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INSTITUT INTERNATIONAL POUR L'UNIFICATION DU DROIT PRIVE

**EN**

**GOVERNING COUNCIL**
**89th session**
**Rome, 10-12 May 2010**

UNIDROIT 2010
C.D. (89) 5(b)
Original: English
February 2010

**Item No. 6 on the agenda:** Transactions on transnational and connected capital markets –

# (b) Principles and Rules Capable of Enhancing Trading in Securities in Emerging Markets

(Memorandum prepared by the Secretariat)

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| *Summary* | *Examination of initial steps to develop a future legislative guide on principles and rules capable of enhancing trading in securities in emerging markets* |
| *Action to be taken* | *See paragraph 16 below* |
| *Mandate* | *Work Programme 2006-2010* |
| *Priority level* | *To be determined* |
| *Status* | */* |
| *Related documents* | *UNIDROIT 2008 – C.D. (87) 23* |

## MANDATE

1. The Governing Council will recall that, at its 87th session (Rome, 16-18 April 2007), it recommended, *inter alia*, to the General Assembly to include in the Work Programme for the triennium 2009-2011, "work on an instrument on netting in financial services, a legislative guide on principles and rules capable of enhancing trading in securities in emerging markets and, resources permitting and possibly included in that guide, rules facilitating convergence of national investor classification systems" (see C.D. (87) 23, para. 118 (a)(iii)).

2. It had been assumed, at that time, that the Convention on Substantive Rules for Intermediated Securities, then still under negotiation, would have been completed before the end of 2008. However, the diplomatic Conference held in Geneva from 1 to 12 September 2008 decided that an Official Commentary to the Convention should be prepared and that a second session should be convened in 2009 to finalise and adopt the Convention.

3. As a result of that decision, the UNIDROIT General Assembly, at its 63rd session, in 2008, agreed to postpone the inclusion of new topics in the organisation's Work Programme and to assign the highest priority to the finalisation of the then outstanding projects, namely, the draft Convention on intermediated securities, the additional chapters of the UNIDROIT Principles of International Commercial Contracts currently under preparation and the Space Protocol to the Cape Town Convention. Following the successful completion of the work on the Convention, and in the light of a reiteration by the Governing Council of the importance attached to the topic (see C.D. (88) 17, para. 59), the UNIDROIT General Assembly, at its 65th session, in 2009, firmly included work on a "Legislative Guide on principles and rules capable of enhancing trading in securities in emerging markets" in the current Work Programme of UNIDROIT (A.G. (65) 10, paras. 18 and 26).

**STATUS OF THE PROJECT**

4. As a first step toward the development of a legislative guide, the UNIDROIT Secretariat started preparing a guidance document intended to provide advice for countries that ratify the Convention on how best to incorporate the Convention and integrate it into their domestic legal systems. This type of instrument is known in the practice of other organisations as a "Ratification Kit" or "Accession Kit".

5. The "Accession Kit" envisaged by the Secretariat will to some extend resemble the declarations memoranda prepared by UNIDROIT for the assistance of States that contemplate becoming Contracting States to the Cape Town Convention on International Interests in Mobile Equipment (the "Cape Town Convention") and its Protocols. The Cape Town Convention and its Protocols allow or require a number of declarations by Contracting States and Regional Economic Integration Organisations. The complexity of the system of declarations, and the fact that declarations affect the rights and obligations of Contracting States mean that particular care must be exercised by Contracting States in making their declarations. The declarations memoranda were prepared by the UNIDROIT Secretariat, as Depositary of the Cape Town Convention and its Protocols, to assist States and Regional Economic Integration Organisations in their preparation of declarations. The declarations memoranda for the Aircraft and the Railway Protocols to the Cape Town Convention are essentially concerned with the provision of advice to assist prospective Contracting States in their preparation of declarations with a view to ensuring that they formulate their declarations in full compliance with the terms of that Convention and its Protocols.

6. The Geneva Securities Convention, too, provides for the making of a number of declarations, some of which deal with complex legal and policy matters that are essential for the proper operation of the Convention.

7. Indeed, the Convention permits a number of "opt-out" declarations.[1] Depending on the case, by making a declaration, Contracting States could, for instance:

(a) limit the sphere of application of the entire Convention, such as article 5, which allows Contracting States to declare that the Convention shall apply only to securities accounts maintained by Central bank and regulated intermediaries;

(b) exclude the application of particular provisions of the Convention to certain specific situations, such as the declaration authorised by article 12 (5), which allows Contracting States to declare that the acquisition and disposition methods provided for in that article do not apply in

[1] See, for instance, Geneva Securities Convention, Articles 5, 12(5)(a)-(c), 12(6), 12(7), 25(5), and 36(2).

relation to interests in intermediated securities granted by or to parties falling within such categories as may be specified in the declaration;

(c) declare the precedence of a law other than the Convention ("non-Convention law") over a particular rule of the Convention, such as article law 19, paragraph 7, which allows a Contracting State to declare that under its non-Convention law an interest granted by a designating entry has priority over any interest granted by any other method provided by Article 12; or

(d) exclude the application of entire chapters of the Convention, as some of which may include entire chapters, as permitted by article 38, paragraph 1.

8. The Convention also allows Contracting States to further shape its application though a number of opt-in declarations, including some that are primarily intended to enhance transparency in the application of the Convention.[2] Salient examples include:

(a) the identification of a "securities settlement system" or of a "securities clearing system" by a Contracting State pursuant to article 1, paragraphs (n) and (o), respectively;

(b) the right given by article 7, paragraph 1, to declare that a person other than the relevant intermediary is responsible for the performance of a function or functions (but not all functions) of the relevant intermediary under this Convention;

(c) the possibility, pursuant to article 22(3), to declare that under its domestic law an attachment of intermediated securities of an account holder made against or so as to affect a person other than the relevant intermediary has effect also against the relevant intermediary;

9. Advice on the formulation of declarations and models of declarations that may be lodged under the Convention, as appropriate, will therefore be a necessary component of the "Accession Kit" that the Secretariat will produce. However, the "Accession Kit" as envisaged by the Secretariat, will go a step further than the declarations memoranda prepared by UNIDROIT for the assistance of States that contemplate becoming Contracting States to the Cape Town Convention on International Interests in Mobile Equipment (the "Cape Town Convention") and its Protocols.

10. Consistent with the functional approach that guided its preparation, the Geneva Securities Convention deals primarily with matters that are necessary for enhancing legal certainty and ensuring the seamless operation of financial markets despite divergences in securities holding patterns, legal theories and regulatory structures. This dictated a certain level of restraint on the topics to be addressed by the Convention and great parsimony in the level of detail with which the Convention dealt with them.

11. Thus, for example, the Convention makes numerous references to the non-convention law:

(a) Article 9(3) defers to the non-Convention law on any limits on security interests, or a limited interest other than a security interest, rights acquired by the credit of securities to a securities account;

(b) It is also the non-Convention law, pursuant to Article 16 (and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system) that determines whether and in what circumstances a debit, credit, designating entry or removal of a designating entry is invalid, is liable to be reversed or may be subject to a condition and the consequences thereof;

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[2] See, for instance, Geneva Securities Convention, Articles 1(n)(iii), 1(o)(iii), 7, 12(5)(a), 19(7), 22(3), and 39(2).

(c) Furthermore, it is non-Convention law, under Article 24(3), that sets the time within which an intermediary must replenish a shortfall in securities and, more generally, under Article 24(4), it is the non-Convention law that provided the method for the intermediary to ensure the permanent sufficiency of securities of the same description as are credited to its clients or to itself;

(d) Article 28 gives broad freedom to non-Convention law (and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system) to specify the obligations of an intermediary under the Convention and to establish the intermediary's liability for their breach.

12. In addition to these specific references to non-Convention law, the Convention assumes the existence of provisions on a number of areas which directly or indirectly are outside its sphere of application, either because the Convention itself declares that it does not govern a particular matter or that its provisions do not "affect" the applicable law on a particular subject, or because the Convention authorises Contracting States to exclude certain provisions by declaration:

(a) Thus, for example, article 6 expressly provides that the Convention does *not* apply to the functions of creation, recording or reconciliation of securities, vis-à-vis the issuer of those securities, by a person such as a central securities depository, central bank, transfer agent or registrar;

(b) Another important limitation to the scope of application of the Convention, is that the Convention does not cover "corporate law" matters, a principle which is expressed by the rules in article 8 that clarify that the Convention "does not affect any right of the account holder against the issuer of the securities" and that it "does not determine whom the issuer is required to recognise as the shareholder, bondholder or other person entitled to receive and exercise the rights attached to the securities or to recognise for any other purpose;"

(c) Other examples of referral to law other than the Convention include: applicable rules of law on non-consensual security interests [3] and their relative priority;[4] rights and liabilities of the "non-innocent" acquirer of securities;[5] possible additional rights or powers of a collateral taker or additional obligations of a collateral provider above and beyond those set forth in the Convention;[6] and the priority interest pre-existing the entry onto force of the Convention in a contracting State.[7]

13. The complexity of the subject matter covered by the Geneva Securities Convention, and the delicate balance between uniform rules and domestic law, make it useful to supplement the advice specifically concerned with the declarations by offering guidance on the relationship between the rules of the Convention and the otherwise applicable laws in a Contracting States. Therefore, in addition to offering technical advice on the formulation of declarations, the "Accession Kit" will contain discussion and advice explaining how to address those issues which the Convention itself refrains from addressing or allows Contracting States to provide for otherwise, and how to fill these gaps. The Secretariat anticipates that the work done in the preparation of the "Accession Kit" to the Convention, by canvassing all the other areas of law that affect or support the development of a modern financial market, will lay the ground for the work on the broad legislative guide to principles and rules capable of enhancing trading in securities in emerging markets.

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3 Geneva Securities Convention, Article 12(8).

4 Geneva Securities Convention, Article 19(7).

5 Geneva Securities Convention, Article 18(4).

6 Geneva Securities Convention, Article 31(2).

7 Geneva Securities Convention, Article 39.

14. A number of such adjacent areas of the law had been tentatively identified at an early stage of consideration of this project. [8] Further areas will emerge in the process of the preparation of the "Accession Kit", a first draft of which is currently being prepared by an outside expert hired under a consultancy contract and is scheduled for delivery on 30 April 2010. The final version of the draft "Accession Kit" will be delivered to the Secretariat by 31 August 2010. The Secretariat will thereafter submit the draft "Accession Kit" for discussion at a meeting of experts to be held in conjunction with the meeting of the States and observers represented on the Committee on Emerging Markets Issues, Follow-Up and Implementation,[9] which the Secretariat intended to convene in Rome during the third quarter of 2010 to examine the reception given to the Geneva Securities Convention in the various countries and consider concrete proposals for its promotion.

15. The Secretariat would use the occasion of such a meeting to also consider the scope of the work to be carried out toward the formulation of a legislative guide on principles and rules capable of enhancing trading in securities in emerging markets.

**ACTION TO BE TAKEN**

*16. The Secretariat would invite the Council to consider the proposed initial steps to develop a future legislative guide on principles and rules capable of enhancing trading in securities in emerging markets and confirm its high propriety status in the Work Programme of the organisation.*

[8] Such as "(a) Nature and types of securities, including fungible and dematerialised securities; (b) Transactional structure of bond issues; (c) Transactional structure of share issues (IPOs); (d) Organisational and transactional provisions to enhance liquidity on secondary markets; (e) General contract law and special rules relating to trading in securities; (f) Legal issues relating to trading and settlement; (g) Legal issues relating to collateralised transactions; (h) Regulatory framework" (see http://www.unidroit.org/english/workprogramme/study078/main.htm).

[9] The Committee on Emerging Markets Issues, Follow-up and Implementation is co-chaired by Mr Alexandre Pinheiro dos Santos (Brazil) and Ms Niu Wenjie (China). Members are: Argentina, Cameroon, Chile, France, Greece, India, Japan, Nigeria, Republic of Korea, South Africa, United States of America and the European Union. Indonesia, the European Central Bank, EuropeanIssuers, the Hague Conference on Private International Law and the Trade Association for the Emerging Markets have been admitted as observers.