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UNIDROIT COMMITTEE OF GOVERNMENTAL EXPERTS FOR THE PREPARATION OF A DRAFT CONVENTION ON SUBSTANTIVE RULES REGARDING INTERMEDIATED SECURITIES
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COMMENTS BY GOVERNMENTS AND INTERNATIONAL ORGANISATIONS

(Comments by the Government of the United States of America)

Proposal on the definition of "intermediated securities" in Article 1(f) and a modification of Article 9(1)(d)

At the second meeting of governmental experts in March 2006 there was a discussion in the plenary of the definition of "intermediated securities" in Article 1(f). In particular, some concerns were expressed concerning the language "'intermediated securities' means rights...". Some concerns also were expressed during that meeting about the failure of the definition to explicitly include rights in the underlying securities. Subsequent informal discussions have indicated that the definition (i) should explicitly refer to Article 9, which describes the rights that an account holder is to receive upon a credit to a securities account, and (ii) should not contain any substantive content separate and apart from Article 9.

For these reasons, we propose that the definition be revised to read as follows:

> (f) "intermediated securities" means what is conferred on an account holder under Article 9 by ~~the rights of an account holder resulting from~~ a credit of securities to a securities account;

We also propose that Article 9(1)(d) be revised to read as follows:

> (d) unless otherwise provided in ~~subject to~~ this Convention, such other rights, including rights in securities, as may be conferred by the domestic non-Convention law.

These changes would address each of the concerns. The definition would encompass whatever is conferred upon a credit, nothing more and nothing less. And it would not include the phrase "...securities means rights...". The change to Article 9(1)(d) would make it clear that when the domestic non-convention law so provides, a credit confers rights in the securities themselves. The "unless otherwise provided" phrase conforms the terminology of Article 9(1)(d) to Article 9(2).

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COMMENTS BY GOVERNMENTS AND INTERNATIONAL ORGANISATIONS

(Comments by the Government of the United States of America)

Proposal for new Article 3*bis* on Applicability of Declarations

Several articles of the draft Convention permit a Contracting State to make a declaration that would have the effect of varying an otherwise applicable Convention rule. We suggest that a clarification of the applicability and effect of these declarations may be appropriate.

Consider an example. Assume that Contracting State A has made a declaration under Article XYZ; Contracting State B has not made a declaration under that article. Assume further that a court in Contracting State A is the forum and that the domestic non-Convention law is that of Contracting State B. Should the forum court apply the Convention as modified by Contracting State A's declaration? Clearly the answer should be no.

In order to remove any doubt about the applicability of a declaration under the Convention, we propose for consideration a new article 3*bis* as follows:

*Article 3*bis

[Applicability of Declarations]

A declaration made by a Contracting State under any article of this Convention is applicable only if the law of that Contracting State is the domestic non-Convention law.

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(Comments by the Government of the United States of America)

Proposal on the Clarification of Article 4(4) and Relocation to Article 8

We propose that Article 4(4) be deleted and that Article 8 be revised.

Article 8 should be clarified to make clear that Article 8(2) and (3) are subject to the successor paragraph to Article 4(4) in Article 8 (paragraph *3bis*, below). Article 8 also should provide that a credit that is effective by virtue of paragraph 3*bis* nonetheless could be reversed. These proposals arise from three principal observations concerning Article 4(4).

First, the introductory phrase ("Without prejudice...") is ambiguous and we believe is not faithful to the plenary discussion on which it was based. The basic point is that an entry should not be ineffective solely because a corresponding entry is not identified. To accommodate the situation in some national regimes, however, it was understood that this rule of effectiveness would in no way restrict the domestic non-Convention law (DNCL) of a state from requiring that no entry be made without a corresponding entry. That was the purpose of the introductory phrase. Unfortunately, it could be read to mean that an entry is ineffective if the DNCL has such a requirement, which was not the intention.

Second, the substance of Article 4(4) seems to us to be out of place. It would better be located in Article 8, which deals generally with effectiveness and reversal.

Third, we believe that the problem to be addressed is broader than the impossibility (or impracticability) of identifying an account to which a corresponding entry has been made. It also may be impossible (or impracticable) to determine whether a corresponding entry has been made at all. Alternatively, it may be possible to determine that no corresponding entry has been made. Moreover, the result of a credit may be the creation of a shortfall in securities that the relevant intermediary is obliged to maintain for its account holders. For example, if a credit were not effective because it would create a shortfall, the intermediary would not appear to have an obligation to allocate securities under Article 19(1), even though the account holder had paid for the securities and there was no mistake, fraud, or other reason for the credit to be ineffective under the DNCL.

Accordingly, we propose the following revisions:

Article 4

~~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.~~

Article 8

2. - Subject to Article 7[1] and paragraph 3*bis*, the ~~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 securities settlement [or clearing] system, may provide that:

(a) a debit or credit of securities or a designating entry is not effective or is liable to be reversed; or

(b) no debit or credit may be made without a corresponding debit or credit.

3. - Subject to Article 7 and paragraph 3*bis*, the domestic non-Convention law determines:

(a) where a debit or designating entry is not authorized or a debit, credit or designating entry is otherwise ineffective, the consequences of such ineffectiveness; or

(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.

3*bis*. - A debit or credit of securities to a securities account is not ineffective as a result of:

(a) it not being possible to determine whether a corresponding credit or debit has been made;

(b) it not being possible to identify a securities account to which a corresponding credit or debit has been made; or

(c) no corresponding entry having been made or the failure of the relevant intermediary to be in compliance with Article 19(1).

[1] In a separate paper we address issues relating to innocent acquisition under Article 7.

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COMMENTS BY GOVERNMENTS AND INTERNATIONAL ORGANISATIONS

(Comments by the Government of the United States of America)

Proposal for Simplification of Article 5

Article 5

[Security interests in intermediated securities]

1. - An account holder may grant to a collateral taker a security interest in intermediated securities so as to be effective against third parties by:

(a) entering into a collateral agreement with the collateral taker; and

(b) delivering the intermediated securities to the collateral taker;

and no further step is necessary; or may be required by the domestic non-Convention law.

2. - Intermediated securities shall be treated as delivered to a collateral taker if they are credited to a securities account of the collateral taker.

3. - <u>If the relevant Contracting State has made a declaration under paragraph 5(a),</u> intermediated ~~Intermediated~~ securities shall also be treated as delivered to a collateral taker <u>if</u>:

(a) ~~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) ~~if~~ a designating entry has been made ~~and the relevant Contracting State has made a declaration under paragraph 4 in respect of this sub-paragraph~~; or

(c) ~~if~~ a control agreement applies ~~and the relevant Contracting State has made a declaration under paragraph 4 in respect of this sub-paragraph~~.

~~4. - A Contracting State may declare 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.~~

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

4~~6~~. - A ~~If the domestic non-Convention law so permits, a~~ security interest may be granted:

(a) 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) in respect of a specified category, quantity, proportion or value of the intermediated securities from time to time standing to the credit of a securities account.

5. - A Contracting State may declare that:

(a) 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;

(b) this Article shall not apply in relation to security interests in intermediated securities granted by or to parties falling within such categories as may be specified in the declaration; or

(c) either or both of sub-paragraphs (a) and (b) of paragraph 4 shall not apply.

6~~7~~. - The domestic non-Convention law determines:

(a) in what circumstances a non-consensual security interest in intermediated securities may arise and become effective against third parties; and

(b) the evidential requirements in respect of a collateral agreement and the delivery of intermediated securities to a collateral taker.

7~~8~~. - 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 6~~.

Explanatory Comment: We share the view informally expressed by other delegations that Article 5 could be simplified. The forgoing draft is an effort in that direction.

Proposed new paragraph 5(c) makes it clear that a declaration may specify that any one or more of subparagraphs (a) to (c) will apply. It follows that there is no reason to repeat the reference to a declaration in each of subparagraphs 3(a), (b), and (c).

The last phrase (“but the priority...”) of paragraph 7 (paragraph 8 of the current draft Convention) is superfluous. That paragraph in no way limits the priority rules that are clearly set out in Article 6, so the qualification is not necessary.

The only change in substance in the proposed draft article is to provide for a declaration (in proposed new paragraph 5) concerning the applicability of paragraphs (4)(a) and (b) [6 (a) and (b) of the current draft Convention] instead of deference to the domestic non-Convention law. This approach we believe adds transparency by providing baseline Convention rules and public notice in a declaration if a Contracting State wishes to deviate. This also allows a Contracting State to take advantage of the provisions in this paragraph even if its domestic non-Convention law is inconsistent.

APPENDIX

Clean version of Article 5 as proposed by the Government of the United States of America

Article 5

[Security interests in intermediated securities]

1. - An account holder may grant to a collateral taker a security interest in intermediated securities so as to be effective against third parties by:

(a) entering into a collateral agreement with the collateral taker; and

(b) delivering the intermediated securities to the collateral taker;

and no further step is necessary or may be required by the domestic non-Convention law.

2. - Intermediated securities shall be treated as delivered to a collateral taker if they are credited to a securities account of the collateral taker.

3. - If the relevant Contracting State has made a declaration under paragraph 5(a), intermediated securities shall also be treated as delivered to a collateral taker if:

(a) the relevant intermediary is itself the collateral taker;

(b) a designating entry has been made; or

(c) a control agreement applies.

4. - A security interest may be granted:

(a) 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) in respect of a specified category, quantity, proportion or value of the intermediated securities from time to time standing to the credit of a securities account.

5. - A Contracting State may declare that:

(a) 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;

(b) this Article shall not apply in relation to security interests in intermediated securities granted by or to parties falling within such categories as may be specified in the declaration; or

(c) either or both of sub-paragraphs (a) and (b) of paragraph 4 shall not apply.

6. - The domestic non-Convention law determines:

(a) in what circumstances a non-consensual security interest in intermediated securities may arise and become effective against third parties; and

(b) the evidential requirements in respect of a collateral agreement and the delivery of intermediated securities to a collateral taker.

7. - 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.

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COMMENTS BY GOVERNMENTS AND INTERNATIONAL ORGANISATIONS

(Comments by the Government of the United States of America)

Observations on Innocent Acquisition under Article 7

1. Structure of the Innocent Acquisition Rules

The Plenary and the Drafting Committee made substantial progress on the operation of the innocent acquisition rules in the Convention during the second meeting of governmental experts in March 2006. We wish to point out, however, a small but very important detail. Article 8(2) should be made subject to the rights of an innocent acquirer under Article 7. This would conform Article 8(2) to Article 8(3).

2. Test for Innocent Acquisition

To date the Plenary has not engaged in a full discussion of the standards for innocent acquisition (*i.e.*, how the qualifying "innocence" should be determined). It does appear, however, that using only the terminology "good faith" as a test would introduce considerable uncertainty. Good faith has different meanings in different jurisdictions and legal cultures. Indeed, the concept of "innocence" also may be misunderstood and, perhaps, should be replaced or eliminated (although it is used only in the caption to Article 7).

The test currently found in Article 7(1) qualifies an acquirer for protection if the acquirer "does not at the time of the credit have knowledge of an adverse claim with respect to the securities." This is intended to describe the circumstances in which an acquirer will not qualify for protection by using "neutral" language designed specifically for the intermediated securities context. Article 7(4) explains the concept of knowledge of an adverse claim. We doubt that Article 7(4)(a) is controversial. If the acquirer has actual knowledge of the adverse claim then protection from the adverse claim clearly is not appropriate. Subparagraph (b), however, reflects an effort to deny protection to an acquirer who does not have actual knowledge of the adverse claim but who intentionally avoids obtaining that knowledge in the face of highly suspicious circumstances known to the acquirer.

Consider a court[1] that has before it a case involving the question of innocent acquisition under the Convention and the need to apply subparagraph (b). The first inquiry involves a determination of the facts known to the acquirer. The court must hear evidence on that. Second, the court must determine whether those facts are "sufficient to indicate that there is a significant probability that the adverse claim exists." The court must hear evidence on that as well. What facts are "sufficient?" That will require expert evidence of the nature and extent of inferences to be drawn from the known facts in the relevant market. The court must determine whether the indication is that the existence of the adverse claim is probable (*i.e.*, more likely than not to exist). The court also must determine whether, if the existence is probable, the probability is "significant," as opposed to slight or barely more than 50 percent.

Next, the court must hear evidence on whether the acquirer "deliberately avoids information that would establish the existence of the adverse claim." For example, if the evidence shows that the acquirer was merely careless and never thought to look for additional information, that would not amount to a "deliberate," *i.e.*, intentional, avoidance of information. Consider an example. The acquirer's officer read in the newspaper that a large number of share certificates of Company X, indorsed in blank, had been stolen and that the rightful owner could supply the certificate numbers to any interested person. The next day a customer offers to give the acquirer a security interest in one of the stolen certificates. At that point the potential acquirer does not know that the adverse claim exists, but knows that there is a significant probability that it does. Knowing this, and to avoid acquiring the knowledge, the acquirer does not contact the rightful owner to check the certificate number. This is the sort of deliberate "willful blindness" that subparagraph (b) is intended to cover.

The various components of the test in subparagraph (b) inform the court that it is a standard of culpability, not one of prudence or reasonable care. Absent some detail on the state of knowledge and an acquirer's so-called "willful blindness," provided by subparagraph (b), a court could mistakenly apply an inappropriate test. For example, absent such guidance, a court might hear evidence to the effect that acquirers in the market normally take certain precautions. If an acquirer failed to do so, a court might wrongly conclude that the acquirer is not innocent. That would be a test of care, not of culpability. Or, a court might conclude that due diligence and investigation is required for protection and that passive lack of knowledge is insufficient. Again, that would reach the wrong result.

Of course we would welcome any attempts to make subparagraph (b) more concise and to remove any "unnecessary moving parts," so long as the test is not materially weakened or strengthened. We would be pleased to consider draft language intended to do so. But we recognize that it may not be possible to materially improve the provision in the current draft.

We have attached some hypothetical examples as Annex 1 to these observations. Working through those facts may be of some assistance or interest in considering and deliberating the Convention text.

3. Entries Made Subsequent to Ineffective or Reversible Entries

Articles 7(5) and (6) address the problem of a credit or designating entry that is ineffective or liable to be reversed and the subsequent credit or designating entry in favor of an innocent third party. These provisions were not discussed in detail at the March 2006 meeting of experts and the Drafting Committee did not have sufficient time to consider them. Although we believe that these

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[1] For convenience we refer to a court but intend to refer as well to a jury, arbitrator, or any other tribunal charged with finding the material facts.

are important provisions that enjoy wide support in principle, as drafted they are quite complex. The United States delegation plans to submit a simplified draft text to the Drafting Committee.

4. Immunity of Intermediaries and Securities Settlement and Clearing Systems

We believe that a new Article should be added to the Convention to address the immunity of intermediaries and securities settlement and clearing systems acting in their capacity as such. Article 7(3) appropriately recognizes that an innocent intermediary should be immune from liability to the holder of an adverse claim as a result of a debit, credit, or designating entry made by the intermediary. However, the standard of innocence in Article 7(3) – knowledge of an adverse claim – is problematic. Even if an intermediary were to acquire such knowledge under Article 7(4), it might be impossible for the intermediary to intervene. Moreover, application of that standard poses significant systemic and liquidity risks for the financial markets. For example, a notification to an intermediary by a stranger asserting an adverse claim to a securities account or to securities that have been credited to the account might force a prudent intermediary to block the account, thus disrupting the liquidity that is the hallmark of the system of intermediated securities.

In order to avoid these problems, we propose a different standard for immunity of an intermediary, reflected by the proposed new Article 7bis set forth below. The current provision of Article 7(3) would be deleted. As always, we welcome any suggestions for improving the text of the proposed revisions.

Article 7bis. - 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 the intermediary made ~~at the time of~~ such debit, credit or designating entry (a) after the intermediary (i) had been served with legal process restraining it from doing so, issued by a court of competent jurisdiction and (ii) had a reasonable opportunity to act on the legal process ~~has knowledge of the adverse claim~~. Or (b) [intermediary fraud and violation of regulatory duty].

Additional language would need to be added to protect securities clearing or settlement systems that do not make debits and credits.

Annex

Example 1. Intermediary (IM)-A has a securities account with IM-B. In order to secure a loan to IM-A, IM-A grants a security interest in X Co. securities to CT and instructs IM-B to credit the X Co. securities to CT's account with IM-B. IM-B does so.[2] IM-A becomes insolvent and is in insolvency proceedings. As it turns out, some of the X Co. securities covered by CT's security interest are necessary to satisfy IM-A's account holders.

Is CT protected against the adverse claims of IM-A's account holders under Article 7 as an innocent acquirer? Although CT knew that IM-A acts as an IM for IM-A's own account holders, CT did not know that the transaction would create a shortfall in X Co. securities for IM-A's account holders.

If CT is not protected, what should it have done? Asked for representations and warranties from IM-A? Examined IM-A's books and records? Require an audit and certification by an independent auditor? Examined public records filed by IM-A with the relevant securities regulator? Other steps?

Example 2. Assume the same facts as Example 1 and that CT qualified for protection as an innocent acquirer. Should any of the following facts change that result? (In considering the hypothetical circumstances, keep in mind that transactions in the financial markets often must proceed with speed and also occur in high volumes each business day.)

a. At the time of the loan CT knew that IM-A had been fined by its securities regulator in the recent past for failing to maintain sufficient securities to cover the claims of its account holders.

b. At the time of the loan CT knew that IM-A was insolvent or nearly so, but did not know about the regulator's past fines.

c. Shortly before the loan was made, an officer of CT who works in the lending department (to which IM-A applied for the loan) read in the *Financial Times* that A Corp., the holding company that owns all of the shares of IM-A, recently received a large distribution of cash and securities from IM-A. The article also mentioned that A Corp. was close to a default under its public bond indentures. Alternatively, assume that the officer of CT who read the article worked in the trust department and had no personal knowledge of IM-A's loan application.

d. Shortly before the loan was made, an officer of CT who works in the lending department (to which IM-A applied for the loan) read in the *Financial Times* that IM-A had been sued by Z Co., who alleged that Z Co. had granted a security interest in X Co. stock to IM-A and that IM-A was wrongfully engaging in sales of and granting security interests in Z Co.'s X Co. stock. The securities to be covered by CT's security interest included a large amount of X Co. stock. CT asked IM-A about the claims, but IM-A denied them. CT conducted no further investigation before it made the loan.

e. Shortly before the loan was made, CT undertook a routine credit check on IM-A with a credit reporting agency. IM-A's credit report revealed that IM-A has been sued by a former employee who was discharged (it is alleged) because the employee notified the securities regulator that IM-A routinely has substantial shortfalls in securities credited to its account holders' accounts. Assume alternatively that: (i) an investigation of these allegations by IM-A's securities regulator is pending (and might continue for several months) and (ii) the investigation by the securities regulator has been completed with no finding of wrongdoing.

f. CT requested IM-A to represent and warrant in writing that:

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[2] Instead of CT making a secured loan to IM-A, the example could involve any person who is the beneficiary of a credit to a securities account, such as a buyer, a borrower of securities, or a transferee in a repo transaction. We have chosen the secured loan context, which we realize might not be typical in some intermediated systems, because some diligence on the part of a lender is normally expected in the extension of credit.

(i) IM-A is solvent and (ii) the securities to be credited to CT's account would not create an account holder shortfall. IM-A made the representation and warranty. CT made the loan and accepted the security interest. The representation and warranty were false.

g. CT requested IM-A to represent and warrant that: (i) IM-A is solvent and (ii) the securities to be credited to CT's account would not create an account holder shortfall. IM-A refused, saying that CT should simply rely on the law and the securities regulator to protect the account holders. CT made the loan and accepted the security interest.

h. IM-A's CEO responded to CT's request for representations and warranties as follows: "We will make the representations and warranties you ask for because we need cash today, but it will take a few days to be sure about the shortfall question. If there is a shortfall, we will promptly acquire X Co securities to cover it." CT made the loan and accepted the security interest.

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Proposal on Article 20

By way of background, Article 20 (formerly Article 18) was modified during the second meeting of experts in March 2006. Its scope was narrowed so as to apply only in an intermediary's insolvency proceeding. New paragraph 3 was added as well to make clear that the article was subject to any conflicting rule applicable in an insolvency proceeding.

It follows that the language in square brackets in paragraph 2 (beginning "Unless otherwise provided ...") is not necessary because new paragraph 3 covers the issue. Accordingly, paragraph 2 can simply state the general rule. Paragraph 3 will override paragraph 2 if there is a conflicting rule applicable in the insolvency proceeding.

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Observations on Exchange-Traded and Over-the-Counter Derivatives

We do not believe that exchange-traded futures, options on exchange-traded futures, or privately negotiated bilateral over-the-counter ("OTC") derivatives contracts are covered by the current draft Convention. While most futures contracts, like securities, are traded on an exchange (although some may not be so traded) there are two critical differences. **First**, whereas the purchase of a security generally provides a bundle of rights but not obligations to the account holder, a futures contract always includes **both** rights and obligations: for the long, a right and obligation to buy, for the short a right and obligation to sell. Long and short futures contracts are not credited or debited to accounts maintained with an intermediary, even when the commodity underlying the contract (the commodity to be bought and sold) is a security. **Second**, unlike most securities, where delivery of the security to the account of the beneficial owner is a fundamental component of the transaction, traders rarely take or make delivery of a futures contract. Most futures contracts are offset: the long enters into corresponding shorts, or vice-versa. At that point, the original futures position is extinguished, and, unlike a transaction on a securities exchange other than an options exchange, the position is not credited or transferred to a third party. (Offset is facilitated by the involvement of a clearinghouse, which becomes the seller to every buyer and the buyer to every seller. Equal and opposite long and short positions held by the same party offset each other and are extinguished.)

It follows that since rights and obligations are not credited or debited, as well as the fact that a futures contract is extinguished upon settlement and not transferred, that futures contracts are not intermediated securities covered by the Convention and that commodity accounts should not be viewed as securities accounts covered by the Convention. Nor do futures contracts involve duties of an intermediary to provide the economic benefits of ownership of a security, as provided by Article 9 of the convention.

Generally, many similar points may be made with respect to privately negotiated bilateral OTC derivatives contracts. Such OTC derivatives contracts are concluded between two parties (usually not referred to as "issuers," in contrast to securities). Generally, each party to the contract has not only rights but also duties and obligations under the contract. These duties cannot be assigned without the consent of the other party. A counterparty to an OTC derivatives contract does not typically dispose of the contract rights by transfer. The two parties to the contract may agree to terminate the contract or one party would enter into an off-setting contract with the same or another counterparty. The Convention by its terms addresses issues such as transfer of rights in securities, and the exercise of ownership rights to securities which are not pertinent to these types of privately negotiated bilateral OTC derivatives contracts.

As currently drafted, the definitions of "securities," "securities account," and "intermediated securities" could cause the Convention to be misconstrued to apply to exchange-traded futures, options on exchange-traded futures, and privately negotiated bilateral OTC derivatives. Accordingly, in order to provide the financial markets with ample legal certainty regarding the scope of the Convention, we believe that some additional wording for the Convention or interpretative guidance for the Explanatory Report should be developed that will provide clarity on this issue.

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COMMENTS BY GOVERNMENTS AND INTERNATIONAL ORGANISATIONS

(Comments by the Government of the United States of America)

Observations on Securities Settlement and Clearing Systems

A consensus is emerging in favor of giving appropriate recognition to the rules of securities settlement or clearing systems ("SSCS") in the text of the Convention. As we and others have articulated previously, this is desirable, given the crucial functions that SSCSs serve in national and international systems for the intermediated holding of securities. The experience of the past few decades has clearly shown that financial markets tend to evolve quickly and in unexpected directions. SSCSs, who serve on the "front-line" of clearing and settlement in these dynamic markets, need the flexibility to adapt their rules and procedures accordingly to reflect evolving market practice. As such, it is important for economic efficiency and systemic stability that SSCS rules be given recognition under the Convention.

At the same time, Contracting States must be very conscious of the significance and implications of granting such recognition to SSCS rules. By deferring to SSCS rules, the Convention will require states party to the Convention to recognize and defer to the rules of entities or systems that are, in some cases, private, although supervised. Such rules will also affect other parties who are not participants in the SSCS but hold intermediated securities through participants in the SSCS. While this is clearly necessary—for reasons such as finality, loss-sharing, and many others—it is also clearly a significant matter for Contracting States to make such rules binding under treaty law.

Prior to making this agreement, Contracting States will need to have an unambiguous understanding of the parties that qualify for this privileged treatment and those who are responsible for policing these parties. The definition in the revised draft Convention makes strides toward this goal. Notably, however, portions of the definition that the United States believes are necessary in order for the Convention to recognize private entity rules appear in brackets. We believe that the substance of the bracketed language needs to be retained.

In our view, three overarching principles should guide the development and use of this definition: transparency, supervision, and declaration. First, it must be clear who does and does not qualify and what rules apply to transactions falling under the Convention. Clause (ii) of the definition ensures that parties to commercial transactions can obtain knowledge of applicable rules. The declaration mechanism contemplated by clause (iv), together with the criteria established by clauses (i) to (iii) further support the three principles. Second, as set forth by clause (ii), any entity qualifying for SSCS status must be a central bank or be supervised by a governmental body. This requirement ensures that national governments play an ongoing gatekeeper role in determining and identifying the entities that qualify for this privileged position. Governments would exercise this responsibility by the mechanism of clause (iv), but always taking careful measure of the criteria established by international agreement in clauses (i), (ii), and (iii). We think that the definition, as revised, carefully excludes parties who should not fall under the SSCS umbrella, such as those that act as brokers and custodian banks, but it may be useful to address this in the commentary in order to prevent any misunderstanding.

With these principles firmly in mind, the United States offers these more specific observations on the definition of "securities settlement or clearing systems" and its use in the text:

- A number of provisions of the draft Convention refer to the effect of one or more of the domestic non-Convention law, an account agreement, and the rules of a SSCS. However, the language of these provisions is not consistent. We suggest that they be conformed to the following formulation:

> "[T] [t]he domestic non-convention law and, to the extent effective under the domestic non-Convention law, an account agreement or the rules and agreements governing the operation of a securities settlement [or clearing] system…"

Note that this formulation uses the phrasing "effective under" rather than "permitted by," the phrasing that is used in some provisions of the current text. The "permitted by" version is ambiguous. It could be understood to refer only to identifiable provisions of the domestic non-Convention law that explicitly authorize a specific result. The "effective under" terminology properly addresses the ultimate issue of whether the domestic non-Convention law would give effect to the relevant provision of the account agreement or rule of a SSCS.

- In addition to conforming the phrasing in the sections that currently make reference to the rules of a SSCS, this same formulation should be adopted for provisions that currently refer to an account agreement but not such rules. These provisions are Article 1(n) (defining "designating entry"); Article 9(1) (c) (rights of account holder); and Article 18 (obligations of intermediary).

- The explanatory comments to Convention should explain that references to the "rules" of a SSCS are not intended to be limiting. The references should be interpreted broadly to include any prescriptive or interpretive promulgations of a system. While individual SSCSs may denominate certain rules as terms and conditions, regulations, procedures, operating circulars, protocols, or something else, the Convention's reference to "rules" should be understood substantively.

- We should carefully review each article to determine whether such article should refer to the rule of a SSCS. We may wish to consider the possibility of deleting Article 21 (Overriding effect of certain rules of securities settlement or clearing systems) which may be overbroad to the extent that we become comfortable that the rules of SSCSs are appropriately referred to in each relevant Article.

- The square brackets around "[or clearing]" should be deleted so that the defined term is properly descriptive of the substance of the definition. In some jurisdictions one entity provides both clearing and settlement and in other jurisdictions different entities provide those functions. It is clear from the current definition that entities that clear securities transactions but that do not settle securities transactions are covered by the definition. It is extremely important, indeed crucial, that the entities that clear securities transactions (but do not settle transactions) be covered by the definition and the Convention. Clearing is a function that is integral both to the process of settlement and to the efficient, safe and sound functioning of a securities market.

- Where clause (ii) of the definition refers to SSCS rules being "publicly accessible," we should make clear that we mean effective, rapid access of a kind consistent with modern transactions. This point can be made in the explanatory text.

- For purposes of clause (iii), the text should specify that a SSCS be supervised as such, rather than simply being a supervised entity. For example, a custodian bank that is supervised as a bank, but not as a settlement or clearing system, should be excluded. On the other hand, it may not be necessary (and may not accord with national regulatory frameworks) for each SSCS rule to be reviewed and approved by a supervisor in order to be given effect under the Convention. Accordingly, we suggest the following reformulation of clause (iii):

> "(iii) is operated by a central bank or conducts operations that are supervised by a regulator that has oversight over the system or entity acting in its capacity as a securities settlement system; and"

The definition should be clarified to ensure that the declaration by a Contracting State of a SSCS under clause (iv) as being made "on the grounds of reduction of risk to the stability of the financial system" is sufficient on its face, and that, once made, the declaration itself is not subject to challenge. References to the "risk to the stability" elsewhere in the draft Convention should be deleted. (*See* Articles 21 and 22(1).)