



**UNIDROIT COMMITTEE OF GOVERNMENTAL EXPERTS FOR
THE PREPARATION OF A DRAFT CONVENTION ON
SUBSTANTIVE RULES REGARDING INTERMEDIATED
SECURITIES
Second session
Rome, 6/14 March 2006**

UNIDROIT 2006
Study LXXVIII – Doc. 43
Original: English/French
May 2006

REPORT

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Introductory Matters

1. From 6 to 14 March 2006, 37 UNIDROIT Member States, 2 non-Member States and 11 observers with a total of 121 delegates (cf. [Appendix 3](#)) convened in Rome for the second session of the UNIDROIT Committee of Governmental Experts for the Preparation of a draft Convention on Harmonised Substantive Rules regarding Intermediated Securities (“the Committee” or “the CGE”).
2. The Chairman of the CGE, Mr Hans Kuhn, opened the session at 10 a.m. and welcomed delegates and observers. He recalled how, at its first meeting, the CGE had identified key issues arising from the text of the preliminary draft Convention on Harmonised Substantive Rules regarding Intermediated Securities (hereinafter referred to as “the preliminary draft Convention”, “the draft text”, or “the future instrument”) as it appeared in Doc. 18 and that on the basis of the discussions during the last session Doc. 24 had been produced. The latter now formed the basis for further work. He equally drew the CGE’s attention to the impressive amount of inter-sessional work undertaken since that first meeting, including during three seminars in Switzerland, Brazil and France, and in two working groups as well as to the numerous comments on the text submitted by delegations and observers to the CGE. At its second meeting it was time, with the benefit of the preparatory work, for the CGE not only to take decisions on key issues outstanding from the last session but to raise any remaining issues. He stressed that the role of the Drafting Committee was precisely to transpose the decisions taken by the CGE.
3. The Secretary General also welcomed delegates and observers on behalf of UNIDROIT – particularly those Member States that had not participated before, notably Hungary, Latvia, (which had joined UNIDROIT in January 2006), Malta, Tunisia and Venezuela, and observers from countries that were not yet UNIDROIT members, notably Singapore and Thailand.
4. The Secretariat summarised the proposed order of business. In particular, two matters suggested for early discussion - the structure of the draft text and the form of the future instrument – would be discussed during the first day and again at greater length on the afternoon of the fifth day. Apart from this, items on the agenda followed, broadly speaking, the structure of the draft text, with some exceptions and some articles being grouped for discussion. One delegation proposed a flexible approach to the order of business so as, for example, to enable “packages” of associated provisions to be discussed together. On that basis that Committee adopted the order of business as set out in [Appendix 2](#).
5. The Chairman and the Secretariat outlined the proposed hours of work and other organisational matters including documentation which lay before the CGE. The CGE was reminded of the composition of the Drafting Committee, chaired by Mr Hideki Kanda (Japan), co-chaired by Mr Guy Morton (UK) and Mr Michel Deschamps (Canada) and including representatives from Belgium, Chile, France, Germany, Luxembourg, a “Nordic” country, Switzerland, the USA as well as any observer invited to attend by the Chairman of the Drafting Committee.
6. The Secretariat reported on inter-sessional work undertaken by the CGE on the basis of decisions taken at the occasion of its first session (cf. [Appendix 13](#) for further explanation).

General Comments

7. One delegation hoped the agenda would allow progress to be made on the issue of how to harmonise the existing incompatibilities between different holding systems, which had been extensively discussed at the first plenary and since.
8. The EU Commission explained to the CGE that, since the second plenary session, its representation of member States of the Union had been formalised. It would be responsible for negotiating, on their behalf, those provisions of the draft text whose subject was dealt with in the Settlement Finality and the Financial Collateral Directives (Directives 98/26/EC and 2002/47/EC). In this context the CGE would be interested to know that there was a proposal for a new Directive on Voting Rights.

Structure of the draft text (presentation of related documents)

9. At the Chairman's invitation, France, followed by the USA, introduced their proposals for restructuring the draft text. These were set out in detail in Doc. 34 and Doc. 29 respectively, to which the CGE was referred.

10. Albeit acknowledging that the text in Doc 24 *had* improved on that in Doc 18, France had substantive proposals for further change. Above all, these had been prompted by the need for neutrality of language, consistent with the functional approach; practicality, consistent with industry practices; and transparency, in the sense that the text should be easy for lawyers working in relevant fields to understand.

11. The general purpose of the proposal from the USA was to enable delegations to evaluate whether the draft text had achieved the objective of creating an internally sound and consistent set of substantive rules. Whilst there was only one new provision, Article 16bis, there had been consolidation of the rules concerning the rights of an account holder, of the rules relating to duties of intermediaries, and of the rules on clearing and settlement systems, as well as a revision of chapter headings and the titles of articles. The first four Chapters contained the core substantive rules of the draft Convention.

12. Taking up a suggestion made by the delegation from the USA, the Chairman supported the idea that the French and USA delegations – and any other that would be interested in doing so – work together to produce a common proposal to be discussed by the CGE (cf. paras 125/126 *infra* and [Appendix 8](#)).

Form of the future instrument (presentation of Doc. 26)

13. The Chairman pointed out that the Italian delegation, at the first session of the CEG, had kindly agreed to chair a working group on legislative techniques for the implementation of the preliminary draft Convention (cf. Doc. 26). The Italian delegation thanked all those delegations that had participated in its work and asked the Secretariat to outline the Group's conclusions. The Secretariat explained that the first task had been to identify what type of international instrument might be best suited to ensure the application of the substantive provisions that the Convention would contain with the objective of harmonisation. The Group had concluded that the flexibility inherent in a "soft law" instrument was likely to result in diversity. This was undesirable in the case of a text such as the present draft, the provisions of which might affect the positions of third parties. For this reason the "hard law" route seemed preferable. However, ratification of the draft Convention as it stood could produce technical hurdles to overcome in certain countries. In particular, it could be problematic where a "monist" State's existing law might, although similar in substance, be so drafted from such a different perspective as to appear to be in conflict with the draft Convention. For that reason the Group had reached the conclusion that Contracting States should be offered the opportunity of "re-translating" the text so as to give identical *effect* to its provisions (cf. [Appendix 17](#) for further explanation). The Chairman thanked the Italian delegation and the Secretariat for its work and referred the CGE to the contents of the report before it, which was to be discussed later during that session (cf. paras 123/124).

Consideration of the text of the preliminary draft Convention

14. The CGE then turned to the text of the preliminary draft Convention itself.

Article 1(a) – Definition of "securities"

15. The Secretariat described the very different approaches participants in the inter-sessional seminars had advocated towards which financial instruments the definition should encompass. It seemed that the key might be found in the answers to four basic questions: (1) Which are the common sense elements of regarding the definition of "securities"?; (2) Is the current definition too broad?; (3) Is the current definition sufficiently broad?; and (4) What is the definition's

relationship to the definition of securities in the Hague Convention? (cf. [Appendix 14](#) for further explanation).

16. One delegation had no difficulty with the definition as it stood – “securities” were simply negotiable financial assets. More significant was the definition of “intermediated securities” in Article 1(f), used frequently throughout the draft Convention. As it stood that definition implied that the rights of an account holder were dependant on intermediation though in fact they would still exist even if the securities in question were no longer in a chain of intermediation. There was support from other delegations for the proposal that this definition should be more explicit.

17. Another delegation thought that the definition of “securities” should be broader and that “transferable” should be deleted. Whether securities could be transferred depended amongst other things on the intention of their issuers. As to “intermediated securities”, domestic non-Convention law was likely to affect the types of assets intermediaries might or might not be prepared to take custody of. Intermediaries were the “gatekeepers” of the system and their acceptance or rejection of securities would be affected by regulation.

18. Another delegation, with the support of others, agreed that the definition should not prevent domestic non-Convention law from excluding certain assets from being credited to a securities account. But the draft Convention should nevertheless provide for the situation where, in State A, certain types of securities are credited to an account which, in State B, could not be. So as to avoid cross-border incompatibility a solution might be to compel State B to treat those securities as they had been in State A. One delegation made the point that, if there was to be a reference to domestic non-Convention law in this context, the CGE would have to decide what, precisely, that meant – for instance, whether it meant the domestic non-Convention law of the issuer. There was some support for that interpretation.

19. As to the question of whether the Convention itself should provide for specific assets to be excluded from the definition of “securities”, one criterion for exclusion might be non-transferability. Transferability could not result simply from the crediting of securities to an account – hence, in all probability, the word was relevant in the context of the draft Convention but not in that of the Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary (hereinafter “Hague Securities Convention”). Another criterion was to limit “securities” to those traded on *organised* financial markets, or words to that effect. Delegations made the point that it would be difficult to produce a workable limitation on that nebulous basis, and it was unclear how it affected the scope of application of the draft Convention.

20. One delegation proposed that it should be the subject of a working document. One delegation expressed its concern that the definition of “securities” in the Hague Securities Convention might not have the same scope.

21. The Chairman concluded that there was broad support for “securities” to be broadly defined but not for the definition to be limited by reference to their being traded on certain markets or by the inclusion of “transferable”. Accordingly, it should be left as it stood though the CGE might revert to it when it came to consider the definition of “intermediated securities” and Article 4.

Article 4 – Intermediated Securities (including Article 9)

22. Following a description by the Secretariat of the mechanisms of Article 4(1)(a) and 4(2) (cf. in detail [Appendix 15](#)), the Chairman called for comments on these rules.

23. One delegation asked whether a CSD or a broker might be characterised as an intermediary. The Secretariat answered that the issue depended on whether the functions of the entity in question fell within the definition of “intermediary” in Article 1 and that this had to be examined on a case-by-case basis. Another delegation suggested that the text should make it clear that a CSD was an intermediary but that, where a broker was simply an agent, it was not. Another made the point that such a question went to the heart of what the scope of Article 4 should be. It should focus on “true” intermediated systems. In these systems the identity of an account holder who put

securities on deposit with an intermediary would not be known at an upper tier. In indirect holding systems the question of who owns rights had to be determined at each level in the chain. In response, another delegation cautioned against describing systems as either “direct” or “indirect” – no “pure” example existed and each expression was interpreted differently.

24. Another delegation made the point that though Article 4(1) rights were at the heart of the draft Convention, they were limited – subject not only to 4(2) but to the remainder of the Article and to variation by States’ laws. This was partly a criticism of the way the Article was currently drafted, a criticism shared for a variety of reasons by a number of other delegations. Criticisms were made of the words “the account holder acting in the capacity of intermediary”; a lack of clarity as to the position of the investor – the last account holder in the chain to whom the intermediary must pass the benefits of ownership - and the way the drafting had departed from the functional approach.

25. The Chairman concluded that, though there was consensus on the need to clarify the drafting of paragraphs (1)(a) and (2), it seemed there was broad agreement on the underlying basic policy to which they should give effect. Equally, he suggested clarifying under what conditions CSDs and mere agents were intermediaries.

26. A discussion of Article 4(1)(b) to (e), which described the minimum content of the right, followed. One delegation pointed out that the final clause of (d) might be superfluous if an alternative drafting of Articles 5 and 6 were accepted. It pointed out that, as to the words in (d) - “the right, by instructions [...] to withdraw securities from a securities account” - this right may be subject to national limitations on the grounds of public policy. Accordingly that wording might be broadened to include a reference to “the law governing the holding of securities accounts” unless the reference at the end of the paragraph to “the account agreement” was sufficient by itself to incorporate such limitations. That delegation thought that the references to “instructions to the relevant intermediary” in Articles 4(1)(b) to (d) was insufficiently precise as to the instructions’ scope. The drafting should make it clear that the instructions must be compliant with the account agreement and conditioned by all the qualifications to which paragraph (1)(d) referred.

27. At this point a delegation made two proposals. First, there should be a new definition of the law under which securities were constituted – i.e., it should be clear that the law was either that of the issuer or that which the parties applied to the contract which conferred title. Second, as to the structure of Article 4(1), there should be a distinction between the rights referred to in paragraph (a) and those referred to in paragraphs (b) to (d). The first were “rights attached” to securities derived from ownership, the second were rights “over securities”. There were however some expressions of concern, principally that the first suggestion came too close to a conflict of laws rule for comfort.

28. The Chairman concluded that there was consensus to accept this second proposal – and, as another delegation had suggested, to ensure that the French and English versions of the text were fully reconciled to each other.

29. The CGE turned to the issues of the prohibition of upper-tier enforcement (Article 4(3)(b)) and upper-tier attachment (Article 9). The Secretariat introduced the issue as set out in [Appendix 16](#).

30. There was a proposal from one delegation to amend Article 4(3)(a) by the addition, after the words “...third parties...” of the words “...and the issuer...” and Article 4(3)(b) by the addition, after the words “relevant intermediary...” of the words “...and against the issuer of these securities...”.

31. In the context of an issue raised by the Secretariat in its presentation (cf. [Appendix 16, slide No. 4](#)) one delegation proposed to provide an exemption from or exception to the provisions of Article 9 for so-called “transparent” holding systems. The prevailing view, following discussion, was to be very cautious before making such a provision. There could, for example, be collateral takers taking an interest under Article 6, who would have earlier-in-time properly constituted interests under a control agreement, in which case the later-in-time attachment should not be able to

override them. The system would also have to be transparent as to the existence of matters such as control agreements. It was not clear whether a transparent system was workable in a cross-border context.

32. The Chairman agreed, however, that the CGE would be given an opportunity to discuss the proposal further before a decision was taken on it. In the meantime he was grateful to accept a proposal made by the delegation from Canada that, rather than discuss the matter further in the plenary it would be discussed in an informal working group which Canada would chair (cf. paras 161-165 and [Appendix 9](#)). The “Nordic” delegations asked the working group to pay special attention to the position of the “account manager” under their systems.

33. The plenary began its discussions of the alternative versions of paragraphs (5) and (6) of Article 4 (cf. also [Appendix 4](#)).

34. The EU Commission explained why its member States preferred version A. First, version A was linked to underlying concepts of property law – rights continued to exist, even though they could not be enjoyed. By contrast, version B did not provide for rights to continue beyond the point where an intermediary could pass them on. Second, the reference in version B to “reasonable commercial standards” did not sit comfortably with the absolute requirement that Article 14 of the EU’s Market in Financial Instruments Directive imposed on anyone who safeguarded consumers financial assets, though the Commission noted that Article 16bis as proposed by the US delegation in Doc. 29 would address this issue, albeit in a “convoluted” manner.

35. There was agreement with the EU Commission in principle. Version B was intended to cater for situations where an intermediary, if it did not have power, should not have liability. Its paragraph (6) could make it clear that an intermediary’s duties could be addressed in the account agreement to the extent that this is allowed by the applicable law or regulatory framework. Both versions might be amalgamated into a single version that was presentationally more attractive.

36. One delegation pointed out that version B provided for one fact pattern which version A did not, notably that of an intermediary that was obliged to establish a relationship with another intermediary which was unusually burdensome.

37. Another delegation pointed out that paragraphs (1) and (5) were inter-related and their drafting should therefore be compatible. Additionally, there was little guidance to be gained from the drafting as to what was meant by the words “within its power” in versions A and B. Another delegation agreed. An intermediary should not be required to form a relationship with another intermediary if that obliged him to operate in a jurisdiction where the legal framework was unsound. However, it was perfectly possible that actions that were “within its power” might nevertheless *not* be reasonable. Another delegation suggested that the question of what was within the power of an intermediary might be clarified by referring to the domestic non-Convention law and the account agreement as long as this was not inconsistent with that law.

38. Several delegations agreed that an attempt could be made to reconcile version A with version B. Regarding the relationship between paragraphs (5) and (6) it was agreed that paragraph (6) could deal with some of the concerns about compelling an intermediary to take actions he ought not to be compelled to do but that the paragraph could not take the whole weight of that concern – particularly regarding the obligation to form a relationship with another intermediary. This was because paragraph (6) refers to the manner of performance and the extent of liability rather than the scope or quantum of the investor’s rights themselves. That was deliberate, because this might imply that the investor’s rights are a purely contractual matter originating solely from the account agreement. Paragraph (1) would have to be revisited or the protective wording in paragraph (5)(b) and (c) expanded so as to make clear that there was no obligation to establish a relationship which did not exist at the time the account holder’s instructions were given.

39. One delegation stated that it preferred widening an exception which relieved the intermediary from the obligation to form a relationship with another in paragraph (5)(c) of version

B to the alternative of rewording paragraph (1)(b) and (c). The fundamental right of an account holder to cause the transfer of securities to another account should not be limited.

40. There was general agreement that the square brackets in paragraph (7) could be removed from the present draft. They had been inserted so as to make clear that, while the taking of a security interest by way of a credit appears to be absolute as between the collateral taker and the debtor the collateral taker is only entitled to a credit to the extent of the secured obligations. The collateral taker would have to account to the debtor for any excess.

41. The Hague Conference pointed to the need to ensure that Article 4 of the draft Convention was consistent with Article 5 of the Hague Securities Convention insofar as it dealt with rights and obligations resulting from the credit of securities to a security's account.

42. The Chairman referred the Article to the drafting group. Its Chairman proposed that it would use Version A as a starting point and would consider how to incorporate elements of version B and Article 16bis as proposed in Doc. 29.

Article 5 and Article 7(1) to 7(5) – Acquisition and disposition

43. The Secretariat then introduced Article 5 and Article 7(1) to (5). There had been broad agreement in the first session of the CGE as to the first three paragraphs of Article 5. As to Article 5(4), this precluded so-called tracing. The rule did not preclude measures requiring that no credit could be made without corresponding credit. However, the rule was clear that credits or debits entailing a breach of such requirement were not ineffective. Paragraph (5) concerned net settlement between two layers of a holding system but did not lead to allowing so-called internalisation. Paragraph (6) provided that transactions effected under domestic non-Convention law, although effective, ranked below those effected under the provisions of the future Convention.

44. Article 7(1)-(5) was introduced by the Chairman of the Drafting Committee. Paragraph (1) stated a fundamental principle – a credit required proper authority, whatever that might be. Paragraphs (2) and (3) dealt with the timing of book entry. Paragraph (4) dealt with the effect/validity of an entry and acknowledged the parties' right to make this conditional upon certain events. These can be set out in the rules of a security's clearance or settlement system or by domestic non-Convention law. Paragraph (5) dealt with the reversal of credits. It meant to address circumstances – all of which cannot be listed – such as a mistaken entry made by an intermediary. Paragraph 6 was a corrective to paragraphs (4) and (5): securities that were credited to an account have been moved to another acquirer; subsequently, the original credit entry was reversed subsequently. The provision listed the conditions under which the third party was protected notwithstanding reversal of the first credit entry.

45. Discussion of the first three paragraphs of Article 5 began with one delegation remarking that acquisition or disposition of securities is not valid under its law without publicity, via filing with a register which seemed incompatible with paragraph (2). Another delegation responded that such requirement was indeed incompatible with the fundamental proposition of the Convention that the book entry was paramount.

46. One delegation supported by others questioned why paragraph (2) applied only to acquisition and not to disposition. Another thought that the reason that paragraph (2) applied only to acquisition was because securities had, at all times, to be owned by somebody. In the case of debit, the owner retains ownership until a credit appears on the purchaser's account. Although this point was accepted the CGE agreed that paragraph (2) should apply to both disposition and acquisition.

47. Some delegations questioned the meaning of "acquire". The act of "acquisition" might occur on a stock exchange. Others responded that although as an economic matter it was correct to say that a stock exchange was the medium for the parties agreement, it was *the passing of title* for which "acquire" was the appropriate word. This explanation failed to satisfy certain delegations who proposed that "acquire" should be replaced by "has the effect of conferring Article 4 rights on the

account holder". Rights were created by credit and extinguished by debit. Alternatively, the provision might refer to "entitlement". Any redrafting would have to be consistent with the definition of "disposition" in Article 1(h).

48. The discussion of the first three paragraphs of Article 5 broadened when one delegation wondered whether the provisions dealt with the creation of title or with perfection, in particular against the background of the rules contained in Article 7. The Chairman of the Drafting Committee explained that Article 5 provided for the necessary and sufficient elements for acquisition and disposition. Validity was dealt with in Article 7. This explanation did not fully convince others who wondered if Article 5 was about the perfection of the transfer of rights against third parties or whether it only concerned transfer of rights between the two parties directly involved. Another delegation understood Article 5 to be about the delivery of assets and to have nothing to do with validity, which was dealt with in Article 7. In some systems the essential elements for "acquisition" were the delivery of assets and the existence of a valid underlying contract.

49. Adding to its earlier explanation of the current drafting of Articles 5, 6 and 7, the Chairman of the Drafting Committee explained that Article 7 provided both for the validity of debit and credit entries and other things – such as timing in Article 7(2). Another matter not referred to was the pre-requisite in some jurisdictions for an underlying valid contract for transfer, whereas in others a book entry alone sufficed. Article 6(1) used the words "so as to" to indicate that Article 6 did provide for creation and perfection. Though the emphasis was on perfection, it also applied to creation.

50. There was however uncertainty as to the exact scope of the Article. In the view of one delegation, it not only covered the relationship between the two parties to a contract but the position of third parties also. The delegation was also uncertain of the effect on "acquisition" on the basis of a void underlying contract which the delegation did not believe was addressed in Article 7(1). In its view, the question of the validity of dealings between the transferor and transferee were dealt with in Article 7(5). Other delegations did not agree that questions relating to the underlying contract were or should be within the scope of Article 5. It was doubtful that it was necessary, when considering the effects of book entry credit or debit, to consider the underlying contract. If it were, the certainty for which the preliminary draft Convention is intended would be seriously undermined.

51. The Chairman, summing up the CGE's discussion of Article 5, thought that there was consensus for improving its drafting, for the application of paragraph (2) to paragraphs (1) and (3) and for making paragraphs (5) and (6) consistent with Article 1(h) as concerns "disposition". As far as other matters, he sensed broad support for the basic policy underlying the Article, i.e. that credit and debit should be the necessary and sufficient conditions for the acquisition and disposition of intermediated securities.

52. Opening the discussion on Article 5(4), one delegation asked whether the reference to domestic non-Convention law was to public and/or private law. Others thought that distinction not relevant. The reference was to the working principle of tracing which might be required by domestic non-Convention law or regulation, however characterised.

53. A number of delegations were in favour of the draft Convention containing a rule that recognised the principle of tracing which was inherent in many legal systems. Opposing this, other delegations explained that such a rule would negate the effect of the provision, because tracing was not always possible, even in those systems which had tracing mechanisms in place and sanctions for failing to observe them. Consequently, acquisition under the future Convention should not depend on it. The words "without prejudice" in paragraph (4) meant that domestic rules could require no credit being made without corresponding debit, but as a consequence of a breach of such rule debits and credits were not ineffective.

54. Another delegation thought paragraph (4) unclear because it did not provide for a time limit in which an attempt to trace should be made. A number of delegations responded that to refer to

any time period during which a transfer would be “suspect” would lead to uncertainty. Regarding a rule, which some delegations favoured, to “carve out” from the effect of Article 5(4) “purely domestic situations” it would be extremely difficult to delineate its scope and to put such rule into practice. The Chairman decided to defer further consideration of this provision.

55. Delegates discussed what was meant by “authorisation” in Article 7(1). It could be burdensome to show authorisation of a credit. One delegation found it difficult to understand why debit or credit has to depend on authorisation from the account holder. Cases did exist, e.g. when authorisation was given to transfer securities from one intermediary to another, but they were rare. That delegation, supported by others, noted a further difficulty. As a credit might require actions of more than one intermediary – each might act for a different account holder – it was not clear whether authorisation applied to the activities of each or only one. A member of the Drafting Committee explained that the authorisation of a debit required by Article 7(1) meant the instruction of an account holder to dispose of his securities. It was merely a question of a debit being supported by some authority.

56. This led to the question of the extent to which the underlying transaction can be a pre-condition for a valid debit. As they stood, paragraphs (4) and (5) did not prevent domestic non-Convention law from stating that the transaction depended on the validity of the underlying transaction or from stating that the credit could be reversed if the underlying transaction was not valid. This might be unwise because the resolution of a dispute regarding the validity of the contract could take many years. Article 7(1) needed to be flexible enough to encompass a number of different types of implicit authorisation. It was equally unclear whether “authorised by the account agreement” was included. A broad interpretation was needed to cover both exchange and non-exchange transactions. The general authority given to a broker on appointment should amount to authority for individual transactions.

57. Looking at the drafting of Article 7(1)(b), one delegation questioned in what circumstances domestic non-Convention law alone could authorise a debit or credit in the absence of an account holder’s or collateral taker’s authorisation. Another delegate explained that the reference might be relevant where domestic non-Convention law gave authorisation to an intermediary to debit an account in his favour as a result of a legal lien.

58. As to drafting the Chairman of the Drafting Committee thought that, in Paragraph 1 “valid” should be substituted for “effective”. As to “effective” one delegation pointed out that it was used in Article 7(1) and 7(4). Article 7(1) was different from 7(4), which is about conditionality, i.e. an event by which a transaction would be validated. This paragraph might be combined with paragraph (5) concerning reversal.

59. As to Article 7(3) there was consensus that its effect was simply to define the time at which a security interest was created.

60. A number of delegations were concerned by the inclusion in paragraph (4) of the provision made by the rule in square brackets. One delegation replied it might be found, on discussion of Article 10, to be superfluous. Another delegation took the view that the object of the rule in the square brackets was only to determine priorities between competing interests and that it was not one of general application. Other delegations thought the rule should concern itself with protecting an acquirer in good faith who might otherwise be at risk from the effects of the provision made regarding conditionality. There was consensus for maintaining the words in square brackets for the time being as drafted.

61. The Committee went on to discuss whether the words in square brackets in paragraph (5) should be retained. One delegation thought it more practicable than a provision for a declaration mechanism. Another delegation thought it would be useful to condition the reference to “a period before” an entry is reversed on the reversal’s occurring “during a reasonable period of time”. The contrary view was to caution against introducing any time limit on an intermediary’s rights to reverse entries made on accounts. There was broad consensus to leave the words in square

brackets as drafted at least until the Committee discussed Article 11 on protection of the innocent acquirer.

Articles 5(5) and 5(6)

62. One delegation raised the question whether Article 5(5) was mandatory in the sense that it would require a contracting State to change its system to make credits and debits on a net basis. There was agreement that this was not intended by the text. Rather, the purpose of Article 5(5) was to state that nothing in the Convention would make debits and credits that were effected on a net basis ineffective or otherwise impermissible or not possible.

63. Furthermore, the necessity of Article 5(6) was questioned. In particular the second part of this rule (after the comma), which subordinates acquisition and disposition that were effected outside the book-entry system to those made within this system, might conflict with domestic law in some countries. There was broad agreement among delegations that the purpose of this rule was to allow acquisition and disposition by means other than book entries. However, from the logic of the draft text, any such dispositions could not affect the book-entry transfer system precisely because they are not apparent to the operation of that system. Therefore, they had to be subordinated. This was a very important general rule.

Article 6 – Securities interests in intermediated securities

64. The Committee then reverted to discussion of Article 6 “Security interests in intermediated securities” in conjunction with the definitions in Article 1(m), (n) of “control agreement” and “designating entry”.

65. Article 6 was introduced by the Chairman of the Drafting Committee. Paragraph 1 was silent on the creation of a security interest in the sense that it did not deal with questions such as whether an underlying contract was a prerequisite. “Delivery” was defined in paragraph (2), which provided in sub-paragraphs (a) to (f) a full list of methods of perfection, i.e., it attempted to cover those that are most significant. Paragraph (3) provided that a securities account as a whole may be the subject of a security interest. Paragraph (4) provided for a declaration mechanism that related to those perfection methods listed in (c) to (f). Paragraph (5) concerned a second declaration mechanism which enables a Contracting State to choose to dis-apply Article 6 with respect to certain parties so as to give Contracting States flexibility while maintaining the basic purpose of the Article. Paragraph (6) left two matters to domestic non-Convention law – (a), a security interest created by operation of law (in particular the creation of a legal lien) and (b), the matter of whether the creation of a security interest was required to be evidenced in writing. Paragraph (7) paralleled the rule of Article 5(6).

66. A number of delegations found the structure of Article 6 too complicated. The Article appeared too long and complex though its general intention – to provide rules on security interests in intermediated securities – seemed to require simplicity and clarity. Instead, a number of delegations thought it was not at all clear what it intended to achieve. They would prefer the article to be simplified, retaining only its core paragraph (2), with the deletion of sub-paragraphs (d), (e) and (f). The many declaration mechanisms were perceived as inappropriate. They undermined the purpose of the draft Convention.

67. A member of the Drafting Committee explained why the structure of paragraph (1) seemed complex. The provision reflected the fact that different systems approached creation and perfection in different ways. Under some systems, it was possible to create a security interest by mere agreement, but further steps were necessary to render it effective as against third parties. Under other systems delivery or dispossession might be a prerequisite of the creation of a security interest itself. Paragraph (1) was intended to take no view on which legal approach was correct – that was for domestic non-Convention law. All that the paragraph said was that both actions were required to create and perfect a security interest.

68. One delegation referred to the need under its domestic law for filing with a register, which was not reflected in the current drafting of Article 6. Others replied that it was true that Article 6 is not compatible with that requirement and that this was deliberate. The interest of certainty of transfers in a book entry system did not necessitate filing or other measures that lie outside the book-entry system. Because of the safeguards in Article 6 Contracting States ought to dis-apply any public filing system as a precondition of legal effectiveness of dispositions. Fraud and double pledging, which registration requirements sought to prevent, could only occur if a debtor retained apparent possession of property that in fact is encumbered. This was avoided by the mechanisms provided for in Article 6.

69. As to declaration mechanisms contained in Article 6, the view was expressed that they were complex but struck a balance between flexibility and certainty. The draft took the view that the main methods of disposition – i.e., transfer, earmarking and control agreement – should be recognised. In the interests of certainty the view was also taken that parties contemplating dispositions should know which of these methods was valid under the domestic non-Convention law to which the transaction was subject and what amounted to control and dispossession under that law.

70. Some delegations supported the view that Article 6 was necessarily detailed to accommodate a number of different systems, though possibly (e) and (f) of paragraph (2) might be excluded. The rest were used widely. These delegations nevertheless accepted that the Article needed to be more readable.

71. The Committee finally accepted a proposal made by one delegation for limiting the methods of taking collateral listed in the Article to those in paragraph (2)(a) as applying to all Contracting States and to those in (b), (c) and (d) as applying to those States which made a declaration in respect of them.

72. The Chairman asked for the Committee's views on paragraph (5), which would allow Contracting States to dis-apply by way of declaration the whole of Article 6 with respect to parties of such descriptions as may be specified in the declaration. The Committee supported this rule and stated that only the drafting might need to be clearer.

73. The Chairman summarised the committee's consensus in the following terms: in Article 6(1)(b) a more neutral term for "possession" or "control" should be used. Both conditions mentioned in paragraph (1) were required to be satisfied. Sub-paragraphs (e) and (f) should be deleted. The declaration mechanism should apply to (b), (c) and (d). Paragraph (7) should be maintained. The declaration mechanism should be based on the need for clarity and simplicity. The Cape Town Convention provided a good example, i.e., the Depository issued model declarations. No clear consensus emerged as to whether the Article related to issues of effectiveness or, more widely, to validity but there was broad agreement that the future instrument did not need to take any position in this regard.

Articles 7(6), 7(7) and 11 – Protection of innocent acquirer

74. The Committee went on discussing the provisions of the draft instrument relating to the protection of innocent acquirers, Articles 7(6), 7(7) and 11, and in particular the general relationship between them and Articles 10 and 18. The Chairman asked the Swiss delegation to introduce a set of fact patterns that it had prepared on the basis of the discussions held at the UNIDROIT Seminar in Bern (cf. UNIDROIT Study LXXVIII Doc. SEM.1) in order to facilitate understanding of the relevant questions (cf. [Appendix 20](#)).

75. The first fact pattern was a simple situation of competing claims of collateral takers (CT-1 and CT-2) neither of whose interests were perfected by way of credits.

76. The second fact pattern involved the account holder's intermediary as the first collateral taker (CT-1), under Art. 6(2)(b), and a second collateral taker (CT-2) whose

security interest was perfected by a method entailing the intermediary's involvement under Art. 6(2)(c) or (d).

77. The third fact pattern involved the competing claims of a first-in-time secured party (CT-1) whose interest was perfected not entailing a credit, Art. 6(2)(c) or (d), and a second secured party (CT-2) whose interest was perfected by transfer to the collateral taker's account with the same intermediary without CT-1's consent.

78. In the fourth fact pattern the first collateral taker (CT-1) perfected its interest by one of the methods provided under Article 6(2)(b) to (d). The subsequent security interest in favour of CT-2 was perfected through a debit of the account holder's position without CT-1's consent and a transfer to Intermediary 2 (INT-2) who credited CT-2's account.

79. The Chairman thanked the Swiss delegation for its presentation which had been most useful identifying core issues and reaching consensus and invited delegations to comment. After detailed discussion, at the invitation of the Chairman, the Secretariat summarised the results of the discussion as follows (cf. [Appendix 21](#)).

80. As to Fact Pattern 1, the Committee had reached consensus that the first in time rule of Article 10 applied.

81. As to Fact Pattern 2, on a strict application of Article 10 the intermediary's security interest - which was first in time - should, for that reason, prevail. But during the discussion there had seemed to be agreement that the intermediary had waived its priority by permitting the second collateral taker's security interest to be perfected without reserving its own, prior, security interest. This waiver of priority could be inherent in Article 10(4) - i.e., the rule that stipulates that persons who had security interests might agree to re-order the ranking of their interest. There also seemed to be agreement that any such "silent" waiver of priority by an intermediary who had a prior security interest should be clarified in the draft Convention by being made explicit in Article 10.

82. As to Fact Pattern 3 there had been consensus that the priority rule of Article 10 should not apply when the second entry was perfected by book entry and thus did not relate to the original securities account. So the security interests relate to different objects. In this situation, the intermediary remained responsible for re-establishing the account holder's position under Article 7(1) to reverse the debit and was then obliged to buy in the missing securities under Article 16(2) to re-establish the balance. The position of CT-2 depended on his eligibility for protection under the "good faith" rules of Articles 7(6) or 11. If something went wrong and the intermediary did not have enough securities to reverse the debit, on the one hand, while maintaining the credit to CT-2's account - especially in insolvency or pre-insolvency - the rules on loss sharing applied to both collateral takers. Up to this point the Committee had been in agreement. It had not agreed however as to whether CT-1 and CT-2 should participate independently with all other account holders in any loss sharing or whether this could unintentionally lead to a more favourable distribution to the original account holder when he paid his debt and the security interests were re-transferred. A majority of the Committee supported treating CT-1 and CT-2 independently from each other - i.e., like any account holder who had to share the loss.

83. Turning to Fact Pattern 4, in this situation Intermediary 1 remained responsible for restoring the account holder's position by reversal of the debit under Article 7(1) and by buying in the missing securities under Article 16(2). The Committee seemed to agree that in this situation Article 11, not 10, applied to CT-2's security interest because this was a book entry security interest under Article 6(2)(a).

84. On this basis, the Secretariat draw the following tentative conclusions:

85. The first in time rule of Article 10 applied only to competing security interests in securities credited to the same account, i.e., all perfected under Article 6(2)(b) to (d).
86. The scope of Article 10(4) should be clarified so as to make it clear that an intermediary with a perfected security interest who participated in the perfection of a subsequent security interest of a third person was deemed to have waived its first in time priority rule under Article 10.
87. The innocent acquisition rule applied to security interests perfected by book entry under Article 6(2)(a).
88. The distinction between the rules relating to innocent acquisition in Articles 7(6) and 11 required clarification.
89. It was unclear whether the shortfall allocation rule in Article 18 should be limited to an intermediary's insolvency.
90. The Chairman asked for comments on the Secretariat's conclusions.
91. One delegation observed as to Fact Pattern 1, the Committee should bear in mind that, unless the intermediary was insolvent, there would be no loss suffered by CT-2 because, under the control agreement, the intermediary would have incurred an obligation to CT-2 – normally, by agreeing to become party to the agreement the intermediary would represent that no-one else had a prior security interest and it would be nonsense for the intermediary to agree to a control agreement giving rights of disposal to CT-2 if the intermediary had previously agreed to a similar control agreement in favour of Ct-1.
92. As to Fact Pattern 3, this delegation agreed CT-2 was protected but said that it was not clear whether and by what means loss allocation should happen. The assumption was that CT-2 was protected because it benefited from the rule protecting the good faith acquirer - but that rule implied that securities were acquired by a transferee who obtained a valid title against the transferor. The transferor could not claim them from the transferee.
93. Other delegations had a different view of the position of CT-1 in Fact Pattern 3 and thought that the correct result was that, since a wrongful debit was ineffective, CT-1 was in the position he would have been if the credit had not taken place. That would lead to participation in allocation of a shortfall if the intermediary was not able to buy-in sufficient securities.
94. Another delegation took the view that the differences between the two interpretations are about who would lose and not who would win. If domestic non-Convention civil law required matching debits and credits it might equally require reversal of both credit and corresponding debit. That delegation's own national law (which did not require matching) had a sharing rule which tried to avoid inflation of the number of securities. The intermediary was required to buy-in shares first and then reverse the debit entry. Another delegation added that buying in however took time whilst in the meantime the securities in the accounts could have circulated further.
95. Another delegation was confused by the discussion. It seemed that under some States' rules an intermediary who had wrongfully debited an account was obliged to buy in securities to correct the situation, and only when he had done so to re-credit the account. But it was unclear what happened if the intermediary had become insolvent before he had done so and what the nature of the rights of collateral takers whose rights have been prejudiced was. If all they could do was to make a claim in the insolvency there was no sufficient protection. Fact Pattern 3 seemed an exceptional circumstance. The draft Convention should perhaps be limited to the protection of CT-2 under a rule of good faith acquisition. Other more difficult problems should be referred to domestic non-convention law. Thus what was strictly necessary to harmonise would be harmonised and more complex situations would be left to the national solution.
96. Another delegation made two general remarks with which many others agreed. First, it would be premature to resolve the outcome of the fact patterns until agreement had been reached

on the rules on innocent acquisition. Second, rules for situations of such complexity as the Committee had been debating might be useful if the draft text were to result in a model law. It was doubtful however that it was necessary to go into this level of harmonisation of substantive rules in a Convention.

97. There seemed general agreement summed up by one delegation with regard to the situation described in Fact Pattern 3, i.e., to treat the level of protection for CT-1 as a matter for domestic non-Convention law. The drafting consequences of that policy decision seemed to be – (a) the need to delete Article 7(1) because its effect was to entrench in the Convention itself the nullity of unauthorised debiting of accounts; (b) it needed to be made clear that the primary rule of Article 7(5) was subject to the innocent purchaser rule, i.e., domestic non-Convention law could not allow for a reversal of a disposition made in circumstances specified in Article 11; (c) Article 11 would have to make it clear that the protection for innocent purchasers was restricted to acquisitions made by book entry so the references in Article 11(1) to a person who acquires a security interest by designation or agreement under Article 6 should be deleted.

98. The Chairman believed there was consensus for this analysis. He believed that the Committee had reached some tentative conclusions on Articles 7(6) and 11 which provided guidance to the Drafting Committee. One delegation asked that the drafting be “neutral” rather than as it was at present, especially with reference to the notion of “knowledge”.

Article 10 – Priority among competing interests

99. The Committee turned its attention to Article 10. As to paragraphs (1)(b) and 4, one delegation referred to its national legislation to the effect that multiple security interests may not be created in the same subject matter. For example, if a pledge is perfected by designation, a second pledge is not permitted. Another delegation thought if domestic non-convention law did not allow the creation of a second interest, Article 10 could not apply to anything.

100. Another delegation criticised the priority rule in paragraph (1)(a) as unnecessary for international harmonisation. A security interest created under national law should not rank below one created under the Convention. Others replied that this diminished the value of Article 6 to the point where it had no useful purpose. The rule in paragraph 1 was critical. One of the Convention's benefits as perceived by industry was that it would give certainty to collateral takers regarding the priority of interests and relieve them from enquiries collateral takers currently have to undertake. In a fast moving market, allowing the priority given by the law of each Contracting State to be perpetuated through its own registries, each of which had to be consulted, did not promote legal certainty.

101. A delegation who opposed the rule in paragraph (1)(a) suggested that where a second collateral taker who acquired his interest under the rules of the Convention had knowledge of a pre-existing security interest in the assets which had been constituted under domestic non-Convention law, his interest subordinated to that of the first and should not be protected by the rules of the convention. Only if he had no “positive knowledge” of the first should the second collateral taker should have priority over it. That view was opposed by delegations who thought a second collateral taker should obtain priority under the Convention even with positive knowledge of the first encumbrance. The knowledge of the existence of a first collateral taker did not always mean that a second might not also take collateral over the same property. The concept of “positive knowledge” was impractical. First, it begged the question whether it should be deemed to exist. If all collateral takers were deemed to have knowledge of what is in public registers, the Convention would be reinforcing a system which it was intended to do away with.

102. Moving on to paragraph (2), two delegations agreed that the text should be clarified so as to ensure that it referred to statutory liens clearly.

103. There were no comments on paragraph (3).

104. As to paragraph (4), one delegation wondered if, where a security interest in favour of an intermediary arose after a control agreement, the intermediary agreed to become party to a control agreement, whether one could infer from that agreement that the intermediary had agreed to subordination. In response, another delegation thought the Committee should not attempt to define what might be understood as an agreement to vary priorities. That was too fact-specific and should be left to domestic non-Convention law. To the extent that the Article leaves issues of priorities to domestic non-Convention law it should also leave to that law whether parties should be able to vary ranking. If there were a statutory interest given in terms that cannot be waived then the draft Convention should not suggest otherwise.

Article 11 – Acquisition by an innocent person of intermediated securities

105. One delegation had difficulty with a rule that made a distinction between “gratuitous” situations and “for value” situations since it was unclear what “for value” meant or when it might occur. Equally, it did not understand the scope of “adverse claim”.

106. Another believed it important that the draft Convention arrive at a common understanding of “innocent acquirer”. It was necessary to bear in mind that the markets with which the draft Convention was concerned were characterised by speedy, anonymous transactions. Buyers did not know who sellers were. The integrity of the intermediation system could and did supply the element of good faith.

107. One delegation referred to previous attempts in international texts to define “good faith”. Against the background of these examples the Committee should not use language based on “good” or “bad faith” but more neutral terms.

108. Another delegation made the point that “adverse claim” means not only a claim against the securities but any claim in connection with the securities, i.e., a claim for damages as well as a claim to have the securities back.

109. Despite the difficulties some delegations perceived in the drafting of Article 11 others thought any problem was likely to be of the precise terminology rather than substance. The Article should preserve acquisitions which under national law, while not made for value, had a legitimate foundation.

110. The Chairman concluded that a majority of delegations were in favour of retaining paragraph (2) and agreed that “adverse claim” should be given a broad interpretation. There was no conclusion on the content of innocent acquirer or good faith though there was some enthusiasm for neutral terminology.

Articles 12 and 14 – Rights of account holders on insolvency of intermediary

111. Some delegations suggested that the Article should be concerned with rights that not only “created” but “perfected” an interest and should also refer to a collateral taker who has perfected his interest by one of the Article 6 methods without receiving a book entry. The reference to an account holder’s rights should make clear that the rights in question were his rights under Article 4 - for which the parallel for secured parties was Article 6.

Articles 8 and 13 – Definition of Securities Clearing or Settlement System

112. The Chairman suggested that the Committee move on to discuss the issue of a definition of “securities clearing or settlement system”. The Secretariat introduced the discussion by questioning whether a common definition was at all possible. It had tried to structure the answer by means of four simple questions. First, what types of entities should, in functional terms, benefit from specific provisions such as those in Articles 8 and 13; second, how could they be defined; third, to what rules of the Convention should any exemption apply, i.e. to all or only some; and fourth, what type of rules can replace those of the future Convention? (cf. [Appendices 5, 6 and 24](#)).

113. One observer considered the overarching feature of securities settlement systems to be their importance for the stability of the financial system. The immediate question, regarding which entities should benefit from exemption, needed to take account of the fact that not all systems are intermediated in the way the draft Convention uses that expression. The word “clearing” should be dropped. The trend was now for clearing to be more and more reserved to clearing houses. Therefore the essence of the definition should be economical. It should exclude entities which are not supervised or operated by a central bank. There should be a declaration mechanism by which systems would be notified by a Contracting State to a Depositary.

114. One delegation concurred widely with these suggestions and it agreed that one requirement for satisfying a definition of “securities clearing or settlement systems” was that the entity in question engaged in transactions. This delegation would add the requirement that the rules of such systems and its agreements with its participants be publicly accessible. Furthermore, central banks should be included but global custodians should be excluded though they are supervised and operate systems for clearance and settlement. Equally, the proposed declaration mechanism was supported.

Article 8 – Overriding effect of certain rules of clearing or settlement systems

115. Turning to the text of Article 8, the EU Commission asked for it to remain in square brackets since the EU was at present discussing the issue for the purpose of future legislation. Another delegation objected, since retaining square brackets gave the indication that the subject matter of the Article might later be omitted. The EU Commission agreed that the scope of exemption that the Article provided was the only matter that might need to be revisited, not the fact of exemption itself. Thus it proposed that only the alternatives should be kept in square brackets. If the words in the second set were preferred, the Article would give those responsible for securities clearing or settlement systems *carte blanche* to pick and choose which provisions of the Convention it chose to accept and which not.

Article 13 – Effectiveness of debits, credits etc., and instructions on insolvency of operator or participants in securities clearing or settlement system

116. One delegation thought Article 13 might be too detailed. The issue of finality could refer to (a) proprietary aspects or (b) settlement. Article 13 seemed to be drafted on the assumption that property law finality encroached on settlement finality. Recognition of property law finality was not compatible with the first-in-time rule. The domestic law of its country provided for settlement finality and for acquisition in good faith in such a way that the fact that a transaction is void from a property law perspective did nevertheless not entail a reversal of a credit entry; instead, it assumed that a new transaction occurred and caused new debit and credit entries. Another delegation commented that Article 13 provided an exception to what would otherwise be the effect of applicable national insolvency law.

Article 16 – Duty of Intermediary with respect to holding or credit of securities

117. Before moving on to Articles 16 and 17 the Chairman of the Drafting committee expressed the view that there had been sufficient agreement within the plenary on Articles 7, 10 and 11 to enable a discussion of these later Articles.

118. One delegation expressed concern that the text of Article 16(1) might not have the effect it was intended to have – i.e., to impose a duty on an intermediary to maintain sufficient assets to support all of the credits he had made to account holders. The current drafting was open to the interpretation that, if there were insufficient assets, a holding system should be “frozen” whereas the emphasis should be on making good any deficiency. Accordingly, the Committee reached consensus on the need to retain paragraph 1 but in a less restrictive form that placed a positive duty on an intermediary to maintain sufficient securities.

Article 17 – Allocation of securities to account holder’s rights: securities so allocated not property of the intermediary

119. The Committee agreed that the first two paragraphs of Article 17 raised a number of questions relating to the way in which different holding systems provide for the segregation of securities an intermediary held for others from those he held for his own account. This might reflect different policies towards who was entitled to the latter in the event of the intermediary’s insolvency, i.e., either his account holders or his general creditors as part of the insolvency estate.

120. The Chairman concluded that delegations were not open to the idea that the draft Convention should amend their different regimes on this subject insofar as these regimes made substantive “proprietary” provision regarding the ownership of or the entitlement to such securities. The drafting should differentiate between a “proprietary” concept and a “regulatory” approach. The Committee was referred to EU legislation that places certain obligations regarding record keeping upon intermediaries in all member States. Accordingly, all such States were subject to that regulatory regime regardless of any other that derived from domestic non-Convention law. Whether they also had rules regarding ownership was therefore a separate matter.

121. Turning to paragraph (4) of Article 17, one delegation thought that, as currently drafted, a declaration made under paragraph (4) was sufficient to discharge a State’s obligation under paragraph (1) – though this was probably unintentional. There was consensus that a State’s choice as to the means of achieving investor protection was a matter for its domestic non-Convention law. So long as they gave effect to investor protection on public policy grounds, different choices could co-exist. The Chairman of the drafting committee undertook to redraft the provision without encroaching on different States’ approaches to investor protection.

Article 18 – Effect of insufficiency of securities held in respect of account holder’s rights

122. Turning to Article 18, the Chairman reminded the Committee that this provision had already been discussed in the context of Article 7, 10 and 11. Some delegations felt that its scope should be limited to insolvency proceedings and that it should be drafted in broad and general terms. It should state that in case of a shortfall the allocation to account holders should be *pro rata* subject to any conflicting insolvency rules of domestic non-Convention law. The drafting should make it clear that allocation was only to account holders of the same intermediary. If an account holder’s interest was subject to a security interest, then the holder of that interest would suffer, but the manner in which it suffered would depend on the precise nature of the security arrangement. That seemed broadly to reflect the view of the majority. The Chairman of the Drafting Committee undertook to attempt a redraft to reflect the Committee’s agreement.

Form of the future instrument

123. The Chairman then asked the Committee for its thoughts on the most appropriate form of instrument for the provisions of the draft Convention – model law, treaty or other. This was the subject of a paper submitted by the “Italy Group” (UNIDROIT Study LXXCIII Doc. 26) and of a presentation made by the Secretariat on the first day of the plenary (cf. [Appendix 17](#)).

124. The Committee thanked the Italian delegation, which had chaired the Working Group, and the Secretariat, for preparing its report. On the basis of what it contained and their awareness of the stage of development of the draft Convention its members had no difficulty in reaching consensus that, although the inter-sessional work on this subject had been useful, it was too early to make any definitive choice regarding these matters.

Structure of the draft text

125. Finally, as to the structure of the future text, the delegations of the USA and of France presented a joint proposal for a re-ordered text of the draft Convention – reproduced in [Appendix 8](#). Previously, both delegations had submitted separate proposals regarding an enhanced structure

of the draft (cf. Documents 34 and 29 and para 10 and 11 *supra*). The joint proposal did not include textual or drafting changes but simply reordered the text so as to make it easier to follow. It now had 5, rather than 7, Chapters. It had grouped provisions according to “conceptual themes”.

126. Apart from the expression of some suggestions such as inserting current Article 25 into the new Chapter IV, reversing the order of new Chapters III and II and leaving separate some individual Articles that had been amalgamated in the new draft, the Committee’s response to the proposal was generally favourable. It was content to submit the new structure to the Drafting Group for its attention, taking into account the comments made on it by delegations.

Art 19 – Position of issuer of securities

127. The Chairman asked the Secretariat to introduce Article 19 on the basis of the document reproduced in Appendix 25. The Secretary outlined the underlying rationale of the provision, i.e., the principle of non-discrimination of investors holding indirectly, and drew the Committee’s attention to Doc. 25. It furthermore indicated that there were policy decisions to make as regards choices offered to both Contracting States and to issuers.

128. While the general principle of non-discrimination as encapsulated in Article 19(1) seemed to find unanimous support, many delegations expressed the view that Article 19(2) went too far and that, generally, the draft Convention should refrain from interfering with Contracting States’ corporate law.

129. It was decided, however, that it was desirable that the draft Convention recognise nominee ownership and split voting by nominees. While there was strong support from a number of delegations to require issuers of publicly traded securities to permit intermediated holding, the prevailing view appeared to be that that might go too far.

Art 20 – Set-off

130. As its only remark, the Secretariat draw the attention of delegations to the fact that the words “in any insolvency proceeding in respect of the issuer” figured in the middle of the first paragraph, because the Secretariat very often felt there was misunderstanding about the scope of the provision, which only applies in the event of insolvency of the issuer.

131. There was broad consensus for maintaining this provision in its current wording.

Definition of “Securities” and “Intermediated Securities”

132. The Committee turned to reviewing certain definitions in Article 1. The delegation of France outlined its proposals for new wording of Article (1)(a) “securities” and (f) “intermediated securities”. The proposal aimed at a review of both definitions in order to highlight the difference between, on the one hand, “intermediated securities” that enter the scope of the present draft text and, on the other hand, the account holder’s rights which flow from the credit of securities to a securities account (cf. Appendix 7).

133. The Committee discussed, in particular, the intended function of the term “intermediated securities” as a cornerstone for Article 4 and for bridging the divide between different concepts as regards the nature of the right that an investor in securities receives (e.g., proprietary or derivative, etc.). A number of delegations cautioned against seeking to interfere with the substance of Article 4 by experimenting with the description of its core elements in the definitions. In particular, the point was made that *securities* were credited to an account instead of *intermediated securities*. Furthermore, the new proposal could lead to the misunderstanding that securities become negotiable only upon credit to a securities account, a concept which would be incompatible with basic legal understanding in some countries. In the current text, the notion “intermediated securities” was only a generic placeholder for the right flowing from the credit of securities to an account (cf. Article 4(1)(a) to (d)), which most probably varied in different countries (cf. Article 4(1)(e)). Others underlined that, by changing the definitions as proposed, not only Article 4 but

most other provisions of the draft instrument had to be rethought conceptually. The effect of the proposed definition would be to compromise the principle of neutrality by stating that what an account holder had was securities, which was not true in some jurisdictions. It was true that the current definition implied that the investors' rights are linked to intermediation, but not in the sense that their character was changed by intermediation.

134. However, some suggested that the notion "intermediated securities" might not be the best choice to express what was intended and that the present discussion stemmed from the linguistic challenge inherent in the realisation of the functional approach. However, whatever words were used, they had to cover the rights of an investor which credits to his account gave regardless whether those rights amounted to ownership of underlying securities, as in many countries, or whether they amounted to some kind of derivative interest in securities, as in other countries.

135. A compromise proposal to substitute "intermediated securities" with "intermediated rights" seemed acceptable to some delegations, if inevitable, but a significant number of delegations expressed their strong reservations in this regard, in particular with respect to consistency with the wording used in the Hague Securities Convention. It was decided that the Drafting Committee needed to consider both options from a drafting standpoint and to more closely examine whether that change was desirable, if consistency and readability of the draft Convention continued to be a priority.

136. Other delegations proposed that the present lack of clarity could be better dealt with in the context of Article 4. The list of rights contained in its paragraph (1) should be redrafted so as to reflect its purpose without any bias in wording or concept towards specific existing concepts.

137. The Chairman concluded that there was broad agreement that the present *concept* could not be changed but that there might be a lack of clarity as regards the interaction of the wording of Article 1(a) and (f) and Article 4(1). He referred the issue of readability to the Drafting Committee. He took note of the Australian delegation's concern that the CHES system be covered.

Chapter VII – General discussion

138. The Chairman asked for general comments on Chapter VII, regarding special provisions with respect to collateral transactions.

139. One observer, the International Swaps and Derivatives Association (ISDA) expressed its appreciation for being invited to participate in the work of the Committee. It drew the attention of delegations to the recently published ISDA 2006 Model Netting Act, which promoted legal certainty with respect to financial collateral in connection with netting agreements. The observer pointed to the additional benefit of such legislation and advocated an inclusion of similar rules into the draft instrument or an additional, future UNIDROIT instrument. Two other delegations were equally in favour of such idea. Another observer pointed to the limited provision on netting in Article 23(5) and cautioned against including netting provisions that would go further than this. The Chairman invited ISDA to give a detailed presentation on its proposal at the end of the day's plenary session (cf. [Appendix 23](#)).

140. The EU Commission highlighted the importance of Chapter VII and expressed its general agreement with its scope and proposed solutions.

141. The Committee discussed briefly whether the rules of Chapter VII should be included in the main body of the draft text, and in particular whether it should be brought close to Article 6, but confirmed that this part of the future instrument should remain optional and therefore stay separately.

Coordination with the UNICITRAL draft guide on secured transactions

142. The delegate from UNCITRAL, which participates as an observer in the work, drew the Committee's attention to a general matter related to Chapter VII of the draft instrument and the

recommendations of the UNCITRAL draft guide on secured transactions. Securities as object of a security interest were generally excluded from the UNCITRAL draft guide on secured transactions. The question was what text would apply to securities that were proceeds of equipment or inventory which were object of a security interest. Under the draft guide, the security interest applied to proceeds, and the rank of the security interest over the proceeds was determined on the basis of the point in time when the original security interest over equipment or inventory had been created. The question was what priority rules applied in case a separate security interest over the securities was subsequently created under the rules of the UNIDROIT draft instrument. Several delegations took the preliminary view that in the case of competing claims of a secured creditor who would have obtained a security interest in intermediated securities under the future UNIDROIT instrument and a competing claimant who would have obtained a security interest in other assets and who would have a claim over the intermediated securities as proceeds of these other assets, the secured creditor under the future UNIDROIT rules would have priority. The Chairman asked the Secretariat to liaise with the UNCITRAL Secretariat in order to clarify this issue.

143. Furthermore, it was not clear whether a security interest in securities (under the UNIDROIT draft instrument) extended to proceeds from the transfer of the securities. There was broad agreement that this was not the case.

144. A third issue was whether the UNCITRAL draft guide should apply to directly held securities or whether security interests over such assets would be dealt with by the UNIDROIT instrument. There was broad agreement that the future UNIDROIT would not apply to directly held securities.

Article 22 – Enforcement

145. One Delegation wondered whether the restriction in paragraph (1), which limited Article 22's application to intermediated securities "of a kind regularly traded on a financial market", should not be removed. Sufficient safeguards would be left to the domestic non-Convention law, paragraph (5). Another delegation added that the possibility of declaration under Article 25 could be widened so as to give contracting States sufficient control mechanisms.

146. Furthermore, several delegations suggested removing paragraph (2) in its entirety as well as the words in the second square brackets in paragraph (1).

147. Another delegation, with reference to the possibility of a declaration under Article 25(2), advocated deletion of the words in the first square brackets in paragraph (1), which would restrict this to people other than natural persons.

148. The Chairman concluded that the issues dealt with in the first and third bracketed portions and the words, "which are of a kind regularly traded on a financial market" in Article 22(1), could be dealt with by the domestic non-Convention law and were to be deleted here, whereas the second bracketed portion was to be retained. Article 22(2) was to be deleted. Articles 22(3), (4) and (5) were, without further discussion, transmitted to the Drafting Committee.

Article 23 – Rights to use collateral securities

149. The Committee discussed whether it would be sensible to delete the text in square brackets in paragraph (2). On the one hand, there seemed no obvious reason for this restriction on the contractual autonomy of the parties to the collateral agreement, and the rule as it stood was not very clear.

150. On the other hand, it might appear sensible to contracting States, for reasons of protection of parties to the collateral agreement, to limit the breadth of a right of re-use by including an obligation to return like assets except in the case of the type of event that the language in the square brackets refers to. One possibility was to introduce a declaration mechanism in this regard. However, as a first step it would be sensible to leave the text as it was and leave the square brackets so that this matter could be considered until the next session of the Committee, also

taking into account a current evaluation of the function of this regime as it applies at the moment in the EU.

151. The Chairman agreed that the Committee was not ready to come to an agreement on this point and therefore proposed to leave the bracketed language as it stood at present.

152. In the context of Article 23, the Committee dealt with the question of whether Chapter VII applied to both title-transfer security interests (as provided for in Article 6(2)a)) and security interests not entailing a transfer of title (as provided for in Article 6(2)b) and d)). This issue appeared because under a title-transfer security arrangement the security taker is, having received the legal title over the securities, at any rate entitled to use the collateral assets for its own purposes, in particular for re-hypothecation. Consequently, Article 23 in its current form did not make much sense with respect to title transfer securities.

153. After detailed discussion and having considered the definition of “disposition” in Article 1 as well as the parallel provisions in the EU Directive on Financial Collateral, the Committee came to the conclusion that title-transfer security interests were included in the scope of Chapter VII. However, the Drafting Committee was asked to highlight the difference in application of Article 23 with respect to both types of security interests.

154. With respect to Article 23(5), the Committee’s opinion was that it should be placed in the context of Article 22, as it clearly regarded the procedure of enforcement of security interests.

Article 24 – Top-up or substitution of collateral

155. The Committee went on to discuss the three options in square brackets in Article 24(a).

156. One observer, supported by one delegation, was in favour of retaining options one and three as alternatives and still maintaining the second option in square brackets. Another observer, for reasons of maximum flexibility, advocated the third option to figure in this paragraph.

157. One delegation thought that the reference included in the third option should be to the domestic non-Convention law instead of to the law applicable as determined by the private international law rules of the forum. This was because the main purpose of the provision was not only to deal with the relationship between the parties but also with the effectiveness of the substitution of the collateral, which might be an insolvency issue. Others were of the opinion that the transaction between the secured party and the collateral provider might be governed by a law that is different from the domestic non-Convention law. Therefore, the current language was considered more accurate.

158. The Chairman concluded that the reference to private international law rules of the forum should remain as they stand and that all three options should figure in paragraph (a), with the second one still in square brackets.

Article 25 – Declaration in respect of Chapter VII

159. Concerning Article 25, the Committee felt that an opt-out declaration mechanism regarding, first, securities that cannot be traded on an exchange or regulated market, second, collateral arrangements entered into by natural persons, and, third, collateral arrangements that provide for secured obligations of certain categories, should be included (cf. above on Article 22(1) and (2)). This entailed a re-draft of paragraph (2) of Article 25.

160. Chapter VII was sent in its entirety to the Drafting Committee with a view to aligning terminology and concepts with the remainder of the draft text.

Informal working group on transparent systems

161. The first Vice Chairman of the CGE who had volunteered to chair an informal working group on specific issues regarding so-called transparent systems introduced to the Committee the document prepared by this group (cf. [Appendix 9](#)). Australia, Belgium, Brazil, Canada, Chile,

Colombia, Finland, Luxemburg, Spain, the US and the Permanent Bureau of the Hague Conference had participated in this process. The first Vice Chairman stressed that the working group was only in a position to highlight the issues involved but could not come to an ultimate conclusion on how to deal with the specificities of such systems in the future instrument.

162. The Chairman and delegations thanked the first Vice Chairman and all participants in this group for having prepared a most helpful paper on this difficult issue.

163. One delegation commented on the paper by highlighting that the purpose of the prohibition of upper-tier attachment was to protect the integrity of the system in intermediated holding and transfer of securities and to ensure that attachment in respect of a particular debtor did not damage the interests of unconnected parties, whether they were intermediaries or other investors. So it did not follow automatically that every attachment at the level other than the lowest levels in the chain must be prohibited from having that damaging effect, provided that the arrangements at the level where the attachment is proposed were such that only the debtor would be affected. However, if this were to lead some jurisdictions to uphold the possibility of upper-tier attachment, from a technical point of view, that ought not to be done by taking out of the scope of the future Convention entities that truly were intermediaries in the sense that they conform in substance to the functions of intermediaries as described in this draft.

164. Other countries agreed in the sense that certain entities in their systems were in a grey zone as they did not fully exercise functions of an intermediary. In this case, some kind of clarification that they were not intermediaries under the future instrument would solve the issue. They pointed to the Hague Securities Convention (Article 1 (3)), which followed a similar approach.

165. The Chairman concluded that the Secretariat should coordinate intersessional exchange on this issue and prepare a report to guide the discussion at the next session of the Committee.

Report of the Chairman of the Drafting Committee

166. The Chairman invited the Chairman of the Drafting Committee to explain the changes that had been made to the text.

167. As a preliminary remark, the Chairman of the Drafting Committee highlighted the fact that the text that had been distributed to delegates (WP 3, reproduced as [Appendix 12](#)) was not in its final form. The Drafting Committee had decided to reorder the text on the basis of the joint proposal submitted by France and the US, taking into account the comments made by delegations during the plenary session (cf. para 126 *supra*). However, as there had been not sufficient time to reorder the Articles of the draft instrument and to adjust all references, the reordering should be effected by the Secretariat.

168. Furthermore, the word "harmonised" had been removed from the title of the text, as it was considered unnecessary.

169. Then, the Chairman of the Drafting Committee mentioned all changes made to the text. He put particular emphasis on the following points:

170. In Article 1(f) a footnote had been inserted to reflect the ongoing discussion regarding the definition of intermediated securities.

171. In Article 1(m) and (n) the sub-paragraphs, which reflected concepts of both positive and negative control, had been collapsed and put into the chapeau in order to make these provisions more readable.

172. In Article 1(p) the definition of "non-consensual securities interests" needed to be added in the future. The concept aims at reflecting statutory liens or security interests by operation of law.

173. The new Article 1(q) tried to accommodate proposals by the EU and the US regarding the definition of "securities settlement [or clearing] system".

174. The new provisions in Article 1(r), (s) and (t) were previously defined in Chapter VII but should also be used outside this chapter.

175. Article 4 had undergone big changes, mainly for reasons of readability and clarity. The basic structure of Paragraph 1 had not been changed, but (a) now dealt with the "rights attached to the securities", i.e., rights for dividends, voting rights, etc. Paragraph 1(a)(i) meant a right held by the ultimate investor i.e., the bottom person of the chain, whereas 1(a)(ii) referred to the person in between i.e., an intermediary acting as intermediary. If the intermediary is not acting as an intermediary then it is covered by 1(a)(i). By these means, both direct and indirect systems were covered. Article 4(1)(b) and (c) covered the "rights over securities" and corresponded basically to old (b), (c) and (d). New paragraph 2 was based on old paragraph 3 and now reflected the changes brought to paragraph 1. In substance, there was no big change.

176. A new Article that had been given the provisional number 4bis corresponded to the old paragraphs 4 (which provided for affirmative duties of an intermediary) and 5 (saying that an intermediary can act only within its power) of Article 4. The Drafting Committee considered it useful to describe the duties of an intermediary in a separate article. Old Article 4(6), which dealt with standard of care of an intermediary, was moved to Article 16bis.

177. On Article 5, the Drafting Committee felt not in a position to propose any better wording.

178. Considerable changes had been made to Article 6. The concept reflected in paragraph (1)(b) was re-labelled from "delivery into possession or control" to "delivery" in order to comply with the functional and neutral approach. Paragraph (2) now dealt with security interests created by book entry, whereas paragraph (3) in its sub-paragraphs dealt with different ways to create a security interest without book-entry. The options formerly contained in (e) and (f) had been deleted.

179. Article 7 had been the most complex and complicated rule to revise. The word "credit" had been removed from paragraph (1) as it was irrelevant. Former paragraphs (2) and (3) had been deleted, as timing provisions in the context of Article 7 were unnecessary. Instead, a timing provision had been included in Article 10. Equally, former paragraph (4) had been removed, as conditional debit or credit could be dealt with in former Article 7(5), now 7(2).

180. The Drafting Committee did not make any proposal on Article 9 with respect to so-called transparent systems, as the plenary decided to pursue this issue further at the next session. In this context it was important to highlight that in the view of the Drafting Committee the current definition of intermediary included CSDs in transparent systems as well as all other sorts of "controversial" types of CSDs.

181. The new wording of Article 10 made clear that this provision dealt with security interests under Article 6(3)(a) to (c) only. This criterion was the demarcation between Articles 10 and 11. Paragraph (3) was a newly inserted provision, concerning the deemed "waiver" of the intermediary's priority.

182. Article 11 had not been finished by the Drafting Committee. The instructions were to collapse the former provision with Article 7(6) and (7) but there was not sufficient time to do so. In response to the amended Article 7, options (a) to (c) had been included in Article 11(1). The Drafting Committee was still unsure about option (c), as a book-entry might be either unauthorized or otherwise ineffective or reversible. This innocent acquisition cut off any adverse claim on the basis of lack of authorisation and effectiveness. However, the question was whether an innocent acquirer was free from reversibility. Under paragraph (1)(c) as it now stood, the credit entry to the innocent acquirer was not ineffective or reversible. The credit-entry was, independently from the

reversibility of other debit and credit-entries, protected. But there were situations where the intermediary agreed with the account holder for reversal, especially in the case of a conditional credit. Such arrangements ought to be recognized. This is what the Drafting Committee tried to reflect in the current paragraph (1)(c).

183. The square brackets in Article 16(1) had been put in order to highlight the following issue: An intermediary held 100 securities for its customers and in addition, owned 50 securities for its own account. Was it required to hold 100 or 150 securities at the upper level? As this had not been explicitly discussed in the plenary, the Drafting Committee had decided to insert a footnote in order to earmark this issue for future discussion. Former paragraph (3) had been deleted because the definition of "sufficient securities" was now included in paragraph (1). Former paragraph (5) had been considered unnecessary and therefore deleted.

184. New Article 16bis was former Article 4(6).

185. In Article 17, now its paragraph (4) provided explicitly for a declaration mechanism that would permit jurisdictions to provide the segregation rule in connexion with the concept of property.

186. Article 18 now applied explicitly to the case of insolvency of an intermediary.

187. The scope of Article 19 had been clarified. Paragraphs (1) and (2) now provided for two distinct scenarios, as discussed in the plenary. In paragraph (2), as no fitting translation of the word "nominee" was available in French, a generic formula had been invented.

188. As regards Chapter VII, the Drafting Committee intended to align the language with the wording used in the remainder of the draft text, taking into account relevant EU directives.

189. Article 21(1) now made clear that Chapter VII applied equally to security interests by transfer of title.

190. Article 22 now exclusively dealt with enforcement. Its paragraph (3) was a netting provision that was relocated from former Article 23(5) with no changes in substance.

191. Article 25(1) had not been changed. New paragraph (2) provided for specific declaration mechanisms as decided by the plenary. Under (b), the Drafting Committee was not in a position to find a good French equivalent for "publicly traded securities", so it decided to use another expression.

192. The Chairman of the Committee thanked the Chairman of the Drafting Committee and its members for the amount of work done and time dedicated. The Chairman of the Committee called for general comments.

193. The EU Commission congratulated the Drafting Committee and drew the Committee's attention to its proposal for the insertion of an accession clause for regional economic integration organisations (cf. [Appendix 10](#)). The clause proposed was the exact copy of the clause inserted in the Securities Hague Convention, and the EU Commission insisted on the importance of its insertion in the Convention.

194. Individual delegations added their thanks to the Drafting Committee to those that the Chairman had expressed earlier and supported its work, insisting on the considerable progress made on the text.

195. A delegation proposed to prepare a draft concerning Article 5(5) or to be present to work on that subject. Another delegation stressed the importance of clarifying the meaning of "intermediary" in the text and stated its intention to make a proposal in writing on this matter,

possibly with other delegations. Several delegations supported that idea. Another delegation reiterated its proposal of a working group on the "good faith" concept. This proposal was supported by several delegations.

196. One delegation, however, supported by others, warned the Committee that if the task seemed easier, it might be due to the fact that the Committee referred a number of matters to the domestic non-Convention law, and wondered if that achieved the objectives that had been set for the Convention. An observer suggested to refer to "interests" instead of "rules" in the title of the Convention. One delegation, supported by others, stated that the scope of the Convention was then settled and that the efforts should now be made on deepening the meaning and understandability of the draft Convention.

197. The Chairman of the Committee considered that the Committee had approved the present text as a good basis for the future. He called on the Member States to undertake a careful reading of the new draft text and to submit comments on it.

Future work

198. The Chairman considered that the next meeting should take place in the fall of 2006 and stated that the dates would be communicated by the Secretariat shortly.

199. As to intersessional work, the Chairman mentioned the enthusiasm met by the proposal of a "good faith" group and also a working group on a definition of "intermediary" in the context of so-called transparent systems. He advised the members of the Committee that the Secretariat would send out invitations to participate in these working groups.

200. One delegation expressed its wish to be part of the Drafting Committee for its future meetings.

201. The EU Commission made a proposal for another working group in relation to securities settlement systems and for chairing it.

202. The Chairman of the Committee concluded by saying that though the session had not always been easy, enormous progress had been made. He wanted to thank all delegates for taking part in the Committee. The session was closed at 1 p.m.

**LIST OF DISTRIBUTED DOCUMENTS
AND INDEX OF ANNEXES**

- References:** UNIDROIT Study LXXVIII (not reproduced in this report; available on <http://www.unidroit.org/english/workprogramme/study078/item1/main.htm>)
- Doc. 23 rev., Report on the first session of the UNIDROIT Committee of governmental experts for the preparation of a draft Convention on harmonised substantive rules regarding intermediated securities, Rome, August 2005
 - Doc. 24, Preliminary draft Convention on harmonised substantive rules regarding intermediated securities as adopted by the Committee of Governmental Experts at its first session, Rome, June 2005
 - Doc. 25, Report of *Ad hoc* Working Group on Article 19.1 of the preliminary draft Convention on harmonised substantive rules regarding intermediated securities, Rome, February 2006
 - Doc. 26, Report of *Ad hoc* Working Group on legislative techniques for the implementation of the preliminary draft Convention on harmonised substantive rules regarding intermediated securities, Rome, February 2006
 - Doc. 27, Comments by the Government of Malta, Rome, January 2006
 - Doc. 28, Comments by the Government of Japan, Rome, January 2006
 - Doc. 29, Comments by the Government of the United States of America, Rome, January 2006
 - Doc. 30, Comments by the CCP12, Rome, January 2006
 - Doc. 31, Comments by the Commission of the European Communities, Rome, January 2006
 - Doc. 32, Comments by the Government of Germany, Rome, January 2006
 - Doc. 33 rev., Comments by the Government of the Russian Federation, Rome, February 2006
 - Doc. 34, Comments by the Government of France, Rome, March 2006
 - Doc. 35 and Doc. 36, Comments by the Government of the United States of America, Rome, February 2006
 - Doc. 37, Comments by the International Swaps and Derivatives Association, Inc. – ISDA, Rome, March 2006
 - Doc. 38, Comments by the Government of Argentina, Rome, March 2006
 - Doc. 39, Comments by the Government of the United States of America, Rome, February 2006
 - Doc. 40, Comments by the European Banking Federation, Rome, March 2006
 - Doc. 41, Comments by the Government of the Federative Republic of Brazil, Rome, March 2006

References: CGE/Securities/2

- OB, *Order of business* (reproduced as [Appendix 2](#))
- W.P.1, *Agenda* (not reproduced)
- W.P.2, *Proposal regarding a revision to Article 4*, submitted by the United States of America (reproduced as [Appendix 4](#))
- W.P.3, *Comments on the preliminary draft Convention on harmonised substantive rules regarding intermediated securities*, submitted by the Federative Republic of Brazil (not reproduced, now Doc. 41)
- W.P.4, *Daily Report*, Plenary session, 6 March 2006 (not reproduced)
- W.P.5, *Proposal regarding a revision to Article 8*, submitted by the United States of America (reproduced as [Appendix 5](#))
- W.P.6, *Daily Report*, Plenary session, 7 March 2006 (not reproduced)
- W.P.7, *Proposal regarding a definition of securities settlement system*, submitted by the European Union (reproduced as [Appendix 6](#))
- W.P.8, *Some clarifications regarding comments of the French Government on Articles 1 and 4*, submitted by the Government of France (reproduced as [Appendix 7](#))
- W.P.9, *Proposal for a restructuring of the plan of the draft Convention*, submitted by the Governments of France and the United States of America (reproduced as [Appendix 8](#))
- W.P.10, *Daily Report*, Plenary session, 8 March 2006 (not reproduced)
- W.P.11, *Report of the Working Group on the rule precluding upper-tier attachment* (reproduced as [Appendix 9](#))
- W.P.12, *Proposal for the insertion of an accession clause for Regional Economic Integration Organisations*, submitted by the European Union (reproduced as [Appendix 10](#))
- W.P.13, *Proposal for the insertion of a regulatory clause in the Convention*, submitted by the European Union (reproduced as [Appendix 11](#))
- W.P.14, *Daily Report*, Plenary session, 9 March 2006 (not reproduced)
- W.P.15, *Daily Report*, Plenary session, 10 March 2006 (not reproduced)
- W.P.16, *Daily Report*, Plenary session, 13 March 2006 (not reproduced)
- W.P.17, *Daily Report*, Plenary session, 14 March 2006 (not reproduced)
- DC/W.P.3, *Text of the preliminary draft Convention*, submitted by the Drafting Committee (reproduced as [Appendix 12](#), now edited by the Secretariat and released as Doc. 42)
- INF. 1, *List of participants* (reproduced as [Appendix 3](#))
- INF. 2, *FAO facilities* (not reproduced)
- INF. 3, *Presentation slides on overview of inter-sessional work*, prepared by the Secretariat (reproduced as [Appendix 13](#))
- INF. 4, *Presentation slides on definition of securities*, prepared by the Secretariat (reproduced as [Appendix 14](#))
- INF. 5, *Presentation slides on Article 4.1 (a) and 4.2*, prepared by the Secretariat (reproduced as [Appendix 15](#))

- INF. 5a, *Presentation slides on upper-tier enforcement and attachment*, prepared by the Secretariat (reproduced as [Appendix 16](#))
- INF. 6, *Presentation slides on form and implementation of the future instrument*, prepared by the Secretariat (reproduced as [Appendix 17](#))
- INF. 7, *Comments submitted by Citigroup* (reproduced as [Appendix 18](#))
- INF. 8, *Comments submitted by Zentraler Kreditausschuss* (reproduced as [Appendix 19](#))
- INF. 9, *Presentation slides on effectiveness of book-entries, priorities and loss sharing*, submitted by the Swiss delegation (reproduced as [Appendix 20](#))
- INF. 10, *Presentation slides on good faith, priorities and loss sharing (Article 7(6); 11; 10 and 18)*, prepared by the Secretariat (reproduced as [Appendix 21](#))
- INF. 11, *Presentation slides on priorities under Article 10*, prepared by the Secretariat (reproduced as [Appendix 22](#))
- INF. 12, *Presentation slides on cross-border insolvency – The future: law reform for netting and collateral in connection with financial market transactions*, submitted by the International Swaps and Derivatives Association, Inc. ISDA (reproduced as [Appendix 23](#))
- INF. 13, *Presentation slides on exemption for SCS*, prepared by the Secretariat (reproduced as [Appendix 24](#))
- INF. 14, *Presentation slides on overview of Article 19*, prepared by the Secretariat (reproduced as [Appendix 25](#))

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

ORDER OF BUSINESS

(proposed by the Secretariat)

6 March (Monday)

- 8:30 a.m. Registration at FAO; Security-Badges
- 10 a.m. *Morning session*
- Opening addresses
 - Adoption of the agenda
 - Organisation of work
 - Report on inter-sessional work
- 11 a.m. Consideration of the text of the Preliminary Draft Convention
- Structure of the draft text (Presentation of related documents; cf. discussion on Friday 10 March, afternoon session)
 - Form of the future instrument (Presentation of Doc. 26; cf. discussion on Friday 10 March, afternoon session)
 - Definitions which need to be discussed separately
 - "Securities" [Art. 1(a)]
 - Intermediated Securities [Art. 4 with Art. 9]
 - Art. 4.1(a) and 4.2 including definitions of "intermediary" and "account holder" [Art. 1(c) and (d)]
 - Minimum content of the right [Art. 4.1(b)-(e)]
- 2 p.m. *Afternoon session*
- Intermediated Securities [Art. 4 with Art. 9] – *continued*
 - Prohibition of exercise at the upper tier [Art. 4.3(b)]
 - Prohibition of upper-tier attachment [Art. 9]
 - Intermediaries' duties [Art. 4.4 – Art. 4.6 (Versions A and B)]
 - Limitation in case of collateral securities [Art. 4.7]
- 6.30 p.m. *Evening reception at the invitation of the Ambassador of Switzerland and the Chairman of the CGE (on invitation)*

7 March (Tuesday)

9 a.m.

Morning session

- Prerequisites for acquisition and disposition of securities [Art. 5, Art. 7.1-5]
 - Effect upon credit/debit [Art. 5.1-3]
 - Effect does not depend on traceability [Art. 5.4]
 - Effect depends on authorisation [Art. 7.1]
 - Timing [Art. 7.2 and 7.4]
 - Reversibility [Art. 7.5]

2 p.m.

Afternoon session

- Security interests in intermediated securities [Art. 6 with Art. 1(m)-(n) and Art. 7.3]

8 March (Wednesday)

9 a.m.

Morning session

- Acquisition by innocent account holders [Art. 7.6 and 7.7 together with Art.11]
 - General relationship between the two provisions and with Articles 10 and 18
 - Elements of Art. 7.6-7
 - Elements of Art. 11

2 a.m.

Afternoon session

- Priority among competing interests [Art. 10]

9 March (Thursday)

9 a.m.

Morning session

- Insolvency of intermediary [Art. 12 and Art. 14]
- Exemptions for CSS [Art. 8 and Art. 13]
 - Definition of CSS
 - Nature and scope of exemptions

2 a.m.

Afternoon session

- Instructions [Art. 15]
- Adjustment of Art. 16-18 in the light of discussions on Art. 5, 7 and 11
- Sufficient securities [Art. 16]
 - Need for Art. 16.1 and 16.5
 - "promptly" or "immediately" [Art. 16.2]

10 March (Friday)

9 a.m.

Morning session

- Allocation of securities to account holders rights [Art. 17]
 - Need for allocation in terms of Art. 17.1-2 / Relationship with Art. 18
 - Allocation and/or segregation?
- Effect of insufficiency of securities [Art. 18]
 - Scope of provision / Cause of shortfall
 - Exemption for CSS [Art. 18.1(a)]
 - Others: *pro-rata* loss-sharing [Art. 18.1(b) with 18.2]

2 p.m.

Afternoon session

- Form of the future instrument (cf. Presentation of Doc. 26 on Monday, 6 March, morning session)
- Structure of the draft text (cf. Presentation of related documents on Monday, 6 March, morning session)

11 March (Saturday)*No plenary session***12 March (Sunday)***No plenary session***13 March (Monday)**

9 a.m.

Morning session

- Report on results achieved so far
- Position of issuers of securities [Art. 19]
- Set-off [Art. 20]

2 p.m.

Afternoon session

- Special provisions on collateral transactions [Art. 21 and Art. 22]
 - "Natural person" [Art. 22.1, cf. Art. 25.2]
 - "Secured Obligation" [Art. 22.1 and Art. 22.2]
 - "Enforcement event" [Art. 21(b) and Art. 22.3-5]

14 March (Tuesday)

9 a.m.

Morning session (no lunch-break until 2 p.m.)

- Right to use collateral securities [Art. 23]
 - Square brackets in Art. 23.2
- Top-up and substitution of collateral [Art. 24]
 - Square brackets in Art. 24(a)
- Declarations [Art. 25]
- Conclusion of any outstanding business
- Future work
- Any other business

2 p.m.

End of the session

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LISTE DEFINITIVE DES PARTICIPANTS

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**PROPOSAL
REGARDING A REVISION TO ARTICLE 4**

(submitted by the delegation of the United States of America)

CHAPTER II – INTERMEDIATED SECURITIES

Article 4

[Rights of account holders]

1. - ~~Subject to paragraphs 2 – 7,~~ ~~the~~ The credit of securities to a securities account confers on the account holder:

- (a) ~~subject to paragraph 2,~~ the right to receive and exercise the rights attached to the securities, including in particular dividends, other distributions and voting rights;
- (b) the right, by instructions to the relevant intermediary, to cause the securities to be debited to the securities account under Article 5 and credited to a securities account of another account holder (whether with the relevant intermediary or another intermediary) or to be delivered into the possession or control of a collateral taker under Article 6;
- (c) the right, by instructions to the relevant intermediary, to cause the securities to be debited to the securities account under Article 5 and credited to a securities account of the account holder with a different intermediary;
- (d) the right, by instructions to the relevant intermediary, to withdraw the securities so as to be held by the account holder otherwise than through a securities account, to the extent permitted under the law under which the securities are constituted, the terms of the securities and the account agreement;
- (e) subject to this Convention, such other rights as may be conferred by the domestic non-Convention law.

[Version A:

5.- Where the enjoyment of any of the rights referred to in paragraph 1 depends on the actions of the relevant intermediary, the scope of those rights is limited to such an extent as is necessary to ensure that the relevant intermediary is not required to take any action that is not within its power. This does not affect any right of the account holder against the issuer of the relevant securities conferred by this Convention, the terms of the relevant securities and the law under which the relevant securities are constituted.

6.- The manner of performance of any obligations of the relevant intermediary in respect of the rights of an account holder under paragraph 1, and the extent of the liability of the relevant intermediary for any failure to perform such obligations, are governed by the account agreement, the law by which the account agreement is governed and any applicable provision of the domestic non-Convention law.]

[...]

[Version B:

5. - To the extent that the rights referred to in paragraph 1 are dependent on the actions of the relevant intermediary, the account holder is not entitled to any such right to the extent that giving effect to the right:

(a) is not within the power of the relevant intermediary;

(b) would require the relevant intermediary to act in a manner that is ~~more burdensome than reasonable commercial standards or that is~~ not permitted by any applicable law or by the terms of the relevant securities;

(c) would require the relevant intermediary to establish a securities account with another intermediary; or

(d) is waived by the account holder in the relevant account agreement in a manner permitted by the domestic non-Convention law.

6.- Subject to any applicable provision of the domestic non-Convention law, any obligation of the relevant intermediary in respect of the rights of the account holder under paragraph 1 shall be satisfied if the relevant intermediary acts with respect to that obligation:

(a) in accordance with the account agreement or, if there is no account agreement, in accordance with ~~reasonable commercial standards~~;

(b) in accordance with an [applicable law] that imposes the substance of the obligation on the relevant intermediary ~~any other agreement between the account holder and the relevant intermediary; or~~

(c) in accordance with an [applicable law] or with the rights of the relevant intermediary arising out of a security interest under a security agreement with the account holder that varies such obligations; or

~~(de)~~ by placing the account holder in a position itself to exercise any relevant right referred to in paragraph 1.]

[Version C, marked to reflect changes to Version A:

5.- Where the enjoyment of any of the rights referred to in paragraph 1 depends on the actions of the relevant intermediary, the scope of those rights is limited to such an extent as is necessary to ensure that the relevant intermediary is not required to take any action that is not within its power and. This does not affect any right of the account holder against the issuer of the relevant securities conferred by this Convention, the terms of the relevant securities and the law under which the relevant securities are constituted.

6.- The ~~manner of performance of any~~ obligations of the relevant intermediary in respect of the rights of an account holder under paragraph 1, the manner of performance of such obligations, and the extent of any ~~the~~ liability of the relevant intermediary for any failure to perform such obligations, are governed by the account agreement, the law by which the account agreement is governed and any applicable provision of the domestic non-Convention law.]

**PROPOSAL
REGARDING A REVISION TO ARTICLE 8**

(submitted by the delegation of the United States of America)

Article 8

[Overriding effect of rules of securities clearing or settlement systems]

1. Any provision of the rules or agreements governing the rights and obligations between a securities clearing or settlement system and its participants shall, to the extent of any inconsistency, prevail over any provision of this Convention, including circumstances in which the provision of the rule or agreement affects another party.
2. CONCEPT: *Minimum standards that an entity must meet to qualify as a CSS (e.g., (a) level of CSS regulator's oversight of CSS's rules and agreements with its participants, or alternatively the fact that the entity is a central bank; (b) nature of entity's activities, and transparency of rules and agreements related thereto).*
3. CONCEPT: *Attributes of mandatory State declaration -- such a declaration should include either or both:*
 - (a) *a list of entities that a State designates as being a CSS; and/or*
 - (b) *a transparent mechanism by which a State designates categories of entities that qualify as a CSS (e.g., entities identified by the "Country X" FSA as qualifying as a CSS, which qualification (and date thereof) is identifiable on the "Country X" FSA website).*

**PROPOSAL
REGARDING A DEFINITION OF SECURITIES [CLEARING OR]
SETTLEMENT SYSTEMS**

(submitted by the European Union)

In this Convention, "securities [clearing or] settlement system" means

- a securities [clearing or] settlement system
- which is operated by a central bank or whose operations are supervised
- and which has been notified as such by a Contracting State
- the notification having been made on the grounds of reduction of risk to the stability of the financial system.

**SOME CLARIFICATIONS
REGARDING COMMENTS ON ARTICLES 1 AND 4**

(submitted by the delegation of France)

I - Definition of "securities" and of "intermediated securities": the link between definition 1.a and 1.f

We consider that the draft Convention should clearly differentiate the concept of intermediated securities, i.e. securities governed by this draft Convention, on the one hand from the rights of a securities holder resulting from the credit of securities to a securities account on the other hand.

The proposal is based on the idea that the convention concerns securities transferable by book entry in the chain of intermediation. In this respect, it is not intended to solve the theoretical issue of the nature of the securities circulating in the chain of intermediation, compared to the securities circulating outside the chain of intermediation. We want to tackle the question of the legal effects linked to the securities circulating in the chain of intermediation.

Accordingly, the definition of "securities" in 1.a should be as large as possible in order to cover any type of financial assets and the reference to the transferability can be deleted. On the other hand, the definition of "intermediated securities" should cover the financial assets which are the main target of this convention, i.e. the securities circulating through the chain of intermediation. In this respect, intermediated securities should not be defined as the rights of the account holder but should be the assets which are credited to a securities account.

Article 1.a is still relevant since the concept of financial asset, not circulating in an intermediary chain, is used for instance in article 4.1 d (possibility for an account holder to close its account and keeps its assets outside the intermediary chain).

These new definitions of "securities" and "intermediated securities" are all the more so relevant if we take into account the debate of the plenary session on article 4. As a matter of fact, there was a majority in favor of a clarification between the rights attached to the intermediated securities (in 4.1.a) and the rights on the intermediated securities. But, such clarification is not possible without a definition of intermediated securities defined as its stands in our proposal (i.e. assets and not rights).

Therefore, we propose a new definition of intermediated securities, in 1.f, based on the criteria of book entry. Thus, **"intermediated securities means securities credited to a securities account and transferable by debit from and credit to a securities account" and "securities means any shares, bonds or other financial instruments or financial assets (other than cash)".**

II – Effectiveness and enforceability of rights against the issuer: Article 4.3.a and b

Article 4.3.a

The French delegation has proposed to add a reference to the issuer in Article 4.3.a in the following way: **“The rights referred to in paragraph 1 are effective against the relevant intermediary, third parties and the issuer”**

The idea was to consider that the benefit of some of the rights listed in Articles 4.1.b to d shall not be restricted by a limitation made by the issuer. As a matter of fact, the rights listed in Articles 4.1.b to d should be effective against any third parties including the issuer. The issuer can not limit the rights on the intermediated securities (which are listed in Articles 4.1.b to d), as for instance the right of the account holder to change the relevant intermediary or the right to transfer by way of security interest, not implying a transfer of ownership, to another account holder.

However, the issuer has the possibility to limit the rights attached to the intermediated securities, as for instance an eligibility provision for any new shareholder. Moreover, the issuer may have the right to limit the right to transfer the ownership of the intermediated securities, which is a right on the intermediated securities, to another account holder.

Therefore, we consider that our initial proposal may not be appropriate since some of the rights on the securities should not be effective against the issuer (despite our drafting proposal); however, we strongly suggest:

- firstly, to have a clear distinction, as already suggested in the previous item on Article 1, between the rights attached to the intermediated securities (i.e. financial and non financial rights such as dividends and voting rights) listed in Article 4.1.a on the one hand and the rights on the intermediated securities listed in Articles 4.1.b to d.
- secondly, to have a better drafting so as to specify which type of rights listed in Articles 4.1.a to d are effective or enforced against the intermediary or the issuer, along the lines described in the first two previous paragraphs.

Article 4.3.b

The French delegation proposes to change the order of this indent, in order to follow the functional approach. This approach implies neutrality regarding the enforceability of rights against the intermediary and the issuer.

In this indent, we do not only cover the issue of effectiveness of the rights on the securities but also the issue of enforceability or exercise of rights attached to the securities. Therefore, we should put on an equal level the intermediary and the issuer and modify the current drafting which focuses on the exercise of rights against the intermediary.

Accordingly, we propose the following wording:

“The rights referred to in paragraph 1 may be enforced against the relevant intermediary and the issuer of the relevant securities, to the extent provided by this Convention, the terms of the relevant intermediary agreement, and the law under which the relevant securities are constituted”.

PROPOSAL
FOR A RESTRUCTURING OF THE PLAN OF THE DRAFT CONVENTION

(submitted by the Governments of France and the United States of America)

The American and the French delegations have separately come to the conclusion that the course of negotiations and the collective evolution of thought have resulted in an opportunity to formulate a plan of the convention that is more readable and coherent.

Further, on a careful reading of the text, many provisions covering related topics appear to be either scattered or redundant in different articles. We suggest it could be possible to simplify the structure of the draft in such a way as to make it easier to understand. We think the draft can be reorganised into about five Chapters. The logic underlying that reorganisation is the following:

- the convention should be structured on the basis on few major blocks or chapters corresponding to the main objectives of the conventions (protection of rights of the account holder, legal certainty for the transfer of rights, protection of the intermediation system);
- each major block should try to combine provisions which are linked into one chapter, which means that the draft of each article should avoid, as much as possible, any cross references to other articles, especially if they are located in other chapters.

Several combinations between the above mentioned blocks are possible. As discussed on Monday's session, the American and the French delegations submitted separate reorganization proposals (in documents 29 and 34 respectively). We are pleased to announce the following joint effort.

- **Chapter I and V** remain as they stand in the convention with their structure unchanged
- A **second Chapter** deals with the issue of transfer of rights (whether outright or by way of security interest) which is closely linked to the book-entry mechanisms used for these transfers of rights and to the respective priorities of these rights. Thus, we propose the following structure for this new chapter II:

CHAPTER II	Transfer of intermediated securities
Article 4 (5)	Acquisition and disposition of intermediated securities
Article 5 (6)	Security interest in intermediated securities
Article 6 (10)	Priority among competing interests
Article 7 (11+7.6&7.7)	Protection of innocent acquirer
Article 8 (7+15)	Authorisation, timing, conditionality and reversal

A **third chapter** covers the entitlement and enforcement of rights by the account holder and the ways these rights are protected relative to the insolvency of the intermediary (which is the critical test for assessing the soundness of the protection offered to these rights) as well as relative to issuers (which is the issue of the impact of the intermediation on the rights of the account holder). Thus, we propose the following structure for this new chapter III :

CHAPTER III	Rights of the account holder
Article 9 (4)	Enjoyment and exercise of rights
Article 10 (12+14)	Rights of account holder in case of insolvency of the intermediary
Article 11 (19+20)	Relations with the issuer

A **fourth chapter** assembles the various rules which aim at protecting the whole chain of intermediation, so that it covers the specific rules that can be implemented within clearing and settlement systems (by merging the old Articles 8 and 13 since they address the same subject-matter), the rule on the prohibition against upper-tier attachment in the chain, the rules concerning the intermediary's general duties in respect of crediting securities to accounts, the rules on the allocation of securities and those on distribution in the case of shortfall of securities. Thus, we propose the following structure for this new chapter IV :

CHAPTER IV	Protection mechanisms of the intermediation system
Article 12 (8+13)	Specific rules of settlement systems
Article 13 (9)	Prohibition of upper-tier attachment
Article 14 (16)	Duty of intermediary with respect to holding or credit of securities
Article 15 (17)	Allocation of securities to account holder
Article 16 (18)	Allocation rules in case of insufficiency of securities

ATTACHMENT

PROPOSAL FOR A NEW PLAN

CHAPTER I	Definitions, scope of application and interpretation (structure unchanged)
Article 1 (1) ¹	Definitions
Article 2 (2)	Scope of application
Article 3 (3)	Principles of interpretation
CHAPTER II	Transfer of intermediated securities
Article 4 (5)	Acquisition and disposition of intermediated securities
Article 5 (6)	Security interest in intermediated securities
Article 6 (10)	Priority among competing interests
Article 7 (11+7.6&7.7)	Protection of innocent acquirer
Article 8 (7+15)	Authorisation, timing, conditionality and reversal
CHAPTER III	Rights of the account holder
Article 9 (4)	Enjoyment and exercise of rights
Article 10 (12+14)	Rights of account holder in case of insolvency of the intermediary
Article 11 (19+20)	Relations with the issuer
CHAPTER IV	Protection mechanisms of the intermediation system
Article 12 (8+13)	Specific rules of settlement systems
Article 13 (9)	Prohibition of upper-tier attachment
Article 14 (16)	Duty of intermediary with respect to holding or credit of securities
Article 15 (17)	Allocation of securities to account holder
Article 16 (18)	Allocation rules in case of insufficiency of securities
CHAPTER V	Special provisions on security interests (structure unchanged)
Article 17 (22)	Enforcement
Article 18 (23)	Re-use
Article 19 (24)	Top-up or substitution of collateral
Article 20 (25)	Declaration in respect of Chapter V

¹ Numbers between brackets refers to the numbering of Document 24.

**REPORT OF THE UNIDROIT INFORMAL WORKING GROUP ON THE RULE
PRECLUDING UPPER-TIER ATTACHMENT [ARTICLE 9]**

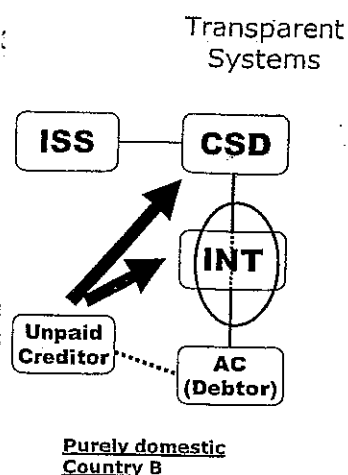
Proposed Article 9 of the draft UNIDROIT Convention is a rule that prevents creditors of an *account holder-debtor* to attach the debtor's intermediated securities on a tier other than the debtor's immediate intermediary (i.e., the relevant intermediary). It is generally recognized that a rule precluding upper-tier attachment is fundamental to the objectives of the Convention (e.g., reduction of systemic risk).

However, concerns were expressed at the meeting of the second session of the Committee of Governmental Experts (CGE) about the impact of that rule on so-called *transparent systems* in certain jurisdictions. In those jurisdictions, attachment at the CSD level is allowed and, in fact, may be the only practical means to seize or otherwise attach a lower-tier account holder's interest in intermediated securities. Also, transparent systems are thought to facilitate the jurisdiction's supervisory, prudential and regulatory oversight of intermediaries and its monitoring of financial crime activities (e.g., money laundering).

In transparent systems, the CSD maintains accounts and sub-accounts that separately identify each lower-tier account holder's interest in intermediated securities held through the CSD. In essence, there are no omnibus accounts maintained or fungible bulks held at the CSD level. The account holder-debtor's immediate intermediary and any other intermediary in the chain between the CSD and ultimate account holder-debtor ("local broker/agents") are not, strictly speaking, maintaining securities accounts for the debtor or others. However, it is unclear whether the local broker/agents would be considered "intermediaries" under the Convention. It is also unclear whether the CSD would be considered to be maintaining a securities account for the debtor – even if the local broker/agents are not considered intermediaries – because there is no direct relationship between the CSD and the debtor.

Given this ambiguity, the working group considered the question of whether the Convention should accommodate an exception to the general rule and allow a form of upper-tier attachment for domestic transparent systems, i.e., where the local CSD, local broker/agents and ultimate account holders are all within a single jurisdiction.

While an exception might be possible, the difficulty is that most domestic holding patterns have a cross-border component of one form or another.



The working group discussed the following possible solutions/ideas:

1. The definition of "intermediary" could be revised to more precisely describe the functions of an intermediary and distinguish between *true* intermediaries and entities that merely act as agents or managers (or in some other administrative capacity) of the ultimate account holder-debtor's securities account maintained by the CSD.

2. The Convention could include interpretive provisions roughly along the lines of the Hague Convention's provisions that *deem* certain entities to be "intermediaries" and others not. It could also include provisions *deeming* certain types of CSDs to be "relevant intermediaries" of lower-tier account holder-debtors merely for the purposes of the upper-tier attachment rule.

3. The Convention could include provisions that permit a Contracting State to make a declaration that local brokers/agents will not be considered intermediaries for the purposes of the Convention with respect to securities accounts maintained by the local CSD governed by the law of that State where the local CSD system identifies at the top tier the precise interests held at a tier below that of the local broker/agents. The working group discussed whether such a declaration mechanism should apply for all purposes of the Convention or only Article 9. It was generally thought that a declaration limited for the purposes of Article 9 only – i.e., where the local broker/agents would not be considered intermediaries for the upper-tier attachment rule but would be so considered for other purposes of the Convention – might not be appropriate. In addition, some consideration may be given to a declaration mechanism for designating certain types of CSDs to be "relevant intermediaries" of lower-tier account holder-debtors, but only for the purposes of the upper-tier attachment rule.

The working group is tabling these solutions/ideas for the CGE's and drafting committee's consideration. We acknowledge that these may not fully resolve the issue, but hope they are useful nonetheless. Members of the working group have urged the delegations that raised this issue to consider submitting further solutions or ideas to the CGE.

Finally, it may be helpful to emphasize that the scope of the Convention should not affect a Contracting State's domestic non-Convention law governing regulatory, supervisory, criminal and other public policy issues.

**PROPOSAL FOR THE INSERTION OF AN ACCESSION CLAUSE FOR
REGIONAL ECONOMIC INTEGRATION ORGANISATIONS**

(submitted by the European Union)

Subsequent to the declaration made by the delegation of the European Commission at the opening session of these negotiations in relation to the competence of the European Union to negotiate parts of this draft Convention on behalf of its Member States, the European Union would like the draft Convention to contain appropriate provisions enabling it to be a party thereto on a par basis with other parties.

The relevant provision could be as follows:

Article X Regional Economic Integration Organisations

- 1. A Regional Economic Integration Organisation which is constituted by sovereign States and has competence over certain matters governed by this Convention may similarly sign, accept, approve or accede to this Convention. The Regional Economic Integration Organisation shall in that case have the rights and obligations of a Contracting State, to the extent that that Organisation has competence over matters governed by this Convention. Where the number of Contracting States is relevant in this Convention, the Regional Economic Integration Organisation shall not count as a Contracting State in addition to its Member States which are Contracting States.*
- 2. The Regional Economic Integration Organisation shall, at the time of signature, acceptance, approval or accession, notify the Depositary in writing specifying the matters governed by this Convention in respect of which competence has been transferred to that Organisation by its Member States. The Regional Economic Integration Organisation shall promptly notify the Depositary in writing of any changes to the distribution of competence specified in the notice in accordance with this paragraph and any new transfer of competence.*
- 3. Any reference to a "Contracting State" or "Contracting States" in this Convention applies equally to a Regional Economic Integration Organisation where the context so requires.*

***PROPOSAL FOR THE INSERTION OF A REGULATORY CLAUSE IN THE
CONVENTION***

(submitted by the European Union)

We have approached this draft as being exactly what it says, a Convention on harmonised substantive law. That name implies to us that this is not a Convention about the law of regulation, of supervision and of oversight.

We have heard and read during this session various comments that reveal a common view that this is indeed the case. However, our recent work, especially in analysing the detail of other contemporary conventions, has made it clear to us that such an interpretation - the split between substance and regulation – is not always certain, unless it is expressly provided for in the main text or the recitals of such conventions.

We would therefore like this Convention to include a new provision or a clarification in its recitals, of an explanatory nature perhaps, that puts it beyond any doubt that this Convention has no impact on, and does not limit the powers of, Contracting States in relation to matters of regulation, supervision and oversight, which are not expressly covered by it.

We suggest that, if this idea is broadly approved, the drafting committee should be asked to suggest appropriate wording for this.

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

CHAPTER I - DEFINITIONS, SCOPE OF APPLICATION AND INTERPRETATION

Article 1

[Definitions]

In this Convention:

(a) *"securities"* means any shares, bonds or other transferable financial instruments or financial assets (other than cash) or any interest therein, which are capable of being credited to a securities account;

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

(c) *"intermediary"* means a person that in the course of a business or other regular activity maintains securities accounts for others or both for others and for its own account and is acting in that capacity;

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

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

(f) *"intermediated securities"* means the rights of an account holder resulting from a credit of securities to a securities account¹;

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

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

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

¹ This definition remains under consideration. Questions have been raised, for example, as to the appropriateness of the particular term "intermediated securities", as to whether it should be replaced by "intermediated rights", and as to whether the definition should be expanded so as to include terms that currently form part of Article 4.

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

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

(l) securities are *"of the same description"* as other securities if they are issued by the same issuer and:

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

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

(m) *"control agreement"* means an agreement between an account holder, the relevant intermediary and a collateral taker, or, if so permitted by the domestic non-Convention law, an agreement between an account holder and a collateral taker of which notice is given to the relevant intermediary, which relates to intermediated securities and provides that, in such circumstances and as to such matters as may be specified in the agreement or provided by the domestic non-Convention law, the relevant intermediary is not permitted to comply with any instruction given by the account holder without having received the consent of the collateral taker, or is obliged to comply with any instructions given by the collateral taker without any further consent of the account holder~~includes either or both of the following provisions:-~~

~~————— (i) — that the relevant intermediary is not permitted to comply with any instructions given by the account holder in respect of the intermediated securities to which the agreement applies without having received the consent of the collateral taker;~~

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

(n) *"designating entry"* means an entry in favour of a collateral taker in a securities account made in favour of a collateral taker in respect of the securities account or in respect of specified securities credited to the securities account, in respect of specified intermediated securities which, under the account agreement, a control agreement or the domestic non-Convention law, has the effect that, in specified circumstances and as to specified matters~~either or both of the following effects:-~~

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

~~————— (ii) — that the relevant intermediary is obliged to comply with any instructions given by the collateral taker in respect of the intermediated securities in relation to which the entry is made in such circumstances and as to such matters as may be provided by the account agreement, a control agreement or the domestic non-Convention law, without any further consent of the account holder;~~

(o) *"domestic non-Convention law"* means the domestic provisions of law of the State whose law is applicable under Article 2, other than those provided in this Convention;-

(p) "non-consensual security interest" [to be defined];

(q) "securities settlement [or clearing] system" means [a system] [an entity] which:

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

_____ (ii) [has rules and agreements with its participants that are publicly accessible];

_____ (iii) is operated by a central bank or conducts operations that are supervised [by a regulator that has oversight over its rules and agreements];

_____ (iv) has been notified as a securities settlement [or clearing] system in a declaration by a Contracting State, [or falls within a category of [systems] [entities] that have been notified as securities settlement [or clearing] systems in a declaration by a Contracting State and has been specifically identified as falling within that category in a publicly accessible website of its regulator which also specifies the date on which it first was designated as falling within that category];

provided that a declaration referred to in this sub-paragraph must be made on the grounds of the reduction of risk to the stability of the financial system;

_____ (r) "collateral taker" means a person to whom a security interest in intermediated securities is granted;

_____ (s) "collateral provider" means an account holder by whom a security interest in intermediated securities is granted;

_____ (t) "collateral agreement" means an agreement between a collateral provider and a collateral taker providing (in whatever terms) for the grant of a security interest in intermediated securities.

Article 2

[Scope of application]

This Convention applies where rules of private international law of the forum state designate the law of a Contracting State.

Article 3

[Principles of interpretation]

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

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

CHAPTER II – INTERMEDIATED SECURITIES

Article 4

[Intermediated securities]

1. - The credit of securities to a securities account confers on the account holder:

(a) ~~subject to paragraph 2,~~ the right to receive and exercise the rights attached to the securities, including in particular dividends, other distributions and voting rights

~~_____ (i) where the account holder is not an intermediary or is an intermediary acting for its own account; and,~~

~~_____ (ii) in any other case, if the domestic non-Convention law so provides.~~

~~(b) the right, by instructions to the relevant intermediary, to dispose of cause the securities in accordance with to be debited to the securities account under Articles 5 and 6 and credited to a securities account of another account holder (whether with the relevant intermediary or another intermediary) or to be delivered into the possession or control of a collateral taker under Article 6;~~

~~_____ (c) the right, by instructions to the relevant intermediary, to cause the securities to be debited to the securities account under Article 5 and credited to a securities account of the account holder with a different intermediary;~~

~~(d)(c) the right, by instructions to the relevant intermediary, to cause the withdraw the securities so as to be held by the account holder otherwise than through a securities account, to the extent permitted under the law under which the securities are constituted, the terms of the securities and the account agreement;~~

~~_____ (e)(d) subject to this Convention, such other rights as may be conferred by the domestic non-Convention law.~~

~~2. Where securities are credited to a securities account of an account holder who is acting in the capacity of intermediary with respect to those securities, that account holder has the rights specified in paragraph 1(a) only if that account holder, or another intermediary through which, directly or indirectly, it holds the relevant securities, is entitled to those rights against the issuer under the terms of the relevant securities and the law under which the relevant securities are constituted.~~

~~3.~~

~~2. - Unless otherwise provided in this Convention, without prejudice to Article 15 and Article 19, the rights referred to in paragraph 1:~~

~~(a) the rights referred to in paragraph 1 are effective against the relevant intermediary and third parties; and~~

~~_____ (b) the rights referred to in paragraph 1(a) may be enforced exercised against the relevant intermediary or the issuer of the securities, or both, and, to the extent provided by in accordance with this Convention, the terms of the relevant securities and the law under which the relevant securities are constituted; the issuer of the relevant securities.~~

~~_____ (c) the rights referred to in paragraph 1(b) and 1(c) may be exercised only against the relevant intermediary.~~

~~3[7. - Where securities are credited to a securities account of an account holder in the capacity of collateral taker under Article 6, the domestic non-Convention law determines any limits on the rights described in paragraph 1.~~

~~] 4. Subject to paragraph 5 and paragraph 6, an intermediary must take appropriate measures to enable its account holders to receive and exercise the rights specified in paragraph 1.~~

Article 4bis
[Measures to enable account
holders to receive and exercise rights]

1. - An intermediary must take appropriate measures to enable its account holders to receive and exercise the rights specified in Article 4(1), but this obligation does not require the relevant intermediary to take any action that is not within its power or to establish a securities account with another intermediary. ~~[Version A-~~

~~5. - Where the enjoyment of any of the rights referred to in paragraph 1 depends on the actions of the relevant intermediary, the scope of those rights is limited to such an extent as is necessary to ensure that the relevant intermediary is not required to take any action that is not within its power. This does not affect any right of the account holder against the issuer of the relevant securities conferred by this Convention, the terms of the relevant securities and the law under which the relevant securities are constituted.~~

~~6. - The manner of performance of any obligations of the relevant intermediary in respect of the rights of an account holder under paragraph 1, and the extent of the liability of the relevant intermediary for any failure to perform such obligations, are governed by the account agreement, the law by which the account agreement is governed and any applicable provision of the domestic non-Convention law.]~~

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

~~[Version B-~~

~~5. - To the extent that the rights referred to in paragraph 1 are dependent on the actions of the relevant intermediary, the account holder is not entitled to any such right to the extent that giving effect to the right:~~

~~(a) is not within the power of the relevant intermediary;~~

~~(b) would require the relevant intermediary to act in a manner that is [more burdensome than reasonable commercial standards or that is] not permitted by any applicable law or by the terms of the relevant securities;~~

~~(c) would require the relevant intermediary to establish a securities account with another intermediary; or~~

~~(d) is waived by the account holder in a manner permitted by the domestic non-Convention law.~~

~~6. - Subject to any applicable provision of the domestic non-Convention law, any obligation of the relevant intermediary in respect of the rights of the account holder under paragraph 1 shall be satisfied if the relevant intermediary acts with respect to that obligation:~~

~~(a) in accordance with the account agreement or, if there is no account agreement, in accordance with [reasonable commercial standards];~~

~~(b) in accordance with any other agreement between the account holder and the relevant intermediary; or~~

~~(c) by placing the account holder in a position itself to exercise any relevant right referred to in paragraph 1.]~~

~~— [7. - Where securities are credited to a securities account of an account holder in the capacity of collateral taker under Article 6, the domestic non-Convention law determines any limits on the rights described in paragraph 1.]~~

Article 5

[Acquisition and disposition of intermediated securities]

1. - Intermediated securities are acquired by an account holder by the credit of securities to that account holder's securities account.

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

3. - Intermediated securities are disposed of by an account holder by the debit of securities to that account holder's securities account.

4. - Without prejudice to any rule of the domestic non-Convention law requiring that no credit or debit be made without a corresponding debit or credit, a debit or credit of securities to a securities account is not ineffective because it is not possible to identify a securities account to which a corresponding credit or debit has been made.

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

6. - This Article does not preclude any other method provided by the domestic non-Convention law for the acquisition or disposition of intermediated securities, ~~but the priority of an interest created by any such other method is subject to the rules in Article 10.~~

Article 6

[Security interests in intermediated securities]

1. - An account holder may grant to ~~a another person ("the collateral taker")~~ a security interest in intermediated securities ~~held by that account holder~~ so as to be effective against third parties by:

(a) entering into a collateral ~~n~~-agreement with the collateral taker ~~providing (in whatever terms) for the grant of such a security interest; and~~

(b) ~~delivering the intermediated securities into the possession or control of the collateral taker in accordance with paragraph 2;~~

and no further step is necessary, or may be required by the domestic non-Convention law, ~~to render a security interest so granted effective against third parties.~~

2. - Intermediated securities shall be treated as delivered ~~into the possession or control of a collateral taker if:-~~

~~— (a) the relevant securities— they are credited to a securities account of the collateral taker, [(in which case the provisions of Article 5 apply)];-~~

3. - Intermediated securities shall also be treated as delivered to a collateral taker -

_____ (a)(b) if the relevant intermediary is itself the collateral taker and the relevant Contracting State has made a declaration under paragraph 4 in respect of this sub-paragraph;

(b)(c) if a designating entry in favour of the collateral taker has been made and in the securities account in respect of the relevant intermediated securities and the making

~~of such a designating entry is specified in a declaration by the relevant~~ the relevant Contracting State has made a declaration under paragraph 4 in respect of this sub-paragraph; ~~as sufficient to result, under the law of that Contracting State, in the intermediated securities being in the possession or control of the collateral taker; or~~

~~(c)(d) if a control agreement with the collateral taker applies to the relevant intermediated securities and the application of such a control agreement is specified in a declaration by the relevant Contracting State under paragraph 4 as sufficient to result, under the law of that Contracting State, in the intermediated securities being in the possession or control of the collateral taker and the relevant Contracting State has made a declaration under paragraph 4 in respect of this sub-paragraph.~~

4. - A Contracting State may ~~by declaration that under its domestic non-Convention law the condition specified in any one or more of sub-paragraphs (a) to (c) of paragraph 3 is sufficient, to constitute delivery of intermediated securities to a collateral taker;~~

~~(a) state which of the conditions specified in paragraph 2(c) to (e) is sufficient, under the law of that Contracting State, to result, under the law of that Contracting State, in intermediated securities being in the possession or control of a collateral taker and describe the requirements under the law of that Contracting State for an effective designating entry or an effective control agreement; and, or alternatively~~

~~(b) describe the manner of holding or designation of securities credited to a securities account which, under the law of that Contracting State, is sufficient to result in the corresponding intermediated securities being in the possession or control of a collateral taker for the purposes of paragraph 2(f);~~

5. - A Contracting State ~~may declare that under its domestic non-Convention law may~~ by declaration elect that this Article shall not apply in relation to security interests in intermediated securities granted by or to parties of such descriptions as may be falling within such categories as may be specified in the declaration.

~~63. - If the domestic non-Convention law so permits, A~~ a security interest may be granted under this Article =

~~(a) in terms such that it extends to~~ in respect of a securities account (and such a security interest extends to all intermediated securities from time to time standing to the credit of the relevant securities account); or,

~~(b) if the domestic non-Convention law so permits, to~~ in respect of a specified category, quantity, proportion or value of such the intermediated securities from time to time standing to the credit of a securities account. Such a security interest is effective without the need for further identification of particular securities.

~~76. - The domestic non-Convention law determines:~~

~~(a) whether and in what circumstances a non-consensual security interest in intermediated securities may arise by operation of law and become effective against third parties; and~~

~~(b) the evidential requirements in respect of whether a collateral agreement such an agreement as is referred to in paragraph 1(a) or and the delivery of intermediated securities into the possession or control of a collateral taker is required to be evidenced in writing or in a legally equivalent manner and whether such evidence must permit the identification of intermediated securities so delivered.~~

~~87.~~ - This Article does not preclude any other method provided by the domestic non-Convention law for the grant of a security interest in intermediated securities, but the priority of a security interest granted by any such other method is subject to the rules in Article 10.

Article 7

[Authorisation, ~~timing~~, conditionality and reversal of debits, credits etc.]

1. - A debit ~~or credit~~ of securities to a securities account or a designating entry is not effective unless the relevant intermediary is authorised to make that debit, ~~credit~~, or designating entry:

(a) by the account holder and, in the case of a debit or designating entry that relates to intermediated securities which are subject to a security interest ~~arising~~ granted under Article 6(3), by the collateral taker; or

(b) by the domestic non-Convention law.

~~2. - Except as otherwise provided by paragraph 4, a debit or credit of securities to a securities account or a designating entry takes effect when it is made.~~

~~3. - The time at which intermediated securities shall be treated as delivered into the possession or control of a collateral taker is as follows:~~

~~(a) in the circumstances specified in Article 6(2)(a), when the relevant securities are credited to a securities account of the collateral taker;~~

~~(b) in the circumstances specified in Article 6(2)(b), when the agreement between the account holder and the relevant intermediary by which the security interest is granted is entered into;~~

~~(c) in the circumstances specified in Article 6(2)(c), (d) or (e), when the relevant condition is fulfilled;~~

~~(d) in the circumstances specified in Article 6(2)(f), when the relevant securities are held or designated in the manner described in the declaration of the relevant Contracting State referred to in Article 6(4).~~

~~25. - The domestic non-Convention law and, to the extent permitted by the domestic non-Convention law, an account agreement or the rules and agreements governing the operation of a settlement [or clearing] system, An account agreement, the rules of a clearing or settlement system or the domestic non-Convention law may provide that a debit or credit of securities or a designating entry is not effective or is liable to be reversed. [The domestic non-Convention law determines whether such a debit, credit or designating entry has any effect against third parties during the period before it is reversed and, if so, what that effect is.]~~

~~3. - Subject to Article [11], the domestic non-Convention law determines -~~

~~(a) where a debit or designating entry is not authorised or a debit, credit or designating entry is otherwise ineffective, the consequences of such ineffectiveness.~~

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

~~4. - A debit or credit of securities which is made conditionally under the terms of an account agreement, the rules of a securities clearing or settlement system or the domestic non-Convention law is effective against third parties when, and only when, the condition is satisfied[-; but if the condition is satisfied, the relevant disposition or acquisition of intermediated securities~~

~~is treated for the purposes of Article 10 as having become effective against third parties when the relevant debit or credit was made conditionally].~~

~~{Article 8~~

~~[Overriding effect of certain rules of securities settlement [or clearing]~~clearing or settlement systems]~~~~

Any provision of the rules or agreements governing the operation of a securities ~~settlement [or clearing] or settlement~~ system [which is directed to the stability of the system or the finality of ~~dispositions~~ transactions effected through the system] shall, to the extent of any inconsistency, prevail over ~~{any provision of~~ in ~~[Articles 7, X, Y, ...7] [any provision of this Convention].}~~

Article 9

[Prohibition of upper-tier attachment]

1. - No attachment of or in respect of intermediated securities of an account holder shall be granted or made against the issuer of the relevant securities or against any intermediary other than the relevant intermediary.

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

Article 10

[Priority among competing security interests]

1. - This Article determines priority between security interests in the same intermediated securities.

2. - Security interests that become effective against third parties arising under Article 5 and Article 6(3):

(a) have priority over any security interest that becomes effective against third parties created by any method permitted by the domestic non-Convention law other than those provided by Article 6(2) or (3) Article 5 or Article 6; and

(b) rank among themselves according to the time of in the order occurrence of the following events: in which they were created:

_____ (i) when the collateral agreement is entered into, if the relevant intermediary is itself the collateral taker;

_____ (ii) when a designating entry is made;

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

3. - Where an intermediary enters into a control agreement with a collateral taker or makes a designating entry in favour of a collateral taker, the security interest of the collateral taker has priority over any security interest of the intermediary that is effective against third parties under Article 6(3).

42. - ~~—~~ An non-consensual security interest in intermediated securities arising or recognised by operation of law under any rule of the domestic non-Convention law has such priority as is afforded to it by that law ~~the rule in question.~~

53. - Subject to paragraph ~~21~~ and paragraph ~~2~~, the priority of any competing security interests in the same intermediated securities is determined by the domestic non-Convention law.

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

CHAPTER III – PROTECTION OF INNOCENT ACQUIRER

Article 11

[Acquisition by an innocent person of intermediated securities]

1. - ~~Where securities are credited A person who acquires intermediated securities by credit to a securities account under Article 5 or who acquires a security interest in such securities by an agreement or designation under Article 6, and who the account holder does not at the time of acquisition the credit have knowledge of an adverse claim with respect to the securities,~~

(a) the account holder is not subject to the ~~at~~ adverse claim;

(b) the account holder is not liable to the holder of the adverse claim; and

(c) the credit is not ineffective or reversible on the ground that the adverse claim² affects any previous debit or credit made to another securities account.

2. - Paragraph 1 does not apply in respect of an acquisition of securities, other than the grant of a security interest, made, ~~or the creation of a security interest effected,~~ by way of gift or otherwise gratuitously.

3. - An intermediary who makes a debit, credit, or designating entry to a securities account is not liable to the holder of an adverse claim with respect to intermediated securities unless at the time of such debit, credit or designating entry the intermediary has knowledge of the adverse claim.

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

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

² Further consideration to be given to whether to deal specifically with adverse claims of the intermediary (e.g. by amending the definition of adverse claim).

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

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

[5. - Notwithstanding Article 7[(3)], if:

(a) securities have been credited to a securities account of an account holder, or have been designated in favour of another person in the manner described in Article 6, in circumstances such that the credit or designating entry is not effective or is liable to be reversed; and

(b) before that credit or designating entry has been [cancelled or] reversed, the securities are credited to a securities account of a third party, or are designated in the manner described in Article 6 in favour of a third party (such a third party being in either case referred to in this sub-paragraph as "the acquirer"), under a further disposition,

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

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

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

(iii) the further disposition is made by way of gift or otherwise gratuitously.]³

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

CHAPTER IV - INSOLVENCY

Article 12

[Rights of account holders on insolvency of intermediary]

The rights of an account holder under Article 4(1) constituted by the credit of securities to a securities account, and the rights of a person a security interest that has become effective against third parties holding a security interest created under Article 6(2) or (3), are effective

³ Further consideration to be given to whether there should be a more general protection against reversal based on reversal etc. of earlier transactions; paragraphs 4 and 5 reproduce Article 7(6) and (7) of Doc.24.

against the insolvency administrator and creditors in any insolvency proceeding in respect of the relevant intermediary.

Article 13

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

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

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

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

2. - Paragraph 1 applies notwithstanding that any invalidation, reversal or revocation referred to in that paragraph would otherwise occur by mandatory operation of the insolvency law of a Contracting State.}

Article 14

[Effects of insolvency]

Subject to Article 13 and Article 24, nothing in this Convention affects:

(a) any rules of law applicable in insolvency proceedings relating to the avoidance of a transaction as a preference or a transfer in fraud of creditors; or

(b) any rules of procedure relating to the enforcement of rights to property which is under the control or supervision of an insolvency administrator.

CHAPTER V – DUTIES OF INTERMEDIARY

Article 15

[Instructions]

1. - Subject to paragraph 2 [and Article 7(1)], an intermediary is neither bound nor entitled to give effect to any instructions with respect to intermediated securities of an account holder given by any person other than that account holder.

2. - Paragraph 1 is subject to:

(a) the provisions of the account agreement, any other agreement between the intermediary and the account holder or any other agreement entered into by the intermediary with the consent of the account holder;

(b) the rights of any person (including the intermediary) who holds a security interest created under Article 6;

(c) subject to Article 9, any judgment, award, order or decision of a court, tribunal or other judicial or administrative authority of competent jurisdiction;

(d) any mandatory rule of the domestic non-Convention law; and

(e) where the intermediary is [the operator of] a securities settlement [or clearing] ~~or settlement~~ system, the rules of that system.

Article 16⁴

~~[Requirement to hold sufficient securities]~~*Duty of intermediary with respect to holding or credit of securities]*

~~1. - An intermediary may not:~~

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

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

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

1. - An intermediary must, for each description of securities, hold securities and intermediated securities of an aggregate number and amount at least equal to the aggregate number and amount of securities of that description credited to securities accounts which it maintains [for account holders]⁵.

2. - If at any time an intermediary does not hold sufficient securities and intermediated securities of any description are not held by an intermediary in accordance with paragraph 1 or credited to securities accounts which it maintains with another intermediary, it must [immediately] [promptly] take such action as is required to ensure that it holds sufficient securities and intermediated securities of that description are so held or credited.

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

3. - The preceding paragraphs Paragraph 2 does not affect any provision of the domestic non-Convention law, or, subject to the domestic non-Convention law, any provision of the rules of a securities settlement [or clearing] or settlement system or of an account agreement, relating to the allocation of the cost of ensuring compliance with the requirements of those paragraphs.

⁴ Articles 16, 17 and 18 are subject to modification in the light of further discussion of and possible changes to Articles 7, 10 and 11.

⁵ The square brackets in paragraph 1 reflect the need to ensure that the Convention does not relax more stringent requirements under a domestic non-Convention law that might, for example, require the intermediary to maintain with another intermediary securities sufficient to reflect securities that the intermediary carries on its books for its own account. Consideration may be given to addressing this issue more generally in the convention.

*Article 16bis**[Application of domestic non-Convention law and account agreement to obligations of intermediary]*

The obligations and duties of an intermediary under this Convention and the extent of the liability of an intermediary are subject to any applicable provision of the domestic non-Convention law and, to the extent permitted by that law, the account agreement.

~~[5. - The fact that a credit or disposition is made in contravention of paragraph 1 does not render that credit or disposition ineffective, but:~~

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

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

*Article 17**[Allocation of securities to account holders' rights: securities so allocated not property of the intermediary]*

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

~~{2. - Securities allocated under paragraph 1 shall not form part of the property of the intermediary available for distribution among or realisation for the benefit of its unsecured creditors in the event of an insolvency proceeding in respect of the intermediary or be otherwise subject to claims of unsecured creditors of the intermediary.}~~

3. - Subject to paragraph 4, the allocation required by paragraph 1 shall be effected by the domestic non-Convention law and, subject to the domestic non-Convention law, by arrangements made by the relevant intermediary.

~~4. - A Contracting State may by declaration elect that the allocation required by paragraph 1 shall be effected by arrangements for the segregation of securities held by the relevant intermediary or credited to securities accounts held by the relevant intermediary with another intermediary sufficient to ensure, under the law of that Contracting State, that the securities so segregated are allocated to the rights of the account holders of the relevant intermediary.~~

4. - A Contracting State may declare that under its domestic non-Convention law the allocation required by paragraph 1 applies only to securities that are held by the relevant intermediary with another intermediary under an arrangement for the segregation of securities held by the relevant intermediary for the benefit of its account holders and does not apply to securities held with another intermediary for the relevant intermediary's own account.

Article 18

[Loss sharing in case of insolvency of the intermediary; Effect of insufficiency of securities held in respect of account holders' rights]

1. - In any insolvency proceeding in respect of an intermediary, if the aggregate number or amount of securities and intermediated securities of any description held by an intermediary or credited to a securities account that it holds with another intermediary is less than the aggregate number or amount of securities of that description credited to securities accounts, the shortfall shall be allocated:

— and

(a) subject to sub-paragraph (b), shall be allocated among the account holders to whose securities accounts securities of the relevant description are credited, in proportion to the respective numbers or amounts of securities so credited; or

(b) where the intermediary is [the operator of] a securities settlement [or clearing] or settlement system and the rules or agreements governing the operation of the system make provision for the allocation of the shortfall, shall be allocated in the manner so provided.

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

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

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

3. - The preceding paragraphs are subject to any conflicting rule applicable in the insolvency proceeding of the intermediary.

CHAPTER VI – RELATIONS WITH ISSUERS OF SECURITIES

Article 19

[Position of issuers of securities]

1. - The law of a Contracting State shall permit the holding through intermediaries of securities that are permitted to be traded on an exchange or regulated market, and the effective exercise of the rights attached to such securities which are so held. This is without prejudice to the terms of issue of the securities. — 1. — Any rule of law of a Contracting State, and any provision of the terms of issue of securities constituted under the law of a Contracting State, which would prevent the holding of securities with an intermediary or the effective exercise by an account holder of rights in respect of intermediated securities shall be modified to the extent required to make possible the holding of such securities with an intermediary and the effective exercise of such rights.

2. - In particular, the law of a Contracting State shall recognise the holding of securities described in paragraph 1 by a person acting in his own name on behalf of another person (including a nominee) and shall permit such a person to exercise voting or other rights in different ways in respect of different parts of a holding of securities of the same description.

~~2. - Without limiting the generality of Paragraph 1, that paragraph applies in particular to any rule or provision:~~

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

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

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

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

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

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

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

~~[3. - Subject to paragraph 1 and paragraph 2, nothing in this Convention makes an issuer of securities bound by, or compels such an issuer to recognise, a right or interest of any person in or in respect of such securities if the issuer is not bound by or compelled to recognise that right or interest under the law under which the securities are constituted and the terms of the securities.]~~

Article 20

[Set-off]

1. - As between an account holder who holds intermediated securities for its own account and the issuer of those securities, the fact that the account holder holds the securities with an intermediary shall not of itself, in any insolvency proceeding in respect of the issuer, preclude the existence or prevent the exercise of any rights of set-off which would have existed and been exercisable if the account holder had held the securities otherwise than through an intermediary.

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

**CHAPTER VII – SPECIAL PROVISIONS WITH RESPECT TO
COLLATERAL TRANSACTIONS⁶**

Article 21

[Scope and interpretation of terms used in Chapter VII]

1. - This Chapter applies to collateral agreements under which a collateral provider delivers intermediated securities to a collateral taker under Article 6(2) or Article 6(3) in order to secure the performance of any existing or future obligation of the collateral provider or a third person.

2. - In this Chapter –

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

(b) “*collateral securities*” means intermediated securities delivered under a collateral agreement;

(c) “*secured obligations*” means the obligations secured by a collateral agreement.

In this Chapter:

(a) “*collateral agreement*”, “*collateral provider*”, “*collateral taker*”, “*collateral securities*” and “*secured obligations*” have the meanings respectively given in Article 22(1);

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

Article 22

[Enforcement]

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

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

(a) present or future, actual or contingent or prospective obligations (including obligations arising under a master agreement, whether under a provision for the acceleration or close out of obligations or otherwise);

(b) obligations to deliver securities or other property;

(c) obligations owed to the collateral taker by a person other than the collateral provider;

(d) obligations of a specified description arising from time to time.]

⁶ Further consideration will be given to the terminology of this Chapter and its consistency with that of the remainder of the preliminary draft Convention.

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

(a) by selling them and applying the net proceeds of sale in or towards the discharge of the secured obligations;

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

24. - Collateral securities may be realised under paragraph 13:

(a) subject to any contrary provision of the collateral agreement, without any requirement that:

(i) prior notice of the intention to realise shall have been given;

(ii) the terms of the realisation be approved by any court, public officer or other person; or

(iii) the realisation be conducted by public auction or in any other prescribed manner; and

(b) notwithstanding the commencement or continuation of an insolvency proceeding in respect of the collateral provider or the collateral taker.

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

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

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

45. - This Article Paragraph 3 and paragraph 4 are is without prejudice to any requirement of the domestic non-Convention law to the effect that the realisation or valuation of financial collateral securities and or the calculation of any the relevant financial obligations must be conducted in a commercially reasonable manner.

Article 23

[Right to use collateral securities]

1. - If and to the extent that the terms of a collateral agreement so provide (or, where collateral securities are delivered to the collateral taker under Article 6(2), if and to the extent that the terms of the collateral agreement do not provide otherwise), the collateral taker shall have the right to use and dispose of the collateral securities as if it were the owner of them (a "right of use").

2. - Where a collateral taker exercises a right of use, it thereby incurs an obligation to replace the collateral securities originally transferred (the "*original collateral securities*") by transferring to the collateral provider, not later than the discharge of the secured obligations, securities of the same issuer or debtor, forming part of the same issue or class and of the same nominal amount, currency and description or, where the collateral agreement provides for the transfer of other assets [following the occurrence of any event relating to or affecting any securities provided as collateral], those other assets.

3. - Securities transferred under paragraph 2 before the secured obligations have been fully discharged:

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

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

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

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

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

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

Article 24

[Top-up or substitution of collateral]

Where a collateral agreement includes:

(a) an obligation to deliver collateral securities or additional collateral securities [in order to take account of changes in the value of the collateral provided under the relevant collateral agreement or in the amount of the secured obligations] [~~in order to take account of any circumstances giving rise to an increase in the credit risk incurred by~~ of the collateral taker] for, to the extent permitted by the applicable law as determined by the private international law rules of the forum, in any other circumstances specified in the ~~relevant~~ collateral agreement]; or

(b) a right to withdraw collateral securities or other assets on providing collateral securities or other assets of substantially the same value,

the provision of securities or other assets as described in paragraph (a) and paragraph (b) shall not be treated as invalid, reversed or declared void solely on the basis that they are provided during a prescribed period before, or on the day of but before, the commencement of an insolvency proceeding in respect of the collateral provider, or after the secured obligations have been incurred.

*Article 25**[Declarations in respect of Chapter VII]*

1. - A Contracting State may ~~declare by declaration elect~~ that this Chapter shall not apply ~~in respect under its domestic non-Convention law of the law of that Contracting State.~~

2. - A Contracting State may declare that under its domestic non-Convention law by declaration elect that this Chapter shall not apply in

(a) in relation to collateral agreements entered into by natural persons or persons falling within such other categories as may be specified in the declaration; security interests in intermediated securities granted by or to parties of such descriptions as may be specified in the declaration;


(b) in relation to intermediated securities which are not permitted to be traded on an exchange or regulated market;

(c) in relation to collateral agreements which provide for secured obligations falling within such categories as may be specified in the declaration.

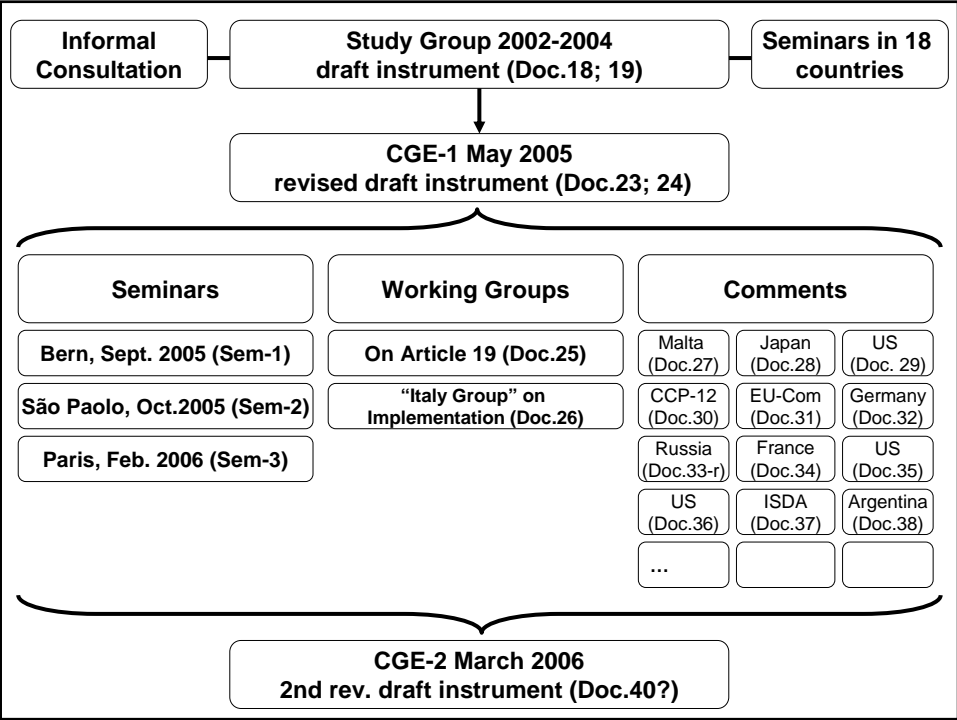
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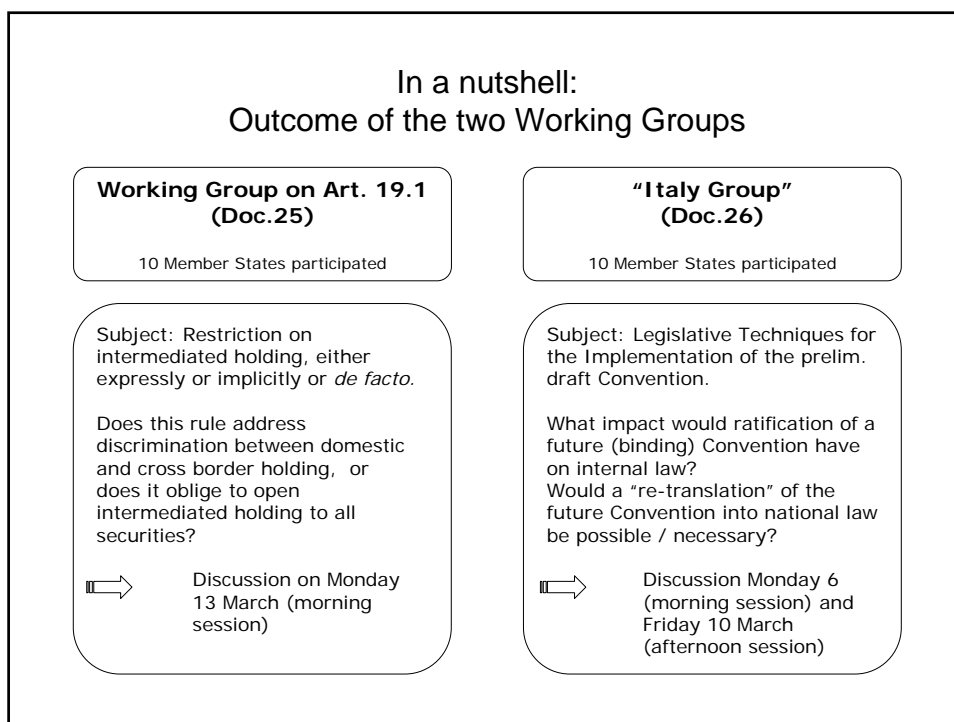
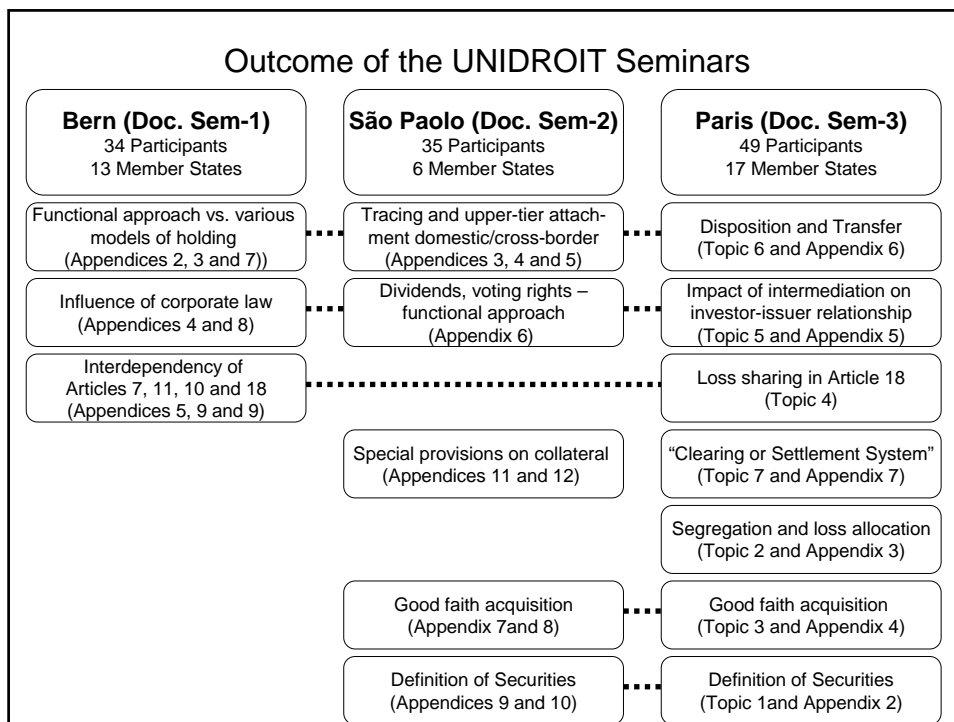
**UNIDROIT CGE-2
on Intermediated Securities**

Rome, 6-14 March 2006



Overview of inter-sessional work
(prepared by the Unidroit Secretariat)





UNIDROIT CGE-2 on Intermediated Securities

Rome, 6-14 March 2006



Definition of Securities

(prepared by the Unidroit Secretariat)

Decision in 4 Steps *with respect to the definition of "securities"*

- 1) Which are the elements of common sense regarding the definition of "securities"
- 2) Is the current definition too broad?
- 3) Otherwise : Is the current definition sufficiently broad?
- 4) Relationship with the definition of "securities" in the Hague Convention

Step 1: Elements of common sense

with respect to the definition of "securities"

- a) A conceptual international definition of "securities" is too difficult to achieve in a reasonable timeframe, if at all.
- b) For the purposes of the draft Convention, a broad definition is needed in order to accommodate future market developments; a "list" of financial instruments that should be covered should be avoided. The current definition in Article 1(a) is such a broad definition.

Step 2: Is the current definition too broad?

- a) Potential issues
 - In the case of the draft Convention, the effect is different from the effect of a Conflict-of-laws instrument, as a substantive law instrument creates/extinguishes legal positions.
 - The definition might cover assets that should not enter the scope of the convention (e.g. shares in "closely held" companies?). In particular if Article 19 were to be understood as obliging jurisdictions to open the intermediated systems for all "securities"
 - The definition is circular (securities-account-intermediary).
 - Other issue?
- b) Remedies
 - Add additional elements to the definition? Which?
 - Leave the definition to national law?
 - Leave the definition *de facto* to intermediaries and their overseers (every financial asset that is capable of being credited to a securities account is a "security") ?
 - Attention! It is not possible to narrow the scope by referring to "intermediated securities" as a "second-tier definition". The term "intermediated securities" is not intended to define the scope of the draft convention. It is merely a generic term to describe in functional terms the right that the law confers to the account holder upon credit of a security to his account.
 - Other remedies?

Step 3: Otherwise, is the current definition sufficiently broad?

- a) Does the definition encompass all assets that should benefit from the enhanced certainty of the Convention regime (e.g. bilateral derivatives, that are by their nature contracts but that are credited to accounts and traded on organised markets) ?
- b) Is full conformity with the definition in the Hague Securities Convention advisable ?(In this case, delete “transferable”.)
- c) Other?

Step 4: Relationship to the definition of “securities” in the Hague Securities C.

Question

in case a definition of “securities” which differs from the definition in the Hague Securities Convention should be envisaged:

Does the gain of legal certainty regarding the definition as such outweigh the potential “confusion” created by two different definitions in two international instruments that relate to the same situation?

UNIDROIT CGE-2 on Intermediated Securities

Rome, 6-14 March 2006

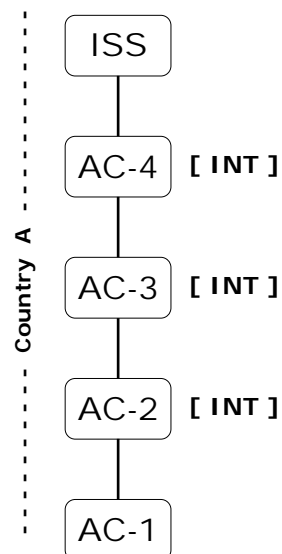


Intermediated Securities [Article 4.1(a) and 4.2]

(prepared by the Unidroit Secretariat)

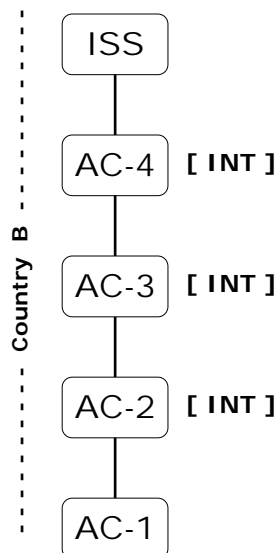
Who receives and exercises the rights attached to securities? (I)

1. With respect to 1 security, the issuer is obliged only *vis-à-vis* 1 person.
2. The question is who is legally entitled to the rights (not how the rights are “processed”).
3. All intermediaries are also account holders.
4. Article 1.1(a) and 1.2 – Rule No 1: An account holder which is not acting as intermediary with respect to the relevant securities is entitled to the rights. Here AC-1.



Who receives and exercises the rights attached to securities? (II)

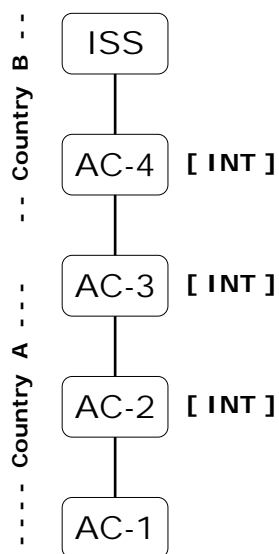
1. Art. 4.1(a) and 4.1 – Rule No 2: Also an account holder who acts as intermediary is entitled to the right, if so provided by the terms of the securities and the law. Example: In country B, AC-4 is entitled to the rights under the relevant provision.
2. Rule No 3: Intermediaries that hold directly or indirectly through another intermediary which is entitled are equally entitled; here: AC-3 (directly) and AC-2 (indirectly).
3. Rule No 1 is still applicable; AC-1 is equally entitled.



Who receives and exercises the rights attached to securities? (III)

1. In a cross-border context, Rule No 3 is applied to the entire holding chain in case a higher-tier intermediary falls under Rule No 2 according to its jurisdiction (here Country B).

AC-2 and AC-3 fall under Rule No.3 (even if in their Country A intermediaries are regularly not entitled under Rule No 2).
2. In all examples: The right can only be enforced under Article 1.3(b)



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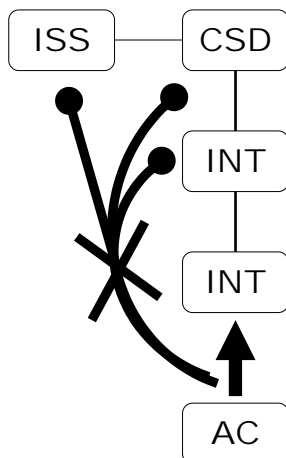


Prohibition of upper-tier
enforcement and attachment
[Article 4.3(b) and 9]

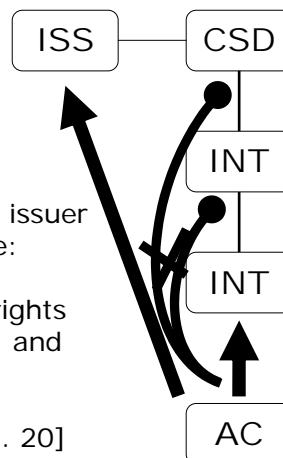
(prepared by the Unidroit Secretariat)

Upper-tier enforcement [Art. 4.3.(b)]

Art. 4.3(b)
1. Alternative



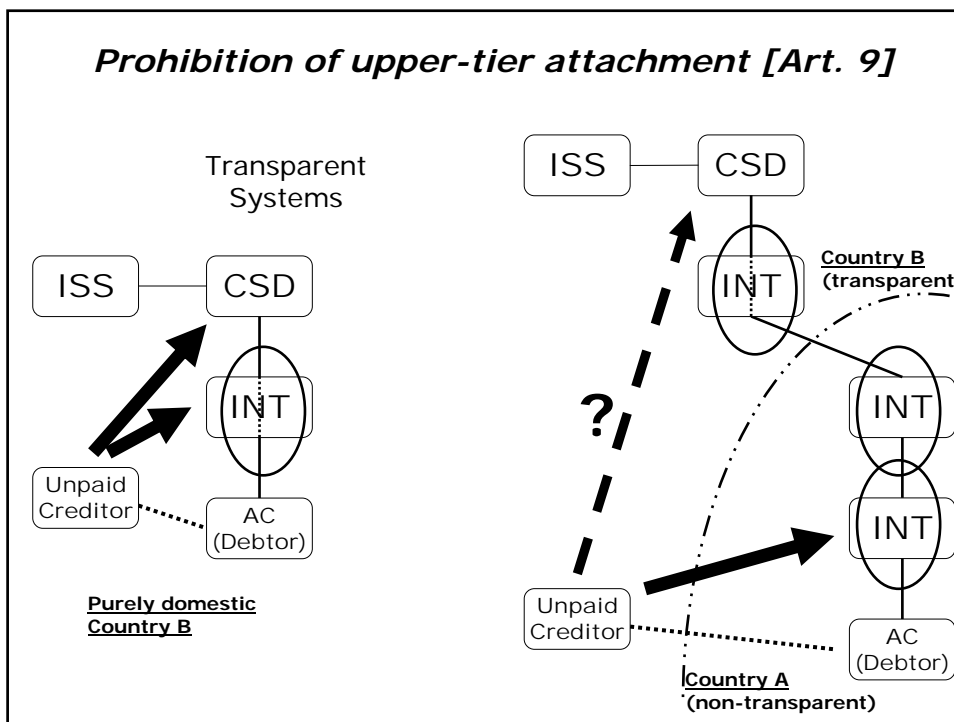
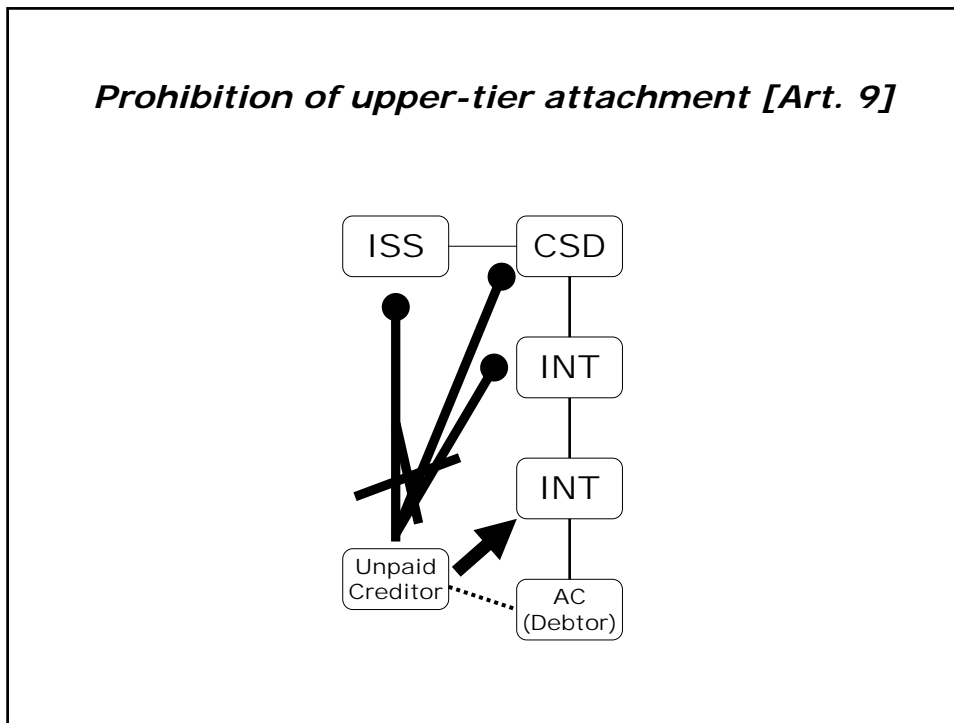
Art. 4.3(b)
2. Alternative



Against the issuer
for example:

Corporate rights
[Art. 4.1(a) and
4.2]

Set-off [Art. 20]



UNIDROIT CGE-2 on Intermediated Securities

Rome, 6-14 March 2006



Form and implementation of the future instrument -
Overview of the achievements of the "Italy Group"

(prepared by the Unidroit Secretariat)

Fundamental Issues ***regarding form and implementation of the future instrument***

- 1) Should the future instrument take a "hard law" format (i.e. convention) or a soft law format (i.e. model law or principles)?
- 2) If the "soft law" route were to be taken, countries were free with respect to implementation
- 3) If the "hard law" route were to be taken:
 - a) What is the role of the functional approach?
 - b) Does it matter whether the future Convention is a self-executing text?
 - c) How could implementation work?

“Hard law” or “soft law” ?

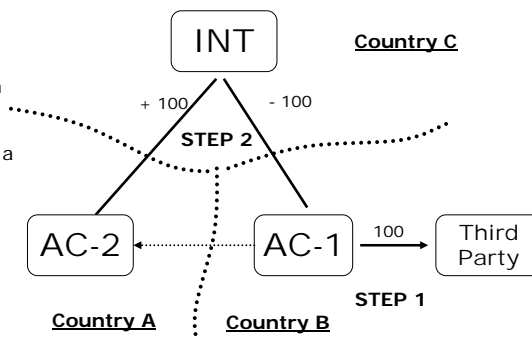
Where third parties rights are at stake, the highest degree of harmonisation is required to ascertain legal certainty.

Example: AC-1 has 100 securities. Country A, B and C are parties to an international instrument.

In STEP 1 he transfers informally to a third party (under domestic rules), the securities are not debited.

In STEP 2 he disposes of his securities (under the rules of the international instrument) via book-entry.

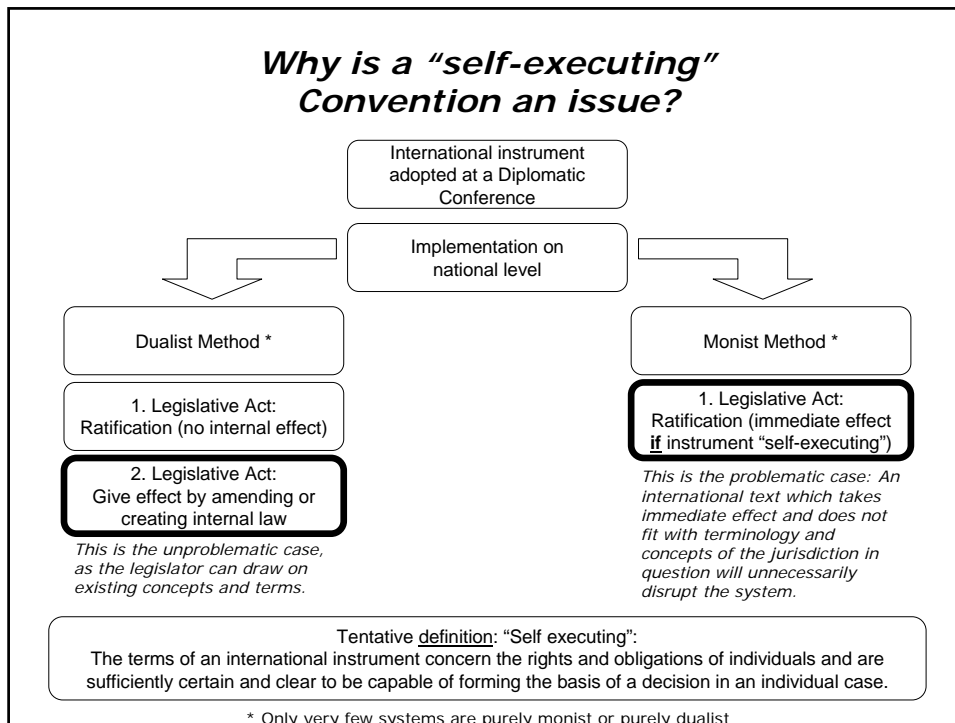
The priority rules of the jurisdictions involved must come to identical results (regardless what the result is: either the first in time informal transfer prevails or it does not) in order to make sure that no conflict arises.



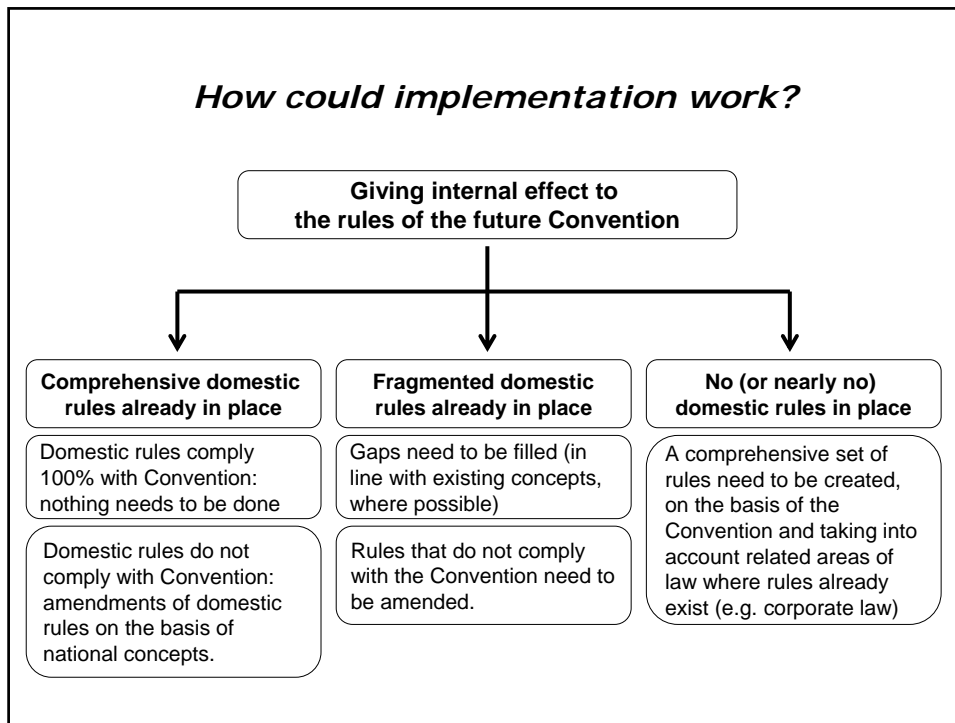
A hard law approach appears to be appropriate.

The role of the functional approach 3 Theses

1. On the basis of the functional approach, the instrument attempts to formulate rules by reference to results and facts and to employ a neutral, not conceptual, language.
2. This is to enable the draft Convention to be accommodated by different jurisdictions without causing unnecessary disruption of the legal tradition.
3. The functional approach has its limits: harmonisation requires that the rules of Contracting States come to the same result with respect to issues under the future Convention. Therefore, amendments of domestic law will be necessary in many cases. However, to achieve the required result, domestic legal concepts and terminology can be used.



- ### Remedies
1. **Final or introductory clause intended to avoid the effect of “self executing” rules.**
Example: “Contracting States shall bring into force whatever laws, regulations and administrative provisions are necessary to comply with this Convention, details of which shall be supplied to the Depository.”
and / or
 2. **Resolution to that effect (adopted by the Diplomatic Conference)**
supplemented by
 3. **Guidance by the Official Commentary**



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6 March 2006

Dr Philipp Paech
Secretary to the Committee of Governmental Experts (CGE)
UNIDROIT
28 Via Panisperna
00184 Rome
Italy

Dear Philipp,

Second Session of the CGE for the Preparation of a Draft Convention on Harmonised Substantive Rules regarding Intermediated Securities (Rome, 6/14 March 2006)

In the context of the ongoing Second Session of the CGE, Citigroup would like to submit some comments in order to support UNIDROIT's efforts regarding the Draft Convention on Harmonised Substantive Rules regarding Intermediated Securities. Citigroup acts as a major securities intermediary in a large number of countries worldwide and has business activities in 23 of the 25 EU Member States.

A. Concerns for securities intermediaries

Citigroup supports UNIDROIT in its endeavour to investigate the issues concerning the ownership of investment securities and we hope that this might result in the international solution that is sought by the finance industry as a whole. We believe that the prime target of any legislation in this area should be to provide a safe market whilst recognising the risks associated for all participants. In particular, we consider that any legislation should not restrict the ability of securities intermediaries to maintain their commercial relationship with those they provide services to.

From our perspective as intermediary there are four main concerns which we believe would be essential for the Draft Convention to take into consideration:

1. The Draft Convention should differentiate between different types of intermediaries and in particular between CSDs and custodians. Consequently CSDs should be recognized as functionally distinct from custodians. Although both maintain securities accounts, the performance of this activity diverges in two major aspects: Firstly, CSDs hold securities accounts centrally, whereas custodians do so in a competitive ambit. Secondly, CSDs hold the root of title and as such can create and eliminate securities. This results in fundamentally different risk implications, with CSDs performing higher risk activities in comparison to custodians, which should be reflected in the Draft Convention.
2. The extent to which persons holding interests in securities for their own account should have direct linkage to the issuer must not be inflexibly set in the Draft Convention. There are risks for intermediaries if such linkages are mandated while at the same time intermediaries are responsible for transmission of investors' rights.
3. The solution(s) adopted by Unidroit and the EU should be compatible with the approach on "relevant" intermediaries, direct linkages, and legal certainty of securities accounts as taken in the US and internationally.

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4. Whenever "mismatch risk" (the rights given to the account-holder are different from - at worst more extensive than - the rights enjoyed by the intermediary) arises, it must always be able without restriction to be excluded by contract.

B. Drafting queries

Having reviewed the Draft Convention, we have the following questions with regards to the text:

Definitions of "account holder" and "relevant intermediary". Is it envisaged that securities in a proprietary account are treated in the same way? Whilst the definition of "intermediary" foresees that an intermediary can maintain securities accounts both for others and on its own account, it is unclear in the definitions of "account holder" and "relevant intermediary" that the intermediary itself could be that person.

Definition of "domestic non-Convention law". Should the reference to "State" in this definition be to the "Contracting State"?

Article 2. The term "forum" could be misconceived as applicable only in case of dispute resolution, which we understand is not the intention of the Convention. It is therefore suggested to amend this expression.

Article 4.1(a). There may well be circumstances in which this is not possible in practice (e.g. where votes cannot be divided). Whilst Citigroup appreciates the attempt to refine this right in Article 4.2 we are not sure that this goes quite far enough. The fundamental problem lies in the fact that intermediaries cannot deliver to the investor the same rights that the investor would have in case his title was recorded at 'root' level. A case in point is the delivery of notices: if the issuer sends out notice, an intermediary may not receive that notice for some days (the time it takes to pass down the chain). Consequently, the notice could not be delivered to the intermediary's account holder unless and until it receives such notice itself.

Article 4.4. Our preference would be for Version A; however, should any other agreement between the intermediary and the account holder also be mentioned in 4.6 (e.g. the Control Agreement)?

Article 7.1(a). This provision seems to implicate that the consent of both the account holder and the collateral taker is required. However, the definition of "control agreement" implies in Article 1 (n) sub paragraph (ii) that the consent of the collateral taker is not always required in respect of instructions of the account holder.

Article 7.6(b). This seems to burden securities intermediaries with an exposure that they would not expect (unless, of course, they make all credits to the accounts they hold conditional upon no reverse at the intermediary level above).

Article 17.1 and 17.2 imply that proprietary account securities will be appropriated to meet shortfalls in client accounts. Whilst this may be consistent with Article 8 UCC, we are not confident that this is what the market wants.

Article 22.1. What is meant by the term "regularly traded" on a financial market? The Financial Collateral Directive has the concept of "normally dealt in".

We would truly appreciate these comments and questions to be considered in the debate during the Second Session of the CGE and hope that our suggestions will be helpful for the discussion.

Yours sincerely,



**ZENTRALER
KREDITAUSSCHUSS**

MITGLIEDER: BUNDESVERBAND DER DEUTSCHEN VOLKSBANKEN UND RAIFFEISENBANKEN E.V. BERLIN ·
BUNDESVERBAND DEUTSCHER BANKEN E.V. BERLIN BUNDESVERBAND ÖFFENTLICHER BANKEN
DEUTSCHLANDS E.V. BERLIN · DEUTSCHER SPARKASSEN- UND GIROVERBAND E.V. BERLIN-BONN
VERBAND DEUTSCHER PFANDBRIEFBANKEN E.V. BERLIN



**Comments
on the
UNIDROIT Preliminary Draft Convention
on Harmonised Substantive Rules
regarding Intermediated Securities**

**(as adopted by
the Committee of Governmental Experts at its first session,
held in Rome, 9-20 May 2005)**

20 January 2006

I. General remarks

We congratulate UNIDROIT on the second draft Convention, in which Articles 2-5 in particular are much improved, and are pleased that major aspects of German and continental-European legal traditions have been taken more strongly into account. We realise that any international harmonisation of law poses a great challenge and appreciate how difficult it is to draft a text that accommodates the special features of a large number of different legal regimes. UNIDROIT deserves great credit for its work in this respect.

It is, however, evident that efforts to find compromises are resulting increasingly in exceptions that may diminish the chances of achieving lasting harmonisation and thus simplified book-entry securities transactions across borders. We would therefore remind UNIDROIT of its objectives as defined in the Study Group position paper of August 2003: these were, on the one hand, to contribute to the internal soundness of the legal regimes affected, but also, on the other hand, to achieve compatibility between the legal regimes. The yardstick for harmonisation was that “a harmonised rule should be regarded as appropriate if, but only if, it is clearly required to reduce legal or systemic risk or to promote market efficiency”. The more exceptions the Convention allows, the less chance there is of reducing legal risk and achieving compatibility between the different jurisdictions. On the other hand, we believe that a functional approach should not mean a number of member states having to abandon fundamental principles of their own legal system in favour of other legal regimes.

Consideration should be given to setting out the objectives of the Convention in Article 1 or in a preamble so that drafts can be evaluated directly against these objectives.

II. Comments on individual provisions

In the following we comment on the revised provisions of the Convention, but also reiterate and in some cases add to our previous remarks on the other articles of the draft Convention.

Chapter 1

Definition of “securities” (Article 1 (a))

The definition of “securities” in Article 1 (a) – not yet dealt with at the intergovernmental conference in Rome – is too broad, particularly considering Article 19. It must be ensured that the term “securities” does not include, for example, participations under company law that are not traditionally transferred by book entry, e.g. shares in *Kommanditgesellschaften* (limited partnerships) and *Gesellschaften mit beschränkter Haftung* (private limited companies). Article 1 (a) should therefore be worded as follows: “Securities’ means any shares, bonds or

other financial instruments or financial assets (other than cash) which are fungible and transferable by book entry or any interest therein”.

Furthermore, in view of the legal framework that European Community law gives numerous UNIDROIT member states, it should be ensured that the definition of “securities” in the UNIDROIT Convention is consistent with the definitions in European directives and regulations, particularly with that in the Directive on Markets in Financial Instruments (MiFID) (Directive 2004/39/EC).

Definition of “control agreement” and “designating entry” (article 1 (m) and (n))

The definition of “control agreement” and “designating entry” stipulates that the relevant intermediary is not allowed to comply with **any** instructions given by the account holder without having received the consent of the collateral taker (see (i) in each case). This would also cover instructions regarding the exercise of voting rights, the exercise of right of avoidance of a shareholders’ resolution and participation in shareholders’ meetings. Article 1 (m) (i) and (n) (i) should therefore include a qualification as already contained inversely in (ii) for the collateral taker. This qualification could be worded as follows:

Article 1 (m) (i)

“that the relevant intermediary is not permitted to comply with any instruction given by the account holder in respect of the intermediated securities to which the agreement applies in such circumstances and as to such matters as may be provided by the account agreement or the domestic non-Convention law without having received the consent of the collateral taker;”

Article 1 (n) (i)

“that the relevant intermediary is not permitted to comply with any instruction given by the account holder in respect of the intermediated securities in relation to which the entry is made in such circumstances and as to such matters as may be provided by the account agreement or the domestic non-Convention law without having received the consent of the collateral taker;”

Scope of application (Article 2)

Article 2 of the present UNIDROIT draft Convention defines a scope of application for the first time. Thought should be given to fine-tune the criteria of this definition. It could, for example, be made clear in Article 2 that the Convention applies only to securities held in safekeeping by intermediaries but not to securities in the direct possession of the investor and not to securities held in individual safekeeping (segregated or “jacket” custody). Article 2 could be worded as follows:

“Paragraph 1

This Convention applies where rules of private international law of the forum state designate the law of the contracting state.

Paragraph 2

This Convention does not apply to securities held in individual safekeeping for the investor by an intermediary.”

Chapter II

Content of the rights resulting from the credit of securities to a securities account (Article 4)

We welcome it that Article 4 is now worded more clearly. That goes particularly for Article 4 (3), which now makes clear that the investor can have rights resulting from the credit of securities to a securities account not only against the intermediary but expressly also against the issuer. We also welcome the retention of Article 4 (3) (b) (previously Article 2 (2) (b)). We continue to regard Article 4 (3) (b) as a key passage in the Convention as a whole. The first intergovernmental conference in Rome made clear that, where the exercise of rights resulting from securities credited to a securities account is concerned, two fundamentally different systems have to be taken into account on an equal basis:

- (i) A number of jurisdictions, e.g. USA, Canada, Australia, UK, only give the investor as account holder rights against his immediate intermediary (account provider) in the bilateral custody relationship. Consequently, the intermediary then has to arrange or take the necessary steps so that the account holder can enjoy the “fruits” of his investment: receipt of distributions (interest, dividends) and repayments, exercise of membership rights (right to vote, right to ask questions, right of avoidance). The bilateral structure of the custody relationship means that the investor has no rights of his own that are enforceable directly against the issuer.
- (ii) In other jurisdictions, e.g. Germany, France, Italy, Spain, Scandinavia (Nordic system), the account holder receives all the rights resulting from the security, which he can enforce directly against the issuer and other third parties; he is the holder of these rights. His intermediary acts only as service provider on his behalf when he collects interest and dividends or exercises any voting rights.

The new version of the Convention presented by the Drafting Group, particularly Article 4 (3) thereof, puts both systems on an equal footing for the first time. For this reason, the fundamental idea it contains should be left untouched to allow implementation of the Convention in as many jurisdictions as possible. At the same time, it should be made clear in Article 4 (3) (b) that in cases in which the investor is entitled to rights as referred to in Article 4 (1) (a) – i.e. the rights resulting from the security – which are enforceable directly against

the issuer, these rights may only be enforced against the issuer and not against the intermediary as well. The discussions in both Rome and Berne showed that a great deal of work is still required on this point to achieve a harmonisation of substantive rules that would simplify cross-border transfers of securities, also in connection with the Hague Securities Convention.

Exercise and enforcement of investors' rights (Article 4 (5)-(6))

Article 4 (4) stipulates that the intermediary must take appropriate measures to enable its account holders to receive and exercise the rights resulting from the credit of securities to a securities account. This requirement is, however, subject to the proviso in Articles 5 and 6, for which two versions are proposed. However, both versions limit the investor's rights to the extent that taking such appropriate measures would place an unreasonable burden on the intermediary. Version A reads: "the scope of those rights is limited to such an extent ..." and version B reads "the account holder is not entitled to any such right to the extent that ...".

We prefer version A of paragraphs 5 and 6. This is because this version upholds investors' rights even if, in order to enforce these rights, investors require the assistance of an intermediary for which assistance constitutes an unreasonable burden (see Article 4 (5), sentence 2, in version A in contrast to "is not entitled to any such right" in version B). Version A is also more consistent with the functional approach pursued by UNIDROIT than version B. In addition, version A fits better into national legal regimes, as it only limits the exercise of rights and thus does not concern the existence of such rights themselves.

Acquisition and disposition – Effectiveness against third parties (Article 5 (2))

Article 5 (2) (previously Article 3 (3)) deals with the effectiveness of acquisition of title against third parties. It is unclear whether its explicit reference to third parties is supposed to mean that it does not cover effectiveness of acquisition against the relevant intermediary. We see no reason for this, so that Article 5 (2) should simply regulate the effectiveness of acquisition of title, but not its effectiveness against third parties. We refer in this connection to UNIDROIT's explanatory remarks on the preliminary draft Convention of November 2004, stating that (p. 26, on Article 2 (2)): "Most jurisdictions give an account holder's right the status of being generally effective against anybody, i.e. the intermediary and third parties. This is also one of the foremost objectives of the preliminary draft Convention." The phrase "against third parties" should thus be amended accordingly.

Relationship of Article 5 (2) with Article 7 ("no further step is necessary")

The categorical statement in Article 5 (2) that crediting to a securities account is all that is needed to render the acquisition of intermediated securities effective ("no further step is necessary") fails to take the provisions of Article 7 into account. For example, Article 7 (1)

stipulates that a credit of securities to a securities account is only effective if the intermediary is authorised to make this credit entry. In addition, Article 7 (4) states that a debit or credit of securities can be made conditionally (see also our comments on Article 7 below). Appropriate clarification is required. The translation of “no further step” may cause confusion here.

Creation of security interests (Article 6)

In the November preliminary draft, creation of a security interest in intermediated securities was subject to compliance by the intermediary with any requirements imposed by the collateral taker with respect to these securities. We criticised this, as it did not in our opinion meet the need for protection on the part of the collateral provider. The conditions now envisaged for the creation of a security interest should take sufficient account of the interests of both the collateral provider and the collateral taker, so that we approve the new version of Article 6, notwithstanding our above mentioned request to amend the definition of “control agreement” and “designating entry”.

We welcome the possibility in Article 6 (4) for Contracting States to state by declaration whether a control agreement or a designating entry is sufficient under their law and to state which requirements apply for the transfer of possession or control, as this leads to more certainty for foreign parties applying the Convention. At the same time, it would certainly be preferable if the Convention could set the same conditions for the creation of a security interest in intermediated securities for all jurisdictions. These could be modelled on the approach adopted in the European Financial Collateral Directive (Directive 2002/47/EC).

Article 6 (5) states that a Contracting State may declare that Article 6 does not apply in relation to security interests in intermediated securities where certain parties are involved as collateral providers or collateral takers. It should, however, be remembered that every exemption from the scope of application of the Convention runs counter to the efforts to achieve harmonisation. Consideration should therefore be given to whether it would not be better for the Convention to describe in more detail the function or the capacity of the persons which may be exempted by the Contracting States.

Effectiveness of debits, credits, etc. – Authorisation by domestic law

A condition for effectiveness is to be that the intermediary is “authorised” to make the debit or credit entry. This authorisation can be given by the securities account holder (as the case may be, jointly with the collateral taker) or by domestic law (Article 7 (1) (b)). What is meant by authorisation of a debit or credit entry by domestic law is something that should be further specified in the Convention itself or at least in explanatory notes in order to establish clarity about the regulatory purpose and scope of application of this option under Article 7.

Conditional debit or credit entry (Article 7 (4))

We expressly welcome it that the possibility for a debit or credit of securities to be made conditionally is established in Article 7 (4). We believe it makes sense for Article 7 (4), final part of the sentence, to provide for retroactive effect of satisfaction of the condition for the purposes of Article 10; there may, however, also be a practical necessity for satisfaction of the condition to take effect *ex nunc*, e.g. in retail business. Moreover, it would be consistent with the principle of freedom of contract for the parties – also in General Business Conditions – to be able to determine themselves when satisfaction of the condition should take effect.

Overriding effect of certain rules of clearing or settlement systems (Article 8)

Only the heading of Article 8 (previously Article 7) has been changed, so that we again point out that only allowing certain rules of securities clearing or settlement systems to override provisions laid down in Article 7 is unlikely to be enough. At the same time, we do not believe that it would be appropriate to allow such rules to override all the provisions of the Convention, as this would jeopardise harmonisation. The overriding rules should therefore be defined more precisely. The present wording of Article 8 appears too general in our opinion. Taking the definitions and proposals by CPSS/IOSCO, CESR/ECB and others as a guide, a more detailed description of the rules or examples of these should be given here. Such an approach would, on the one hand, give the clearing and settlement systems the flexibility needed for their secure and efficient operation and, on the other hand, foster a minimum level of harmonisation and transparency. It should be borne in mind that derogations from the Convention in order to maintain the stability of the clearing or settlement systems should only be allowed to the extent necessary for this purpose.

In addition, the new draft Convention does not contain any definition of clearing or settlement systems either. To avoid misunderstandings in practice, such a definition should, however, be incorporated. Article 1 would be the obvious place to do so. Such a definition ought, if possible, to be consistent with the definitions used internationally, e.g. by CPSS/IOSCO. Like under Article 10 of the Settlement Finality Directive (Directive 98/26/EC), the member states could also be required to designate such systems to a central authority according to certain criteria so as to ensure harmonisation.

Upper-tier attachment (Article 9)

We welcome this article in principle. However, it should not go as far as excluding any attachment measure against the issuer for failure to comply with its duties arising in connection with intermediated securities. Clarification on this point, also in view of the principle enshrined in Article 4 (3), should at least be incorporated into the explanatory notes on the Convention. This need for clarification is tied to the phrase “or in respect of” in Article 9 (1).

Priority among competing interests (Article 10)

Article 10 (4) stipulates that the order of priority of security interests may be varied by agreement between the parties entitled to the interests. Clarification that this is only possible if the interests of third parties are not affected should be included in the Convention itself.

Wording to this effect is to be found in the explanatory notes on the November 2004 preliminary draft (p. 30), but not in the Convention.

Chapter III

Acquisition by an innocent person of intermediated securities (Article 11)

In Article 11 (2), we are in favour of deleting the wording in square brackets. This is because, unlike the beneficiary of, for example, a disposition of securities made by way of gift, a person acquiring a security interest merits more protection because of the purpose of the security.

We understand Article 11 (3), final paragraph, which deals with when a person acts with knowledge of an adverse claim, to mean that *bona fide* acquisition is ruled out if the relevant information has been received by the “organisation” and not been duly forwarded within the organisation. This interpretation should be reflected either in the Convention itself or at least in the explanatory notes.

Chapter V

Duties of the intermediary (Article 16)

In the revised version of Article 16, paragraph 1 has been put in square brackets. These brackets should be retained in our opinion.

Article 16 (5) should be reviewed in the light of the possibility to reverse a credit or debit entry provided for under Article 7 (5). Should Article 16 (5) be retained, it would have to be made clear that Article 7 (5) remains unaffected.

Allocation of securities to account holders’ rights (Article 17 (1))

We understand Article 17 (1) to mean that securities of the same type held by an intermediary itself or with another, higher-tier intermediary are allocated to the account holders of the relevant intermediary to the extent necessary to cover the credit entries made by the relevant intermediary for its account holders in this type of securities.

However, we miss a provision stipulating that securities held by the intermediary for its own account may be allocated to account holders **only** if the shortfall in securities held for account holders is due to an unlawful disposition by the intermediary or to the fact that the account holder has already paid the purchase price and received a credit entry, but the securities have not yet been delivered into the cover holding (see Section 32 of the German Safe Custody Act). Furthermore, it would be sufficient in our view to limit the scope of Article 17 to insolvency on the part of the intermediary, provided that a provision is included in Article 16 or Article 18 stating that the intermediary is liable for any shortfall caused by it.

Effect of insufficiency of securities held in respect of account holders' rights (Article 18)

This article contains arrangements to deal with a shortfall. In the first place, we would like to suggest including a precise definition of a shortfall in the general list of definitions in Article 1 in order to make clear which of the conceivable cases are covered.

Article 18 (1) (b) establishes the principle that (subject to Article 18 (1) (a)) any shortfall must be borne by all securities account holders on a proportional basis. Article 16 (2) stipulates that in the event of a shortfall the intermediary must immediately take such action as is required to replenish the cover holding. Reference should be made to this in Article 18.

We regard the principle of proportional distribution of liability provided for in Article 18 (1) (b) as unreasonable at least where the shortfall is due to a single investor having received an uncovered credit entry. In this case, we feel it would be fairer to make this investor bear the consequences of the insufficient cover alone, unless the conditions for *bona fide* acquisition have been satisfied.

We also miss a provision stipulating that losses caused by the intermediary due to careless or unlawful action on its part must be borne by the intermediary. We understand the interplay between Article 16 and Article 18 in their present version to mean that an intermediary could discharge itself from liability for such fault. This must not be allowed to happen. Liability on the part of the intermediary for wilful or grossly negligent breach of duty should not be ruled out at any event. Where a shortfall occurs subsequently as a result of, for example, force majeure, riots, wars or natural disasters, pro-rata liability of all investors "participating" in the cover holding is, on the other hand, a fair solution and has our support.

Chapter VI

Terms of issue which prevent collective safekeeping (Article 19)

Article 19 bans any national rules of law and any provisions of the terms of issue of securities that would prevent collective safekeeping. Article 19 (1) only appears acceptable if the limiting definition of "securities" called for above is taken into account. Otherwise the issue

of certain investment products (e.g. shares in *Kommanditgesellschaften* (limited partnerships) and *Gesellschaften mit beschränkter Haftung* (private limited companies), certain types of registered bond, etc.) could be overly restricted.

**Restriction of the exercise of rights in respect of different parts of a holding of securities
(Article 19 (2))**

Article 19 (1) stipulates that any rules of law and any terms of issue which prevent the indirect safekeeping of securities or the exercise of rights of account holders in respect of intermediated securities must be modified. Under Article 19 (2) (a), these include, in particular, rules which restrict the ability of a holder of securities (what is meant is no doubt the securities holder acting for itself or as a nominee) to exercise voting rights or other rights in respect of different parts of a holding of securities. We understand Article 19 (2) (a) to mean that it is to be possible for an account holder (other intermediary or investor) for example, to exercise rights in respect of one part of a holding of securities differently than for another part, i.e. to vote “yes” for 70 and “no” for 30 of the 100 shares held by it. This is particularly important for shares held by nominees. We would therefore be grateful for clarification to this effect in the explanatory notes.

Article 19 (2) (b)

We believe that Article 19 (2) (b) is out of place in a convention on substantive rules regarding intermediated securities. This provision is irrelevant for a safekeeping system based on book entry. Such a provision should be left to national jurisdictions, particularly because of the far reaching consequences in terms of costs, which intermediaries cannot be made to bear.

**Exercise of rights conditional on the maintenance of records in a particular medium
(Article 19 (2) (d))**

Article 19 (2) (d) is inappropriate in our view. We understand it to mean that an entry in a register (e.g. an entry in the share ledger) may be required, but not the maintenance of such a register in a particular form. If an entry in a register can actually be made a condition for the exercise of shareholders’ rights, then stipulating the form of register as well would not appear to be any further hindrance to the exercise of rights by the intermediary.

Should Article 19 (2) (d) be retained, we should like its sense to be made clearer in the wording. It should be made clear that the words “in a particular medium” refer to the type of medium but not to any entry in a medium.

Article 19 (2) (e)

Article 19 (2) (e) requires the removal particularly of any rules of national law which restrict the collective safekeeping of securities by intermediaries by reference to the status or other

characteristics or circumstances of an intermediary. It is doubtful whether Article 19 (2) (e) is necessary to harmonise substantive law. This is because system stability can only be ensured if, among other things, the investor receives not only a legally secure position but also a position that is largely independent of the economic fate of the intermediaries involved. It is therefore conceivable that national law imposes restrictions on domestic intermediaries in regard to the foreign intermediaries they are allowed to do business with so as to ensure that they only do business with foreign intermediaries whose organisational form and activities rule out any negative impact on the stability of the system. The explanatory comments on the preliminary draft Convention of November 2004 (p. 11, section 2.2.3) draw attention to a potential “domino effect” between related intermediaries if one of them is unable to meet its obligations. Particularly in the case of intermediaries based in countries that will not have subscribed to the UNIDROIT Convention, the content of the law applicable to them will also be of importance for assessing system stability both in terms of internal soundness and compatibility. Against this background, Article 19 (2) (e) should be dropped in its entirety. Article 19 (1), which allows restrictions on business relations with “unsafe” intermediaries (see Section 5 (4) of the German Safe Custody Act), should be adequate.

On the other hand, merely deleting individual criteria laid down in Article 19 (2) does not appear sufficient, as any restrictions that refer in any way to the intermediary may affect system stability.

Article 19 (3)

Article 19 (3), which is still in square brackets, should be kept in order to allow the retention of restrictedly transferable registered shares under the Convention.

Set-off (Article 20)

It would, we feel, make more sense to place the rules on set-off in the event of insolvency (Article 20) in Chapter IV (Insolvency).

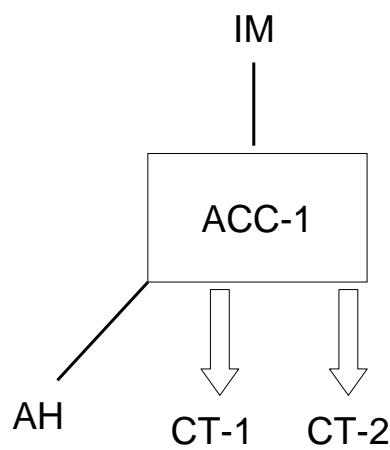
Chapter VII

We reserve the right to submit comments on Chapter VII at a later date.

Effectiveness of book-entries, priorities and loss sharing

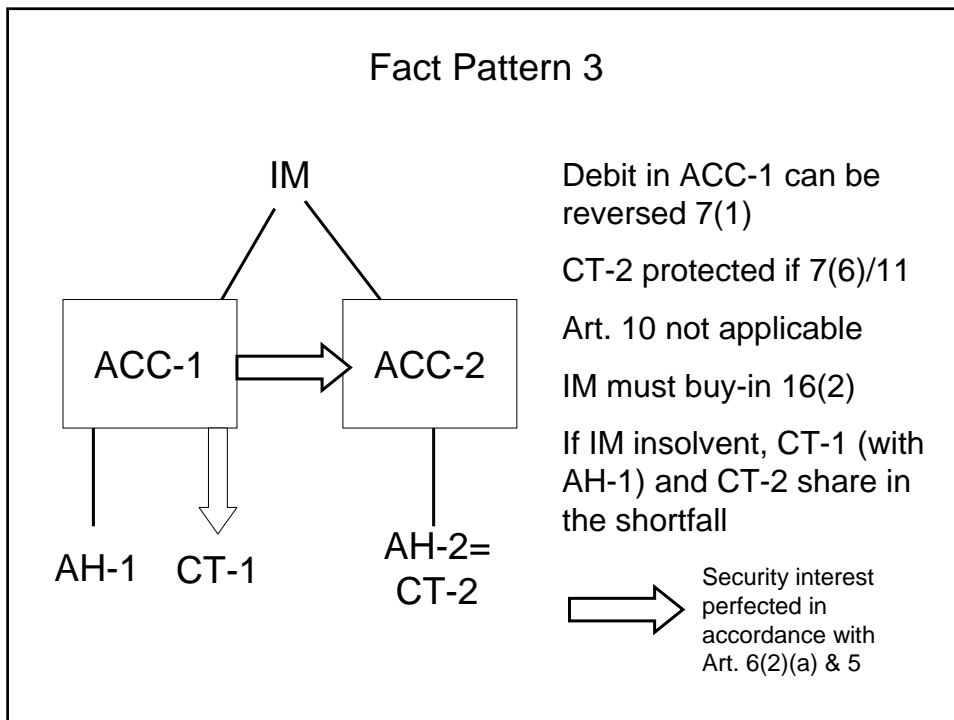
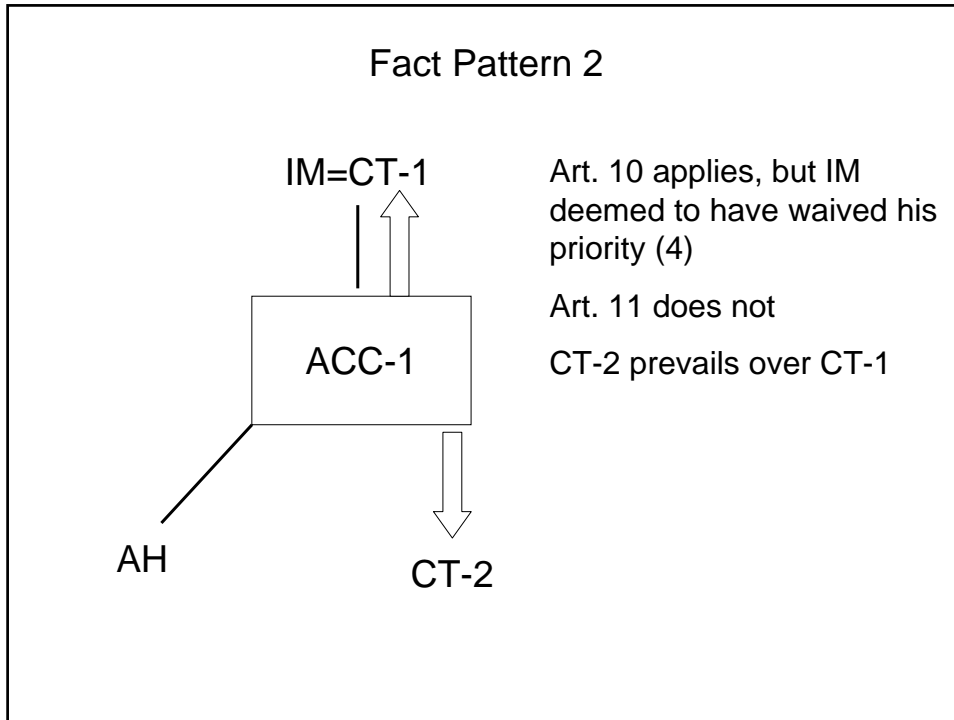
Partial report about the Bern Seminar
(September 2006)
by the Swiss delegation

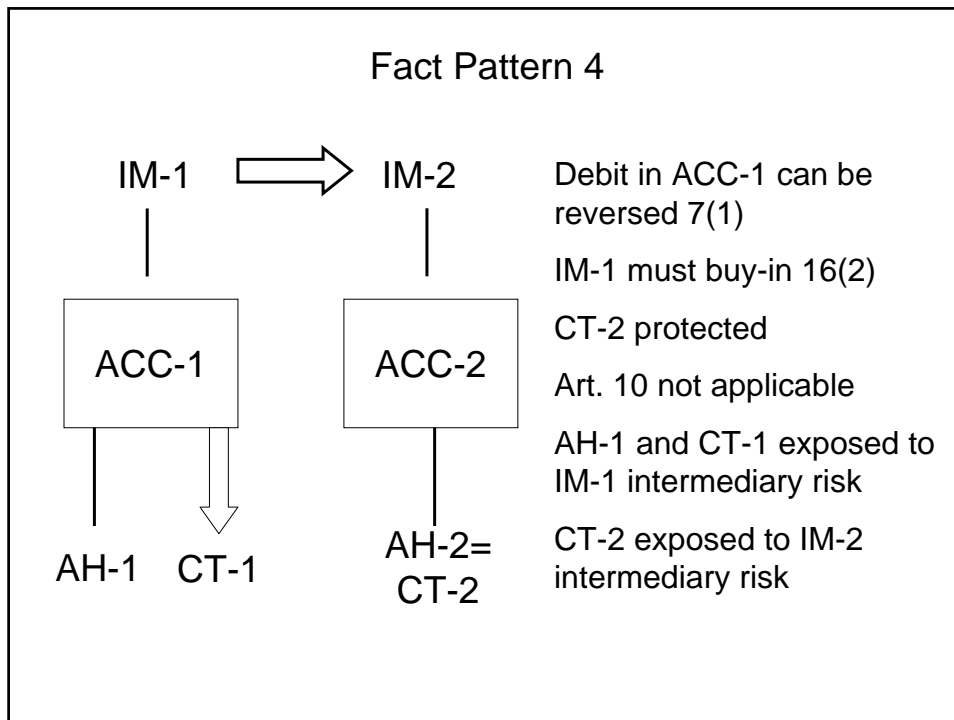
Fact Pattern 1



Art. 10 applies
Art. 11 does not
CT-1 prevails over CT-2
CT-2 may have claims
against AH and / or IM

↓
Security interest
perfected in
accordance with
Art. 6(2)(b) to (f)





Some conclusions for discussion

- Order of reasoning should be clarified:
 - Art. 7 corrections, Art. 16(2) buy in
 - Art. 10 and 11
 - Art. 18 shortfall
- Scope of Art. 10 should be narrowed to competing interest over securities in the same account
- Art. 10(4) should be clarified about implied waiver of priority by intermediary
- Art. 7(6) & 11 may be put together / merged

UNIDROIT CGE-2 on Intermediated Securities

Rome, 6-14 March 2006



Good faith, priorities and loss sharing
(Article 7.6; 11; 10 and 18)
Tentative results of the discussion

(prepared by the Unidroit Secretariat)

Fact Pattern 1*

- 1) This was a simple situation of competing claims of collateral takers neither of whose interests were perfected by way of credits.
- 2) There seemed to be consensus that the first-in-time rule of Article 10 applied.

**All slides relate to the fact patterns used earlier by the Swiss delegation (Doc. INF 9).*

Fact Pattern 2

- 1) This situation involved the account holders intermediary as the first collateral taker [Art. 6.2(b)] and a second collateral taker whose security interest was perfected by a method entailing the intermediary's involvement under Art. 6.2(c) or (d).
- 2) Under strict application of Art. 10 the intermediary's security interest should prevail as being first in time.
- 3) However, there was agreement that the intermediary (CT-1) waived its priority (probably under Article 10.4) by permitting CT-2's security interest to be perfected without reserving its prior interest.
- 4) There was a suggestion that this "deemed waiver" should be clarified and possibly made explicit in Article 10.

Fact Pattern 3

- 1) This situation involved the competing claims of a first-in-time secured party whose interest was perfected not entailing a credit [Art. 6.2(c) or (d)] and a second secured party whose interest was perfected by transfer to a the collateral taker's account with the same intermediary without CT-1's consent.
- 2) It appeared to be the consensus that the priority rule of Art. 10 should not apply when the second security interest is perfected by book entry (thus not relating to the original securities account).
- 3) The Intermediary remains responsible to re-establish the account holder's position (reverse the debit [Art. 7.1] and buy in the missing securities [Art. 16.2]).
- 4) CT-2's position depends on his eligibility for protection under Art 7.6 or Art. 11.
- 5) If the intermediary does not have enough securities to reverse the debit on the one hand while maintaining the credit to CT-2's account on the other [Insolvency?], the rules on loss sharing apply to both the account holder and CT-1 on the one hand and CT-2 on the other.
- 6) A question was whether CT-1 and CT-2 should participate independently in any loss sharing with all other account holders or whether this could lead unintentionally to a more favourable distribution to the original account holder. A majority appeared to support treating CT-1 and CT-2 independently.

Fact Pattern 4

- 1) In this fact pattern the first collateral taker perfected its interest by one of the methods 6.2(b)-(d). The subsequent security interest in favour of CT-2 was perfected through a debit of the accountholders position without CT-1's consent and a transfer to INT-2 who credited CT-2's account.
- 2) INT-1 remains responsible to re-establish the account holders position (reverse the debit [Art. 7.1] and buy in the missing securities [Art. 16.2]).
- 3) There was consensus that Art. 11 (and not Art. 10) applied to CT-2's [book-entry = Art. 6.2(a)] security interest.

Tentative Conclusions as preliminary drafting basis

- 1) The first-in-time rule of Article 10 applies to competing security interests relating to securities credited to the same account, i.e. perfected under Article 6.2(b)-(d).
- 2) The scope of Article 10.4 should be clarified so as to make clear that an intermediary with a perfected security interest that participates in the perfection of a subsequent security interest of a third person is deemed to have waived its first in time priority.
- 3) The innocent acquisition rule applies to security interests perfected by book-entries, i.e. under Article 6.2(a).
- 4) The distinction between Article 11 and Article 7.6/7 requires clarification.
- 5) It is unclear whether the shortfall allocation rule of Article 18 should be limited to intermediary insolvency.

UNIDROIT CGE-2 on Intermediated Securities

Rome, 6-14 March 2006

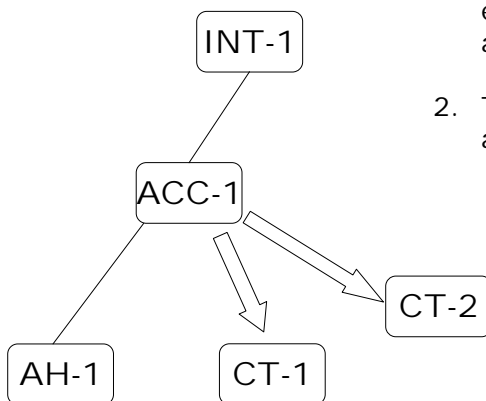


Priorities under Article 10

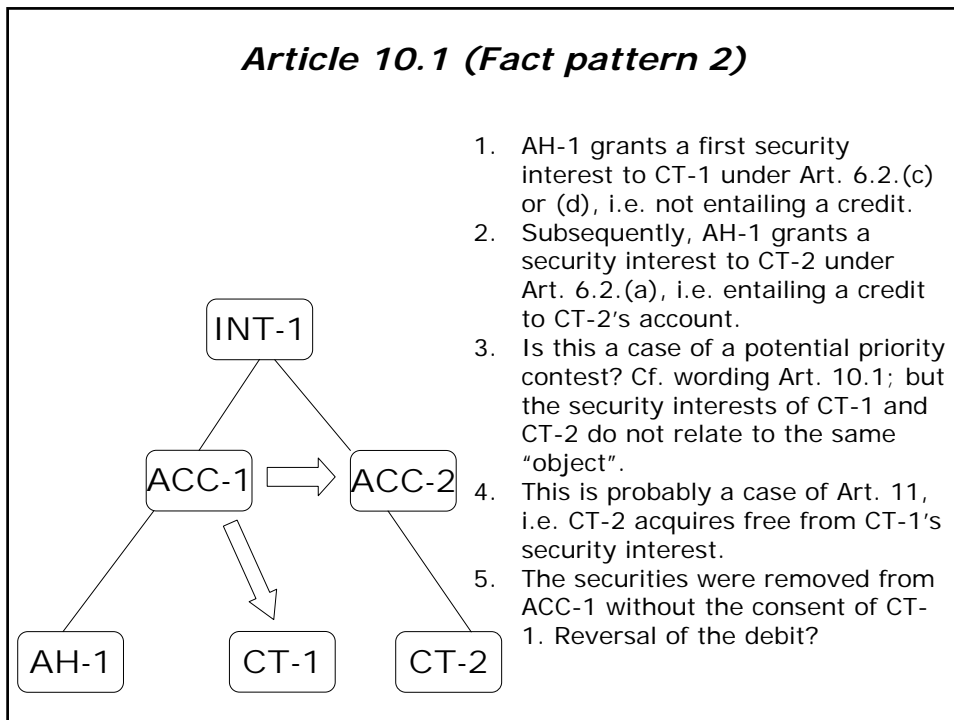
(prepared by the Unidroit Secretariat)

Article 10.1 (Fact pattern 1)

1. AH-1 grants a first security interest to CT-1 and a subsequent one to CT-2, both under Art. 6.2.(c) or (d), i.e. not entailing a credit to the CTs' accounts.
2. The first-in-time rule of Art. 10.1 applies.

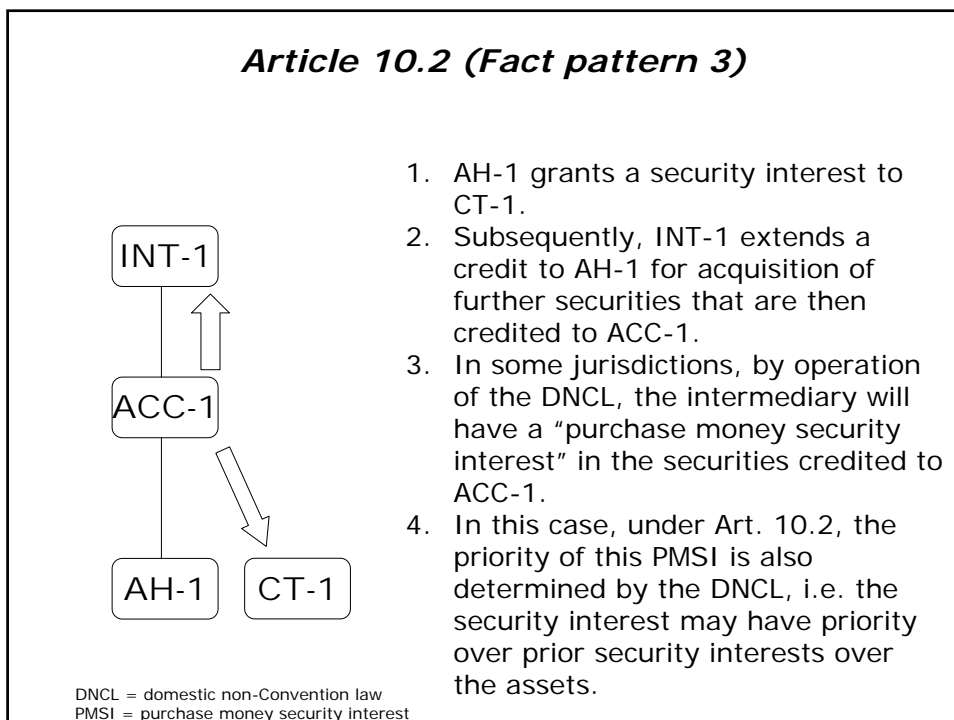


Article 10.1 (Fact pattern 2)



1. AH-1 grants a first security interest to CT-1 under Art. 6.2.(c) or (d), i.e. not entailing a credit.
2. Subsequently, AH-1 grants a security interest to CT-2 under Art. 6.2.(a), i.e. entailing a credit to CT-2's account.
3. Is this a case of a potential priority contest? Cf. wording Art. 10.1; but the security interests of CT-1 and CT-2 do not relate to the same "object".
4. This is probably a case of Art. 11, i.e. CT-2 acquires free from CT-1's security interest.
5. The securities were removed from ACC-1 without the consent of CT-1. Reversal of the debit?

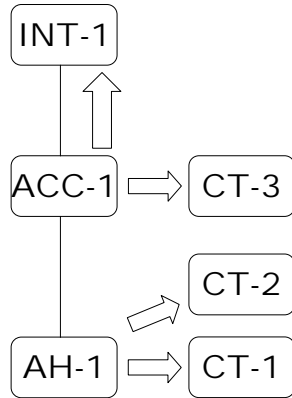
Article 10.2 (Fact pattern 3)



1. AH-1 grants a security interest to CT-1.
2. Subsequently, INT-1 extends a credit to AH-1 for acquisition of further securities that are then credited to ACC-1.
3. In some jurisdictions, by operation of the DNCL, the intermediary will have a "purchase money security interest" in the securities credited to ACC-1.
4. In this case, under Art. 10.2, the priority of this PMSI is also determined by the DNCL, i.e. the security interest may have priority over prior security interests over the assets.

DNCL = domestic non-Convention law
 PMSI = purchase money security interest

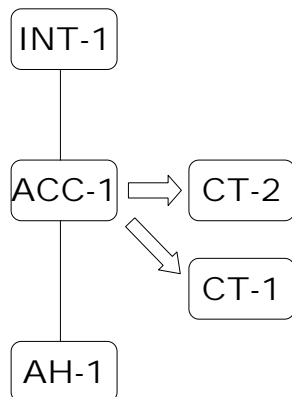
Article 10.3 (Fact pattern 4)



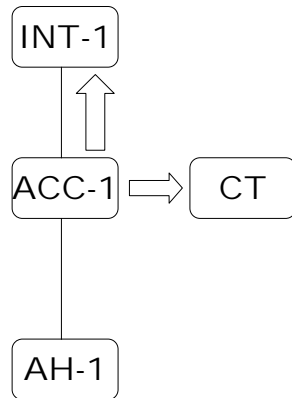
1. AH-1 grants a SI to CT-1 under a domestic method, Art. 6.7, e.g. entailing a contract and filing with a register.
2. AH-1 grants subsequently a SI to CT-2 under a different domestic method (Art. 6.7), e.g. entailing a contract and notification of the intermediary.
3. Subsequently, AH-1 grants a SI to CT-3 using a method provided for in Art. 6.
4. Subsequently, INT-1 acquires a SI under a PMSI rule.
5. The priority amongst CT-1 and CT-2 is determined by the NCDL, Art. 10.3.
6. However, CT-3's SI prevails, Art. 10.3
7. The rank of the PMSI of INT-1 is determined by the DNCL, i.e. might prevail over all other SIs

DNCL = domestic non-Convention law
 PMSI = purchase money security interest

Article 10.4 (Fact pattern 5)



1. AH-1 grants a SI to CT-1 under Art. 6.2(c) or (d).
2. AH-1 grants subsequently a SI to CT-2, equally under Art. 6.2(c) or (d).
3. Under Art. 10.1 the first-in-time rule applies.
4. CT-1 can agree that its SI ranks behind, e.g. in a three-party contract.

Article 10.4 (Fact pattern 6)

1. INT-1 has a PMSI.
2. Subsequently, AH-1 grants a SI to CT, on the basis of a control agreement between AH-1, INT-1 and CT (Art. 6.2(d)).
3. In case INT-1 does not mention its prior PMSI and provided that the PMSI does not prevail under the DNLC (Art. 10.2), it is deemed to have silently waived its priority in favour of CT.
4. Alternative: INT-1 and CT could agree to share the same priority rank.

DNCL = domestic non-Convention law
PMSI = purchase money security interest

**Cross-Border Insolvency – The Future:
Law Reform for Netting and Collateral
in connection with
Financial Market Transactions**

ISDA
Lawrence S. Brandman
Goldman, Sachs & Co.
Vice Chairman ISDA Collateral Law Reform Group

UNIDROIT
Rome, Italy
March 2006

ISDA[®]

International Swaps and Derivatives Association, Inc.

Financial Market Transactions

- Local insolvency and property laws throughout the world treat netting and collateral issues in various ways
- Pace of global legal reform has not kept up with the
 - Paradigm shift in the market place
 - Product proliferation
 - Technological developments
- Current reality
 - Products and activities are broad-based
 - Market participants are diverse
 - Markets are fast-moving

Financial Market Transactions

- Effective systemic and credit risk management requires legal certainty, consistency and efficiency
- Effective systemic and credit risk management is a foundation for liquidity, capital formation and market efficiency

3

ISDA®

Netting laws should

- facilitate the close-out netting
- of transactions
- in the case of default
- whether in or outside the context of insolvency
- without stay or delay
- free from avoidance, claw-back or “cherry-pick” risk

4

ISDA®

Netting laws should

- permit single and cross-product netting
- whether pursuant to a single or multiple master agreements (including “master-master” and cross-product master agreements)
- which permit a default under one transaction or agreement to become a close-out event for all transactions and agreements

5

ISDA®

Netting laws should

- avoid cumbersome complexity
- including the elimination of narrow protected classes of:
 - counterparties
 - products
 - specifically approved netting agreements
- as well as unreasonable contractual predicates for netting
- eliminate distinctions between “set-off” and enforceable close-out netting

6

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Laws relating to collateral should

- facilitate the foreclosure and liquidation of collateral
- in the case of default
- whether in or outside the context of insolvency
- without stay or delay
- free from avoidance and claw-back

7

ISDA®

Laws relating to collateral should

- avoid cumbersome and impractical rules for creating, “perfecting” and maintaining interests in collateral
- avoid obstacles for enforcement
- eliminate recharacterization concerns as well as distinctions between pledge and title transfer collateral arrangements
- permit the use, reuse, rehypothecation and substitution of collateral by the collateral taker

8

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Laws relating to collateral should

- permit robust collateral arrangements including collateral deliveries based on
 - mark-to-market (“top-up”)
 - credit ratings and other triggers
- all protected from the effect of preference and zero-hour rules
- as well as from the action of third parties (including attaching creditors)
- providing the collateral taker with a priority position in the collateral

9

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Laws relating to collateral should

- Eliminate the uncertainty of conflict of laws principles
- Adopt approaches like The Hague Securities Convention which facilitate legal certainty and efficiency

10

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Law reform will facilitate market liquidity and capital formation which will result in opportunities for investment and risk management

11

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2006 ISDA Model Netting Act

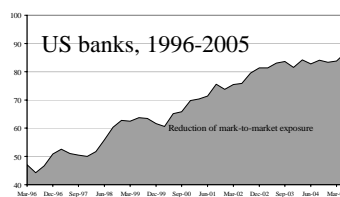
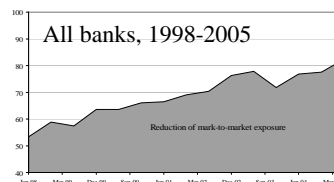
- Model netting statute, including provisions relating to collateral arrangements and multibranch netting
- Previous versions (2002 and 1996) have influenced netting legislation in a number of countries
- List of countries that have adopted or are currently considering netting legislation appears on ISDA website (<http://www.isda.org>)
- Memorandum on Netting Legislation (March 2006), with guidance for legislators on implementation of netting legislation, with particular attention to civil code jurisdictions
- Currently in near final draft form. Expected final publication date: end March 2006

12

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Risk reduction through close-out netting: Evidence

- Bank for International Settlements, November 2005
 - As of June 2005, total notional amount of all outstanding OTC derivatives was \$270.1 trillion
 - The total mark-to-market value of these outstanding OTC derivatives was \$10.7 trillion (4.0% of notional amount).
 - After applying close-out netting, the total mark-to-market credit exposure was \$1.9 trillion (0.7% of notional amount), a reduction of over 80 percent.
- U.S. Department of the Treasury, Office of the Comptroller of the Currency, 3Q2005
 - For federally chartered U.S. banks, netting benefit as of September 2005 was 85 percent



13

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2005 ISDA Margin Survey - Headlines

Estimated US\$ 1.209 trillion collateral in circulation (18.9% increase from the 2004 ISDA Margin Survey)

Total collateral reported is US\$ 853.9 billion, compared with US\$ 707 billion last year

- Reported collateral grew 20% among firms responding in both the 2004 and 2005 ISDA Margin Surveys

Respondents report over 70,000 collateral agreements in place

- Respondents that provided a forecast expect 33% growth in 2005

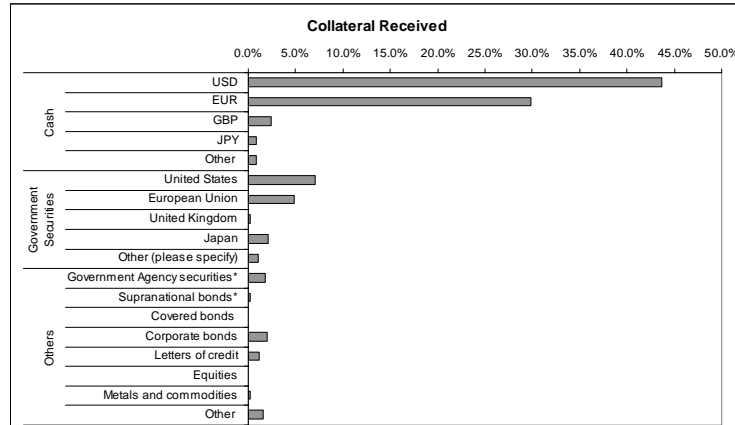
Approximately 55 % of OTC derivatives trade volume and exposure is now collateralized, compared with about 50% last year

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Types of assets used as collateral

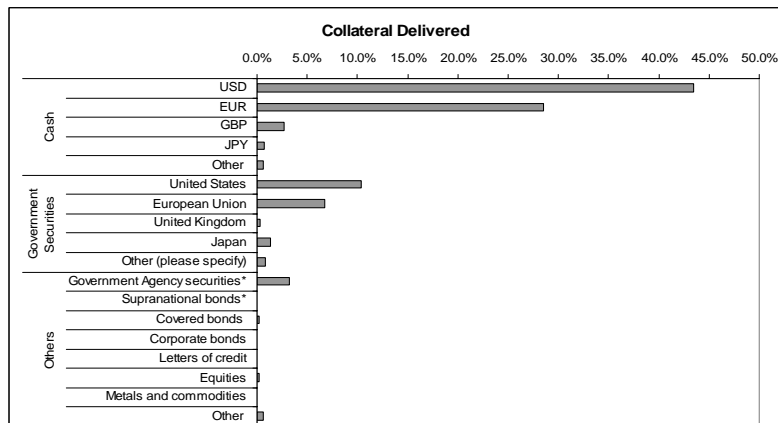
- US\$ and Euro continue to be the most widely used forms of collateral
 - Use of all cash collateral received has increased from 69% last year to 77%



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Collateral Delivered



16

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UNIDROIT CGE-2 on Intermediated Securities

Rome, 6-14 March 2006



Exemption for SCS

(prepared by the Unidroit Secretariat)

4 Question with respect to the Exemption

- 1) Which types of entities should be covered?
- 2) How could these entities be defined for purposes of the draft text?
- 3) What rules of the draft text can be overridden by the rules of such entity?
- 4) What type of rules can replace the rules of the draft text?

Question 1

Which types of entities should be covered?

- SSS, SCS, CSD, ICSD, CCP ...?
- All have pivotal functions.
- Should there be a distinction?

Question 2

How could these entities be defined for purposes of the draft text?

- Three options:
 - attempt finding a common definition
 - leave to national law
 - “dynamic approach”, i.e. leave it to national law, giving however some guidance
- Additionally: declaration mechanism

Question 3

What rules of the draft text can be overridden by the rules of such entity?

- Article 8
- Article 13
- Any provision of the draft text

Question 4

What rules of the draft text can be overridden by the rules of such entity?

- Should the overriding effect be given to
 - rules of any content; or
 - rules that are consistent with the rational of the future Convention?

UNIDROIT CGE-2 on Intermediated Securities

Rome, 6-14 March 2006



Overview of Art. 19

(prepared by the Unidroit Secretariat)

Scope of Art. 19

Anti Discrimination of Investors

Cross border intermediated holding ought not to be treated differently as far as exercise of rights which flow from the securities is concerned.

Make intermed. holding possible

Contracting States permit issuer to choose whether to open up to intermediated holding or not.

Investors may hold all kinds of securities through intermediaries.

Publicly traded securities may be held through intermediaries, for other securities: choice of the issuer

?

