

UNIDROIT

INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW

UNIDROIT Seminar on Intermediated Securities – São Paulo, Brazil

13 - 14 October 2005





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Intermediated Securities – São Paulo, Brazil

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NOTICE

The participants and other speakers at the seminar are each expert in the field of financial markets law in the legal system of their country. However, they participate in the work of UNIDROIT on a strictly personal basis. The views expressed in this paper are those of the speakers and do not necessarily reflect those of their institution, their Government or UNIDROIT.

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UNIDROIT 2005 - Study LXXVIII / SEM. 2 (English only)

AGENDA

October 13th

14:30 – 15:00

Welcome

Gilberto Mifano (CBLC, Brazil); *Emilio Ferré* (CNV, Argentina); *Pedro Marcílio de Souza* (Brazilian Securities Commission) and *Efrain Carvajal* (Caja de Valores, Argentina)

SESSION 1

Chair: *Margarida Baptista* (CBLC, Brazil)

15:00 – 16:00

Introduction

Speaker: *Philipp Paech* (UNIDROIT)

Overview of the UNIDROIT Convention on Harmonised Substantive Rules regarding Intermediated Securities – Key issues – Perspectives

16:00 – 16:15

Coffee Break

16:15 – 17:45

Topic 1: Tracing, upper tier attachment and -exercise in different systems – internal and cross-border situations

Speaker: *Ignácio Gomez Sancha* (Iberclear, Spain)

Panelists: *Marcos Galileu Lorena Dutra* (CVM, Brazil)

Martin Paladino (Caja de Valores, Argentina)

Q&A Session

18:00

Reception and dinner

October 14th

SESSION 2

Chair: *Efrain Carvajal* (Caja de Valores, Argentina)

9:00 – 10:30

Topic 2: Dividends, voting rights, legal actions – Functional approach and the role of the intermediary and the issuer

Speaker: *Nora Rachman* (CBLC, Brazil)

Panelists: *Ary Oswaldo Mattos Filho* (Mattos Filho, Veiga Filho, Marrey Junior e Quiroga Advogados, Brazil)

Luiz Antonio Sampaio Campos (Barbosa, Müssnich & Aragão Advogados, Brazil)

Q&A Session

10:30 – 10:45

Coffee Break

- 10:45 – 12:15 **Topic 3: Good faith acquisition, effectiveness of credits, insolvency, priorities and loss sharing**
Speaker: *Edgar Jelonche* (Member of the former UNIDROIT Study Group and Independent Legal Consultant, Argentina)
Panelists: *Emilio Ferré* (CNV, Argentina)
Fernando Almeida Prado (Pinheiro Neto Advogados, Brazil)
Q&A Session
- 12:15 – 13:30 Lunch
- SESSION 3**
Chair: *João Lauro Amaral* (BM&F, Brazil)
- 13:30 – 15:00 **Topic 4: Does the preliminary draft Convention need a narrower definition of the term “securities”?**
Speaker: *Javier Diaz* (SVS, Chile)
Panelists: *Edgar Jelonche* (Member of the former UNIDROIT Study Group and Independent Legal Consultant, Argentina)
Otávio Yazbek (BM&F, Brazil)
Q&A Session
- 15:00 – 16:30 **Topic 5: Special provisions on collateral over securities – realisation of collateral in a cross-border environment**
Speaker: *João Lauro Amaral* (BM&F, Brazil)
Panelists: *Henrique L. Cavalcanti* (L. C. Sturzenegger & Adv. Assoc., Brazil)
Otávio Yazbek (BM&F, Brazil)
Q&A Session
- 16:30 – 16:45 Coffee Break
- 16:45 – 17:30 **Conclusions/Results**
Edgar Jelonche (Member of the former UNIDROIT Study Group and Independent Legal Consultant, Argentina)
Philipp Paech (UNIDROIT)
- 17:30 – 17:45 Closure of the Seminar

SUMMARY

The second *Unidroit Seminar on Intermediated Securities* was held in São Paulo (Brazil) on 13 and 14 October 2005 to give South American legal experts an opportunity to discuss the preliminary draft *Convention on Harmonised Substantive Rules Regarding Intermediated Securities*¹ with a view to providing additional input to the next session of the Committee of Governmental Experts, to be held from 6 to 14 March 2006 in Rome.

The conference was co-organised by the Brazilian Clearing and Depository Corporation (CBLC), the Brazilian Mercantile & Futures Exchange (BMF), Caja de Valores (Argentina) and Comisión Nacional de Valores (CNV, Argentina). The participants² were welcomed by Messrs Gilberto Mifano (CBLC), Enico Ferré (CNV), Pedro Marcílio de Souza (Brazilian Securities Commission) and Efrain Carvajal (Caja de Valores).

The agenda commenced with an introduction to the UNIDROIT project. Five different topics were then taken in turn. Each was, following a detailed presentation given by an individual speaker, opened for discussion to a panel of legal experts and to the floor.

The first part of the seminar was chaired by Ms Margarida Baptista who gave an account of the achievements of the first meeting of the Committee of Governmental Experts (Rome, 9-20 May 2005) from the perspective of the Brazilian delegation³.

Mr Philipp Paech then presented a detailed overview of the future Convention (cf. *Appendix 2*), moving on from an outline of its scope, history and status and an introduction to the legal background of securities holding models, to a discussion of why these models were difficult to apply smoothly across different jurisdictions. Cross-border incompatibilities or conflicts arose even in transactions between two internally sound and reliable systems. Mr Paech went on to describe the future instrument's complementary relationship with the Hague Securities Convention⁴. Since that Convention could not, by its very nature, ensure that the applicable national law was clear, satisfactory and workable in cross-border situations, harmonised substantive rules were not only desirable but necessary. The benefits of increased legal certainty would improve economic efficiency and enhance a mutual understanding of the legal framework across jurisdictions.

Mr Paech listed five key live issues currently under discussion that arise from the draft Convention, namely: -

(i) which structures of intermediation fall within its scope; (ii) which characteristics are common to so-called "direct" and "indirect" holding systems; (iii) protection mechanisms designed to balance the interests of account holders against the need for system stability; (iv) techniques for incorporating the future Convention into domestic law; and (v) clear and simple rules for the enforcement of collateral.

The subsequent discussion centred on the value which the future Convention could add in jurisdictions where the national law on securities holding and transfer is internally sound and the system is considered as efficient and safe. It was stressed that no system was, however, "closed", in the sense that inevitably there are many links with other systems under different jurisdictions. The future Convention could assist in limiting the uncertainties which arise from these linkages.

¹ UNIDROIT Study LXXVIII, Doc. 24, June 2005

² List of participants cf. Appendix 1

³ UNIDROIT Study LXXVIII, Doc. 23 rev., August 2005

⁴ Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary, adopted under the auspices of *The Hague Conference on Private International Law*, The Hague, on 13 December 2002.

The second speaker, Mr Ignacio Gomez Sancha, focused on *Direct and indirect holding*, cf. *Appendix 3*. He distinguished characteristics between so called "direct" and "indirect" holding systems. Mr Gomez Sancha argued that the complexity of modern securities settlement systems led legislators to adopt one of two options: (i) to adapt the law to reality, creating indirect holding systems; or (ii) to adapt reality to the law, creating direct holding systems. From his perspective, the challenge facing the UNIDROIT Convention was to find a middle way and to ensure that its provisions encompassed every system. Creating such legal rules required careful scrutiny of different systems so as to find a way of accommodating each and ensuring cross-border compatibility.

Two panellists, Mr Marcos Galileu Lorena Dutra and Mr Martin Paladino, then described what, in their views, was at stake for their respective organisations with regard to the legal framework of securities settlement (cf. *Appendix 5*) and, joined by Mr Gomez Sancha, answered questions from the floor.

The second session, chaired by Mr Efrain Carvacal, began with a presentation, given by Ms Nora Rachman, of the activities and depository services performed by CBLC, cf. *Appendix 6*. Ms Rachman then compared the UNIDROIT text, in particular its Article 4, with Brazilian law on the processing of dividends, voting rights and legal actions in different systems and the roles of the intermediary and the issuer. She emphasised the need for a neutral approach to these issues. It became clear in the ensuing debate that the new wording of Article 4 was not incompatible with Brazilian law.

Two panellists, Messrs Ary Oswaldo Mattos Filho and Luiz Antonio Sampaio Campos, entered into discussion with the audience on whether, in the face of international harmonisation, it was necessary to consider amending national law. Some speakers feared that a national system that worked well could be overridden by international rules so as to make domestic markets more easily accessible to participants from more economically significant markets in Europe and North America. The prevailing view was that there was room for a neutral solution in the sense that all acceding jurisdictions could benefit from harmonised rules.

The next topic on the agenda was the interrelationship between good faith acquisition, the effectiveness of book entries, priorities and loss sharing. This was the subject of a presentation given by Mr Edgar Jelonche, a member of the former UNIDROIT Study Group (cf. *Appendix 7*). Mr Jelonche provided an insight into the mechanisms of the draft Convention that were designed to balance the account holder's interest in receiving a valid credit to his account against the need for system stability. Describing situations to which more than one such mechanism might be relevant, he stressed that it was crucial that the rules of the draft Convention interacted smoothly so as to provide a single, clear solution.

Mr Emilio Ferré compared the rules of the draft instrument to national Argentinean legislation (cf. *Appendix 8*) and answered, together with Mr Fernando Almeida Prado, questions from the floor.

Mr Javier Diaz focused on the question "Does the preliminary draft Convention need a narrower definition of the term 'securities'?", cf. *Appendix 9*. Balancing the points for and against a narrower definition of the term "securities", he came to the conclusion that the approach taken by the UNIDROIT draft instrument is a sensible one.

During discussion with the panel that followed, Mr Edgar Jelonche explained that the Study Group had called attention to the definition of "securities", had emphasised the need for flexibility and suggested that it should be based on the characteristic of transferability. This meant that "security" should refer to an instrument capable of being traded in financial markets without reference to the personality of the creditor. Mr Octavio Yazbek (cf. *Appendix 10*) concluded by affirming that the UNIDROIT definition of "securities", although broader than national

definitions, did not conflict with the Brazilian definition since the latter provided a “list” of “securities” that was sufficiently flexible to allow wide interpretation of the term.

The final agenda topic, the special provisions on collateral and collateral execution in a cross-border environment contained in Chapter VII of the draft instrument, was the subject of a presentation given by Mr João Lauro Amaral. Mr Amaral agreed, in principle, with the approach taken in Chapter VII of the draft UNIDROIT Convention. The possibility to opt out from this chapter would considerably smoothen the way, though he expected that on the long run Chapter VII will and should be widely accepted. Messrs Mr Henrique Leite Cavalcanti and Octovio Yasbek replied to Mr Amaral’s presentation in their role as pannelists (cf. Appendices 11 and 12).

A majority of participants concurred, during the following discussion, that the opt-out clause was desirable for States that were less familiar with the subject matter. The main body of the draft Convention could work perfectly well without Chapter VII. Chapter VII being optional, States were free to decide whether they would sign the Convention with or without it. It was explained that the chapter had been drafted in the light of existing European legislation and therefore already reflects a compromise between a number of jurisdictions.

Mr Jelonche and Mr Paech shared the task of summing up and presenting the *conclusions* of the seminar. Mr Jelonche highlighted the international character of the future Convention, stressing that it would help countries to face the current competition among capital markets. He pointed out that most Latin American markets were certainly not legally “underdeveloped” compared to highly “developed” capital markets, but the differences among them were significant. It was important in this context to strengthen investor confidence in these “underdeveloped” markets. In Mr Jelonche’s view, the presentations and the discussions that followed had shown that the systems examined were internally reliable. It was when they had to function in a global environment that States found they could not develop their internal market without the need for international cooperation. The main challenge facing the future Convention would be its incorporation into domestic legislation without impairing each system’s internal soundness.

Mr Paech reminded the participants of the overall context when talking about a safe infrastructure for securities holding and transfer: the first precondition is a properly and reliably working operational system; the second is a sound legal framework. In some cases it might appear to be difficult to distinguish whether a measure belongs to the operational or the legal side, as might be the case with the correlation of system-participants (transferee-transferor) through a mechanism of identification.

Any discussion on legal certainty had, on the one hand, to be put into a purely domestic context but, on the other, had to be seen against the background of a cross border situation. Measures that deliver a perfectly sound result internally do not always guarantee legal certainty internationally.

Finally, he made the point that adopting a functional and neutral approach did not necessarily mean that no changes to the law of a participating country were necessary. The “functional approach” should, however, guarantee that no system had to change fundamental legal concepts where such changes would entail too many consequential adjustments to other areas of law and regulation. While efforts had been made to render the Convention as functional and neutral as possible, it could nevertheless not accommodate the *status quo* in all things. Some amendments might be necessary in order to eliminate incompatibilities. The question each State should ask itself was: “Will the advantages of harmonisation through the future Convention outweigh the difficulties entailed in changing national laws regarding securities holding and transfer?”

He emphasised that, with a revised draft (Doc. 24) on the table, the UNIDROIT project was well on the way to accommodating the great majority of legal systems. In his view, this was also illustrated by Ms Rachman’s presentation on whether the rules of Article 4 were functional in the

sense that they accommodate the legal concepts current in Brazilian law. He felt that this meeting, as well as the meeting held in Switzerland shortly before, had contributed to the common understanding of different systems, in particular, the "transparent" systems adopted by many countries.

Finally, he thanked again the four co-organising organisations, BM&F (on the premises of which the meeting was hosted), CBLC, Caja de Valores and CNV. In particular, the local Secretariat which was led by Ms Margarida Baptista (CBLC) did an admirable job as regards the organisation of this event.

APPENDIX 1

LIST OF PARTICIPANTS

Ms Monique ALMEIDA	Depository Services Supervisor CBLC – Brazilian Clearing and Depository Corporation Brazil
Mr Fernando ALMEIDA PRADO	Partner Pinheiro Neto Law Firm Brazil
Mr João Lauro AMARAL	Director of International Affairs BM&F – Brazilian Mercantile and Futures Exchange Brazil
Mr Luciano ANDRADE FROIS	Advisor Banco Central do Brasil Brazil
Ms Margarida BAPTISTA	Head of Project Development CBLC – Brazilian Clearing and Depository Corporation Brazil
Mr Luiz Felipe CALABRO	Lawyer BOVESPA – Brazil Stock Exchange Brazil
Mr Efrain CARVAJAL	Legal Assistant Manager Caja de Valores Argentina
Ms Fernanda CAMPOS	Lawyer Merrill Lynch Brazil
Mr Esteves Pedro COLNAGO Jr	Coodinator of Social Policy Ministério da Fazenda (Ministry of Finance) Brazil
Mr Marcelo DESCHAMPS D'ALVARENGA	Senior Consultant Banco Central do Brasil Brazil

Mr Javier DIAZ	Lawyer Superintendencia de Valores e Seguros Chile
Mr Domingo EYZAGUIRRE	Lawyer DCV – Depósito Central de Valores Chile
Ms Raquel FERRARI	Settlement Services Supervisor CBLC – Brazilian Clearing and Depository Corporation Brazil
Mr Emilio FERRÉ	Commissioner CNV – Comisión Nacional de Valores Argentina
Ms Renata FIALHO DE OLIVEIRA	Lawyer Zilveti Sanden Adv. Law Firm Brazil
Mr Erivaldo Alfredo GOMES	Coordinator of Foreign Trade Ministério da Fazenda (Ministry of Finance) Brazil
Mr Francisco Carlos GOMES	Director of Control CBLC – Brazilian Clearing and Depository Corporation Brazil
Mr Daniel GRUENBAUM	Lawyer Casella Advogados Law Firm Brazil
Mr Edgar JELONCHE	Independent Legal Consultant Argentina
Mr Henrique LEITE CAVALCANTI	Partner L. C. Sturzenegger & Adv. Assoc. Law Firm Brazil
Mr Marcos Galileu LORENA DUTRA	Manager of Market Oversight Department CVM – Comissão de Valores Mobiliários (Securities and Exchange Commission) Brazil
Mr Eduardo MANHÃES	Head of International Affairs Department CVM – Comissão de Valores Mobiliários (Securities and Exchange Commission) Brazil

Mr Pedro MARCILIO DE SOUZA	Director CVM – Comissão de Valores Mobiliários (Securities and Exchange Commission) Brazil
Mr Ary Oswaldo MATTOS FILHO	Founding Partner Mattos Filho Law Firm Brazil
Mr Fernando MERINO	Lawyer JP Morgan Brazil
Mr Gilberto MIFANO	CEO CBLC – Brazilian Clearing and Depository Corporation Brazil
Mr Julio NAGAY	Project Development Analyst CBLC – Brazilian Clearing and Depository Corporation Brazil
Ms Selma OLIVEIRA SILVA DOS SANTOS	Advisor Banco Central do Brasil Brazil
Mr Philipp PAECH	Secretary to the Committee of Governmental Experts UNIDROIT
Mr Luiz Felipe PAIVA	Depository Services Supervisor CBLC – Brazilian Clearing and Depository Corporation Brazil
Mr Martin PALADINO	Legal Department Caja de Valores Argentina
Ms Nora RACHMAN	Legal Affairs Superintendent CBLC – Brazilian Clearing and Depository Corporation Brazil
Mr Danilo RODRIGUES	Project Development Analyst CBLC – Brazilian Clearing and Depository Corporation Brazil

Ms Maria Cecília ROSSI	Consultant Interlink Consultoria Brazil
Mr Luiz Antonio SAMPAIO CAMPOS	Lawyer Barbosa, Musnich & Aragão Adv. Law Firm Brazil
Mr Ignacio GOMEZ SANCHA	Head of Legal – IBERCLEAR Deputy Secretary-General to the Board of Directors. - BME Spain
Ms Maria Helena SANTANA	Executive Director BOVESPA – Brazil Stock Exchange Brazil
Mr Amarílis P. SARDENBERG	Chief Operations Officer CBLC – Brazilian Clearing and Depository Corporation Brazil
Mr Francisco SATIRO	Professor USP – University of S. Paulo Brazil
Mr Leandro SOUZA	Depository Services Manager CBLC – Brazilian Clearing and Depository Corporation Brazil
Mr Luiz Carlos STURZENEGGER	Founding Partner L. C. Sturzenegger & Adv. Assoc. Law Firm Brazil
Ms Erika TABACNIKS	Analyst CBLC – Brazilian Clearing and Depository Corporation Brazil
Mr Gianfranco TROVATORE	Officer CONSOB Italy
Mr Paulo VALLE	Head of Public Debt Operations Tesouro Nacional (National Treasury) Brazil

Ms Marusa VASCONCELOS FREIRE	Lawyer Banco Central do Brasil Brazil
Ms Maria VERMAAS	Head of Legal Services STRATE South Africa
Mr Anacleto WAGNER	Risk Manager CBLC – Brazilian Clearing and Depository Corporation Brazil
Mr Otávio YAZBEK	Lawyer BM&F – Brazilian Mercantile and Futures Exchange Brazil

The Draft UNIDROIT Convention on Intermediated Securities

Background – Key Issues - Perspectives

Dr Philipp Paech, Unidroit (ph.paech@unidroit.org)

Scope in a nutshell

- Objectives
 - Protection of market participants
 - Protection of the financial system
 - Gains in economic efficiency
- “Intermediated securities” means securities held through a bank or broker etc.
- Estimated value of securities held in custody world wide: 50.000.000.000.000 Euro/USD
- Legal risk, because legal framework not always compatible amongst different jurisdictions

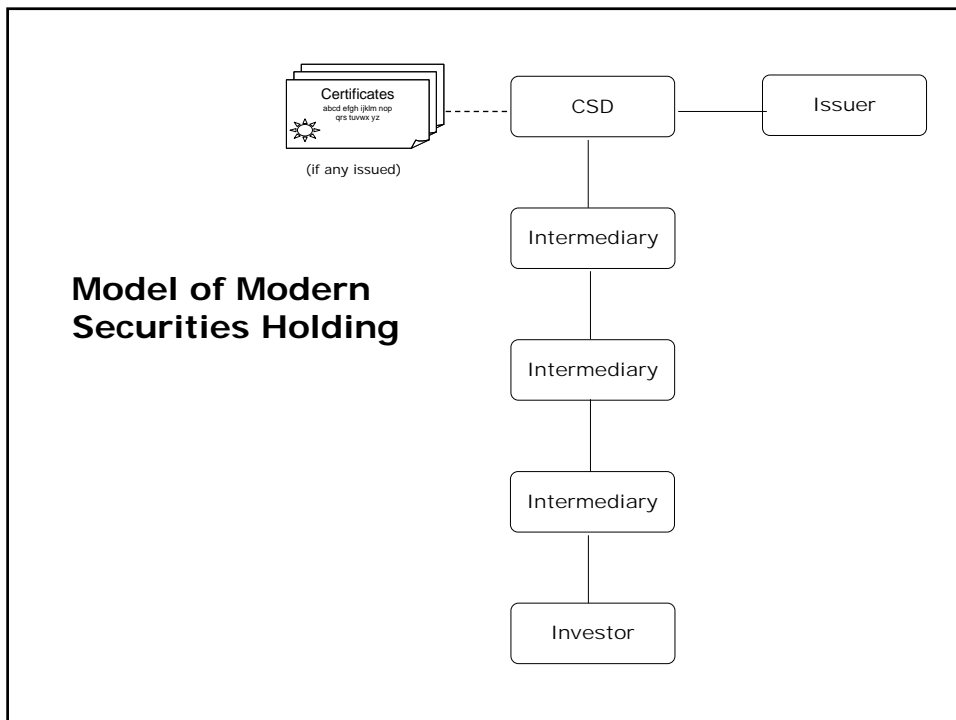
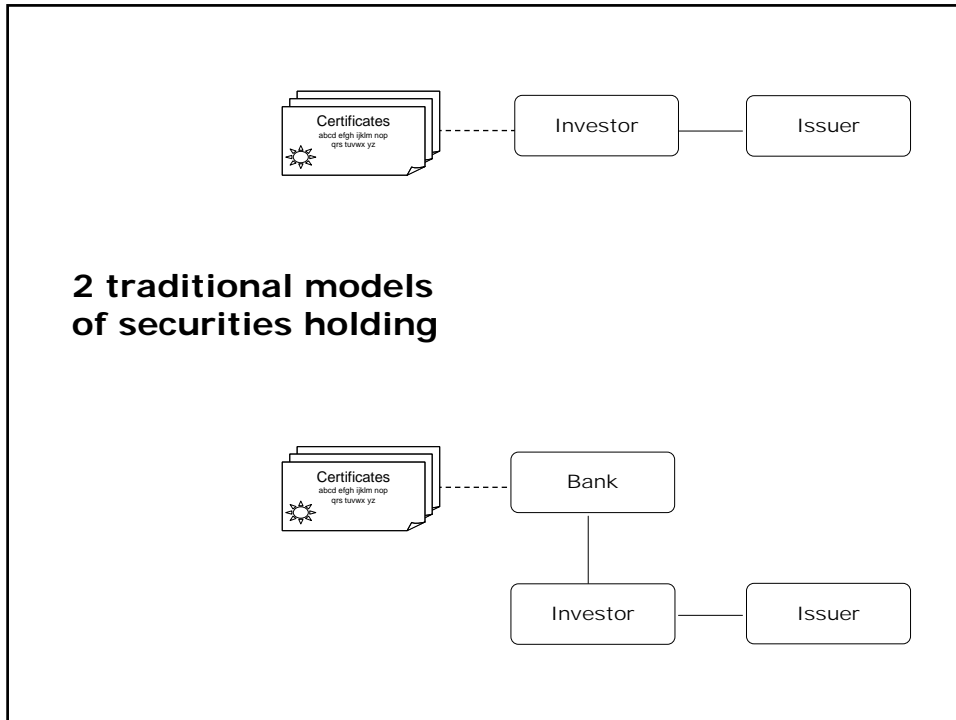
History and Status

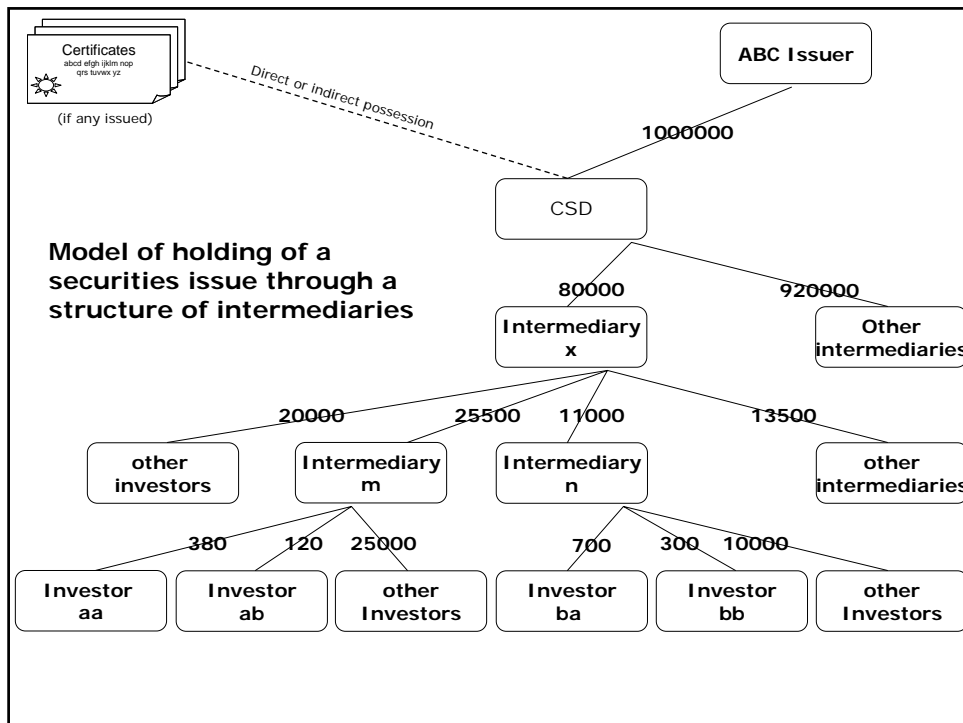
- Expert Study Group 2002 – 2004
- Consultations in 20 countries
- Preliminary Draft UNIDROIT Convention (Doc. 18)
- Explanatory Notes (Doc. 19)
- 1st intergovernmental meeting (33 countries and 10 internat. organisations) 9-20 May 2005
- Amended preliminary draft Convention (Doc. 24)
- Next session: 6-14 March 2006
- Outlook: Diplomatic Conference Winter 2006/2007

Part I - Background

Question 1:

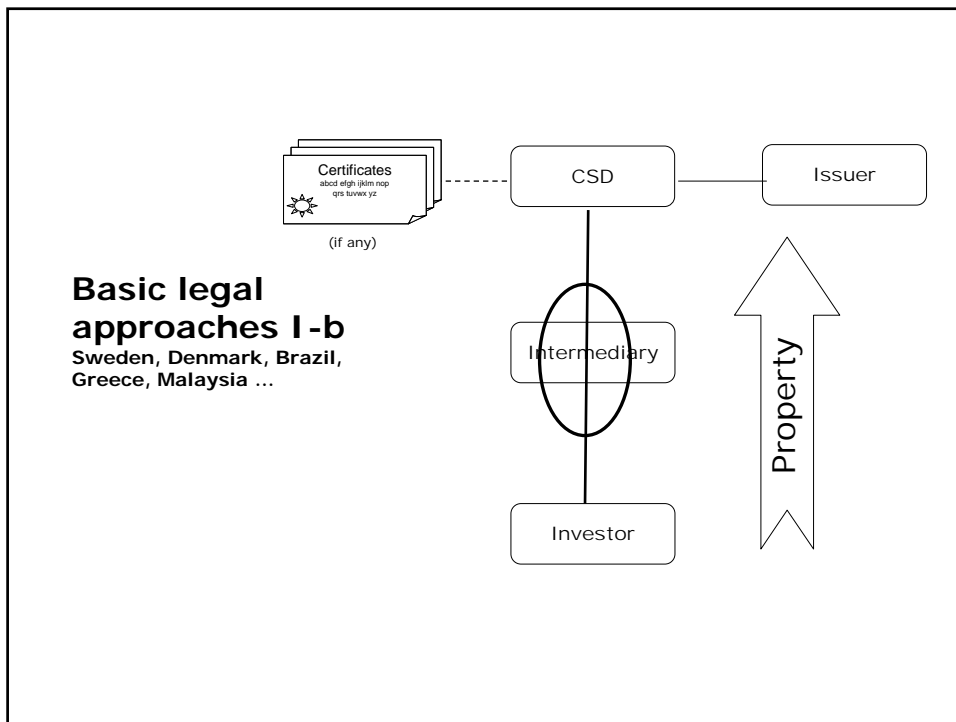
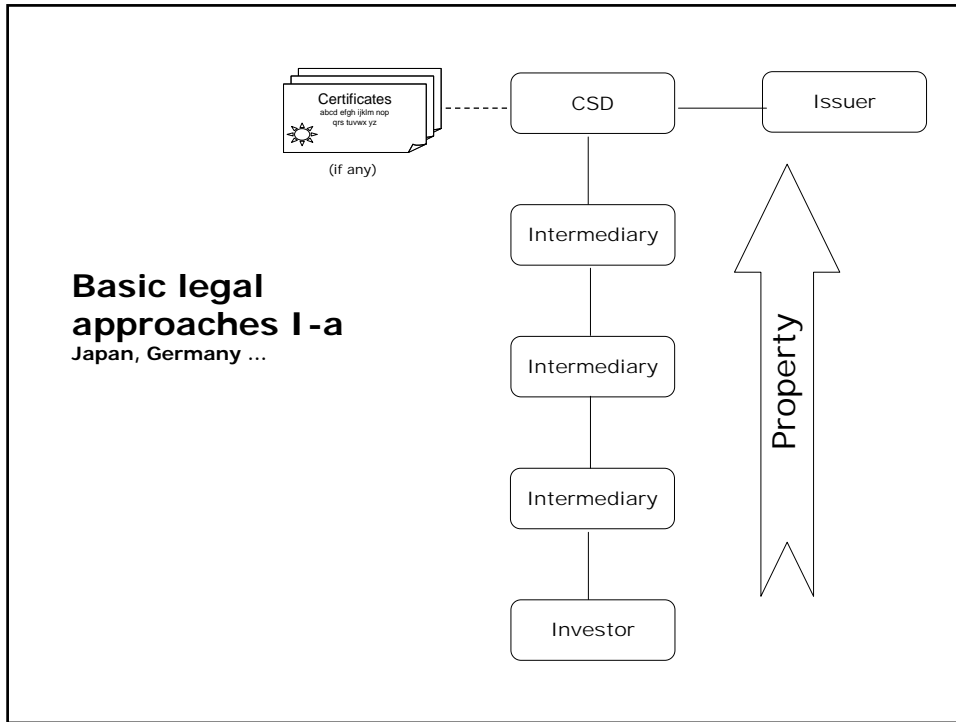
How are securities held in practical terms?

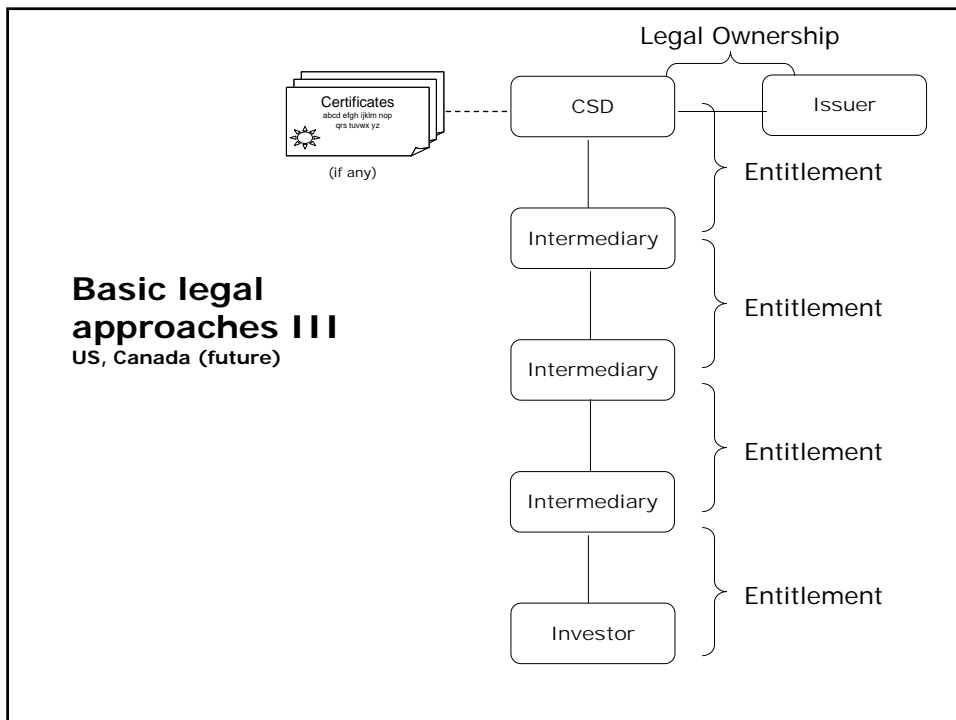
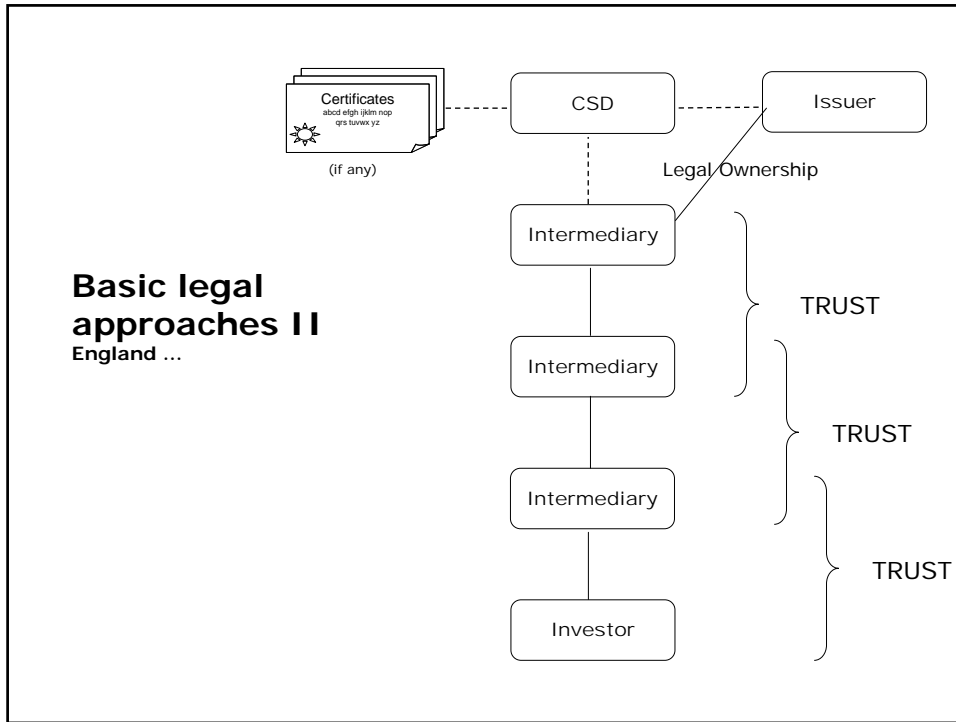




Question 2

Which legal concepts are applied to this practice in different jurisdictions?

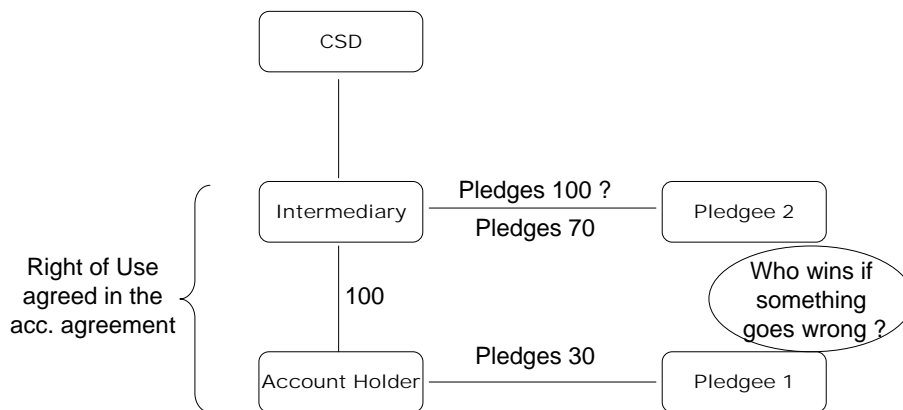


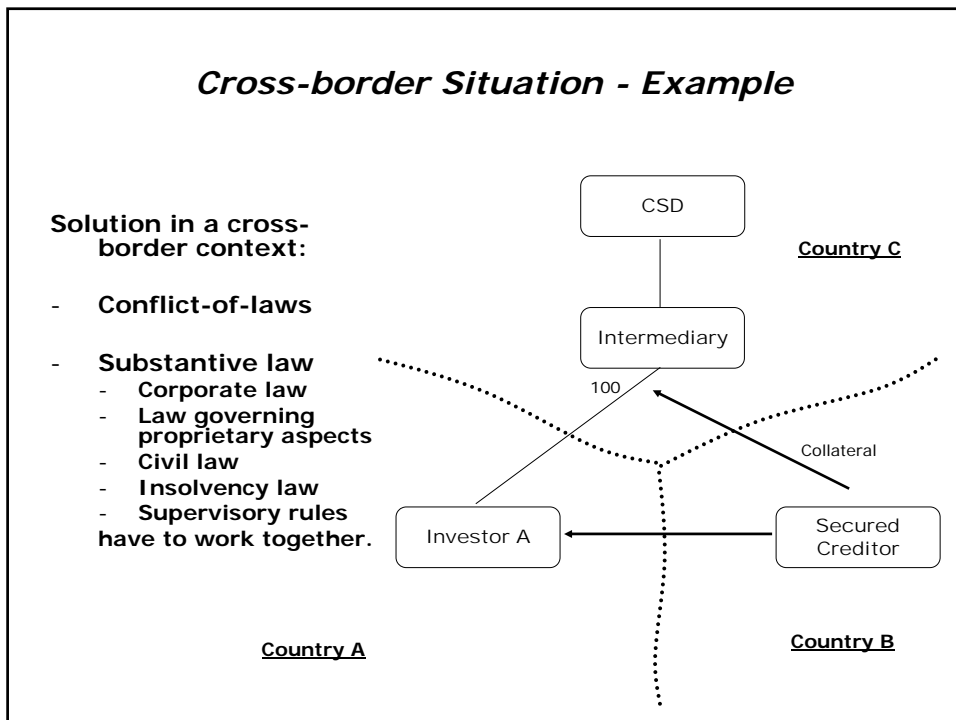
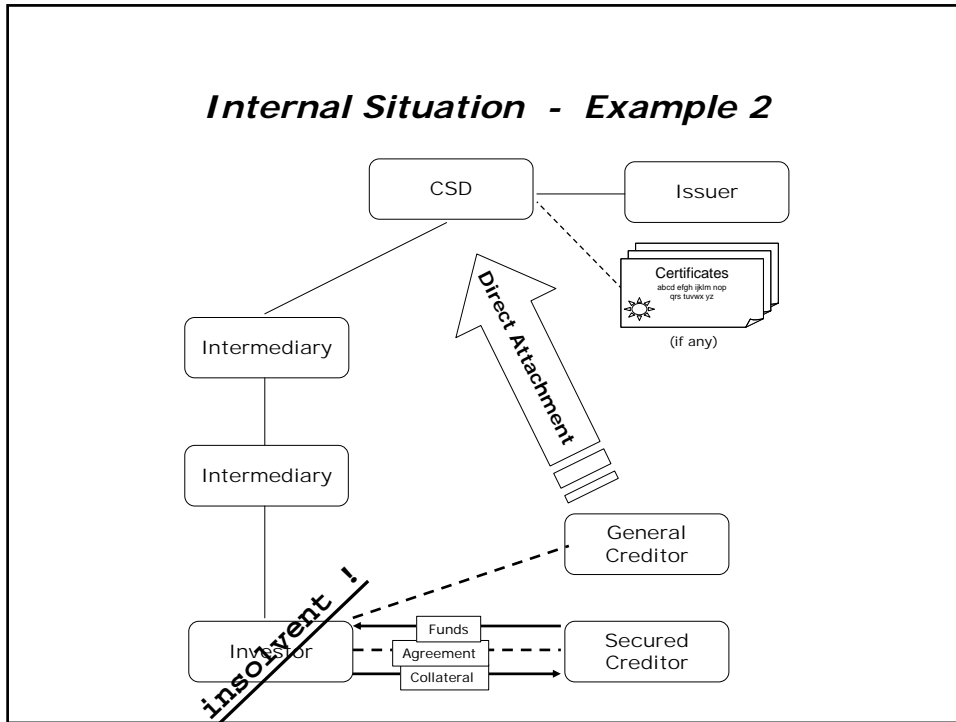


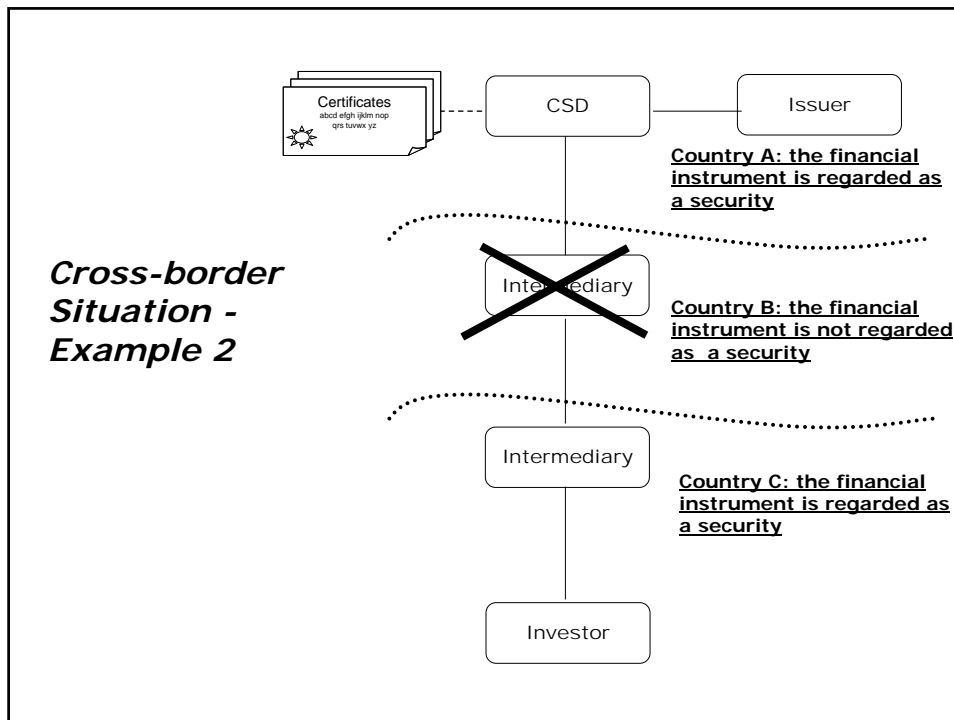
Question 3

Do all concepts apply smoothly to the practice?

Internal Situation - Example 1







Conclusion: Practice and Law regarding Intermediated Securities

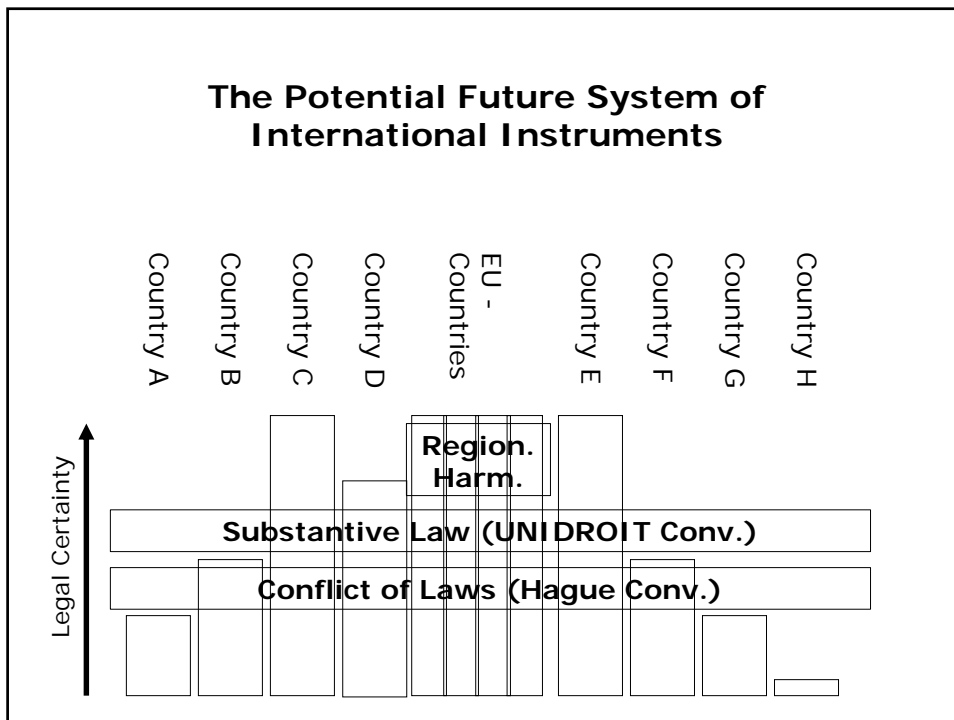
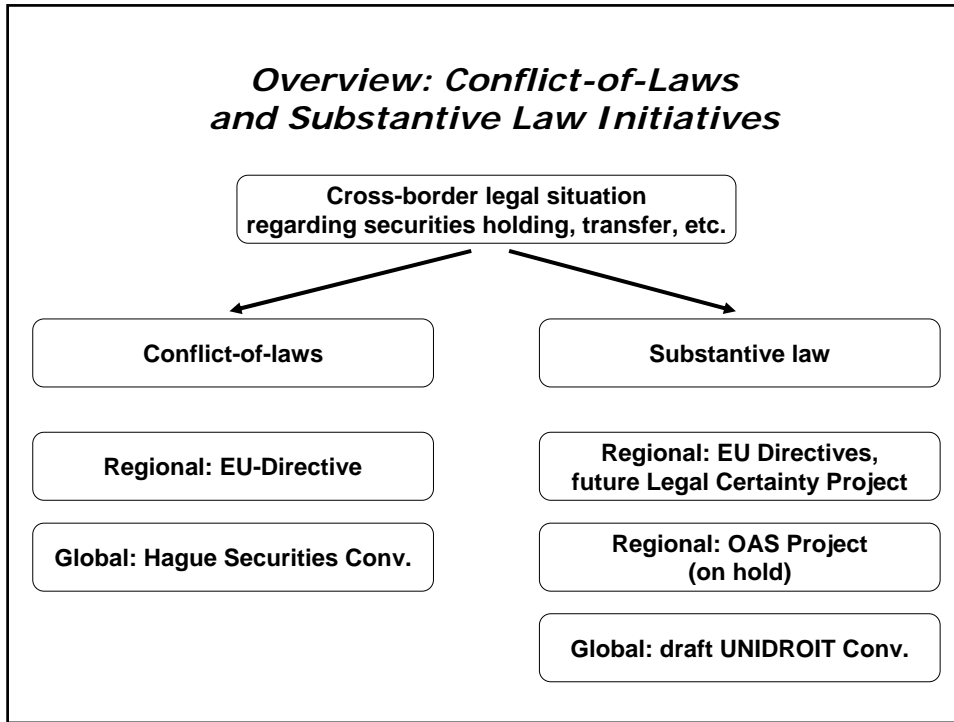
- Practice of securities holding and transfer has departed from the law since traditional holding patterns disappeared.
- Domestic legislation is "insular", i.e. differs from country to country => Cross border compatibility?
- Domestic legislation is not always sound in itself => Internal soundness?

Conclusion: Legal Approach to a Cross-Border Situation - Conflict of Laws

- Need: absolutely essential in absence of a uniform supranational substantive law
- Different solutions world-wide
- Harmonisation to date: Hague Securities Convention and EU Collateral Directive

Conclusion: Legal Approach to a Cross-Border Situation - Substantive Law

- Need for harmonised substantive law?
- Two questions cannot be addressed by a conflict-of-laws rule:
 - Is the domestic law identified by the international rule clear and satisfactory?
 - Does the domestic law work effectively with other jurisdictions in a cross-border context?
- Approach: improving *internal soundness* and *compatibility*
- Economic efficiency
- Harmonisation of substantive law to date:
EU - Finality and Collateral Directives. Future: UNIDROIT



Additional Benefits

- Improvement of economic efficiency
 - Lower transaction costs
 - Lower credit costs

- Enhanced understanding of the legal framework from outside the country
 - Standard for emerging markets
 - Useful even for some developed markets

Part II

Draft Unidroit Convention

Policy Decisions

1. Improving *internal soundness and compatibility* of national legal frameworks
2. Scope: cross-border and domestic transactions
3. Neutrality, functionality, accommodation of different legal approaches (no uniform “International Deposit Act”)
4. Unifying element: recognition of book-entry accounts
5. Compatibility with other relevant instruments (Hague Convention, EU-Directives etc.)

The needs of market participants: guidelines for core-issues

1. Effective book-entries (Art. 4, 7)
 - Against the intermediary and third parties
 - In particular, in case of intermediary’s insolvency
2. Fruits, voting rights, etc. (Art. 4(2),(4)-(6))
3. Clear and simple rules for acquisition and disposition, including creation of security interests (Art. 5, 6)
4. Recognition of net settlement (Art. 5(5))
5. Prohibition of upper-tier attachment (Art. 9)
6. Clear rules on priority (Art. 10)
7. Good faith acquisition (Art. 11)
8. Insolvency protection (Art. 12)
9. Instructions (Art. 15)
10. Integrity of the issue/investor protection/loss sharing (Art. 16-18)

Additional need: World-wide recognition of important market techniques

Facilitating cross-border intermediation (Art. 19)

Chapter VII

Facilitated realisation of security interests

- Rules regarding a right to use clients' assets for own purposes (if agreed among account holder and intermediary)
- Protection of agreements on top-up and substitution in the event of insolvency

but: Opt out, in particular against the background of public policy concerns that might occur

Key Issue 1: "Intermediation"?

- Are entities that are mere book-keepers within the scope of the convention ("intermediary")
- Are systems, where the investor is known to the top tier "intermediated systems"?

Key Issue 2: "Direct" vs. "Indirect" Holding?

- Direct interest in the securities or interest against the intermediary with respect to the underlying securities?
- Functional approach
- Difficulties
- Dividends, voting rights, etc.

Key Issue 3: Balanced protection-mechanisms

- Account holder vs. account holder (who wins?)
- Good faith acquisition
- Effectiveness of book-entry
- Allocation of shortfall

Key Issue 4: Technique of implementation into domestic law?

- Civil/Commercial law
- Regulatory measures
- Self execution or transposition?

Key Issue 5: Collateral enforcement

- Consumer protection?
- Compatible with property-based systems?
- Interference with insolvency laws.





UNIDROIT INTER-SESSIONAL MEETING
October 13-14 2005, São Paulo, Brazil


Direct and Indirect holding systems:
practical implications



Ignacio Gómez-Sancha October 13th, 2005









Today we will speak about...





- I. Direct vs. Indirect holding systems: characteristics.
- II. Making a direct holding system work: the Spanish case.
- III. Practical implications: Pros and cons.
- IV. Are both systems compatible?

2

	
	<h2 style="text-align: center;">Direct vs. Indirect holding systems (I)</h2> <ul style="list-style-type: none"> ❖ The need for cheaper money in the origin of Securities Markets. <ul style="list-style-type: none"> ■ “disintermediation” and a legal relationship between issuers and investors (investment banking vs. commercial banking) ■ documented in paper certificates: <ul style="list-style-type: none"> ✓ Good for issuers “I know who is my creditor” “I only pay him if he shows the certificate that I issued, and then I am free” ✓ Good for investors “I can have liquidity without notice to my debtor-issuer” “I can rest on legal protection based on publicity; I don’t fear adverse claims” ❖ But “paperwork crunch” <ul style="list-style-type: none"> ■ Incompatible with the growth pace of modern securities markets. ■ Inconsistent with foreign investment, as paper needs to be close to the issuer (presentation)
3	

	
	<h2 style="text-align: center;">Direct vs. Indirect holding systems (II)</h2> <ul style="list-style-type: none"> ❖ Common solution: allow for transfers through entries in an electronic book or record → book entry securities ❖ How to keep advantages for issuers and investors while not “closing the eyes to reality”? ❖ In late XXth century Legislators adopted two kind of directions/aims: <ul style="list-style-type: none"> ■ Adapt Law to reality → indirect holding systems ■ Adapt reality to the Law → direct holding systems ❖ Nothing to do with common law / civil law. ❖ Not all systems are direct or indirect. Intermediate families, but two main streams/orientations.
4	

IB ER CLEAR	BME X REGULATED MARKET
	<h3>Characteristics of indirect holding systems</h3> <ul style="list-style-type: none"> ➤ Bundle of rights against the relevant intermediary: New kind of “legal asset” (securities entitlement, co-ownership of a pool of securities etc.) ➤ No “direct” legal relationship with the issuer. Some systems try to maintain it through the chain, but is not realistic. ➤ Transfer of rights or attachments do not require intervention of the upper-tier CSD or intermediary. ➤ “Credits” and “debits” may occur by mere confirmation, and determine extinction / creation of rights each time. <ul style="list-style-type: none"> ▪ No need to look inside the “black-box” ➤ Insolvency: no traceability → need for shortfall-allocation arrangements
	5

IB ER CLEAR	BME X REGULATED MARKET
	<h3>Characteristics of direct holding systems (I)</h3> <ul style="list-style-type: none"> ➤ Law recognizes the account holder – investor as the legal counterpart of the issuer ➤ Intermediaries are mere book-keepers <ul style="list-style-type: none"> ▪ No legal interest in the underlying asset → only entitled to custody fees, etc. ▪ Acts vis-à-vis the issuer “in the name” and “on behalf” the investor ➤ Issuer is “free” if it fulfills its obligations vis-à-vis the “direct holder”, and has a way to know who this is ➤ Upper-tier attachments are generally seen as more protection ➤ A credit usually requires an effective entry in a concrete record / account, not a mere “confirmation” of the intermediary: the “black box” needs to be checked.
	6

IBERCLEAR
BME

Characteristics of direct holding systems (II)

- But... this needs to be ensured by someone!!
 - An infinite "holding chain" is not easily compatible with a "direct holding" legal structure → issuers would be defenseless
 - Someone must bear responsibility for:
 - ❖ Avoiding "creation of securities" through reconciliations
 - ❖ Maintaining the primary electronic records
 - ❖ Co-ordinate / facilitate exercise of rights
 - The vital role of CSDs: two possible realistic structures.

7

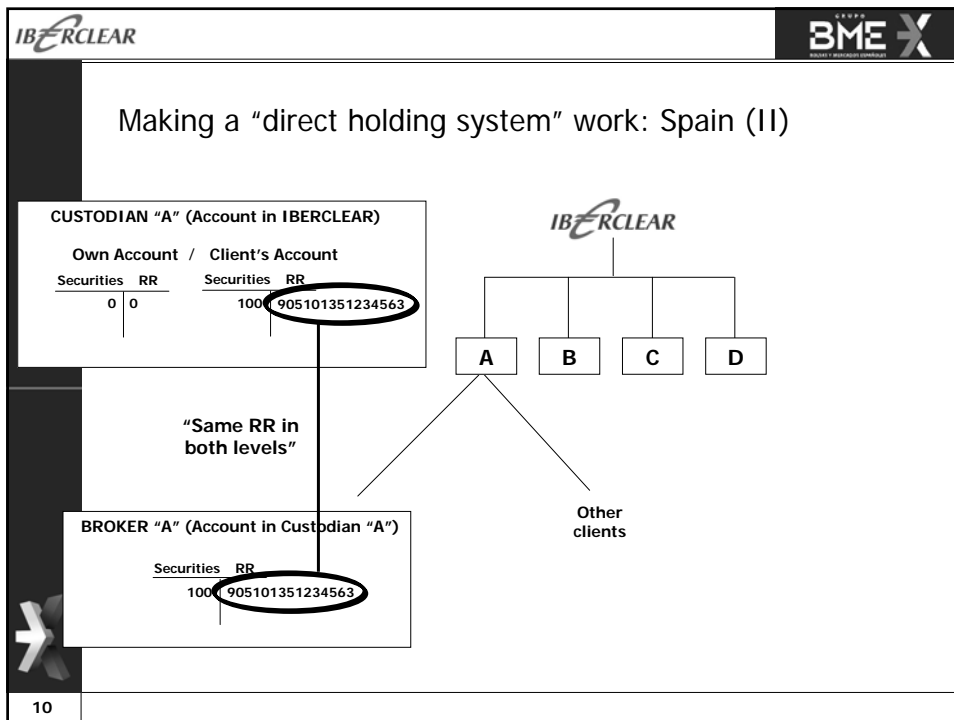
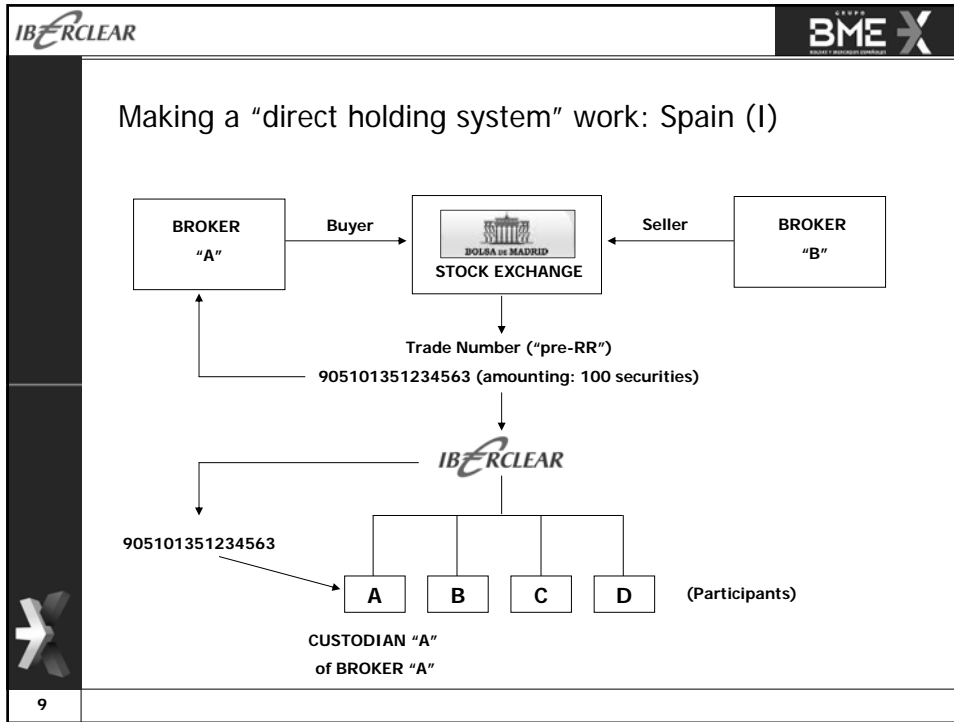
IBERCLEAR
BME

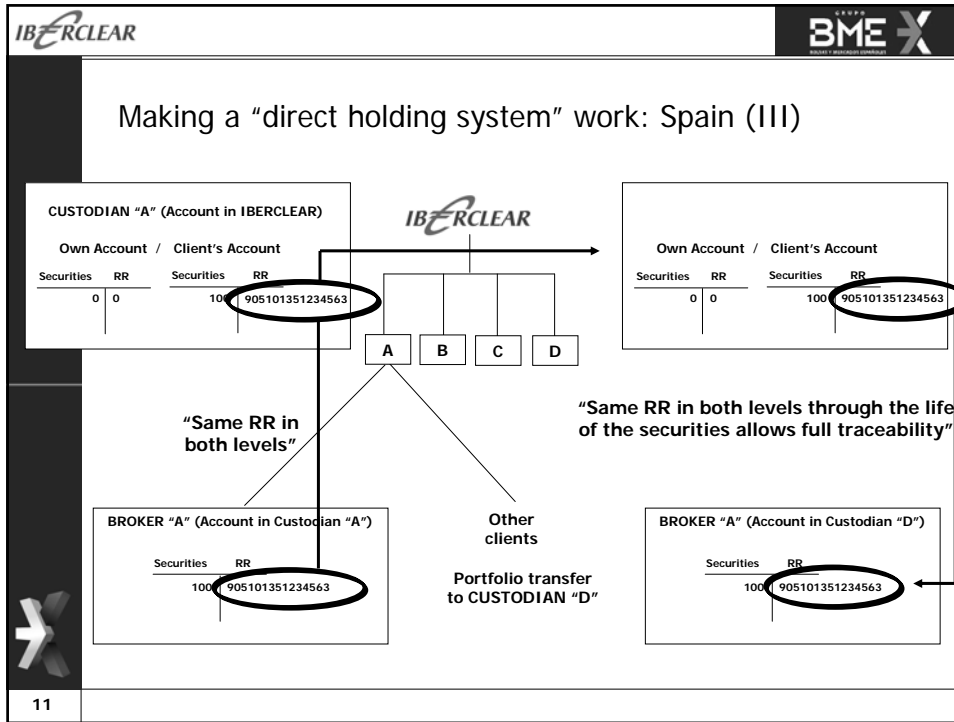
Two ways of organizing a direct holding system

- Single tier centralized registry system: Greece, Nordic CSDS

 - As many accounts as investors
 - "Indirect" investors (through trusts, nominees or omnibus accounts) are subject to potential legal contingencies
 - Compatible with custody industry: the CSD only maintains the "legal registry". The account is operated by a custodian bank
 - Issuers and supervisors are happy
- Two tier centralized system: Spain full legal reform in 1992

8





IBERCLEAR **BME**

Structure of the RR (registry reference)

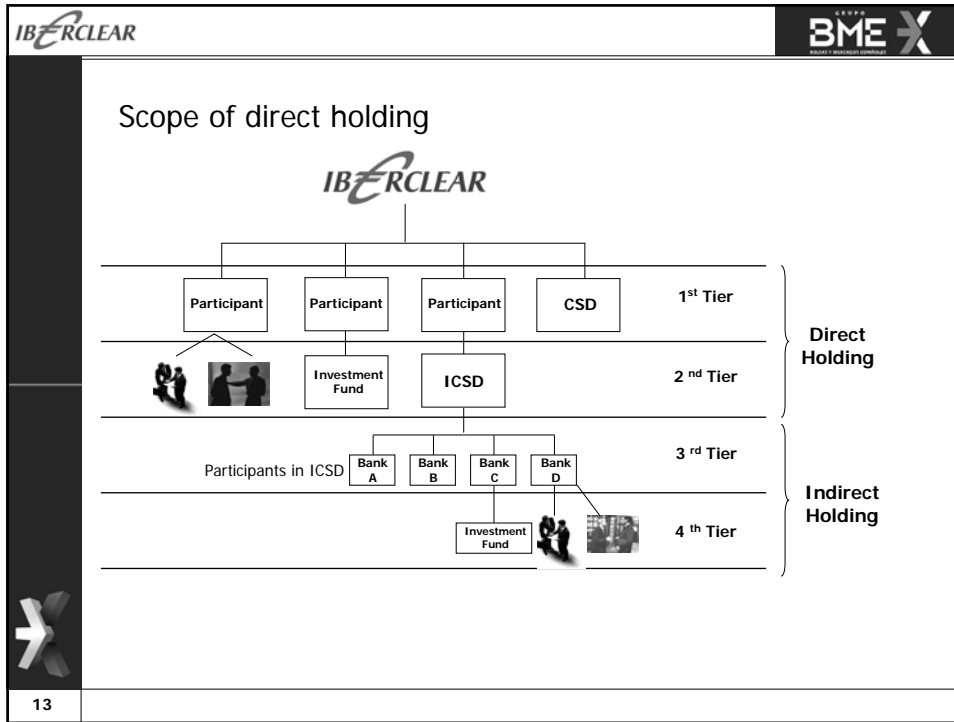
RR = 9/051013/5/123456/3

9	Origin of the transaction (9: buy in Stock Exchange, 6: buy in Latibex Market)
051013	Date of transaction (yymmdd)
5	Detail of the origin of the transaction (5: buy in Bilbao Stock Exchange, 8: bilateral loan)
123456	Sequential number
3	Control digit

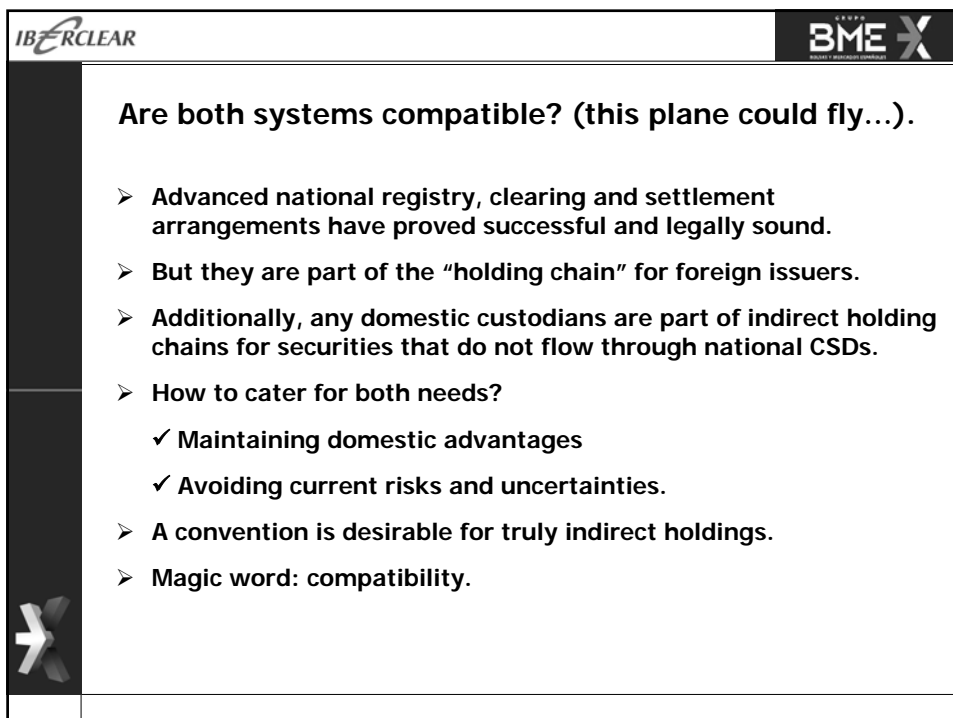
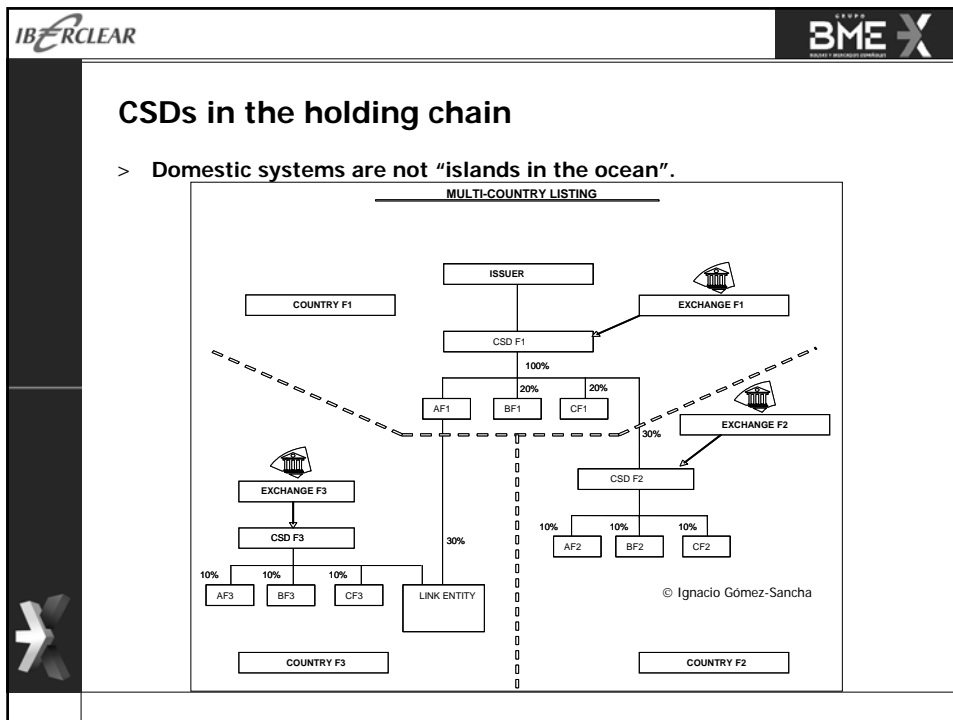
FUNCTIONS:




- ✓ Controls "naked short selling": total prohibition
- ✓ Allows control of "legal short selling" through stock lending
- ✓ Daily update of registry of shareholders (nominative shares)
- ✓ No "RR" means no property rights, only claim against the intermediary
- ✓ Allows traceability: Broker, Exchange, CSD, custodian investor share the same RR



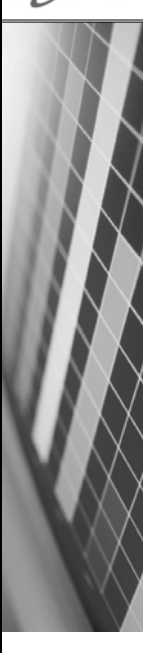
12



Practical implications: Pros and cons			
Direct		Indirect	
Pros	Cons	Pros	Cons
As legally sound as old paper certificates	Created before the cross-border settlement era	Realistic path for cross border investment	Legally unsound in a long chain of holdings: more legal risk
Fully integrated with clearing and settlement processes in CSDs /less risk	Does not allow "internalised settlement"	Allows internalised settlement	Incompatible with foreign clearing and settlement arrangements / more risk
Designed to cater issuer's needs	Does not facilitate distance voting/ divided voting / take over thresholds, etc.	Good flow of economic rights through the chain (cash distributions)	Burdensome/uncertain exercise of shareholder's political rights.
Full protection in "direct" collateral taking	Uncertain indirect collateral taking (upper-tier attachments)	Allows cross border collateral taking	But uncertain enforceability / upper-tier shortfalls.
Traceability / good public supervision / transparency	Considers "owner" a mere nominee/trustee.	Right to choose place of custody.	No traceability / bad supervision, no transparency



	
	<p>Are both systems compatible? (this plane could fly...).</p> <ul style="list-style-type: none">➤ Three potential ways of tackling the issue within the Convention:<ul style="list-style-type: none">✓ Declaration of each State excluding CSDs + participants.✓ Finding a good definition for CSDs + participants and prioritise these rules (Article 8).✓ Save singularities article by article: vital role of “domestic non-convention law”.➤ A challenging work ahead...

	
	<p>Ignacio Gómez-Sancha Trueba Head Legal Counsel, IBERCLEAR Deputy Secretary to the Board of Directors, BME</p> <p>More Information ignacio.gomez-sancha@iberclear.es www.iberclear.es www.bolsasymercados.es Pedro Teixeira, 8 – 2ª plta. 28020 – MADRID SPAIN +34 91 417 48 00</p>



H4




Comissão de Valores Mobiliários (CVM)

- Brazilian securities regulator;
- Created in 1976 by Federal Law 6,385;
- Independent federal agency;
- Commissioners appointed by the President of the Republic, after being approved by the Senate;
- Three offices in Brazil (Brasília, Rio and São Paulo)
 - Approx. 500 staff.

3

H5




Legal role of CVM

- stimulate the investment in securities;
- promote the expansion and the regular and efficient operation of exchanges and OTC markets;
- protect securities holders and market investors against:
 - irregular issue of securities;
 - illegal acts of officers and controlling shareholders of publicly held corporations, or managers of securities portfolios;
 - the use of relevant information not disclosed to the market.
 - avoid or prevent any kind of fraud or manipulation of supply, demand or price of the securities;
- guarantee public access to information;
- guarantee the observance of equitable business practices.

4

H6




What are “valores mobiliários” under Brazilian legislation?

- Shares;
- Corporate bonds;
- Commercial papers;
- Certificates of deposit of securities;
- Shares of investment funds;
- futures, options and other derivatives regardless of the respective underlying assets;
- other collective investment instruments or agreements, as defined by the law.

5


H7



CVM – regulated entities

- 1,017 public companies
- 455 independent auditors (individuals)
- 118 banks
- 447 broker-dealers (“corretoras e distribuidoras”)
- 1,230 asset managers (individuals)


6



Comissão de Valores Mobiliários (CVM) – Law 6,385

- Activities that are governed and controlled by CVM (among others):
 - trading and intermediation on the securities market;
 - organization and operation of Stock Exchanges and Commodities and Futures Exchanges;
 - management of securities portfolios and the custody of securities.
- Stock Exchanges, Futures Exchanges, over-the-counter market entities and securities clearing and settlement entities are considered self regulatory organizations (SROs).

7




Brazilian markets - overview

- Use of dematerialized securities
 - Treasury bonds: since 1972
 - Stocks: since 1976
 - Other securities: since 1986.
- Final investors are identified at the higher tier of the system (at the CSD level).
- “Pooling” is not admitted.
- All accounts must be segregated at the CSD level.

8


H1



Legal framework bearer securities

- The issuing of bearer securities has not been authorized by Brazilian legislation since 1990;
- Law 8,021:
 - ◆ Sec. #1. (...) The payment or withdrawal of any security or investment, as well as as any gains, is not authorized without the identification of the beneficiary. (...)
 - ◆ Sec. #2. It is forbidden:
 - ◆ I – to issue bearer investment fund shares (...);
 - ◆ II – to issue bearer securities and to collect any deposits without the identification of the beneficiary (...);
- New Civil Code (2002):
 - Sec. #907. Any bearer instrument issued without specific legal authorization is null and void.

9




CVM's regulatory approach

Regulation and oversight of securities settlement systems

- CPSS/IOSCO Recommendations for Securities Settlement Systems (Recommendation 18):
 - “Securities settlement systems should be subject to regulation and oversight. The responsibilities and objectives of the securities regulator and the central bank with respect to SSSs should be clearly defined, and their roles and major policies should be publicly disclosed. They should have the ability and the resources to perform their responsibilities, including assessing and promoting implementation of these recommendations. They should cooperate with each other and with other relevant authorities.”


10



Market participants Main players

- **CBLC:**
 - provides clearance, settlement, depository and risk management activities for the equity market (single Brazilian CSD for equities) and for the fixed income market.
- **BM&F:**
 - provides the trading systems and clearance, settlement and risk management activities for the derivatives, treasury bonds and foreign exchange markets.


11



CVM and the custodians Law 6,385, Sec.#24

- CVM shall authorize **securities custody activities**, which shall be carried out exclusively by **financial institutions** and **entities of clearing and settlement**.
 - “Custody of securities” is defined as the activities of depositing securities for safekeeping, receiving dividends or stock dividends, redemption, amortization or reimbursement, the exercise of underwriting rights, without the depository having powers to transfer the securities deposited or reinvest the amounts received, except upon the express authorization of the depositor in each case.


12



**Regulatory framework
CVM Instruction #387**

- Sec. #9 - Brokerage houses shall register their clients, by keeping them updated.
- § 1st Brokerage houses shall, also, **supply exchanges and clearing houses** (...) with the basic register data of each client, in such a way as to allow their clear identification (...).


13



**Regulatory framework
CVM Instruction #387**

- Sec.#3 - The Exchanges shall establish rules of conduct to be observed by the brokerage houses in the relation with their clients and other market participants, following these guidelines: (...)
 - IV – diligence in the control of clients' positions in the custody, with the periodic reconciliation between:
 - a) Executed orders;
 - b) Balances supplied by the entity rendering the custody services; and
 - c) **Positions supplied by clearing houses;** (...)
- § 3rd The Exchanges are responsible for the auditing of the brokerage houses regarding compliance with the principles referred to in paragraphs I to VIII of this article.


14



Regulatory framework CVM Instruction #122

- Section #1:
 - It is prohibited:
 - ◆ for brokerage houses, to transmit or execute orders of clients who are **not identified at the exchange systems or at the correspondent clearing house.**
 - ◆ for exchanges and their correspondent clearing houses, **to clear and settle such transactions.**
 - General rule, with one single exception:
 - Low value orders CVM Instruction #387, Sec. #10.


15



Regulatory framework CVM Instruction #283

- For derivatives, position limits must be established by the exchanges and/or clearing houses (Sec.#3);
- Position limits must be established considering:
 - the consolidated position of each intermediary;
 - the individual position of each investor;
 - the position of groups of investors that have some connection with each other, e.g., one company and their subsidiaries, or one individual and all his/her relatives (Sec.#5).


16



Regulatory framework CVM Instruction #379

- Exchanges and clearing houses must provide CVM, whenever requested, with complete information concerning all registered transactions.
 - CVM may ask for the identification of the investors at each trade. (Sec.#1 & #2).

17

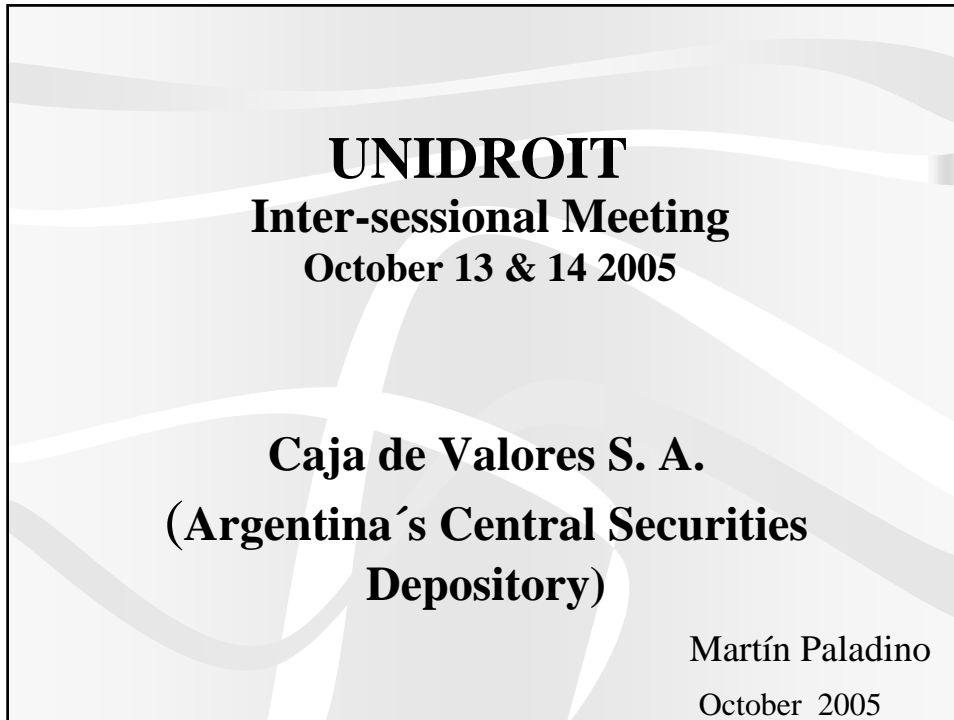


Regulatory framework Anti-money laundering – Law 9,613

- Sec. #10 - The persons listed in section #9(*) shall:
 - I - Identify their clients and keep updated record thereof, in keeping with the instructions laid down by the competent authorities; (...)
- Sec. #11 - The persons listed in section #9(*) shall:
 - I – afford special attention to the transactions that (...) may serve as substantial indicia of [money laundering] (...);
 - II – make proper disclosure [of those transactions] to the [authorities] within 24 hours (...).

(*) Entities permanently or temporarily engaged in custody, issuance, underwriting, settlement, trading, intermediation or management of securities.

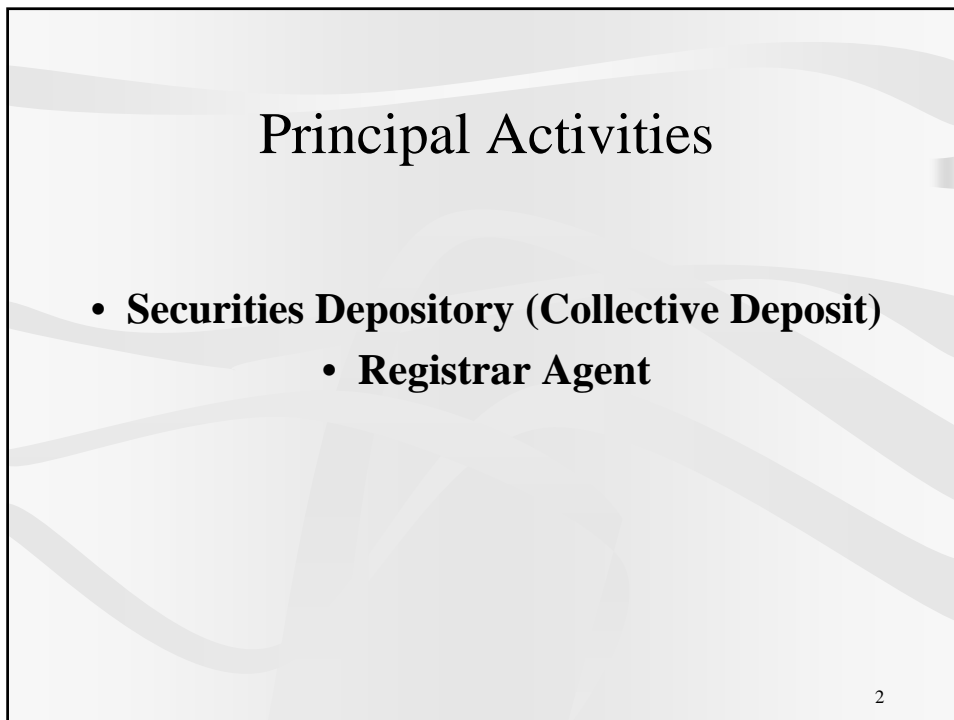
18

A slide with a light gray background featuring abstract white and gray curved lines. The text is centered and reads:

UNIDROIT
Inter-sessional Meeting
October 13 & 14 2005

Caja de Valores S. A.
(Argentina's Central Securities
Depository)

Martín Paladino
October 2005

A slide with a light gray background featuring abstract white and gray curved lines. The text is centered and reads:

Principal Activities

- **Securities Depository (Collective Deposit)**
 - **Registrar Agent**

2

Collective Deposit

- **Caja de Valores S.A.: Central Securities Depository.**
- **Eligible securities**
- **Participants**

3

Depositors (Intermediaries)

- Stock Brokers
- Over the counter dealers
- Stock Markets and Stock Exchanges
- Banks and Financial Institutions
- Insurance Companies
- Mutual Funds
- Other Central Securities Depositories
- Others

4

Argentinean System: Collective Deposit

Indirect Holding System
Interprofessional System

Participants

- Central Securities Depository
- Direct Participants (Depositors)
- Beneficial Owners (Depositors' Clients)

- Securities: in the order of the Depositors
in the name of the Beneficial Owners

Collective Deposit

- CO – PROPERTY OF SECURITIES OF THE SAME DESCRIPTION:
 - » Class
 - » Type
 - » Issuer

7

Collective deposit

- **Identification of Depositors**
- **Identification of beneficial owners**

8

Identification of Depositors

- **Legal analysis**
- **Opening of Depositor's Account**

9

Identification of Beneficial Owners

- **Records**
- **Securities Accounts and Subaccounts**
- **Code Number**
- **Separated Holding of Securities**

10

Identification of Beneficial Owners RECORDS

- By Caja de Valores (substitution of Issuer's Records)
- By the Depositors

11

Identification of Beneficial Owners SECURITIES ACCOUNTS AND SUB ACCOUNTS

- Caja de Valores: opens account in the name of the Depositor
- Depositors: opens sub accounts in the name of the Beneficial Owners
- Data to be provided

12

Identification of Beneficial Owners
CODE NUMBER

- Allocation of identification number for Beneficial Owner
- Depositor: own sub account with its corresponding number

13

Identification of Beneficial Owners
SEPARATED HOLDING OF
SECURITIES

- Use of deposited securities
- Ownership of deposited securities
- Legal conceptions
- Insolvency of Depositor

14

ATTACHMENT, FREEZING AND OTHER LEGAL REMEDIES

- Ability to order such remedies
- Securities to be affected
- Other beneficial owners' rights
- Co-ownership

15

OMNIBUS SUB ACCOUNTS

- Problems with identification of real owners
- Sub accounts opened in the name of Global Custodians
- Order must be addressed to the right intermediary

16

CROSS BORDER LINKS

Links between Caja de Valores and Other CSDs

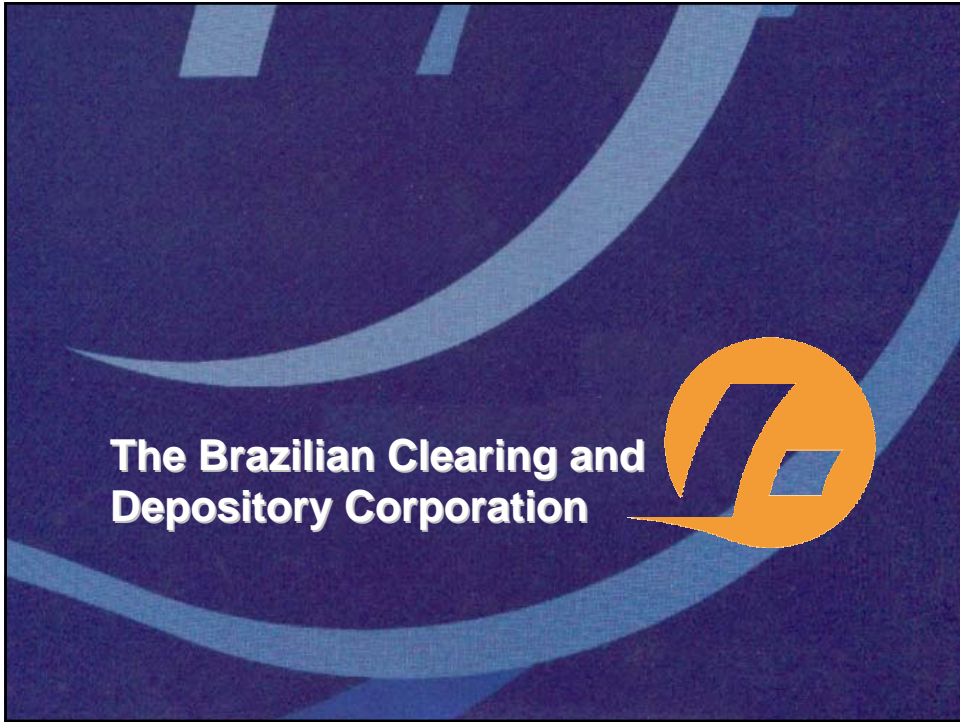
- Euroclear
- Clearstream
 - DTCC
- Iberclear
- CBLC

17

REGISTRAR AGENT

- **Diversity of securities: stocks, corporate and public bonds, trust securities, etc.**
- **Substitution of Issuer's Records**
- **Direct relationship with securities' owner**
- **Global accounts**

18



MAIN FEATURES

Fiduciary ownership of all securities

- At the registrar level CBLC appears as nominee for safekeeping purposes

Daily reconciliation

- Comparison of the number of securities held in CBLC service with the securities registered with the issuer in the name of CBLC as the fiduciary owner (nominee)
- This procedure guarantees the accuracy of the depository records



MAIN FEATURES

Seggregated accounts at the level of the ultimate (final) investors

- The ultimate investors (represented at CBLC by the custodians) of all securities are identified in the records of CBLC
- The custodians are responsible for the holding and movement of securities held in the investors accounts, according to the Brazilian Securities Commission (CVM)
- Allows CBLC to directly inform the ultimate investors on their holdings at the depository service



ACCOUNT STRUCTURE

```

graph TD
    CBLC[CBLC] --- Custodian[Custodian]
    Custodian --- CustodianAccount[Custodian Account]
    Custodian --- FinalInvestorsAccounts[Final Investors Accounts]
    FinalInvestorsAccounts --> Segregation[Segregation of Accounts: Permits the tracking of property rights in the event of custodian insolvency or bankruptcy]
            
```

STATISTICS

Securities Holdings (September 2005)

Number.....4,888 trillions

Value (US\$).....215,7 billions

Number of Accounts

Direct Participants.....237

Ultimate investors with balance.....163.865

Segregation of Accounts: Permits the tracking of property rights in the event of custodian insolvency or bankruptcy

INFORMATION TO CUSTODIANS

- CBLCNet (IP Proprietary Network) links CBLC to its participants
- Account status in real time

INFORMATION TO ULTIMATE INVESTORS

- Monthly, a statement is sent to the investor with the outstanding balance and all securities movement into and out of the accounts
- Daily through the Internet: Investor's Electronic Channel

INTERNET – INVESTOR'S ELECTRONIC CHANNEL

CBLC - Companhia Brasileira de Liquidação e Custódia - Microsoft Internet Explorer

Endereço: http://www.cblc.com.br/cblc/default.asp

Canal Eletrônico do Investidor - CEI

Sua conta já em custódia e muito mais

Por questões de segurança, o acesso ao CEI deve ser feito pelo site da sua Corretora/Agente de Custódia.

Ou utilize a relação de corretoras / agentes abaixo:

Lista em ordem alfabética

Lista em ordem numérica

Escolha aqui

1

Custodian's code and name

CBLC

INTERNET – INVESTOR'S ELECTRONIC CHANNEL

Canal Eletrônico do Investidor - CEI

Agência: 1000

Senha: 12345678

2

Investor's account

3

Investor's password

CBLC

INFORMATION TO ISSUERS

- Daily information (total figures) for purposes of reconciliation
- Lists of ultimate investors sent:
 - Whenever a corporate action is distributed/paid
 - At least once a year
 - For General Meeting purposes
 - When a lien/pledge is constituted
- Issuance of certificates for attendance in General Meetings

ASSET SERVICING

Corporate Actions:

- Dividends
- Stock Dividends
- Interest
- Earnings
- Redemption

Reorganizing Process:

- Mergers
- Consolidations
- Splits
- Spin-offs
- Subscription
- Conversion
- Reverse split

ASSET SERVICING - INFORMATION SERVICES (I)

- Issuers are obliged by law to provide BOVESPA with all relevant corporate action information
- Information is classified by type and made available on the electronic system (Periodic and Occasional Information) in PDF or Word file
- CBLC has an agreement with BOVESPA to receive all corporate action information automatically
- Issuers are also contractually obliged to provide information directly to CBLC

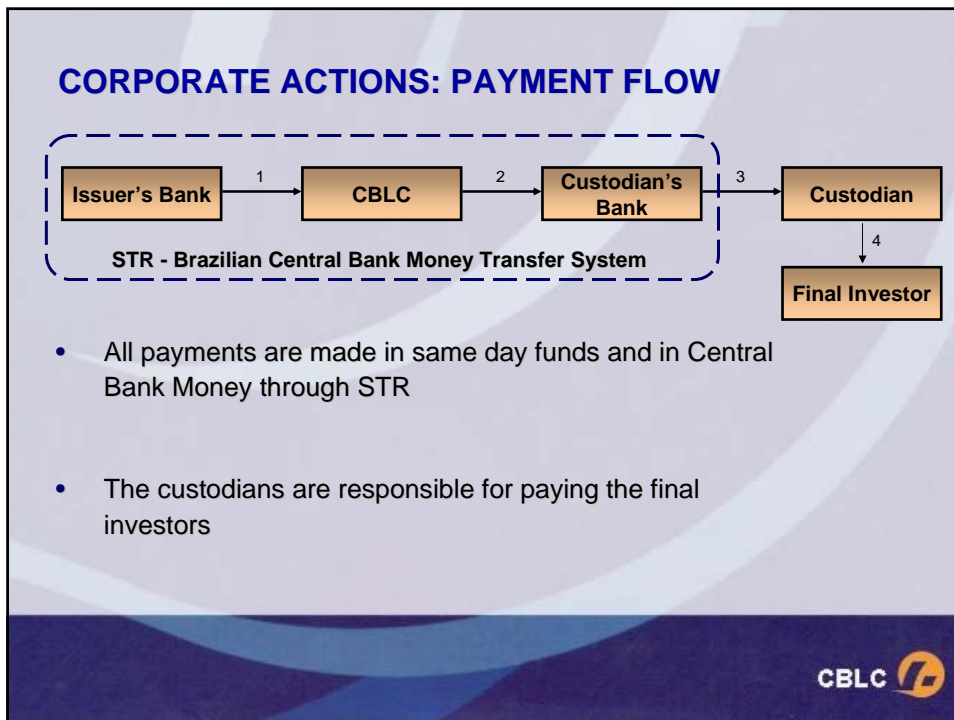
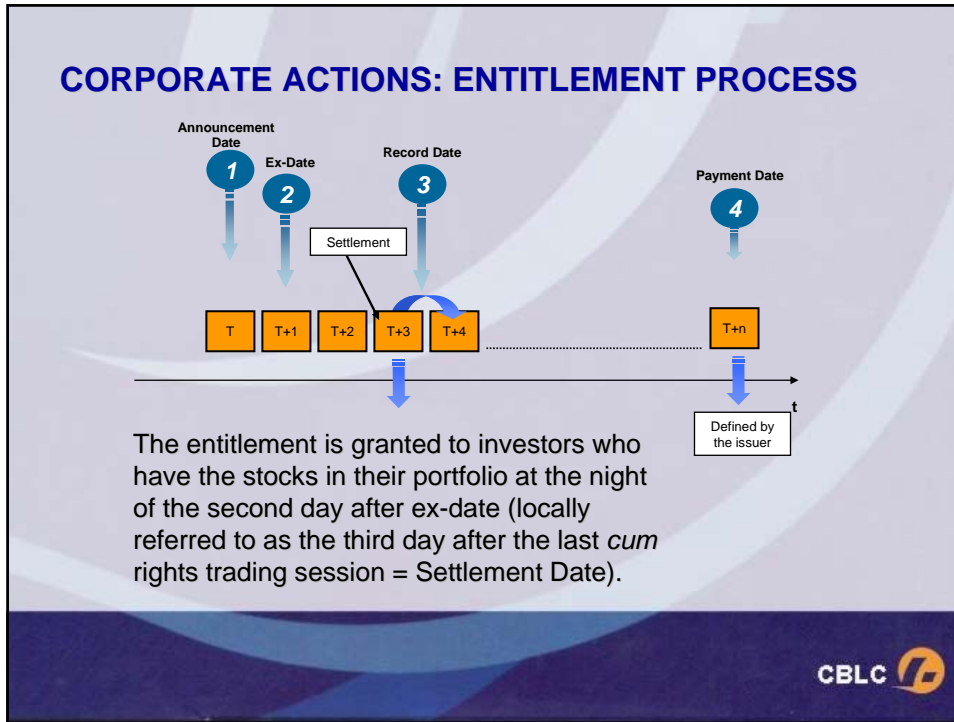
All information related to corporate events is sent to CBLC depository service within the same electronic system in a real time basis



ASSET SERVICING - INFORMATION SERVICES (II)

- Information, deadlines and forms related to cash and securities events are available in the CBLC proprietary network
- CBLC provides the custodians with all information on corporate events to be paid to their clients on the level of the ultimate investor







UNIDROIT CONVENTION – Comparative Chart		
ACCOUNT HOLDERS HAVE THE RIGHT TO:	<u>UNIDROIT CONVENTION</u>	<u>BRAZILIAN LAW</u>
	Article 4, Paragraph 1(a): exercise the rights attached to the securities, including in particular dividends, other distributions and voting rights	Law 6404 (Corporate Law), Art 109 – essential rights: I - to participate in the corporate profits; II - to participate in the assets of the corporation in the case of liquidation; III - to supervise the management of the corporate business; IV – preemptive right in the subscription of securities; V – to withdraw from the corporation in the cases provided for in the Law Article 126, III, CVM Instruction 115 – representation in Shareholders Meetings Shareholder status is proved through a certificate issued by the depositary

CBLC 

UNIDROIT CONVENTION – Comparative Chart

**ACCOUNT
HOLDERS
HAVE THE
RIGHT TO:**

UNIDROIT CONVENTION

Article 4, Paragraph 1(b): instruct the transfer of securities through the relevant intermediary to other account holder (with the same intermediary or with a different one) or to a collateral taker account

BRAZILIAN LAW

Law 6385, Art. 24, Sole Paragraph – and CVM Instruction 115

Transfer of securities deposited depends on express authorization of the depositor

CBLC Rulings: Operational Regulations items 107.1 and 107.14:

Custodians must have the investor's authorization to instruct any transfer



UNIDROIT CONVENTION – Comparative Chart

**ACCOUNT
HOLDERS
HAVE THE
RIGHT TO:**

UNIDROIT CONVENTION

Article 4, Paragraph 1(c): withdraw securities, respecting the law, the terms of the securities and the account agreement

BRAZILIAN LAW

Law 6404, Art. 42, 2nd Paragraph

The depositor may at any time terminate the custody and request the return of the shares

CBLC Rulings: Operational Regulations, item 107.1: Custodians must have investor's authorization to instruct the withdrawal



UNIDROIT CONVENTION – Comparative Chart

ACCOUNT HOLDER WHO IS ACTING AS INTERMEDIARY:	<u>UNIDROIT CONVENTION</u>	<u>BRAZILIAN LAW</u>
	<p>Article 4, Paragraph 2: can exercise the rights attached to the securities (voting, dividends and others) only if he is entitled to those rights against the issuer</p>	<p>Law 6404 (Corporate Law) <u>Voting rights</u> Article 126, III: If the intermediary has a shareholder status (if he is a shareholder himself) or Article 126, paragraph 1: If the intermediary is nominated as proxy representative <u>Other rights:</u> Article 42: The owners of shares are always represented by the depository – not by the intermediary</p>

UNIDROIT CONVENTION – Comparative Chart

THE ACCOUNT HOLDERS' RIGHTS	<u>UNIDROIT CONVENTION</u>	<u>BRAZILIAN LAW</u>
	<p>Article 4, Paragraph 3: -are effective against the relevant intermediary and third parties -may be enforced against the relevant intermediary and the issuer</p>	<p>CVM Instructions 122, 310 and 387 Requirement of segregated accounts at the level of ultimate investors. Thus, rights are effective against intermediary and third parties Law 6404 (Corporate Law) Against Issuer: Articles 109 and 126: Essential rights and representation in Shareholders Meetings Against relevant Intermediary: CBLC Rulings: Operational Procedures, item 24.2, minimum provisions required in the Account Agreement</p>

UNIDROIT CONVENTION – Comparative Chart

INTERME- DIARY MUST TAKE NECESSARY MEASURES

UNIDROIT CONVENTION

Article 4, Paragraph 4:
to enable its account
holders to receive and
exercise the rights
specified in paragraph 1.

BRAZILIAN LAW

**CBLC Rulings: Operational
Procedures, item 24.2,** minimum
provisions required in the Account
Agreement

UNIDROIT CONVENTION – Comparative Chart

WHEN THE ENJOYMENT OF RIGHTS DEPENDS ON THE ACTIONS TO BE TAKEN BY THE INTERME- DIARY.... LIMITATION OF LIABILITY

UNIDROIT CONVENTION

Article 4, Paragraph 5:
(Version A)
-Not within its powers

(Version B)
- Not within its powers
- More than reasonable
commercial standards
- Requirement of a
securities account with
another intermediary
- waived by account holder

BRAZILIAN LAW

Civil Code principle:
Liberty of contract

UNIDROIT CONVENTION – Comparative Chart

MANNER OF PERFORMANCE OF THE OBLIGATIONS OF THE RELEVANT INTERMEDIARY	<u>UNIDROIT CONVENTION</u>	<u>BRAZILIAN LAW</u>
	Article 4, Paragraph 6: (Version A) - account agreement, - law by which the account agreement is governed and - domestic non-convention law. (Version B) account agreement or reasonable commercial standards; - other agreement with the account holder- placing the account holder to exercise any relevant right	Civil Code principle: Liberty of contract

UNIDROIT CONVENTION – Comparative Chart

REGARDING SECURITIES POSTED AS COLLATERAL ...	<u>UNIDROIT CONVENTION</u>	<u>BRAZILIAN LAW</u>
	Article 4, Paragraph 7: The domestic non-convention law determines limits on the rights described in paragraph 1.	CBLC Ruling: Operational Procedures, item 2.3.2.4, Chapter V: Securities posted as collateral must be registered in the name of the account holder. Thus, there are no kind of limits in the rights described in paragraph 1

CONCLUSION – SOME ISSUES TO BE CONSIDERED

- Is the Convention text neutral and functional (result based rules) according to Brazilian law?
- Do the Brazilian law / procedures offer certainty for the investor in relation to the fruits / rights which flow from the intermediated securities?
- Can such rights be exercised by the final investors or it necessarily depend on the intermediary?



Good faith acquisition
Effectiveness
Insolvency Process
Priorities
Loss sharing

Unidroit Inter-Sessional Meeting, Sao Paulo 13-14/10/05

Edgar I. Jelonche

Acquisition and disposition (art. 5)

- Intermediated securities are acquired by credit to the securities account (of the account holder)
- No further step is necessary or may be required by the domestic non-convention law to render the acquisition effective against third parties
- Intermediated securities are disposed by the debit to the securities account

Unidroit Inter-Sessional Meeting, Sao Paulo 13-14/10/05

Edgar I. Jelonche

Netting - Other methods (art. 5)

- A credit or debit of securities to a securities account is not ineffective because it is not possible to identify securities account to which a corresponding debit or credit has been made
- But, without prejudice of any rule ...
- For securities of the same description, debits and credits may be effected on a net basis
- Other methods ... (But, subordinated, art. 10)

Unidroit Inter-Sessional Meeting, Sao Paulo 13-14/10/05

Edgar I. Jelonche

Good faith acquisition (art. 11)

- Acquisition by an innocent person
- A person who does not at the time of acquisition have knowledge of an adverse claim with respect to the securities
- Securities (acquired by credit to a securities account) or a security interest (art. 6)
- Not by way of gift or otherwise gratuitously.

Unidroit Inter-Sessional Meeting, Sao Paulo 13-14/10/05

Edgar I. Jelonche

Knowledge of an adverse claim

- When a 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

Unidroit Inter-Sessional Meeting, Sao Paulo 13-14/10/05

Edgar I. Jelonche

Knowledge received by an organization

- It 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
- When a claim has been notified?
- Securities bought in regulated markets?

Unidroit Inter-Sessional Meeting, Sao Paulo 13-14/10/05

Edgar I. Jelonche

Effectiveness (art. 13)

- Provisions of rules or agreements governing the operation of a clearing or settlement system, directed to the stability of the system or the finality of acquisitions or dispositions through it, shall have effect notwithstanding the commencement of an insolvency proceeding in respect of the operator of the system or any participant in the system

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To the extent that such provision

- Precludes invalidation or reversal of any acquisition or disposition effected by debit or credit of securities or a designating entry in a securities account of the system after the time at which such acquisition or disposition is treated as final

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Also to the extent that such provision

- Precludes the revocation of any instruction given by a participant in the system

for a disposition of securities or a payment relating to an acquisition or disposition

after the time at which that instruction is treated under the rules of the system as having been entered irrevocably into it

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No mandatory operation of insolvency law

- Preclusion of invalidation, reversal or revocation prevails over mandatory operation of the insolvency law of a contracting State
- This applies to:
settlement of cash transactions
collaterals
futures?

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Insolvency of the intermediary

- In insolvency proceeding in respect of the relevant intermediary,

... the rights of an account holder constituted by de credit of securities to a securities account, and the rights of a person holding a securities interest created under article 6,

... are effective against the insolvency administrator and creditors.

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Fraud - Enforcement of rights (Art. 14)

- Application of any rule of law relating to:

Avoidance of a transaction as a preference or a transfer in fraud of creditors

Enforcement of rights to property which is under the control or supervision of an insolvency administrator

- Subject to Articles 13 and 24

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Exception introduced by Article 13

- Effectiveness of debit, credit or designating entry in a securities account of a C & S system effected through such system
- Multilateral system
- Bilateral system?
- Auction trading or electronic matching
- Over-the-telephone transactions?

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Exception introduced by Article 24

- Top-up (delivery of additional collaterals) or substitution of collateralized assets
- Not invalid, reversed or declared void solely for having been provided during a prescribed period before the insolvency proceeding commencement
- But, Chapter VII may be excluded by States

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Priority of interests under art. 5 and 6

- Interests arising under articles 5 and 6:

have priority over interests created by other methods, and
rank among them in the order of which they were created
- Interest arising from a rule of domestic law has priority as is afforded to it by such rule

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Priority of competing interests

- The priority of any competing interests is determined by domestic non-convention law,

But, subject to rules mentioned before
- Priorities may be varied by agreement between persons entitled to any interests

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Insufficiency of securities

- In case of insufficient securities in a clearing or settlement system, if the system make provision for elimination of the shortfall, shall be allocated in the manner so provided
- Subject to that rule, shortfall shall be allocated among account holders to whom securities of the relevant description are credited, in proportion to the respective number or amounts of securities so credited

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No origin or time in allocation

- In any allocation, no account shall be taken of:

the origin of, or any past dealing in, any securities held by the intermediary or credited to securities accounts held by such intermediary with another intermediary, or

the order in which or time at which any securities are credited or debited to the respective account
- Unless otherwise provided by domestic law

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Dear Colleagues,

- This is only a very brief description, open to many possible interpretations
- Now, it is the time to discuss the best possible solutions for any inconsistency or question that may arise
- When the first *commentaire* on the Civil Code was published, Napoleon exclaimed: *Mon Dieu, mon Code est perdu!*
- But, it did not happen.

**GOOD FAITH ACQUISITION, PRIORITIES,
EFFECTIVENESS AND LOSS-SHARING IN ARGENTINA**

*(Emilio Ferré, Commissioner, Securities and Exchange Commission, Argentina)
– Speaking notes –*

Good faith acquisitions

Taking into account that in Argentina the accounting and recording of operations in accounts and sub-accounts takes place electronically by annotation in the account (credits and debits) of registered securities, and that the beneficial owner is the proprietor of the securities deposited in the respective sub-account, it is possible to say that, as far as the “acquisition of the property right” there are no differences between local regulation in Argentina and the proposed Article 11.1 of the draft Convention.

In the same article, the Convention proposes that the debits and credits related to the same issues take place on a “net basis” (as indeed happens in Argentina). Without prejudice to the use of other methods recognized by the regulation of each country, the Project tries to avoid conflicts of interests on the matter, establishing priorities of interest in its articles 9, 10 and 16.

With respect to the provisions contained in Article 11 of the Project which aim to protect the innocent purchaser not only regarding the securities but also regarding the emergent rights, it is possible to say that in our jurisdiction we have on the one hand the dispositions contained in Sections 44 and 45 of Act N° 20.643 on the responsibility that Caja de Valores in the case of total or partial destruction of securities (even by *act of God* or *force majeure*), whereas Section 18 of the *Operating Rules* refers exclusively to the responsibility of the depositors *vis-à-vis* Caja de Valores with respect to the legitimacy of the securities deposited with it until the contract of collective deposit is drawn up, which will be effective once the transmission of the securities has occurred and the period of 48 hours (without being objected by Caja de Valores) is passed.

Priorities

With respect to Article 9.1 of the Project, local regulation is clear: it sets forth that the beneficial owners will only be able to claim directly to Caja de Valores in order to assert their rights of co-property, in case that they are affected by disability, bankruptcy, death, crime or another legal facts in the sphere of the depositor, affecting in his relation with the beneficial owner. Any claim with respect to the resulting rights of the maintained securities will have to take place not against the issuer but against the intermediary involved. Considering that Caja de Valores will only accept the registration of pre-judgement measures on securities in collective deposit and its credits, whenever they come from competent authority, we see that there are no differences with respect to the provision of Section 9.

The Convention establishes a range of priorities regarding interests on the emergent rights in securities:

1. The credits of rights, which, according to the project, would be sufficiently representative of the property right, without any further proceeding; in the same way as the debits originated in the exercise of said rights.
2. Security interests in intermediated securities in favour of a collateral taker so as to be effective against third parties.

3. Competing interests: in case of conflict of interests, the priorities will be resolved as planned in the local regulation, without prejudice that these ones would be modified if there was an agreement between the interested parties.

4. Any judicial or administrative measure enacted by competent authority in the local jurisdiction.

5. Compensation to beneficial owners in case that the intermediary has credited or debited the account in a way which doesn't follow the provisions of the Convention, in which case, he will have to take the necessary measures to make this compensation effective.

Insolvency / Effectiveness

Caja de Valores' system assures the segregation of equity between the deposit taker, the depositors (agents, banks, etc.) and the beneficial owners (final beneficiaries of the securities in deposit) by means of a structure of accounts (for depositors) opened (within the registries of Caja de Valores) including sub-accounts for final beneficiaries. This happens automatically and without any additional procedure to fulfil. In case of bankruptcy of the depositor the assets deposited in the separated sub-accounts remain outside the mass of the bankruptcy. No similar rule exists with respect to the segregation of funds.

In our jurisdiction, bankruptcy legislation establishes that certain legal acts performed during the "suspicion period" – a period between the date determined as the beginning of the insolvency state and the date of the adjudication of the bankruptcy – are ineffective to creditors, such as among other cases, when proved that the third party was aware of the debtor's insolvency state.

The *Public Offering of Securities Act* and the *Operating Regulations of the Mercado de Valores* (MERVAL) contain dispositions regarding the event of a stockbroker or brokerage firm's bankruptcy. In this case, the MERVAL guarantees the settlement of transactions performed by the broker dealer, after the bankruptcy is adjudicated to a stockbroker or brokerage firm. The stock market shall immediately proceed to settle all the unsettled operations. If from the settlement results a positive balance, the amount shall be deposited to the order of the bankruptcy court.

Operations which are carried out and registered within a non stock-exchange market are not guaranteed. The negotiation is carried out on a bilateral basis at risk of the counterparty.

Therefore, the claims of beneficial owners with respect to the operations which are not guaranteed by stock markets will have to be made worth within justice, against the intermediary involved. The matter proposed in Article 12 of the project would not collide with the local legislation.

Furthermore, Act N° 20.643, which regulates the operation of Caja de Valores, contains the legal principle of segregation of assets regarding securities.

In accordance with the project, the credits, debits and instructions, despite the beginning of the process of insolvency with respect to the operator of the system or any other participant, will be effective when their aim is to guarantee the stability of the clearance and settlement system.

Loss sharing

Somehow this concept can be related to the comment mentioned above, with respect to the depositor's responsibilities against the beneficial owners, regarding the securities deposited and emergent rights. Concerning this matter, we must do a comment about Caja de Valores' responsibility in connection with international depositories:

-
- The maintenance of an account of Caja de Valores in an international depository and its operativity must be neutral for the equity of Caja de Valores, making it clear that this account will be considered like an extension of its treasure.
 - Caja de Valores is not forced to investigate the financial condition of any issuer or guarantor of securities, nor the validity or legitimacy of the securities.
 - Caja de Valores will not be responsible with its equity, except in case of "dolo". Therefore, it only responds to the existence of the securities and the credits when these securities are eligible for their deposit in the international depository.
 - The securities transferred to Caja de Valores by the international depository will be those that Caja transfers to the depositor. Caja de Valores will not guarantee that they are good faith securities.
 - Caja de Valores will not be responsible for what have been acted on the base of signatures considered to be genuine, except for "*dolo*" or "*culpa grave*".

**DOES THE PRELIMINARY CONVENTION NEED A NARROWER DEFINITION OF THE TERM
“SECURITIES”?**

*(Prepared by Javier Díaz, Attorney, Securities Legal Department
Superintendencia de Valores y Seguros, Chile)*

I. Introduction

First of all, I would like to thank the organization of this seminar for inviting me to share with you some ideas about the Unidroit Draft Convention. It is always a pleasure for me to visit Brazil, especially if it is related to discuss such important Convention for the future developments of our financial markets.

As the Chilean government delegate to the first meeting of governmental experts that took place in Rome last may, and as a member of the Drafting Committee then appointed, the organization of the seminar invited me to share with you some ideas about the question of whether it may be convenient for the Unidroit Convention to look for a narrower definition for “securities”, as it stands currently.

In this point, I confess, I am doubtful whether I should be so grateful with the organization of the seminar.

The concept of “securities”, let’s admit, is very far from clear in any jurisdiction. Its relation to some blurred concepts like “financial instruments”, “negotiability”, “intangible things”, and so on, makes a little bit risky any attempt to build a theoretical or dogmatic concept of “securities” that may be satisfactory for different jurisdictions.

However, I will try to honor my word, giving you some ideas that I consider relevant, in light of the text of the Convention as it is currently drafted.

Let me start with the words of a well known French author, that I think we all should have in mind, before the exam of this issue. You may consider these words a little desperate, but I think they are perfectly accurate to describe our job here: “Who knows nowadays what the securities are?” (Viandier)

II. Preliminary Considerations

Before getting into the subject matter of this conversation, I will beg you to have in mind two relevant issues concerning the definition that the Unidroit Draft Convention lays down for “securities”.

Article 1 was not discussed in the meeting of governmental experts that took place in Rome.

The first point relates to the fact that Article 1, which contains most of the definitions of the Draft Convention, was not extensively discussed in Rome, as you can see in the report of the meeting. In fact, the discussions started with Article 2. If you read the report of the first meeting you will see that some changes were proposed to Article 1 in several provisions, but they were originated not in the exam of Article 1, but in other Articles, which I will not refer here.

Even though, some delegations expressed some views on the issue of the definition of securities, they did it just as a general statement, without a proper discussion, neither in the plenary, nor in the drafting committee.

You may be wondering why the discussion of Article 1 was delayed in the meeting. Why it had been decided not to discuss what might be considered a core issue of this entire task, you may be wondering. At the end, the special rules that, hopefully, might be agreed upon the Convention in order to regulate the entitlement and transfer of securities under custody, will be justified mainly because the subject matter are securities, and not apples or helicopters.

Well, let us blame the Unidroit Secretary. He, wisely in my opinion, had in mind previous experiences with other conventions, where the discussion of the glossary unduly delayed the discussion of the substantive rules. Thus, they thought that it could be convenient for the discussion, to postpone the exam of these rather formal rules, if you wish, in order to advance faster in the more relevant ones, delaying the discussion of the definitions to the forthcoming meetings of experts, when we could have a more refined "consensus" on the content of the Convention.

I must say that I was doubtful at the beginning. However, as the discussion developed in Rome, I became convinced that it was a sensible proposal and decision. It does not mean that I think that the discussion of this issue will be easy when the time comes, but we all hope that it would likely be less disputed, if a wide agreement has already been reached on the other subjects.

Consequently, the definition of securities was not really discussed in the Drafting Committee either. Therefore, I am sorry that I will not be able to give you some ideas from that perspective, in case you were eagerly waiting for them.

I must say, however, that some countries expressed some views of this issue, before the first meeting. That was the case of the European Banking Federation, which by letter dated on April 18th 2005, suggested that the definition should be clarified to ensure that it encompasses not only bearer securities but also registered ones. As you will see later, I agree with this observation.

That was also the case of the German government, which suggested that the definition of "securities" should not be based on vested titles, but rather on technical features of securities, such a separateness, transport and legitimization function. Moreover, the German government stated that the definition should be more narrowly defined, because as it currently stands, it could cover assets which are not or should not conferred on the basis of book entries, such as shares in a partnership. I will refer to this also.

Functional Approach

Having said that, my words in this seminar will be necessary based on the text as it stands and in the Explanatory Notes of the Draft Convention.

In that sense, we must have in mind that the Draft Convention has been elaborated following a principle called the "functional approach". The functional approach, which is well underlined as a drafting principle in the Explanatory Notes, means that the words used by the Convention were chosen trying to follow a neutral language, from a legal point of view. The purpose of the functional approach is that the Draft Convention can be read, understood and applied in a similar way by practitioners and judges from different jurisdictions, without respect the legal tradition they may belong.

Certainly, we must not understand the functional approach as a neutral scope of the Convention, but only the language it uses. At the end, the Unidroit Convention intends to harmonize the substantive law on the entitlement and transfer of securities held in custody by intermediaries. The functional approach is just the instrument by which the Draft Convention seeks to regulate a specific regime for these matters, without recourse to specific legal concepts that may have perfect and full sense under certain jurisdictions but not in others.

I think that before starting the analysis, this approach must be very clear.

III. The concept of "Securities" in the Unidroit Convention

I do not think I have to underline how important the definition of securities is for the Draft Convention. No matter how neutral the language of the Draft Convention is, in certain points we will have to refer to the concept of securities, crucial nowadays in the commercial and financial world. And, as I said before, the purpose of the Draft Convention is to regulate the entitlement and transfer of "securities" (not apples or helicopters), held in custody by intermediaries.

Certainly, my purpose this afternoon is not to draw an overview of the concept of securities currently used in different jurisdictions and markets. The efforts on this issue have been essayed for a long time, in the different legal families of the world. And we remember the words of Viandier that I quoted before, don't we?

Of course, I will not bother you talking about the theoretical discussions that we have in Chile about this issue either.

My purpose this afternoon will be more modest than those. I will try to share with you some ideas about the "functional" definition of securities contained in Article 1(a) of the Draft Convention, its scope and if we really need a narrower definition of securities, according to these considerations.

So, let's start with the text of Article 1(a)

1. Article 1(a)

"Securities" means any shares, bonds or other transferable financial instruments or financial assets (other than cash) or any interest therein.

I think that, in the audience, there are some non-lawyers. They must be astonished that such a little sentence can be, not only discussed, but the subject matter of a discussion in a seminar. They must be remembering a question that they might have asked themselves before: Why do lawyers exist?

Well. Certainly, the answer to that question goes beyond my capacities and I have a conflict of interest. But I can assure you, non-lawyers, that this little sentence can be fully discussed by lawyers worldwide, each one of them with perfect sense, and they may perfectly not reach a common position on this issue. I will be just another brick in this wall of lawyers.

In order to reach a sensible analysis of this definition, let me start, not with the text in itself, but with the declared intention of the drafters. Later I will come back to the text you have heard and seen.

2. The objectives of the definition securities of the Unidroit Draft Convention and the Hague Securities Convention

According to the Explanatory Notes, the definition of "securities" was intentionally very broad. The drafters did not want to include a "laundry list" of assets currently considered as securities in most jurisdictions, since that list may become insufficient in the future. Instead, the drafters tried to elaborate a "fluid" concept, flexible enough to cover the developments of the financial markets in the future.

I think that most of us will agree that this looks like a sound policy. Financial markets, maybe the most commercial of commercial places, are essentially dynamic. We have just to see how they have changed the last 30 years.

Furthermore, in this specific point, as the Explanatory Notes recognizes, the Unidroit Draft Convention is not precisely original, because it follows the Hague Securities Convention.

In my opinion, this reference to the Hague Convention is absolutely fundamental to understand the real scope of the concept of securities in the Unidroit Draft Convention, as I will explain you immediately.

The Explanatory Report of the Hague Securities Convention recently issued, states that the concept of securities is deliberately broad. It is a fluid definition, mainly based on the criterion of whether a "...financial instrument is capable of being credited to a securities account."

Here we find what we should consider the key of the concept of securities: No matter their nature from a substantive law perspective, they must be such of a kind of being capable to be credited to a securities account.

Both the Unidroit Convention and the Hague Securities Convention agree on the fact that, for the definition of securities, the market where the assets are traded or issued is irrelevant. It is equally irrelevant whether the securities are certificated or uncertificated or if they are traded on official markets or not. It is irrelevant, finally, whether they represent equity or debt or some other type of claim.

What is really relevant is the fact that, according to the law and the practice, they are capable of being credited to securities accounts. In other words, they main feature of the assets is not intrinsic to them, but to some external factor.

This first feature, certainly, makes easier the task of describing what securities are, since we do not have to go into deep legal questions of what we should consider to be securities, as things in the world of the law. Almost any thing could be considered a "security" for the Convention, if this thing can be credited to a securities account.

In that sense, the Convention is faithful with many legal systems nowadays, where the role of the securities account is considered in the center of a new legal regime. The securities account as the virtual or real place where property and security interests over securities are now created.

I said that "almost" any thing could be considered as a security for the Convention. Why not everything?

The answer is, finally, in the text in itself. The assets or instruments must be financial in nature. In that sense, not any thing capable of being credited to a securities account will be considered as a security, but only financial things.

I have to mention that on these two features that I have underlined before, that is, the financial nature of the assets credited to the securities account and, specially, the relevance of the concept of "securities account", should recognize certain paternity in UCC Article 8, after 1994, at least in some extent. But I am not looking for troubles, so I will leave this statement just there.

Let's go back for a little while. I have said that the definition of "securities" is very broad, trying to build a "fluid" concept that may easily absorb the new developments of financial markets. I have also said that this fluid concept is built on the fact that any new financial asset that may be created in the future will be considered as a security, as far as it can be credited to a securities account. And, I have also said that these elements of the definition are common for the Unidroit Draft Convention and the Hague Securities Convention.

Now, I should start with the text of Article 1(a). But let me say a couple of comments of what I have said until now, from a personal point of view.

First of all, I do not like very much this word “fluid” that both the Explanatory Notes of the Unidroit Draft Convention and the Hague Securities Convention, use. Maybe it is just that I might be “lost in translation”, but in principle I do not like because the word “fluid” reminds me something that changes permanently. Some of you may be remembering Heraclitus. And that’s what I mean.

I do not think that the concept should be described as “fluid” but “elastic”. You may be wondering what I am talking about. I am trying to underline a little difference, a detail if you want. But evil lives in details.

What I want to express is that the definition must have (and I think it has) a core element and we must specify it: the financial nature of the assets credited to a securities account. Certainly, this financial nature will be determined in practice by commercial usage and not by a rigid rule of law, and that is what makes this definition dynamic. But it cannot be a mere formal definition where anything could be included in it, as time goes by.

A second element that I would like to underline is that the Unidroit Draft Convention has to be as compatible as possible with the Hague Securities Convention. Even though that both legal texts seek to regulate different issues, both of them are complementary. In that sense, the drafters of the Unidroit Draft Convention not only seek to build a dynamic concept of securities, but also one that fits well with the Hague Securities Convention.

I think this goal is sound, and therefore, both concepts should be consistent and compatible. And I say so, because of some of the comments of the German Government I mentioned before, and which I will treat later. If both Conventions are not consistent, and they finally regulate something different, I can easily imagine practitioners in different jurisdictions trying to make a “Convention shopping”, according to their particular interest in a specific case or situation, harming thus one of the main objectives of both Conventions: legal certainty and predictability.

Now, let’s go to the text of the Draft Convention.

3. Elements of the definition

Article 1(a)

“Securities” means any shares, bonds or other transferable financial instruments or financial assets (other than cash) or any interest therein.

As we can read from the text, the definition has three different parts: “shares and bonds”, “other transferable financial instruments and financial assets” and “any interest therein”. I will refer to them in the same order.

Shares and bonds

“Shares” and “bonds” are examples of assets traditionally considered as securities. I do not think it is necessary to go deeper in these concepts. Certainly in each jurisdiction we can find discussion of what, from a dogmatic perspective, shares and bonds are. If they are tangible or intangible, negotiable or not and what kind of thing is a dematerialized share, for example. However, this would certainly go beyond the purpose of this presentation.

I will just say what I consider the most relevant. No matter what the legal concept of shares or bonds were, there should be no doubts that the Unidroit Draft Convention and the Hague Securities Convention would be perfectly applicable in their respect.

As legal concepts commonly known in the financial world, the drafters of the Unidroit Draft Convention did not consider necessary to include a definition of shares or bonds, or

to say that they should be "transferable". Thus, in commercial law we should trust for that.

Other transferable financial instruments or financial assets

The second part of the definition refers to "transferable financial instruments or financial assets".

Indeed, this part is the most important in the drafting of the definition, since it is the residual category of assets. In other words, the dynamic feature of the definition sought by the drafters resides here.

First of all, I must underline that the Explanatory Notes do not go very deep in the concept of "financial instrument" or "financial asset".

However, the Explanatory Report of the Hague Securities Convention has taken a clearer position. Financial instruments or financial assets typically embody "...a tradable entitlement to money (with or without other rights, such as a right to vote and/or membership rights) and, where not intended to be held solely by a single investor, are issued on terms standard for each unit of the issue with a view of being held, directly or indirectly, through intermediaries, as a medium for investment."

From these words, one could argue that, for the Hague Securities Convention, and from there, for the Unidroit Convention, the concept of "financial instruments or financial assets" is a flexible category that, however, has to accomplish certain minimum requirements: it must be a "tradable entitlement to money", issued in large numbers (one of a bulk, instead of one of a kind), that may be held through intermediaries as medium for investment.

However, this is not true. These elements that I have mentioned are just common features that "financial instruments or financial assets" usually have, but they do not restrict our concept of "financial instrument" or "financial asset", because any of them is necessary. The Explanatory Report expressly says that the "financial instruments or financial assets" credited to a securities account do not have necessarily to fulfill with any of these features, to be considered as "securities" for the Hague Securities Convention.

To be considered as "financial instruments" or "financial assets" it is only necessary that they may be credited to a securities account and that they are financial in nature. If the corresponding asset fulfills both of these elements, it must be considered as a security, and the Convention could be applied.

The possibility of crediting the assets to a securities account will depend on the specific regulation of each market, because it is a regulatory matter. From a pure dogmatic perspective, there is only one relevant feature over which the definition rests: the assets have to be financial in nature, excluding cash, of course.

So, what does it mean? The Explanatory Report of the Hague Securities Convention does not go into further theoretical considerations or arguments that may endanger the widest application of the Convention. It simply states that the financial nature of those assets will be determined by "market usage". In other words, it is to be determined by commercial custom.

In this point, I want to underline a point where the Unidroit Draft Convention differs from the Hague Securities Convention. The drafters of the Unidroit Draft Convention stated that the "financial instruments" or "financial assets" have to be "transferable", a requirement absent in the Hague Securities Convention.

Unfortunately, the Explanatory Report does not make a deep analysis on this issue, which I think should be done. And it should be done because of one reason. The word “transferable” may not be neutral enough.

If, as explained before, “financial assets” and “financial instruments” must be “financial in nature”, we could argue that, one of the main features of this nature, is that the assets can be transferred. I think that we should agree that any asset that cannot be, legally speaking, the subject matter of a transfer, should not be considered as a financial one. Thus, if the transferability of the asset resides in its financial nature, one could argue that the word “transferable” in Article 1(a) is redundant.

But we can also argue that it is not redundant, because it may be referring to a specific sort of transferability status that certain assets enjoy. In other words, transferability may imply negotiability. Thus, one could argue that “financial assets” or “financial instruments”, in order to be under the Unidroit Draft Convention, must be not only financial in nature, but negotiable in character.

I think that this is the core of the critic posed by the European Banking Federation that I mentioned before. And I agree.

I do not think that this was the intention of the drafters. I do not think that they want to restrict the scope of application of the Convention to negotiable instruments, as they are known in different jurisdictions. And I would not agree with the Convention, if that was the intention.

As I mentioned before, I cannot give you more details in this point, because it was not debated in the meeting of experts, and it has not been treated deeply in the Explanatory Notes. Therefore, it should be clarified in the future, in order to avoid misrepresentations in such important matter.

Or any interest therein

Finally, in this point, I will refer to the third element of the definition: “...any interest therein”.

According to the Explanatory Notes, which in this point concur with the Explanatory Report of the Hague Convention, the goal of this provision, firstly, is to include within the concept of “securities” not only full ownership of securities, but also “lesser rights”, such as possessory and non possessory security interests, and certain indirect holding positions (where the account holder is the beneficial owner, and the relevant intermediary, the legal owner).

The words “interest therein” seem to refer to any sort of right over the assets mentioned above. With other words, we, lawyers, usually call these interests “rights in rem”, that is, ownership, and the lesser forms of “iura in rem”.

Until this point, the definition of “securities” was referred to assets, whether they were tangible or intangible, but not to legal relations. In this part, a “security” can be not only an asset but also any interest referred to it. So, if I own a share of IBM, for example, we should conclude that the certificate is a security for the Draft Convention, as well as the ownership that I am entitled to.

The Explanatory Notes of the Unidroit Draft Convention and the Explanatory Report of the Hague Securities Convention are very clear on this point. The Explanatory Report, for instance, states that “...the provisions of the Convention relating to the holding and disposition of securities are not confined to full ownership and co-ownership (including co-ownership which confers against the relevant intermediary property rights in relation to

underlying securities) but extend to lesser interests, for example, possessory and non-possessory security interests.”

Therefore, if the owner of an IBM share creates a security interest over it in benefit of a creditor, let's say a bank; there would be three “securities”, in terms of the Draft Convention: the certificated share of IBM, the ownership over or in that share and the created security interest.

Consequently, the pledgee would not only be entitled to a right in rem (the pledge) but also would be the owner of a specific “security”: the pledge he has in the share of IBM.

I must be honest. I am not convinced with this part of the definition, fundamentally because of dogmatic reasons. When we speak of shares, bonds or financial assets or instruments, we are talking about things. Weird things, if you want, but things.

But when we speak about “any interest therein”, we are referring to something quite different: a legal relation. We are talking about ownership and security interests.

In the ancient Roman law, they were different categories. The first one would be considered as “corpus” and the latter, as “iura”. This distinction remains until now, in continental civil law jurisdictions. In the traditional English common law, the distinction also exists, when they talk of “choses in possession” as opposed to “choses in action”.

In that sense, I would think that the definition of securities may be better limited to the description of things, as the subject matter of legal relations.

The Explanatory Notes of the Unidroit Convention and the Explanatory Report justify this part of the definition in a second ground. It purports to include also the entitlement that the intermediary of the account holder would have, in relation to the securities when he holds the securities through another intermediary, in a typical chain of several intermediaries.

I agree that the Draft Convention will have finally to deal with the legal relations created around securities, whether there or elsewhere. But I have the impression that it may be better from a dogmatic point of view, to leave the legal relations to the rules provided by the Convention and not in a common category with the subject matter of these relations.

Exclusion of Cash

Finally, the definition of securities expressly excludes cash. I do not think I have to get deeper in this issue. Even though money, whether in cash or in bank deposits, is the most typical financial asset, it has its own regime, completely different from securities, and I do not think we have to refer to this particular point any longer.

IV. A narrower definition of securities?

The time has come to answer the question that I am supposed to. Would be convenient to change the definition of securities for another more restricted one?

The answer does not seem to be easy. First of all, due to substantive law reasons, we should have the tendency of looking for a more firm concept. I think that the observation of the German government I quoted before is grounded on this.

However, in my professional experience, the notion of securities in the Chilean system of law is far from being theoretically clear. I do not want to imagine how it would be the task of harmonizing a definition from that perspective, for many different jurisdictions. The creation of a dogmatic concept acceptable for many different jurisdictions could easily be an impossible task.

The alternative option consisting in a "laundry list" has the problem accurately underlined in the Explanatory Notes. Moreover, I think that it is very likely that the main problem of dogmatic characterization would appear again. Let's imagine that after a while, a new representation of a financial interest is created by financial markets, which of course is not considered in the laundry list. I am quite positive that there would be local efforts in order to build a theoretical concept of securities from the laundry list, flexible enough to include the new "security" in it. So, we would be again in front of a problem of a dogmatic characterization of securities.

In that sense, the position of the Unidroit Draft Convention may be more modest but certainly more practical. The definition does not purport to create a definitive concept of securities, but only to lay down that any representation of a financial interest may well be considered as a security, if it is financial in nature and is one of a kind of being credited to a securities account.

In that sense, it is quite obvious that the Unidroit Draft Convention is seeking to expand as much as possible its range of application. And I think it is a valuable intention, since it purports to enhance legal certainty worldwide.

Another strong point in favor of the Unidroit Draft Convention and the Hague Securities Convention is the role that the definition of securities allocates to the market practices, as the device that enables the dynamic of the securities concept.

Modern financial markets are very competitive as trading infrastructures. This competitiveness should lead to an accelerated convergence towards more efficient arrangements worldwide. This convergence should be enhanced if they will be supported by law.

One may argue that underdeveloped markets may shrink, face to face the bigger markets; that this will be another bill of the globalization that will be paid by less developed countries.

I cannot say that this risk does not exist, because it does. But the answer to that problem, in my opinion, should not be any sort of protectionism, but a hard effort to improve the competitiveness of our markets. This choice, at the end, is the only one that may ensure lesser cost of capital, more efficient capital markets, and economies, and better welfare for our nations.

And, at the end, this is what really matters, isn't it?

Thank you very much

**DOES THE PRELIMINARY CONVENTION NEED A
NARROWER DEFINITION OF THE TERM "SECURITIES"?**

(Otávio Yazbek, Lawyer, Brazilian Mercantile and Futures Exchange, Brazil)

– Speaking notes –

First of all, I would like to thank my colleagues and friends João Lauro and Margarida for the kind invitation to take part in two panels of this seminar. I believe that the importance of these inter-sessional meetings is, in part, to submit the text of the preliminary convention to some criticism from the point of view of different legal systems and legal cultures, in order to verify if its terms can maintain their validity.

In this sense, I think that the framework from which I should look at the definition of security in the preliminary convention is the Brazilian experience. This will be my departure.

The definition of security was first given in Brazil, after few years of assystematic use, by the same law that created the Brazilian Securities and Exchange Commission, in mid-seventies. In Brazil, the definition of "Valores Mobiliários" was, and still is, mainly instrumental, being designed to mark the field over which CVM could act.

The Brazilian legislator had two possibilities that were considered. To create a "laundry list", as Javier named it, or to adopt a more theoretical approach, trying to create a concept of security. It adopted the first option, defining a list of instruments that should be considered "valores mobiliários".

In a first moment, this list only encompassed the instruments issued by corporations under the traditional categories of equity and debt and some other securities that derived from these first, like its certificates. There was a specific exemption for the securities issued by banks (like CDs) and public bonds that should remain under the responsibility of the Brazilian Central Bank. This difference, its important to

emphasize, is not due to remarkable differences in the instruments, being related only to the nature of the issuers.

In the last thirty years, that list was more than once questioned. I believe that the problem with lists is that they shall be understood as "numerus clausus", and the reality is more complex and more dynamic than the legal texts. Once again, to make reference to the speech of Javier, the reality of financial markets is, in fact, that river of which Heraclitus spoke.

I think it is not necessary to remind you of the acceleration of the financial innovation process in the last decades and its terrible effects to the national regulatory structures. By this motive, after few isolated adjustments, the law that defined securities was largely amended in 2001. Where we originally could find only those instruments involved with the corporate finance process, we could now find a more complex reality, involving the shares issued by mutual funds, derivatives and other investment instruments.

Though we continue having a list, this list has some tricks that allow a less restrictive interpretation. One of these tricks is in the concept of "contrato de investimento coletivo". These are generally defined, in the last item of the list, as "*any other collective investment instrument or agreement that creates the right of participation on profits or remuneration, including as a*

result of the rendering of services, and whose profits derive from the efforts of the entrepreneur or from the efforts of third parties."

Another example is in the reference to "derivatives", a concept that has no legal definition and, as you may be aware, can encompass almost everything. Especially these two examples brought some discussion about what should be considered

"valor mobiliário" in practice. It is in the middle of these conceptual battles that I came to the definition of securities provided for the preliminary convention.

In a first moment, I didn't like what I saw. As a lawyer, I usually think based on formal categories and I've got a crush on legal terms and concepts. The definition I found here is anything but formalistic and it has no legal content, at least in a first sight. It reminded me the reference, in Brazilian law, to "derivatives", around which we are now having those conceptual battles.

Another thing that made me feel uncomfortable is that, as Javier emphasized, one of the main characteristics of the securities for the preliminary convention is, and here I quote my colleague, that they "must be such of a kind of being capable to be credited to a securities account". I have to recognize that to have such an important definition based on what appeared to be a merely procedural aspect sounded weird to me.

After those first impressions, however, I have to recognize that I started to get used to the definition given and to find some merits in it. Merits that were well discussed by Javier. I would like to reconsider some points from now on:

- (i) first, I think that the definition chosen does not pay a price for not being exhaustively discussed in the former meetings. I think that even being at the core of the convention, it has an instrumental character. In this sense, I understand that in those meetings more attention was given to the regime effectively proposed. The previous discussions, yesterday and even this morning showed us that are more dramatic differences to solve;
- (ii) second, the choice of such an informal definition is symptomatic and shows that the convention takes some care in avoiding conflicts with national definitions – it seems that almost everything fits into that definition. Of course we will have some specificity in different jurisdictions. One point that I think it is necessary to recognize is that the definition of securities is probably larger than the local definitions. This is clear in the Brazilian system, where, as I told you, instruments issued by banks and by government are not considered "valores mobiliários". There is a difference in the scope of the definition contained in the preliminary convention and our legal definition. I believe this must happen in other cases too but I don't think there is any conflict;
- (iii) another point is that, now, the recognition of the "credibility" in a securities account as a common trace sounds like a very good criteria to me. Actually, securities are, from a dogmatic point of view, rights and contractual relations vested into an instrument, made concrete and negotiable by this process. Nowadays it is common to talk about a disintermediation movement in banking activities that make more and more relations securitized. It is natural that this large number of instruments shall be subject to some mechanisms that ensure the recognition of the property rights or any other entitlement and these mechanisms are different than those created for other kinds of property.
- (iv) Another point I would like to emphasize is that I disagree with Javier when he shows his discontentment with the inclusion of "any interest therein" in the definition of

securities. Of course, he is right when he says that these interests are not properly negotiable things. Notwithstanding even this kind of abstract relationships (i) are sometimes necessary to qualify the content of a specific instrument, giving to it some specificity, and (ii) even they may be vested sometimes into negotiable instruments. When I say this I am thinking about the creativity of the market forces, but I think we have some concrete examples too. We have in Brazil an instrument issued by warehouses that can be split into two different securities, one representing a property right and the other representing a pledge. Another example are in debt instruments issued with detachable coupon bonds.

The last point I would like to remember is related to my condition of lawyer in a derivatives exchange and clearinghouse. In the discussions I could have access securities are usually referred to as "assets". This made me ask if the convention really intended to refer to the derivatives as securities. As you may be aware, derivative instruments are qualified as off balance sheet relations, not being formally qualified as assets. Was that kind of reference only an old habit? This is the question with which I finish my intervention.

**SPECIAL PROVISIONS ON COLLATERAL OVER SECURITIES -
REALISATION OF COLLATERAL IN A CROSS-BORDER ENVIRONMENT**

*(Henrique Leite Cavalcanti, Partner, L. C. Sturzenegger & Adv. Assoc. Law Firm, Brazil)
– Speaking notes –*

Reading the articles of the Convention related to security interests in intermediated securities and special provisions with respect to collateral transactions I thought that it would be a good idea to take a look at some points regarding the constitution, use and execution of collateral in the Convention that the Brazilian legal system deals with in a rather different manner.

In fact, I chose a couple of points from the Convention to discuss with you. They are stated in Articles 6, 22 and 23.

The first point deals with the necessity, under Brazilian law, for the formal registration of the constitution of guarantees in order to be effective against third parties. Under Articles 1.432 and 1.452, of the Brazilian civil code, the instrument of pledge shall be registered by the parties with the appropriate official registry. The ordinary pledge and the pledge of rights, for example, shall be registered with the official registry of titles and deeds. The agricultural pledge and the mercantile pledge, with the official registry of real estate property. In the case of shares, Law n° 6.404/76, the Brazilian corporation law, regulates the registration of the pledge.

According to Articles 39, 40 and 41, a pledge of shares is constituted by registration in the books of the issuing company, or in the books of the financial institution, in the case of book shares, the so-called "ações estruturais". Aware of the dynamics of the capital markets and the difficulties of harmonising the registration of pledges with the speed of the transactions, CVM, interpreting Law 6.404/76, last year enacted a regulation (deliberacao 472/04) stating that:

"The books kept by the institutions authorized by CVM to render the services of custody of fungible shares are part of and complement, for all legal purposes, the books of the issuing company or the registrations of the financial institutions rendering services of book shares".

Even having said that, CVM has not waived the need for registration in the books of the issuing company. It is not clear yet how the Brazilian courts are going to interpret this rule. But the important thing here is to keep in mind that under the Brazilian legal system the effectiveness of a pledge against third parties is subject to its registration.

The second point I would like to mention deals with the ability of the collateral taker to realise the collateral securities by appropriating them as his own property, setting off their value against the debt.

Art. 1.428 of the Brazilian civil code states that any "commissary clause" included in the pledge agreement is null and void. If the debt is paid on time, the creditor cannot retain the assets given as guarantee as its own property. One argument for this prohibition is that, in a normal market, the creditor could easily deceive the debtor by taking the assets for himself, stipulating their price in an arbitrary manner (normally lower than the price that the debtor could get in the market). It is important to note that in the case of securities with liquidity and negotiated in an organized market, such argument does not prevail.

In any case, under the Brazilian legal system, it is not possible for the collateral taker to realize the collateral securities by appropriating them as his own property, setting off their value against the debt. It is also worth mentioning that, in Brazil, the collateral taker cannot use and dispose of the collateral securities as if it were the owner of them before the discharge of the secured obligation.

**SPECIAL PROVISIONS ON COLLATERAL OVER SECURITIES -
REALISATION OF COLLATERAL IN A CROSS-BORDER ENVIRONMENT**

(Otávio Yazbek, Lawyer, Brazilian Mercantile and Futures Exchange, Brazil)

– Speaking notes –

Again I will begin by discussing the reality in which I am embedded, in order to identify some specific problems that I see in the discussion of cross border collaterals. Henrique Leite Cavalcanti, in his intervention, focused on private law issues and I shall discuss something that on a first sight could appear to be incidental here. My point is related to some prudential and systemic questions. As I believe, these different fields are more closely related than it seems.

As you may know, BM&F was created as a derivatives exchange and clearinghouse. With the new Brazilian Payments System, since 2002, the clearing activities started to receive more attention than before and BM&F developed two more clearing systems, one for the foreign exchange interbank market and the other for the government bonds. Nowadays, the FX clearinghouse and the derivatives clearinghouse are faced with the same cross border issues. Under different circumstances, these two clearing systems have to receive collaterals abroad.

The FX clearinghouse receives collaterals from Brazilian financial institutions that have their foreign exchange operations settled through the clearing accounts in New York. In this case, the institutions are located in Brazil and generally speaking the law applicable to any insolvency process is the Brazilian Law.

The derivatives clearinghouse receives collaterals from foreign investors that negotiate in BM&F markets under a specific resolution of the Brazilian Central Bank. This resolution allows the investors in commodities derivatives the settlement of their operations in accounts maintained by the clearinghouse in New York. In this case, the clearing is responsible for the remittance of the cash to Brazil. The collaterals are given in United States and are subject to the North American regime.

Though relatively clear and safe for BM&F, this kind of situation brings some questions that I think should be present in any discussion about the crossborder collaterals in the present moment.

As you may be aware, a large number of countries, especially developing countries that always face a remarkable need to reduce some risks in their markets in order to attract capital flows, have been restructuring their payment systems. These processes are directed by the principles stated by CPSS and they involve a set of different measures.

The first principle of CPSS declares that it is necessary to have a sound legal basis and this means that it is necessary to create some specific protection to a payment system. In general this protection is given under some exemption rules by which the clearinghouses are considered different than other creditors, receiving what is owed under some procedures different than the common insolvency rules.

Even the collaterals given to those clearing systems are especially protected, not being subject to collection or to any other preference, stated by any other law. In this sense, the article 6 of the Law that gave the sound legal basis to the Brazilian Payments System states that those

assets *"cannot be pledged, and shall not be the subject matter of attachment, seizure or any other act of restraint, except for compliance with the obligations assumed by the clearing house"*.

I saw that the documents and discussions that give support to the draft convention talk about the importance of internal soundness and compatibility. I believe that the countries that have been adopting the receipt referred to above are meeting higher standards of that internal soundness, but I am not so sure about the possibility of having that compatibility that those documents describe.

Article 8 of the draft convention say that the rules or agreements that govern the operation of a clearing or settlement system which is directed to the stability of the system or the finality of dispositions effected through the systems shall, in any case, prevail over the provisions of the convention. This is not the point I aim to discuss.

Of course it is possible to harmonize rules and procedures related to the collaterals, avoiding the legal and operational risks that come from the diversity and recognizing the prevalence of the internal public order. But is it possible to have those special safeguards and guarantees that local systems are giving to their systemically important clearing systems extended for other jurisdictions? Is it interesting to obtain that extension?

I think that this is one important question to be considered here, especially if we see a potential conflict between the model of the CPSS, designed for providing the necessary internal soundness, and the reality of the cross border collaterals.

It is necessary in a world globalized to have the cross border collateralization mechanisms uniformized, but in what sense these mechanisms can coexist with the needs of systemic regulation. A kind of regulation, it is necessary to emphasize, that not only creates exemptions to some private law rules, but that even qualifies the applicability of those rules.