities of clarity and legal certainty if they could be overridden by conflicting transactions under national rules. Accordingly, Article 9 gives acquisitions and dispositions of securities effected by book entry primacy over interests created by other methods under national laws.

ARTICLE 4 – CREATION OF SECURITY INTERESTS OVER SECURITIES HELD WITH AN INTERMEDIARY

The preliminary draft Convention provides for a full set of possibilities to provide a security interest over securities:

- security by way of disposition and acquisition under Article 3(1) and (2), cf. Article 3(6);
- security not requiring disposition and acquisition of the securities, either in favour of the security provider's intermediary (Article 4(1)(a)), or in favour of a third person (Article 4(1)(b)); or
- security under regimes other than the present text (Article 4(5)).

Paragraphs (1) and (2)

The valid creation of a contractual security interest which is not based on an outright transfer of the asset requires, according to traditional legal principles, the security taker's “possession” or “control” over the asset, as well as publicity. The preliminary draft Convention adapts these principles to the modern practice of securities holding.

As regards the element of “possession” or “control” over the asset, as far as security is provided to the security provider's intermediary (Paragraph 1(a)), the latter is already in a comparable position with respect to the securities. Its position enables the security provider's intermediary to bar the security provider (account holder) from exercising rights such as dispositions or withdrawals of the securities, or from granting a security interest to a third person under the rules of Article 4. To that end, it is neither necessary, nor is it even possible, to strengthen the factual position of the security taker (intermediary) over the securities.

The position is different where the security taker is a third person. A third person achieves control over the securities as soon as the intermediary is committed to follow the third person's requirements. The possible requirements referred to in this sub-paragraph include: requirements to debit the securities to the account holder's securities account and to credit them to a securities account of the secured creditor in whose favour the security interest has been created, or of a third party to whom the secured creditor has disposed of the securities on realising its security; requirements with respect to the payment of dividends and other sums receivable in respect of the securities to the secured creditor; and requirements regarding the exercise of voting rights as directed by the secured creditor.

To that extent, the preliminary draft Convention gives the security taker a stronger position than that which is provided by some traditional types of security interests, such as, for example, the traditional pledge, where the pledgee is not entitled to dispose of the security. A policy question arises as to whether the Convention should also provide for a category of security interest analogous to a traditional pledge, which deprives the pledgor of the ability to dispose of the security but does not enable the pledgee to do so without the sanction of a court.

The element of publicity is dealt with in Paragraph (2): the securities account and any account statements need to indicate the existence of the security interest, e.g. by “earmarking” or “flagging”. It is a policy question whether a security interest in favour of the intermediary should require a degree of annotation in account statements similar to that required for security interests granted to third parties. If it were decided that no annotation should be required for security interests in favour of the relevant intermediary, the reference in this Paragraph would be to Paragraph (1)(b); otherwise the reference would be to Paragraph (1).

Paragraphs (4) and (5)

See Article 3(3) and (7).

ARTICLE 5 – EFFECTIVENESS OF CREDITS, DEBITS, ETC.

Article 5 deals with the effectiveness of debits and credits of securities to a securities account and of the designation of securities under Article 4. Such a transaction is effective (“final”) when the debit, credit or designation of securities held with an intermediary is made, cf. Article 6. If a credit, debit or designation is not effective, it may be reversed by the intermediary.

Paragraph (1)

The authority conferred by this Paragraph may consist of specific instructions or may be a general authority. While this Paragraph does not refer to the creation of a security interest in favour of the relevant intermediary under Article 4(1)(a), the same principle applies, since Article 4(1)(a) requires the agreement of the account holder.

Paragraph (2)

Credits, debits and designations that are made subject to a condition are ineffective when the condition is not met. To take an example, a common condition linked to a credit to a securities account is that the intermediary itself will receive a corresponding credit in its account with the higher tier.

Paragraph (3)

A credit, debit or designation that is effective following the rules of Articles 3-5 may, however, be reversed under a clearly stated rule of the applicable law on the ground of fraud or misrepresentation or any other ground. The law also determines the consequences of such reversal for third parties.

Paragraphs (4) and (5)

Paragraph (4) protects a party that acquired either securities or a security interest under Article 4(1)(b) from an account holder to whose account the securities in question are subsequently debited for one of the reasons in Paragraphs (1)-(3). The protection is subject to certain conditions, (i)-(iii) of Paragraph 4 and Paragraph 5. With respect to the latter, cf. Article 10(3).

ARTICLE 6 - FINALITY OF CREDITS, DEBITS ETC.

The purpose of Article 6 is to endorse the notion that a credit, debit or designation under Article 4(1)(b) can no longer be reversed from the moment when it is made ("Finality").

ARTICLE 7 – OVERRIDING EFFECT OF CERTAIN RULES OF CLEARING AND SETTLEMENT SYSTEMS

Article 7 reflects the fact that clearing and settlement systems are heavily regulated entities with an advanced operational and legal structure designed to minimise legal and systemic risk.

It may be useful to insert in Article 1 a definition of the term 'clearing and settlement system'. One might use the following wording: 'The term 'clearing and settlement system' describes a formal arrangement between several intermediaries with common rules and standardised operational practices for the execution of transactions between them'. - Moreover, the Committee of governmental experts will have to consider which categories of intermediary are eligible to be part of such a system. Furthermore, the Committee may wish to consider whether, to what extent and by whom the characterisation as 'clearing and settlement system' in the sense of the draft instrument is to be made public.

ARTICLE 8 – PROHIBITION OF UPPER-TIER ATTACHMENT

This article prohibits the making of orders, such as so-called "upper-tier attachment" orders, which would disrupt the system of holding securities through intermediaries by permitting a creditor or other person seeking to enforce a judgment or claim against an account holder by attaching securities held by the account holder to obtain an order against a higher-tier intermediary, compelling the higher-tier intermediary to freeze or segregate securities held in an account in which the account holder is indirectly interested. The risk of such an order undermines the integrity of the intermediated holding system, because a higher-tier intermediary will typically have no means of identifying any interest of an account holder holding securities with a lower-tier intermediary, but will merely operate an omnibus securities account, in the name of the lower-tier intermediary. The freezing of such an account will consequently damage the interests of all account holders of the lower-tier intermediary and severely disrupt the operation of the system.

ARTICLE 9 – PRIORITIES AMONG COMPETING INTERESTS

The methods of acquisition, disposition and granting security provided by this Convention do not preclude other – traditional – methods that are provided by the applicable domestic law, cf. Articles 3(7) and 4(5). However, legal certainty with respect to book entry holdings and transactions requires the existence of a uniform system that delivers a clear and predictable legal result in all jurisdictions concerned. Therefore, Article 9 gives interests created under Article 3 and 4 of the preliminary draft Convention absolute priority over interests created under traditional rules.

Security interests arising by operation of a mandatory rule of the domestic law are entirely exempt from these rules: their priority is exclusively governed by the domestic law, i.e. such a security interest might prevail over a book-entry transaction effected under Articles 3 and 4.

Transactions under Article 3 and 4 rank among themselves in the order in which they are created. The priority of transactions under traditional domestic law that do not comply with Article 3 and 4 is determined by the domestic law.

Priority rules can be changed contractually between parties to a transaction, as long as the interests of third parties are not affected.

ARTICLE 10 – ACQUISITION BY AN INNOCENT PERSON OF SECURITIES HELD WITH AN INTERMEDIARY

Article 10 is the generic form of a legal concept which can be found in most jurisdictions and which is traditionally termed “good faith acquisition”.

In the preliminary draft Convention, the concept of “good faith” is replaced by neutral, fact-based language: the acquirer must not have “knowledge” of an existing adverse claim. An acquirer who does not have knowledge takes the securities free from the adverse claim. The term “knowledge” is defined in Paragraph 3 and divided into either actual or imputed knowledge. Knowledge is for this purpose imputed only in relatively narrow circumstances: where the acquirer has (actual) knowledge of circumstances sufficient to indicate a significant probability that the adverse claim exists and *deliberately* avoids information that would establish its existence. Additionally, Paragraph 3 defines at what point in time an organisation receives knowledge.

The third party’s claim is termed “adverse claim”, in order to ensure as broad a scope as possible, cf. Article 1(i).

In the case of an acquisition made by gift or otherwise gratuitously, the acquirer need not be protected, cf. Paragraph 2. It should be discussed whether reference should be made in this Paragraph to the acquisition of a security interest, which cannot, by definition, be wholly gratuitous.

Article 10 cannot remove the difficulties that occur traditionally in the context of good faith acquisition or similar concepts as regards, first, *proof* of knowledge or knowledge of sufficient facts, and, second, *interpretation* of the terms “sufficient”, “significant probability” and “reasonably”. These terms need to be interpreted against the background of standard commercial practice with regard to securities transactions, taking into consideration the fundamental principles of the preliminary draft Convention.

ARTICLE 11 – RIGHTS OF ACCOUNT HOLDERS ON INSOLVENCY OF INTERMEDIARY

The protection of the account holders’ securities in the insolvency of the relevant intermediary is the core of any sound legal framework with respect to securities held with an intermediary. Article 11 sets out a rule of recognition, making it clear that the status of the rights of an account holder is not affected by the commencement of insolvency proceedings in respect of the intermediary and are therefore effective against the insolvency administrator and creditors. The article should be read together with article 15, which, as explained below, states that securities held by the intermediary or credited to accounts held by the intermediary with a higher-tier intermediary are, to the extent required to ensure that the intermediary’s account holders’ rights are protected, appropriated to the account holders’ rights, are not property of the intermediary and are not available for distribution among the intermediary or otherwise subject to their claims. As explained below in relation to article 15, the legal analysis by which this result is achieved is left to the applicable law.

The recognition under Article 11 relates to securities acquired by book-entry credit and security interests granted under Article 4. Securities or security interests acquired under other methods (cf. Articles 3(7) and 4(5)) are protected in the insolvency of the intermediary following the rules of the domestic law.

ARTICLE 12 – EFFECTIVENESS OF DEBITS, CREDITS ETC. AND INSTRUCTIONS ON INSOLVENCY OF OPERATOR OR PARTICIPANT IN SECURITIES CLEARING OR SETTLEMENT SYSTEM

Article 12 deals with the so-called “finality” of transactions within clearing and settlement systems.

The rules of such systems, for reasons of system stability, in most cases determine that transactions (acquisition, disposition, provision of a security interest), once effected in the accounts of the system, cannot be reversed and instructions given with respect to effecting such transaction, once entered into the system, cannot be revoked and must be effected.

Paragraph (1) states that such rules shall have effect notwithstanding the commencement of an insolvency proceeding over the system or a participant of the system.

Paragraph (2) makes it clear that Paragraph (1) applies even if mandatory rules of the domestic insolvency law provide for a different result with respect to finality of book-entries and instructions. Thus rules of insolvency law which typically would invalidate dispositions of property made at or around the commencement of insolvency proceedings, and treat unexecuted instructions as being revoked by the commencement of such proceedings, are overridden by this article.

Paragraph (1)(b) is the only provision of the preliminary draft Convention which deals with cash payments in addition to dispositions of securities. The reason for this exception is that many securities settlement systems are structured on a cash-against-delivery basis and accordingly the purpose of protecting the integrity of such systems in the context of insolvency cannot be effectively achieved without protecting the effectiveness of instructions relating to both cash and securities.

ARTICLE 13 – DUTIES OF INTERMEDIARY

The purpose of this Article is to protect the integrity of the relationship between an account holder and its relevant intermediary, cf. Paragraph (1). As a general rule, the account holder can be sure of that integrity because the relevant intermediary is not entitled to execute instructions with respect to the account given by a third person. The intermediary, for its part, has the assurance that it is not bound to follow a third person's instructions which would result in a violation of its duties *vis-à-vis* the account holder.

All persons which are not account holders in the sense of Article 1(1)(d), i.e. persons in whose name the intermediary maintains the account are therefore excluded from giving instructions to the intermediary. This applies in particular to account holders that seek to give instructions to an intermediary which is not the relevant intermediary but part of the "holding chain" at the upper level, e.g. a CSD. Paragraph (1) therefore forms part of the set of provisions that preclude the exercise of rights at the upper tier, cf. Article 2(2)(b).

This rule can be modified contractually, cf. Paragraph (2)(a). Additionally, the provision respects the intermediary's obligation to comply with the commitments required by a security taker under Article 4(1)(b), cf. Paragraph (2). Furthermore, attachments ordered by a court and similar actions need to be given effect by the intermediary, cf. Paragraph (3). Last, the general rule of Paragraph 1 is overridden by any mandatory rule of the applicable law.

ARTICLE 14 – DUTY OF INTERMEDIARY WITH RESPECT TO HOLDING OR CREDIT OF SECURITIES

With a view to protecting account holders' rights, an intermediary must at all times itself hold sufficient securities of a given description with respect to the number of securities of that description that are booked to its customers' accounts.

Paragraphs (1)-(3), (6)

Paragraph (1) prohibits any credits to customers accounts or disposition of securities held by the intermediary that would lead to an imbalance with respect to sufficient holdings in the above sense as soon as they became effective. The reference to a credit or disposition becoming *effective* makes it clear that a conditional credit may be made under Article 5(2) provided that, at the time the condition is fulfilled and the credit therefore becomes effective against third parties, the requirements of Paragraph (1) are satisfied.

The *duty* imposed on the intermediary under Paragraph (1) will not in all cases avoid an imbalance in the above sense, e.g. as a consequence of credits or debits made as a result of operational error (or even

fraud). Paragraph (2) therefore requires the intermediary to eliminate the imbalance immediately. This can be done either by increasing the holdings of the intermediary (e.g. by purchasing securities on the market) or by reducing the holdings of the intermediary's customers (e.g. using a so-called securities lending arrangement).

Paragraph (3) defines the term "sufficient securities", which is used to describe the imbalance in the books of the intermediary.

Paragraph (6) makes clear that a credit or disposition made in violation of Paragraph (1) is not ineffective, but triggers the duty under Paragraph (2) and does not affect any liability of the intermediary to compensate the account holder for any loss arising from the violation.

Paragraph (4)

Clearing and settlement systems regularly process orders in cycles at predefined points in time in the course of any working day. Imbalances in the sense of Paragraph (1) are inevitable in most systems. These are commonly eliminated within a very short timeframe, mostly within the same day. As clearing and settlement systems are heavily supervised by regulatory agencies, an exception from Paragraph (1) would appear to be acceptable.

Paragraph (5)

The purpose of Paragraph (5) is to protect the intermediary in circumstances where it is obliged by the account agreement with the account holder, or by lack of alternatives, to hold securities of a given description with a specific higher tier intermediary. In this case, where the intermediary's choice is so limited, it should not necessarily bear the risk of the insolvency of this higher tier intermediary. Rather, Paragraph (5) opens the possibility of allocating the risk to account holders.

ARTICLE 15 – APPROPRIATION OF SECURITIES TO ACCOUNT HOLDERS RIGHTS: SECURITIES SO APPROPRIATED NOT PROPERTY OF INTERMEDIARY

This article establishes the principle that securities held by an intermediary are appropriated to the rights of the intermediary's account holders to the extent of the securities of the relevant description credited to their accounts, but recognises that different legal systems use different techniques for ensuring that securities held for account holders are protected from the insolvency of the intermediary and that accordingly it is for the applicable law to determine the precise technique by which the appropriation is effected and the procedure by which account holders' rights are enforced.

In particular, Paragraph (2) provides that the required appropriation may be conferred by creating a segregated pool of account holders' securities. Under a legal system which treats securities held with an intermediary as owned by the underlying account holders, the legal structure will of itself ensure that such securities are not available for realisation for the benefit of the general unsecured creditors of the intermediary.

If protection is conferred by creating a segregated pool, but insufficient securities are segregated, this article will provide fall-back protection (this is the effect of the words "if and to the extent that" in Paragraph (3)(b)).

ARTICLE 16 – EFFECT OF INSUFFICIENT SECURITIES HELD IN RESPECT OF ACCOUNT HOLDERS' RIGHTS

Article 16 applies in a case where an imbalance in the sense of Article 15 persists, despite the intermediary's duty (Article 14(2)) immediately to eliminate it. The main example of such a situation might be the insolvency of the intermediary.

In this case, where the intermediary is the operator of a securities clearing or settlement system and the rules of the system make provision for the allocation of the shortfall, it is allocated in the manner so provided, cf. Paragraph (1)(a).

In all other cases, the shortfall is allocated among the account holders to whose securities accounts securities of the relevant description are credited *pro rata*, cf. Paragraph (1)(b).

Paragraph (2) underlines that apart from sharing the shortfall in proportion to the respective numbers or amounts of securities credited to the account holders accounts, no other criteria (e.g. origin of the securities, chronology of acquisition) may be applied to allocate the loss.

ARTICLE 17 – POSITION OF ISSUERS OF SECURITIES

In some jurisdictions, the holding of securities with intermediaries is prevented or hampered by the law or by the terms of issue of securities. Very often, the only reason for this is that these rules have been developed with respect to the traditional method of holding of securities and are not compatible with modern holding patterns. Paragraph (1) requires Contracting States to modify such rules to the extent required to make possible the holding of securities with an intermediary and the effective exercise of the account holder's rights.

Paragraph (2) presents some examples of possible impediments in this context. With respect to Paragraph (2)(e) it should be noted that the intended effect of this provision is not to prohibit nationality restrictions and suchlike altogether, but to permit them so long as they operate by reference to the ultimate investor and not to any intermediary.

ARTICLE 18 – RIGHTS OF SET-OFF

Investors who hold securities with an intermediary generally assume that their economic position is substantially the same as if they held the securities directly, e.g. as the registered holder or in the form of a bearer certificate. In the case of a debt security, this assumption may be of particular importance in the context of the insolvency of the issuer. If the general rules of the relevant insolvency law allow (or require) the set-off of amounts owing to and by the insolvent entity, the investors concerned are likely to assume that they cannot be obliged to pay their debts in full and receive merely a dividend in the liquidation in respect of their holding of bonds. If however the effect of holding the bonds through an intermediary is technically to disqualify the investors from set-off, for example because their claims in respect of the bonds, not being direct, are not regarded as "mutual" under the applicable set-off rules, this assumption will prove false. Article 18 ensures that investors' expectations will not be frustrated in this way, by providing that the indirect nature of the holding does not of itself, in any insolvency proceeding in respect of the issuer, preclude the existence or prevent the exercise of any rights of set-off which would have existed and been exercisable if the investor had held the securities directly.

ARTICLE 19 – INTERPRETATION OF TERMS USED IN CHAPTER VII

Article 19 provides for a set of definitions that are exclusively used in Chapter VII (Articles 19-23). The interpretation of terms used in this Chapter is not integrated in Article 1(1), as Contracting States have the possibility of an opt-out, cf. Article 23. Therefore, a separate provision regarding definitions is needed.

ARTICLE 20 – SPECIAL PROVISIONS ON ENFORCEMENT

Article 20 offers a set of rules that are intended to facilitate enforcement of securities collateral.

Paragraph (1) outlines the scope of this Article and defines the terms of “relevant collateral agreement”, “collateral provider”, “collateral taker”, “collateral securities” and “secured obligations”.

As to the persons capable of being collateral provider under the present rules, the negotiating States are invited to consider the question whether natural persons should be excluded. On the one hand, considerations of consumer protection could suggest exempting natural persons as “consumers” from the facilitated regime of collateral enforcement. On the other hand, it should be taken into consideration that the delimitation of consumers is rather vague and that natural persons sometimes participate with huge values in the capital market and that it would be problematic to bar them from more favourable credit conditions which would be granted if the facilitated enforcement regime applied to them. Furthermore, it will be worth testing whether a collateral provider is actually less protected under the present rules.

As to the notion of collateral securities, it is worth mentioning that only securities of the kind regularly traded can be elected collateral securities under the regime of Chapter VII. This is because all market practices addressed by Articles 20-22 are very much based upon the notion that the securities can be sold or that the value of the collateral can be immediately and clearly determined with a view to appropriation or set-off. This rule is an important element of the protection of the collateral provider, as it enables the parties to determine very easily whether the collateral provided actually covers or maybe even exceeds the value of the secured obligation and makes the enforcement as transparent and predictable a process as possible.

Paragraph (2) sets out as broad a notion of the secured obligation as possible.

Paragraph (3) defines both methods of facilitated enforcement of the secured obligation: (a) sale of the collateral securities; or (b) appropriation of the collateral securities, if so provided by the collateral agreement. The second alternative is conditional upon a provision in the account agreement allowing for appropriation. The reason for this additional requirement is the decreased level of protection of the collateral provider under the second provision.

Following Paragraph (4), the above rules are subject to the account agreement. However, the latter must not require prior notice, court approval or similar, or public auction or similar, as these elements would be contrary to the purpose of the present Article. Article 20 applies also after the commencement of an insolvency proceeding, cf. Paragraph 4(b).

Paragraph (5) endorses that realisation under Paragraph (3) shall be effectuated in a commercially reasonable manner.

ARTICLE 21 – SPECIAL PROVISIONS ON THE RIGHT TO USE SECURITIES

In some jurisdictions, collateral takers are allowed to use the collateral securities for their own purposes, in particular for so-called re-pledge or re-hypothecation, under full respect of the collateral provider’s rights. Other jurisdictions even allow for the use of the collateral securities “as if the collateral taker were the owner” of them, e.g. by selling them. Under this latter model, the collateral taker is obliged to render an equal amount of identical securities when the secured obligation is fully performed.

The possibility of using collateral securities increases the liquidity in the capital market. Furthermore, the collateral taker produces income by using the collateral securities. This is also to the benefit of the collateral provider, as this income allows for a more favourable credit arrangement.

The proposed rule in *Paragraph (1)* settles on the latter of the above cited models, i.e. the collateral taker shall be in a position to use the securities as if it were the owner of them.

Paragraph (2) defines the obligations that the collateral taker incurs by using the collateral, notably to replace the same number or amount of securities of the same description (cf. Article 1(1)(l)) no later

than the performance of the secured obligation. In the event that the collateral securities are re-transferred before the secured obligation is performed by the collateral provider, these re-transferred securities are regarded as if they were the securities over which the collateral had been originally created, cf. Paragraph (3).

Paragraph (4) addresses the possible concern that, if a right of use is exercised, the collateral taker will be treated under ordinary rules of the applicable law as having forfeited its rights of security by parting with possession of the property originally taken as security. It is made clear that this is not the case where a right of use is permitted.

Paragraph (5) recognises that, where a collateral taker has exercised a right of use, and is as a result obliged to return equivalent securities under Paragraph (2), the appropriate enforcement mechanism if an event of default occurs while this obligation remains outstanding is a close-out, netting the collateral taker's obligation to return equivalent securities against the collateral providers obligations; the traditional remedies of a pledgee such as the sale of the securities will not be applicable, since in this situation the collateral taker will no longer be holding the securities.

ARTICLE 22 – PROTECTION OF CERTAIN PROVISIONS RELATING TO TOP-UP OR SUBSTITUTION OF COLLATERAL

In commercial practice, two additional mechanisms can be found which make collateral arrangements economically more flexible for both parties: the adjustment of the amount of the collateral, particularly to take account of changes of the value of the collateral ("top-up collateral"), and the exchange of collateral securities against securities of substantially the same value by the collateral provider ("substitute collateral").

Top-up collateral plays an important part in limiting counterparty risk, because it permits market participants to limit their credit exposure to each other. This is in general done by calculations under which the current market value of the collateral is compared with the amount secured. If a shortfall of collateral occurs, the collateral taker asks for top-up collateral and, correspondingly, if the calculation reveals a collateral surplus, the collateral taker is obliged to return the surplus. Top-up collateral may also be required upon deterioration of the credit rating of the collateral provider.

Substitution of the collateral securities occurs where a portfolio of securities is provided as collateral. In this case, it will often be of key importance to the collateral provider to be able to withdraw particular securities by replacing them with other securities of equivalent value. This enables the collateral provider to continue to trade in the securities provided as collateral. Accordingly, many collateral arrangements provide for such a right of substitution.

In some jurisdictions, both top-up and substitute collateral face the risk of being invalid when they are provided after the commencement of an insolvency procedure, in the event of an insolvency proceeding over the collateral provider. The risk may even exist before the commencement, notably during a "suspect period" or by operation of a "zero-hour rule" (the latter giving retroactive effect to the commencement of insolvency events by deeming them to have begun at midnight). The background is that top-up and substitution collateral are not necessarily regarded as the continuation of the originally provided collateral but rather as newly provided collateral. Article 22 of the preliminary draft Convention would bind Contracting States to ensure the validity of such arrangements.

The choice between the alternative formulations in Paragraph (a) depends on a policy decision on whether protection should be granted for obligations to provide further collateral only where the obligation is triggered by market movements, or more generally.

The effect of the word "solely" in the last Paragraph is to make clear that this Article protects top-up and substitute collateral only against automatic invalidation during a suspect period or through the operation of a zero-hour rule backdating the effect of an insolvency proceeding. Rules invalidating transactions on other grounds such as fraudulent preference are not affected.

ARTICLE 23 – DECLARATIONS IN RESPECT OF CHAPTER VII

The above rules regarding facilitated enforcement, close-out, right of use, top-up and substitute collateral reflect important market practices that need a harmonised and sound legal basis, not only with a view to increasing legal certainty with respect to cross border transactions. However, the proposed rules are not immediately connected to the regime of book-entry holding and dispositions brought forward in Chapters I-VI. As the functioning of the system proposed in Chapters I-VI does not necessarily require a reform of the issues addressed in Chapter VII, and as the latter implies important issues of public policy, notably as regards consumer protection and insolvency procedure, Contracting States should have the possibility to opt out of Chapter VII with a view to facilitating negotiations on Chapters I-VI.

PRELIMINARY DRAFT CONVENTION ON HARMONISED SUBSTANTIVE RULES
REGARDING SECURITIES HELD WITH AN INTERMEDIARY

CHAPTER I - INTERPRETATION

Article 1
[Definitions and interpretation]

1. - In this Convention:

(a) **"securities"** means any shares, bonds or other transferable financial instruments or financial assets (other than cash) or any interest therein;

(b) **"securities account"** means an account maintained by an intermediary to which securities may be credited or debited;

(c) **"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;

(d) **"account holder"** means a person (including another intermediary) in whose name an intermediary maintains a securities account;

(e) **"account agreement"** means, in relation to a securities account, the agreement with the relevant intermediary governing that securities account;

(f) **"securities held with an intermediary"** means the rights of an account holder resulting from a credit of securities to a securities account;

(g) **"relevant intermediary"** means, with respect to an account holder, the intermediary that maintains the securities account for the account holder;

(h) [**"disposition"** means an act of an account holder disposing of securities held with an intermediary and includes a transfer of title, whether outright or by way of security, and a grant of a security interest;]

(i) **"adverse claim"** means, with respect to any securities, a claim that a person has an interest in those securities that is effective against third parties and that it is a violation of the rights of that person for another person to hold or dispose of those securities;

(j) **"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;

(k) **"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;

(l) 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 form part of the same issue.

2. - In the implementation, interpretation and application of this Convention, regard is to be had to its purposes, to its international character and to the need to promote uniformity and predictability in its application.

3. - For the purposes of implementation, interpretation and application of this Convention in a Contracting State, "***the applicable law***" means the provisions of the law of that Contracting State, other than those provided by this Convention, in relation to the subject matter of this Convention.

4. - Questions concerning matters governed by this Convention which are not expressly settled in the Convention are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the applicable law.

5. - For the purposes of the application and interpretation of this Convention by the courts of a Contracting State, references to the applicable law are to the domestic rules of the law applicable by virtue of the rules of private international law of the forum State.

CHAPTER II – RIGHTS RESULTING FROM THE CREDIT OF SECURITIES TO A SECURITIES ACCOUNT

Article 2

[Rights resulting from the credit of securities to a securities account]

1. - The credit of securities to a securities account with an intermediary confers on the account holder the following rights:

(a) where the account holder is acting for its own account with respect to the securities, the right to receive and enjoy the fruits of ownership of the securities, including in particular dividends and other distributions and the exercise of voting rights;

(b) the right to dispose of the securities in accordance with Articles 3 and 4;

(c) the right, by instructions to the relevant intermediary, to cause the securities to be held by the account holder with a different intermediary;

(d) the right, by instructions to the relevant intermediary, to withdraw the securities so as to be held by the account holder otherwise than with an intermediary, to the extent permitted under the applicable law;

(e) subject to this Convention, such other rights as may be conferred by the applicable law.

2. - Without prejudice to Articles 13 and 17, the rights referred to in the preceding paragraph [:

(a)] are effective against the relevant intermediary and third parties[; but

(b) except as otherwise provided by this Convention, by the terms of issue of any securities or by the law under which any securities are constituted, may be enforced only against the relevant intermediary].

3. - To the extent that the rights referred to in paragraph 1(a) are dependent on the assistance of the relevant intermediary:

(a) the rights do not entitle the account holder to receive or effect more than can be received or effected through such assistance as is within the power of the relevant intermediary to provide; and

(b) the manner of performance of the obligations of the relevant intermediary in providing such assistance and the extent of the liability of the relevant intermediary for any failure to perform those obligations are governed by the account agreement [and the applicable law].

Article 3

[Acquisition and disposition of securities held with an intermediary by debits and credits to securities accounts]

1. - Securities held with an intermediary are acquired by an account holder by the credit of those securities to a securities account of that account holder.

2. - Securities held with an intermediary are disposed of by an account holder by the debit of those securities to a securities account of that account holder.

3. - No further step or event is necessary, or may be required by the applicable law, to render such an acquisition or disposition effective against third parties.

4. - A debit or credit of securities to a securities account is not ineffective because it is not possible to identify a securities account to which a corresponding credit or debit has been made.

5. - Debits and credits to securities accounts in respect of securities of the same description may be effected on a net basis.

6. - Securities held with an intermediary may be disposed of and acquired under this Article by way of security. The applicable law determines in what circumstances an acquisition or disposition made under this Article is made by way of security.

7. - This Article does not preclude any other method provided by the applicable law for the acquisition or disposition of securities held with an intermediary, provided that the priority of an interest created by any such other method is subject to the rules in Article 9.

Article 4

[Creation of security interests over securities held with an intermediary]

1. - A security interest over securities held with an intermediary, or over a securities account, may be created:

(a) in favour of the relevant intermediary, by an agreement between the account holder and the relevant intermediary;

(b) in favour of a person other than the relevant intermediary, by the designation of the securities or the securities account in a manner such that the relevant intermediary is committed to complying with any requirements which that other person may impose with respect to those securities or that securities account.

2. - A security interest created under paragraph 1[(b)] is not effective against third parties unless the relevant intermediary makes arrangements for the securities account and any account statements issued in respect of the securities account to be so annotated as to indicate the existence of the security interest.

3. - A security interest created with respect to a securities account under this Article has effect with respect to all securities from time to time credited to that securities account, without the need for any further identification of particular securities.

4. - No further step or event is necessary to render a security interest created under this Article effective against third parties.

5. - This Article does not preclude any other method provided by the applicable law for the creation of a security interest over securities held with an intermediary or over a securities account, provided that the priority of an interest created by any such other method is subject to the rules in Article 9.

Article 5

[Effectiveness of debits, credits etc.]

1. - A debit or credit of securities to a securities account, and a designation made under Article 4, is not effective [against third parties] unless it is made with the authority of the account holder.

2. - A debit or credit of securities to a securities account, and a designation made under Article 4, which is made conditionally under the terms of the account agreement or the rules of a securities clearing or settlement system is effective against third parties when, and only when, the condition is satisfied; but if the condition is satisfied, an interest created by such a credit or designation is treated for the purposes of Article 9 as having been created at the time when the relevant credit or designation was made conditionally.

3. - The applicable law may provide that a debit or credit of securities is liable to be reversed on the ground of fraud or misrepresentation or any other ground. The applicable law determines whether a debit or credit which is so liable to be reversed has any effect against third parties and, if so, what that effect is.

4. - Notwithstanding the preceding paragraphs, if:

(a) securities have been credited to a securities account of an account holder, or have been designated in favour of another person in the manner described in Article 4, in circumstances such that the credit or designation is not effective or is liable to be reversed; and

(b) before that credit or designation has been [cancelled or] reversed, the securities are credited to a securities account of a third party, or are designated in the manner described in Article 4 in favour of a third party (such a third party being in either case referred to in this subparagraph as "**the acquirer**"), under a further disposition,

the fact that the initial credit or designation was made in circumstances such that it is not effective or is liable to be reversed does not make the further credit or designation ineffective, in favour of the acquirer, against the person making the further disposition, the relevant intermediary or third parties unless:

(i) the further credit or designation is made conditionally and the condition has not been satisfied;

(ii) the acquirer has knowledge, at the time when the further credit or designation is made, that it is made as a result of the further disposition and that the further disposition is made in the circumstances referred to in this paragraph; or

(iii) the further disposition is made by way of gift or otherwise gratuitously.

5. - For the purposes of the preceding paragraph the acquirer has knowledge that the further credit or designation is made as a result of a purported disposition made in the circumstances referred to in that paragraph if the acquirer has actual knowledge that it is so made, or has knowledge of facts sufficient to indicate that there is a significant probability that it is so made and deliberately avoids information that would establish that that is the case.

Article 6
[Finality of debits, credits etc.]

Except as otherwise provided by Article 5, a debit, credit or designation of securities held with an intermediary is effective when it is made.

Article 7
[Overriding effect of certain rules of clearing and settlement systems]

Any provision of the rules or agreements governing the operation of a securities clearing or settlement system which is directed to the stability of the system or the finality of dispositions effected through the system shall, to the extent of any inconsistency, prevail over [any provision in Article 5 or Article 6] [any provision of this Convention].

Article 8
[Prohibition of upper-tier attachment]

1. - No attachment of or in respect of securities credited to a securities account of an account holder shall be granted or made against the issuer of those securities or against any 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 or for freezing, restricting or impounding securities in order to ensure their availability to enforce or satisfy any future such judgment, award or decision.

Article 9
[Priority among competing interests]

1. - Interests arising under Articles 3 and 4:

(a) have priority over any interest created by any method permitted by the applicable law other than those provided by Article 3 or Article 4; and

(b) rank among themselves in the order in which they were created.

2. - An interest in securities held with an intermediary arising by operation of law under any mandatory rule of the applicable law has such priority as is afforded to it by the rule in question.

3. - Subject to the preceding paragraphs, the priority of any competing interests in securities held with an intermediary is determined by the applicable law.

4. - As between persons entitled to any interests referred to in this Article, the priorities provided by the preceding paragraphs may be varied by agreement between those persons.

CHAPTER III – PROTECTION OF INNOCENT ACQUIRER

Article 10

[Acquisition by an innocent person of securities held with an intermediary]

1. - A person who acquires securities held with an intermediary by credit to a securities account under Article 3, or who acquires a security interest in such securities by an agreement or designation under Article 4, and who does not at the time of acquisition have knowledge of an adverse claim with respect to the securities is not subject to that adverse claim.

2. - The preceding paragraph does not apply in respect of an acquisition of securities made[, or the creation of a security interest effected,] by way of gift or otherwise gratuitously.

3. - For the purposes of this Article a person acts with knowledge of an adverse claim if that person:

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

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

and knowledge received by an organisation is effective for a particular transaction from the time when it is or ought reasonably to have been brought to the attention of the individual conducting that transaction.

CHAPTER IV - INSOLVENCY

Article 11

[Rights of account holders on insolvency of intermediary]

The rights of an account holder constituted by the credit of securities to a securities account, and the rights of a person holding a security interest created under Article 4, are effective against the insolvency administrator and creditors in any insolvency proceeding in respect of the relevant intermediary.

Article 12

[Effectiveness of debits, credits etc. and instructions on insolvency of operator or participant in securities clearing or settlement system]

1. - Any provision of the rules or agreements governing the operation of a securities clearing or settlement system which is directed to the stability of the system or the finality of acquisitions or dispositions effected through the system shall have effect notwithstanding the commencement of an insolvency proceeding in respect of the operator of the system or any participant in the system to the extent that that provision:

(a) precludes the invalidation or reversal of any acquisition or disposition effected by a credit, debit or designation in a securities account which forms part of the system after the time at which that acquisition or disposition is treated as final under the rules of the system;

(b) precludes the revocation of any instruction given by a participant in the system for making a disposition of securities, or for making a payment relating to an acquisition or disposition of securities, after the time at which that instruction is treated under the rules of the system as having been entered irrevocably into the system.

2. - The preceding paragraph applies notwithstanding that any invalidation, reversal or revocation referred to in that paragraph would otherwise occur by mandatory operation of the insolvency law of a Contracting State.

CHAPTER V – DUTIES OF INTERMEDIARY

Article 13 *[Duties of intermediary]*

1. - Subject to paragraph 2, an intermediary is neither bound nor entitled to give effect to any instructions with respect to securities credited to a securities account of an account holder given by any person other than that account holder.

2. - The preceding paragraph 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 a security interest created under Article 4;

(c) subject to Article 8, any judgment, award, order or decision of a court, tribunal or other judicial or administrative authority of the competent jurisdiction;

(d) any mandatory rule of the applicable law.

Article 14 *[Duty of intermediary with respect to holding or credit of securities]*

1. - An intermediary may not:

(a) make any credit of securities to a securities account maintained by it; or

(b) dispose of securities held by it or credited to a securities account which it holds with another intermediary,

if upon that credit or disposition becoming effective there would not be sufficient securities of the same description held by it or credited to securities accounts which it holds with another intermediary.

2. - If at any time sufficient securities of any description are not held by an intermediary or credited to securities accounts which it maintains with another intermediary, it must immediately take such action as is required to ensure that sufficient securities of that description are so held or credited.

3. - In the preceding paragraphs "**sufficient securities**" of any description means securities of an aggregate number or amount at least equal to the aggregate number or amount of securities of that description credited to securities accounts maintained by the intermediary.

4. - Nothing in this Article affects any provision of the rules of a securities clearing or settlement system or other system involving the holding of securities with an intermediary relating to the allocation of the cost of ensuring compliance with the requirements of paragraph 2, including without limitation any provision:

(a) entitling the system operator [or other relevant intermediary] to debit securities to an account holder's securities account in circumstances where a credit of securities to that securities account is not or does not become effective, or is reversed, under Article 5;

(b) requiring an account holder to procure, or indemnify the system operator or other relevant intermediary against the cost of procuring, the credit of further securities to a securities account of that account holder in circumstances where securities have been or may be debited to that securities account under sub-paragraph (a); or

(c) requiring participants in the system to contribute to the cost of making good any failure by any particular participant to comply with its obligations under sub-paragraph (b) or otherwise to contribute to the cost of ensuring compliance with the requirements of paragraph 2.

5. - Nothing in this Article affects any provision of an account agreement relating to the allocation of the cost of any action taken by an intermediary to ensure compliance with paragraph 2 in a case where:

(a) the action is required because the intermediary holds or has held securities with another intermediary ("**the higher-tier intermediary**") in circumstances where the intermediary is obliged by its agreements with its account holders to hold securities of the relevant description with the higher-tier intermediary or there is no intermediary other than the higher-tier intermediary with which the intermediary is able to hold securities of the relevant description]; and

(b) the number or amount of the securities so held has been reduced under Article 16 as a result of the insolvency of the higher-tier intermediary.

6. - The fact that a credit or disposition is made in contravention of paragraph 1 does not render that credit or disposition ineffective, but:

(a) the intermediary must immediately comply with paragraph 2; and

(b) this paragraph does not affect any liability of the intermediary to compensate an account holder for any loss arising from the contravention.

Article 15

[Appropriation of securities to account holders' rights: securities so appropriated not property of the intermediary]

1. - Securities of each description held by an intermediary or credited to securities accounts held by an intermediary with another intermediary shall be appropriated to the rights of the account holders of that intermediary to the extent necessary to ensure that the aggregate number or amount of the securities of that description so appropriated is equal to the aggregate number or amount of such securities credited to securities accounts maintained by the intermediary.

2. - Securities appropriated under the preceding paragraph shall not form part of the property of the intermediary available for distribution among or realisation for the benefit of its creditors in the event of an insolvency proceeding in respect of the intermediary or be otherwise subject to claims of creditors of the intermediary.

3. - The appropriation required by paragraph 1:

(a) may be effected by appropriate arrangements made by the relevant intermediary in accordance with the applicable law;

(b) if and to the extent that it is not effected by such arrangements, shall be effected by operation of law in accordance with the applicable law.

Article 16

[Effect of insufficiency of securities held in respect of account holders' rights]

1. - If the aggregate number or amount of securities of any description held by an intermediary or credited to a securities account that it holds with another intermediary is less than the aggregate number or amount of securities of that description credited to securities accounts, the shortfall:

(a) where the intermediary is the operator of a securities clearing or settlement system and the rules of the system make provision for the allocation of the shortfall, shall be allocated in the manner so provided;

(b) in any other case, shall be allocated among the account holders to whose securities accounts securities of the relevant description are credited, in proportion to the respective numbers or amounts of securities so credited.

2. - [Unless otherwise provided by the applicable law,] [I]n any allocation required under paragraph 1(b) no account shall be taken of:

(a) the origin of, or any past dealings in, any securities held by the intermediary or credited to securities accounts held by the intermediary with another intermediary; or

(b) the order in which or time at which any securities are credited or debited to the respective securities accounts of account holders.

CHAPTER VI – RELATIONS WITH ISSUERS OF SECURITIES

Article 17

[Position of issuers of securities]

1. - Any rule of law of a Contracting State, and any provision of the terms of issue of securities constituted under the law of a Contracting State, which would prevent the holding of securities with an intermediary or the effective exercise by an account holder of rights in respect of securities held with an intermediary shall be modified to the extent required to make possible the holding of such securities with an intermediary and the effective exercise of such rights.

2. - Without limiting the generality of the preceding paragraph, that paragraph applies in particular to any rule or provision:

(a) which restricts the ability of a holder of securities to exercise voting or other rights in different ways in respect of different parts of a holding of securities of the same description;

(b) [which does not include adequate provision for making available to account holders holding securities with an intermediary, or to intermediaries for transmission to such account holders:

(i) copies of notices, accounts, circulars and other materials addressed by the issuer to holders of such securities; and

(ii) means of exercising the rights attaching to such securities either in person or through a proxy or other representative;]

(c) which prohibits or fails to recognise the holding of securities by a person acting in the capacity of nominee or intermediary;

(d) under which recognition of the holding of securities by an intermediary or the exercise of rights by an account holder holding securities with an intermediary is conditional on the maintenance of records in a particular medium;

(e) which imposes restrictions on the holding of securities or the exercise of rights attaching to securities by reference to the identity, status, residence, nationality, domicile or other characteristics or circumstances of any person acting in the capacity of intermediary.

[3. - Subject to the preceding paragraphs, nothing in this Convention makes an issuer of securities bound by, or compels such an issuer to recognise, a right or interest of any person in or in respect of such securities if the issuer is not bound by or compelled to recognise that right or interest under the law under which the securities are constituted and the terms of issue of the securities.]

Article 18
[Rights of set-off]

1. - As between an account holder to whose securities account securities are credited and the issuer of those securities, the fact that the account holder holds the securities with an intermediary shall not of itself, in any insolvency proceeding in respect of the issuer, preclude the existence or prevent the exercise of any rights of set-off which would have existed and been exercisable if the account holder had held the securities directly.

2. - This Article does not affect any express provision of the terms of issue of the relevant securities.

**CHAPTER VII – SPECIAL PROVISIONS WITH RESPECT TO
COLLATERAL TRANSACTIONS**

Article 19
[Interpretation of terms used in Chapter VII]

In this Chapter:

(a) **“relevant collateral agreement”**, **“collateral provider”**, **“collateral taker”**, **“collateral securities”** and **“secured obligations”** have the meanings respectively given in Article [20](1);

(b) **“enforcement event”** means, in relation to a relevant collateral agreement, an event on the occurrence of which, under the terms of the relevant collateral agreement, the collateral taker is entitled to enforce its security.

Article 20
[Special provisions on enforcement]

1. - This Article applies in respect of an agreement (a **“relevant collateral agreement”**) under which a person [other than a natural person] (the **“collateral provider”**) creates a security interest in favour of another person (the **“collateral taker”**) in securities held with an intermediary which are of a kind regularly traded on a financial market (the **“collateral securities”**) in order to secure the performance of financial obligations of any kind referred to in paragraph 2 (the **“secured obligations”**).

2. - The secured obligations may consist of or include any obligation of a financial character, including:

- (a) present or future, actual or contingent or prospective obligations (including obligations arising under a master agreement, whether under a provision for the acceleration or close-out of obligations or otherwise);
- (b) obligations to deliver securities or other property;
- (c) obligations owed to the collateral taker by a person other than the collateral provider;
- (d) obligations of a specified description arising from time to time.

3. - On the occurrence of an enforcement event, the collateral taker may realise the collateral securities:

- (a) by selling them and applying the net proceeds of sale in or towards the discharge of the secured obligations;
- (b) by appropriating the collateral securities as the collateral taker's own property and setting off their value against, or applying their value in or towards the discharge of, the secured obligations, provided that the relevant collateral agreement provides for realisation in this manner and specifies the basis on which collateral securities are to be valued for this purpose.

4. - Collateral securities may be realised under the preceding paragraph:

- (a) subject to any contrary provision of the relevant collateral agreement, without any requirement that:
 - (i) prior notice of the intention to realise shall have been given;
 - (ii) the terms of the realisation be approved by any court, public officer or other person; or
 - (iii) the realisation be conducted by public auction or in any other prescribed manner; and
- (b) notwithstanding the commencement or continuation of an insolvency proceeding in respect of the collateral provider or the collateral taker.

5. - Realisation under paragraph shall be effected in a commercially reasonable manner.

Article 21

[Special provisions on the right to use collateral securities]

1. - If and to the extent that the terms of a relevant collateral agreement so provide, the collateral taker shall have the right to use and dispose of the collateral securities as if it were the owner of them (a "**right of use**").

2. - Where a collateral taker exercises a right of use, it thereby incurs an obligation to replace the collateral securities originally transferred (the "**original collateral securities**") by transferring the same number or amount of securities of the same description to the collateral provider not later than the performance of the secured obligations.

3. - Securities transferred under the preceding paragraph at a time before the secured obligations have been fully discharged:

(a) shall, in the same manner as the original collateral securities, be subject to a security interest under the relevant collateral agreement, which shall be treated as having been created at the same time as the security interest in respect of the original collateral securities was created; and

(b) shall in all other respects be subject to the terms of the relevant collateral agreement.

4. - The exercise of a right of use shall not render invalid or unenforceable any right of the collateral taker under the relevant collateral agreement.

5. - The relevant collateral agreement may provide that, if an enforcement event occurs before the secured obligations have been fully performed, either or both of the following shall occur, or may at the election of the collateral taker occur, whether through the operation of netting or set-off or otherwise:

(a) the respective obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value or are terminated and replaced by an obligation to pay such an amount;

(b) an account is taken of what is due from each party to the other in respect of such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party.

Article 22

[Protection of certain provisions relating to top-up or substitution of collateral]

Where a relevant collateral agreement includes:

(a) an obligation to deliver collateral securities or additional collateral securities [in circumstances specified in the relevant collateral agreement][in order to take account of changes in the value of the collateral provided under the relevant collateral agreement or in the amount of the secured obligations]; or

(b) a right to withdraw collateral securities or other collateral on providing, by way of substitution or exchange, collateral securities of substantially the same value,

the provision of such collateral securities or additional, substitute or replacement collateral securities shall not be treated as invalid, reversed or declared void solely on the basis that it occurs after, or during a prescribed period before, the commencement of an insolvency proceeding in respect of the collateral provider, or after the secured obligations have been incurred.

Article 23

[Declarations in respect of Chapter VII]

A Contracting State may, at the time of signature, ratification, acceptance, approval or accession, make a declaration that this Chapter shall not apply in respect of the law of that Contracting State.