



**EN**

**GOVERNING COUNCIL**  
**95<sup>th</sup> session**  
**Rome, 18-20 May 2016**

UNIDROIT 2016  
C.D. (95) 6 rev.  
Original: English  
May 2016

**Item No. 6 on the agenda: Transactions on Transnational and Connected Capital Markets - Principles and Rules Capable of Enhancing Trading in Securities in Emerging Markets**

(prepared by the Secretariat)

|                           |  |
|---------------------------|--|
| <i>Summary</i>            | <i>Examination of steps to develop a future Legislative Guide on Principles and Rules capable of enhancing trading in securities in emerging markets and to prepare for a fourth meeting of the Committee on Emerging Markets Issues, Follow-Up and Implementation</i> |
| <i>Action to be taken</i> | <i>Take note of the activities undertaken by the Secretariat</i>   |
| <i>Mandate</i>            | <i>Work Programme 2014-2016</i>  |
| <i>Priority level</i>     | <i>Medium</i>  |
| <i>Related documents</i>  | <i>Annual Report 2015 (C.D. (95) 2)</i>  |

**INTRODUCTION**

1. The final session of the diplomatic Conference to adopt a Convention on Substantive Rules regarding Intermediated Securities (Geneva, 5-9 October 2009), *inter alia*, adopted the UNIDROIT Convention on Substantive Rules for Intermediated Securities (the 'Geneva Securities Convention' or the 'Convention') and established a Committee on Emerging Markets Issues, Follow-Up and Implementation (the 'Committee') to assist with the Convention's promotion and implementation.

2. Thereafter, the UNIDROIT General Assembly, at its 65<sup>th</sup> session in 2009, included work on drafting a Legislative Guide on Principles and Rules capable of enhancing trading in securities in emerging markets (the 'Legislative Guide') in the UNIDROIT Work Programme (UNIDROIT 2009 – A.G. (65) 10). The Governing Council, at its 89<sup>th</sup> session (Rome, 10-12 May 2010), then took note of the steps planned by the Secretariat to prepare the Legislative Guide, but assigned medium/low priority to this work until completion of the Principles on Close-Out Netting.

3. Upon adoption of the Principles on Close-Out Netting, the Governing Council, at its 92<sup>nd</sup> session (Rome, 8-10 May 2013), elevated the priority given to the work on drafting the Legislative Guide (from Medium/Low to Medium). This decision was approved by the General Assembly at its 72<sup>nd</sup> session (Rome, 5 December 2013) and the Legislative Guide was included in the Work Programme of the Organisation for the 2014-2016 triennium at this higher level of priority (UNIDROIT 2013 - A.G. (72) 4).

## **I. PREPARATORY WORK AND MEETINGS OF THE COMMITTEE**

4. Since the conclusion of the diplomatic Conference, the Committee has met three times. The first meeting was held in Rome (6-8 September 2010) at UNIDROIT's headquarters, the second in Rio de Janeiro (27-28 March 2012), and the third in Istanbul (11-13 November 2013).

5. Initially, the Secretariat prepared in advance of the Committee's first meeting a draft Accession Kit, as a first step toward the development of a Legislative Guide on Principles and Rules capable of enhancing trading in securities in emerging markets (UNIDROIT 2010 - S78B/CEM/1/Doc. 3). It was intended to provide advice for countries seeking to become Party to the Geneva Securities Convention on how best to incorporate and integrate it into their domestic legal systems.

6. At the first meeting, the Committee decided to divide the draft document in two. The first part containing an explanatory memorandum for the assistance of States and Regional Economic Integration Organisations on the system of declarations under the Convention ultimately became a UNIDROIT document in its capacity as Depositary of the Geneva Securities Convention (UNIDROIT 2011 – DC11/DEP/Doc. 1 rev.). The second part containing references to sources of law outside the Convention was subsequently prepared and provided to the Committee in advance of its meeting in Rio de Janeiro as a potential basis for further work on the future Legislative Guide (UNIDROIT 2011 – S78B/CEM/2/Doc. 2).

7. At the second meeting, the Committee discussed, among other things, the Legislative Guide's potential scope, content, and structure. The Committee stressed the importance of formulating principles focusing on private law aspects of securities trading, but participants indicated that given the complexity of the subject matter, consideration of other aspects (including regulatory law) and cooperation with other organisations would be required. Inputs received by the Committee also indicated that the future Legislative Guide should not be a uniform law text, but a document setting out various options on issues fundamental generally to securities trading and particularly to the Convention's proper implementation. The Committee then set up an informal working group to draft a proposal on these issues for consideration by the full Committee at its next meeting.

8. At the third meeting, the Committee focused its attention on the Legislative Guide's scope and structure by discussing the annotated outline presented by the Secretariat (UNIDROIT 2013 – S78B/CEM/3/Doc. 2). This document, prepared in consultation with the informal working group, covered the universe of public and private law subjects related to securities trading in emerging markets. The intent of the broad outline was to provide the Committee with a full picture of transactional, private law topics, as well as related regulatory and public law topics, from which to select those that the Legislative Guide should cover. To narrow the expected content for an initial draft, a group of States presented a proposal focused mainly on private law issues, but which included some regulatory aspects with direct relevance to party transactions. The proposal called for three substantive sections and was accepted by consensus by the Committee to serve as the basis for setting the scope of the Legislative Guide and organising the content and structure of the initial draft (UNIDROIT 2015 – C.D. (94) 6, Annexe 1).

## **II. STATUS OF THE PROJECT**

9. Following the Committee's third meeting, the Governing Council, at its 93<sup>rd</sup> session (Rome, 7-10 May 2014), expressed its appreciation for the work completed thus far on the project to prepare the Legislative Guide, notwithstanding the staff shortage at that time. Work fully recommenced during the fall of 2014 with the arrival of new staff and the engagement of an expert consultant to prepare an initial draft of the Legislative Guide and, at its 94<sup>th</sup> session (Rome, 6-8 May 2015), the Governing Council noted the activities undertaken and the planned scheduling of a Committee meeting in early 2016. Following that session, however, the draft was not completed by the expert consultant as anticipated. In August 2015, preparation was undertaken internally at the Secretariat, which opted to convene a small, informal group of experts for the preparation and review of an initial draft of the Legislative Guide.

### **A. The informal experts group**

10. The informal experts group is chaired by Mr Hideki Kanda (Professor of Law, Gakushuin University) and includes Mr Philippe Dupont (Partner, Arendt & Medernach), Ms Dorothee Einsele (Professor of Law, University of Kiel), Mr Francisco J. Garcimartín Alférez (Professor of Law, Universidad Autónoma of Madrid), Mr Thomas Keijser (Senior Researcher, Radboud University), Ms Maria Chiara Malaguti (Professor of Law, Catholic University of the Sacred Heart), Mr Charles W. Mooney, Jr. (Professor of Law, University of Pennsylvania), and Mr Luc Thévenoz (Professor of Law, University of Geneva).

11. This informal experts group met for the first time at UNIDROIT's headquarters on 23-24 October 2015 and considered a partial initial draft, which was organised into four parts: (a) background on the emergence of intermediated securities, current holding models, and legal uncertainty and systemic risk; (b) an overview of the Geneva Securities Convention; (c) the principles and rules, organised by market participant – account holder, intermediary, and collateral taker – and covering the Convention's references to non-Convention law, applicable law, etc.; and (d) other issues. At that informal meeting, the Secretariat obtained expert input on various issues, including the proposed scope, structure, and content of the Guide, as well as on the organisation of further work on the initial draft, with a view to its completion by mid-2016. Together with a follow up videoconference on 16 November 2015, a revised outline for the initial draft was agreed, and each expert agreed to be responsible for certain portions (see Annex 1), which were to be drafted and submitted to the Secretariat by early January 2016.

12. Once those individual drafts were complete, they were combined into a single document by the Secretariat and circulated to the informal experts group in February 2016. Another videoconference was held on 7 March 2016 to share initial comments on the combined draft and to identify how best to proceed in advance of the group's next meeting on 16-17 May 2016. It was agreed that the experts would endeavour to provide comments on the combined draft by the end of March 2016 and then to provide revisions to their respective contributions, in light of the comments received and the discussions during the videoconference, by the end of April 2016 for the creation of a revised draft to be circulated in advance of the group's next meeting in Rome on 16-17 May 2016.

### **B. The current draft Legislative Guide**

13. As of this writing, the draft Legislative Guide seeks (1) to improve the legal framework applicable to intermediated securities by providing guidance for States to consider in establishing an intermediated securities holding system or evaluating an existing system; and (2) to promote the adoption and implementation of the Convention. As set forth in the updated outline in Annex 1

and the in-progress initial draft of the Legislative Guide in Annex 2, the Guide is currently structured in the following nine parts:

- Part I provides an overview on intermediated securities, describing their origins and development and discussing the various models of intermediated securities holding systems, including the individual ownership model, the co-ownership model, the trust model, the security entitlement model, and the contractual model;
- Part II describes in brief the Geneva Securities Convention, including its purpose to reduce legal uncertainty and risk, its core and functional harmonisation approach, and the important role of law outside the Convention;
- Parts III-VII identify key principles and rules capable of enhancing trading in securities and explain their interaction with law outside the Convention together with various model examples of such law, in particular by summarising the core Convention rules and, as necessary, discussing the choices to be made by declaration, the matters to be addressed or clarified by law outside the Convention, and matters not mentioned in the Convention;
- Part VIII provides an overview on conflicts of law aspects; and
- Part IX provides an overview on implementation of the Geneva Securities Convention and its relationship with other international instruments.

### **C. Next steps**

14. As noted above, the informal experts group is planning to meet for the second time in Rome on 16-17 May 2016. A revised draft of the Legislative Guide, updated in light of the experts' comments and revisions received by the end of April 2016, was circulated to the group on 9 May 2016 (see Annex 2).

15. At that meeting, the group is expected, *inter alia*, to review the revised draft in detail and offer expert input to the Secretariat regarding the collection of examples and options, such as legislative or regulatory text or related descriptions, from various intermediated holding systems to offer States guidance in establishing an intermediated securities holding system or evaluating an existing system.

16. After that meeting, as soon as a revised draft – updated based on the input received – is ready, it is expected that that draft will then be circulated for (a) review within the Committee, in particular the informal working group which had been established to work on the project at the Committee's meeting in Rio de Janeiro, had been supplemented at the Istanbul meeting, and currently includes the co-chairs of the Committee, Brazil and China, and France, Germany, Italy, Japan, the Russian Federation, South Africa, Switzerland, and the United States of America; and (b) extensive consultation and collaboration with other organisations and interested stakeholders to solicit their comments and input. In addition, the Secretariat is also considering circulation of the draft to UNIDROIT's network of Correspondents in order to request suggestions of possible examples and options from the greatest variety of intermediated holding systems.

17. Indeed, given the significant progress made thus far and expected in the near future on the draft Legislative Guide, it is envisioned that convening a fourth meeting of the full Committee could soon be warranted. Similar to the Committee's previous meetings, the Secretariat would propose that it begin with a Colloquium on Financial Markets Law to which non-governmental organisations and private sector participants would also be invited.

18. Following the Colloquium, the Committee would reconvene to consider the items on its agenda. At this time, it is expected that the Committee would consider the reception given to the Convention in various countries, including any related developments; review in detail the latest draft of the Legislative Guide; and discuss proposals for follow-up promotional activities and possible future work by UNIDROIT in the area of capital markets. This includes consideration of promotional activities for both the Convention and the Principles on Close-Out Netting. It is hoped that a fourth meeting of the Committee could be convened, either in an emerging market State or at UNIDROIT's headquarters in Rome, in or around January 2017.

#### **ACTION TO BE TAKEN**

19. *The Secretariat invites the Governing Council to take note of the activities undertaken by the Secretariat, including steps taken to develop a Legislative Guide on principles and rules capable of enhancing trading in securities in emerging markets and to plan an upcoming meeting of the Committee in or around January 2017.*

**ANNEX 1****Provisional Title: Legislative Guide on Principles and Rules capable of enhancing trading in securities in emerging markets****PREFACE****CONTENTS****LIST OF CONTRIBUTORS****LIST OF ABBREVIATIONS****GENERAL INTRODUCTION****I. OVERVIEW ON SECURITIES** (Bergman)

- A. Basics of securities and securities holding
- B. Intermediated securities holding models

**II. THE GENEVA SECURITIES CONVENTION** (Bergman)

- A. Purpose
- B. Approach
- C. Terminology
- D. Scope
- E. Law outside of the Convention

**III. RIGHTS OF ACCOUNT HOLDERS AND DUTIES AND LIABILITIES OF INTERMEDIARIES [Arts. 9, 10, 23, 28]** (Thévenoz)

- A. Rights of account holders
- B. Measures to enable the exercise of account holder rights
- C. Liability of intermediaries

**IV. TRANSFER OF INTERMEDIATED SECURITIES**

- A. Acquisition and disposition of intermediated securities [Arts. 11-13] (Bergman)
- B. Unauthorised dispositions and reversal [Arts. 15 and 16] (Einsele)
- C. Protection of an innocent acquirer [Arts. 17-18] (Einsele)
- D. Priorities [Arts. 19-20, 39] (Mooney)

**V. INTEGRITY OF THE INTERMEDIATED HOLDING SYSTEM**

- A. Prohibition of upper-tier attachment [Art. 22] (Kanda)

- B. Prevention of shortfalls and allocation of securities [Arts. 24-25] (Keijser)
- C. Securities clearance systems (SCSs) and securities settlement systems (SSSs) [Art. 27 and other relevant articles] (Dupont)
- D. Issuers and set-off [Arts. 8, 29-30] (Garcimartín)

**VI. INSOLVENCY PROTECTION [Arts. 14, 20, 21, 26] (Mooney)**

- A. Core Convention rules
- B. Choices to be made by declaration
- C. Matters to be addressed or clarified by law outside the Convention

**VII. SPECIAL PROVISIONS IN RELATION TO COLLATERAL TRANSACTIONS [Arts. 31-38] (Keijser)**

- A. Core Convention rules
- B. Choices to be made by declaration
- C. Matters to be addressed or clarified by law outside the Convention
- D. Matters not mentioned in the Convention

**VIII. CONFLICTS OF LAW ASPECTS [Arts. 2-3] (Garcimartín)**

- A. Introduction: the conflicts of law dimension
- B. The Convention's sphere of application
- C. Conflicts of law rules for intermediated securities
- D. Interaction between the Convention and conflicts of law rules: the "tier by tier" approach
- E. PRIMA approach and other conflicts of law rules

**IX. IMPLEMENTATION AND RELATIONSHIP WITH OTHER INTERNATIONAL INSTRUMENTS AND DOCUMENTS (Malaguti)**

- A. Link to other international instruments or regulations
- B. Overview of implementation in domestic legal frameworks

**ANNEXES (Bergman)**

1. Glossary
2. References to 'non-convention law'
3. References to 'applicable law'
4. References to rules relating to insolvency
5. References to uniform rules of SCSs and SSSs



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

---

**Draft**

**(in-progress)**

**Legislative Guide**

**9 May 2016**



## **PREFACE**

[Placeholder]

**LIST OF CONTRIBUTORS**

[Placeholder]

**LIST OF ABBREVIATIONS**

[Placeholder]

**CONTENTS**

|   |    |
|---|----|
| PREFACE .....   | 2  |
| LIST OF CONTRIBUTORS .....  | 3  |
| LIST OF ABBREVIATIONS.....  | 4  |
| CONTENTS.....   | 5  |
| GENERAL INTRODUCTION.....   | 7  |
| I. OVERVIEW ON SECURITIES .....   | 8  |
| A. Basics of securities and securities holding .....                                | 8  |
| B. Intermediated securities holding models.....                                     | 14 |
| II. THE GENEVA SECURITIES CONVENTION .....  | 19 |
| A. Purpose.....   | 19 |
| B. Approach.....  | 20 |
| C. Terminology.....   | 21 |
| D. Scope .....  | 22 |
| E. Law outside of the Convention .....  | 22 |
| III. RIGHTS OF ACCOUNT HOLDERS AND DUTIES AND LIABILITIES OF INTERMEDIARIES.....    | 23 |
| A. Rights of account holders .....  | 23 |
| B. Measures to enable the exercise of account holder rights.....                    | 27 |
| C. Liability of intermediaries .....  | 30 |
| IV. TRANSFER OF INTERMEDIATED SECURITIES.....                                       | 30 |
| A. Acquisition and disposition of intermediated securities.....                     | 30 |
| B. Unauthorised dispositions and reversal.....                                      | 36 |
| C. Protection of an innocent acquirer .....   | 38 |
| D. Priorities.....  | 40 |
| V. INTEGRITY OF THE INTERMEDIATED HOLDING SYSTEM .....                              | 42 |
| A. Prohibition of upper-tier attachment .....                                       | 42 |
| B. Prevention of shortfalls and allocation of securities .....                      | 45 |
| C. Securities clearing systems (SCSs) and securities settlement systems (SSSs)..... | 47 |

|       |  |    |
|-------|--|----|
| D.    | Issuers and set-off.....   | 49 |
| VI.   | INSOLVENCY PROTECTION .....  | 53 |
| A.    | Core Convention rules.....   | 53 |
| B.    | Choices to be made by declaration.....   | 54 |
| C.    | Matters to be addressed or clarified by law outside the Convention .....                         | 54 |
| VII.  | SPECIAL PROVISIONS IN RELATION TO COLLATERAL TRANSACTIONS .....                                  | 57 |
| A.    | Core Convention rules.....   | 57 |
| B.    | Choices to be made by declaration.....   | 58 |
| C.    | Matters to be addressed or clarified by law outside the Convention .....                         | 59 |
| D.    | Matters not mentioned in the Convention .....  | 60 |
| VIII. | CONFLICTS OF LAW ASPECTS .....   | 60 |
| A.    | Introduction: the conflict of laws dimension .....   | 61 |
| B.    | The Convention’s sphere of application.....  | 61 |
| C.    | Conflict of laws rules for intermediated securities .....  | 61 |
| D.    | Interaction between the Convention and conflict of laws rules: the “tier by tier” approach ..... | 62 |
| E.    | PRIMA approach and other conflict of laws rules .....  | 63 |
| IX.   | IMPLEMENTATION AND OTHER INSTRUMENTS AND REGULATIONS.....  | 63 |
| A.    | Link to other international instruments or regulations .....                                     | 63 |
| B.    | Overview of implementation in domestic legal framework.....                                      | 64 |
|       | ANNEX 1: GLOSSARY .....  | 66 |
|       | ANNEX 2: REFERENCES TO “NON-CONVENTION LAW”.....   | 67 |
|       | ANNEX 3: REFERENCES TO “APPLICABLE LAW” .....  | 72 |
|       | ANNEX 4: REFERENCES TO RULES RELATING TO INSOLVENCY.....   | 73 |
|       | ANNEX 5: REFERENCES TO UNIFORM RULES OF SCSs AND SSSs .....                                      | 75 |

## GENERAL INTRODUCTION

1. The Legislative Guide on Principles and Rules Capable of Enhancing Trading in Securities in Emerging Markets (the “Guide”) addresses important matters to be considered in the creation of an intermediated securities holding system or the evaluation of an existing system. The Guide summarises the core principles and rules from the UNIDROIT Convention on Substantive Rules for Intermediated Securities (the “Geneva Securities Convention” or the “Convention”) and offers guidance and recommendations on those principles and rules as well as related matters not addressed in the Convention.

2. As the Convention’s drafters adopted a core and functional harmonisation approach, the Convention provides harmonised rules regarding certain intermediated securities issues, but also leaves various issues to be defined and determined by other rules of law in force in a Contracting State. The Guide is intended to complement the Convention by addressing these issues and, like the Convention, improve the legal framework for holding and transfer of intermediated securities, in order to enhance the internal soundness of domestic financial markets and their cross-border compatibility and, as such, to promote sustainable capital formation. In particular, the Guide explains what is and what is not covered by the Convention and provides a menu of options and examples for States to consider in establishing an intermediated securities holding system or evaluating an existing one. The Guide thus makes clear that the Convention is capable of accommodating different domestic holding systems and rendering their interactions significantly more predictable and less risky. The Guide further seeks to promote the creation of comprehensive and coherent sets of legal rules for intermediated securities, thereby increasing legal certainty and economic efficiency with respect to intermediated securities holding, both domestically and in cross-border situations.

3. The Guide is structured in nine Parts as follows.

- Part I provides an overview on intermediated securities, describing their origins and development and identifying five general models of intermediated securities holding systems.
- Part II describes in brief the Geneva Securities Convention, including its purpose to reduce legal uncertainty and risk, its core and functional harmonisation approach, and the important role of law outside the Convention.
- Parts III-VII identify key principles and rules capable of enhancing trading in securities and explain their interaction with law outside the Geneva Securities Convention together with various model examples of such law. This discussion includes coverage of the rights of account holders and the duties and liabilities of intermediaries (Part III), the transfer of intermediated securities (Part IV), the integrity of the intermediated holding system (Part V), insolvency protection (Part VI), and special provisions in relation to collateral transactions (Part VII).
- Part VIII provides an overview on conflicts of law aspects.
- Part IX provides an overview on implementation of the Geneva Securities Convention and its relationship with other international instruments.

4. Lastly, it must be noted at the outset that the Guide is not intended to assist judges, arbitrators or practitioners in interpreting the Convention’s principles or understanding its implications. The Official Commentary on the UNIDROIT Convention on Substantive Rules for Intermediated Securities (the “OFFICIAL COMMENTARY”) provides such comprehensive guidance and the Guide, accordingly, draws from it extensively.

## **I. OVERVIEW ON SECURITIES**

5. This Part provides an overview on securities. First, Part I.A describes the basics of securities and securities holding. Second, Part I.B identifies and briefly discusses five general models of intermediated securities holding systems.

### ***A. Basics of securities and securities holding***

6. Governments and enterprises need money to finance their activities, and they often raise money from the public. For that purpose, they may issue bonds, which are bought and sold by investors in capital markets. The investors commit to lend money, known as the principal, to the issuers and, in exchange, the issuers commit to pay interest and repay the principal amount of the bond when it matures.

7. Enterprises, in addition, may issue shares, which are also bought and sold by investors in capital markets. Investors who purchase and hold shares commit to provide the money to the issuers and, in exchange, the issuers commit to pay the investors dividends (e.g. a portion of an enterprise's profit) and to grant them particular participatory rights in the enterprise, such as voting in shareholder meetings.

8. Bonds and shares, as well as other financial instruments or assets, are generally known as securities, although the definition varies from system to system. Such securities may be traditional non-intermediated securities or intermediated securities.

#### **1. Non-intermediated securities**

9. Securities were traditionally issued in the form of physical certificates or by recordation of ownership of shares or other interests in the issuer's books.

10. Where physical certificates are used, ownership generally vests in the holder who may sell the securities by delivery of the physical certificates to a buyer in exchange for the payment of an agreed price and, where necessary, an agreement to transfer ownership to the buyer. In this kind of securities holding, the holder (i.e. bearer of physical certificates) is usually unknown to the issuer.

11. For registered securities, on the other hand, ownership of the securities may derive from the issuer's recordation of such ownership in its securities register. In keeping these records, the issuer can mail payments (e.g. dividends or interest) directly to the owner. Such securities can be sold by a contractual agreement between the owner and a buyer to transfer the securities. Usually the securities would be endorsed to the buyer, or they may be endorsed in blank, and the issuer is to record such transfer from the seller to the buyer in its register.

#### **2. Intermediated securities**

12. Due to technological advances, it is no longer necessary to hold securities in physical paper form or to register ownership or transfers directly in the issuer's paper register. Holding and transfer of securities are now generally registered as electronic book-entries in securities accounts maintained by intermediaries, such as banks and other financial institutions. These intermediaries are an important link between the issuer and the investor in what are referred to as intermediated holding chains.

13. The emergence of the book-entry system is also connected with the immobilisation and dematerialisation of securities. Immobilisation involves the deposit of paper securities, which remain immobilised at a central securities depository ("CSD"), which may be considered as another intermediary in the intermediated holding chain between an issuer and an investor. The deposit of securities at the CSD may be done in the form of individual certificates or a combined certificate, known as a global or jumbo certificate, which represents the total volume of securities. Transfers of immobilised securities are

effected by electronic book-entries by intermediaries and do not require actual movement of the certificates.

14. Dematerialisation goes further than immobilisation and eliminates certificates altogether. The securities are represented by book-entries alone throughout the intermediated holding chain.

15. These developments have reduced significantly and, in some systems, even eliminated the paperwork traditionally necessary for securities transfers. Such developments have accordingly allowed for greater numbers of holdings and transfers and increased the size of capital markets.

### **3. Common securities transactions**

16. Securities are bought and sold on capital markets, and there are many types of securities transactions. Some common transactions are so-called “plain” sales of securities, creation of a security interest, repurchase transactions known as repos, and securities lending transactions:

- A “plain” sale of securities consists of a single transaction of securities for cash.
- A security interest (such as a lien, pledge, or charge) is a legal claim to assets used as collateral in secured transactions in the event of default by a borrower. For example, if Company A loans funds to Company B for the purchase of equipment, a security interest may be created in the equipment in favour of Company A, in order to ensure that A can recover the value of the loan. In the event that Company B defaults in repaying the loan, Company A could obtain the equipment and sell it to recover what Company B owes.
- In a repo transaction, a seller seeking cash transfers securities to a buyer outright in exchange for cash at the purchase date, while the seller returns the cash together with an interest component at the repurchase date in exchange for equivalent securities.
- A securities lending transaction is similar to a repo, except that the borrower seeks specific securities instead of cash. For example, a lender transfers securities (e.g. 100 shares of Company A) to a borrower in exchange for securities (e.g. 100 shares of Company B) and, at a later date, both parties transfer back equivalent securities and the borrower pays a fee.

17. Market participants may enter into multiple transactions every day. Such transactions occur on various exchanges or trading platforms, where they are entered into through a central counterparty (CCP), an entity which operates as the buyer to every seller and as the seller to every buyer so that the parties only bear the standard credit risk of the CCP, or on the so-called “over-the-counter” market, in which parties know each other and enter into transactions directly. Where multiple transactions are made every day, it makes sense not to transfer gross quantities per transaction but, where possible, to net transfer obligations at predetermined times and to transfer only the resulting net amount.

18. The transaction process involves what is known as clearing and settlement. The process of verifying and reconciling transaction details and calculating gross or net amounts payable is commonly referred to as “clearing”. The subsequent actual transfer of securities is known as “settlement”. Specialised entities in the market carry out these clearing and settlement functions.

### **4. Securities holding chains**

19. In the context of securities holding, as mentioned above, there are various key participants, who occupy different places in securities holding chains. These participants include:

- *Issuers* – at one end of the chain – such as a government issuing bonds or an enterprise issuing bonds or shares to raise capital;



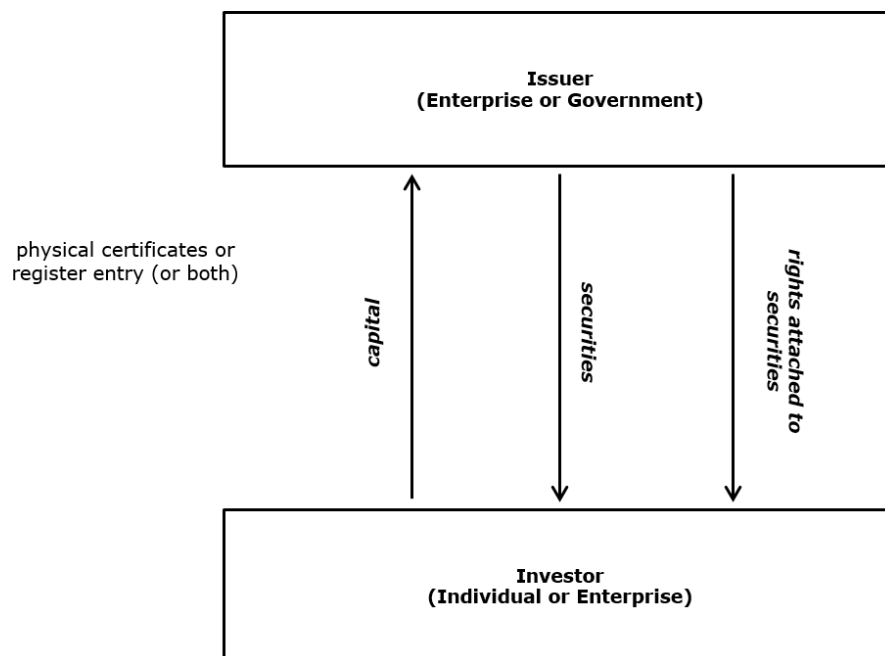
- *Intermediaries* – in the middle of the chain – such as a CSD, which is responsible for keeping paper securities, if any, maintaining electronic records, and administering them, and banks or other financial institutions which maintain accounts on behalf of investors or on their own behalf; and
- *Investors* – at the other end of the chain – such as individuals and enterprises.

20. The following are securities holding diagrams, showing both (a) a simple non-intermediated securities holding example and (b) various examples of intermediated holding chains.

*a. Non-intermediated holding*

21. In traditional non-intermediated securities holding, there are no intermediaries between the issuer and the investor. Such holding may encompass, for example, certificated securities held physically by the investor or securities directly registered in the issuer's registry in the investor's name or both. The advantage of such a direct connection between the issuer and the investor, as shown in diagram 21-1 below, is that the issuer is able to identify the investor (except where it is a bearer security) and the investor is able to exercise its rights directly with the issuer.

*Diagram 21-1:*



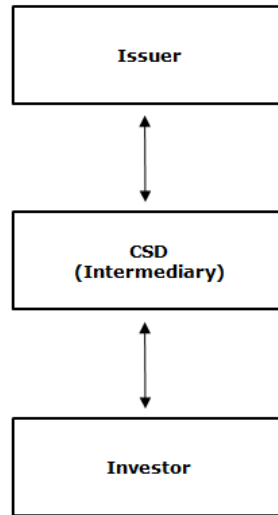
*b. Intermediated holding*

22. In an intermediated holding chain, there is at least one intermediary – and possibly more – between the issuer and the investor. Such chains may encompass, for example, securities represented by physical certificates or solely electronic book-entries because intermediation can work with either form. Such chains, moreover, may be (i) entirely domestic or (ii) international (i.e. cross-border).

*(i) Domestic examples*

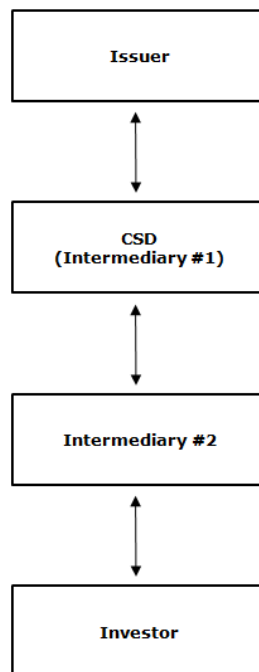
23. Domestic intermediated holding chains can be simple. The CSD, for example, may be the only intermediary between the issuer and the investor, as set forth in diagram 23-1 below. In some systems, there are no intermediaries involved other than the CSD, and the investors hold their securities directly with the CSD. Apart from safekeeping of securities, in some systems, the CSD may act merely as a conduit for communications between the issuer and the investor. In others, the CSD may have more responsibilities and play a greater role in a particular securities clearing system or securities settlement system for the efficient transfer of securities, depending on how such responsibilities are divided among CSDs, stock exchanges, central banks, and other market participants.

Diagram 23-1:



24. Domestic intermediated holding chains, however, can also be rather long, with several links of intermediaries in between the issuer and the investor. In such chains, investors are at the end of the chains, with their securities accounts maintained by intermediaries. These intermediaries can be broker-dealers, banks or investment entities. Diagram 24-1 shows an example where a top-tier intermediary (CSD) holds the securities in an account on behalf of another intermediary (#2), and the latter holds them on behalf of the investor.

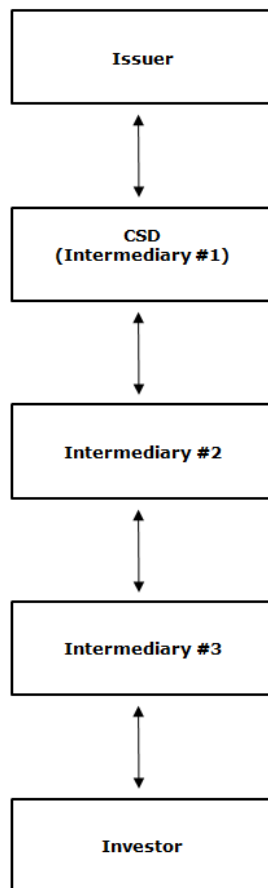
Diagram 24-1:



25. Naturally, holding chains may become even more complex as the number of intermediaries increases, as diagram 25-1 shows. The CSD keeps the securities and maintains an account for intermediary #2, which in turn maintains an account for intermediary #3, which in turn maintains an

account for the investor. Such chains are actually quite common in the book-entry system. Regulation of intermediaries, as a result, becomes very important and, in some systems, intermediaries are extensively regulated.

*Diagram 25-1:*



26. Even in these domestic examples, the presence of intermediaries between the issuers and investors means that the issuers and investors may not have a direct relationship. Absent proper laws and regulations within a domestic system, it may be difficult to determine who is entitled to exercise the rights attached to the securities (e.g. rights which accrue to a holder of securities by virtue of holding the securities, such as dividends, distributions, bonuses, voting rights). It depends, for example, on whether that system enables an investor at one end of the chain to exercise its rights directly with the issuer, or whether those rights are passed along and exercised via the chain of intermediaries.

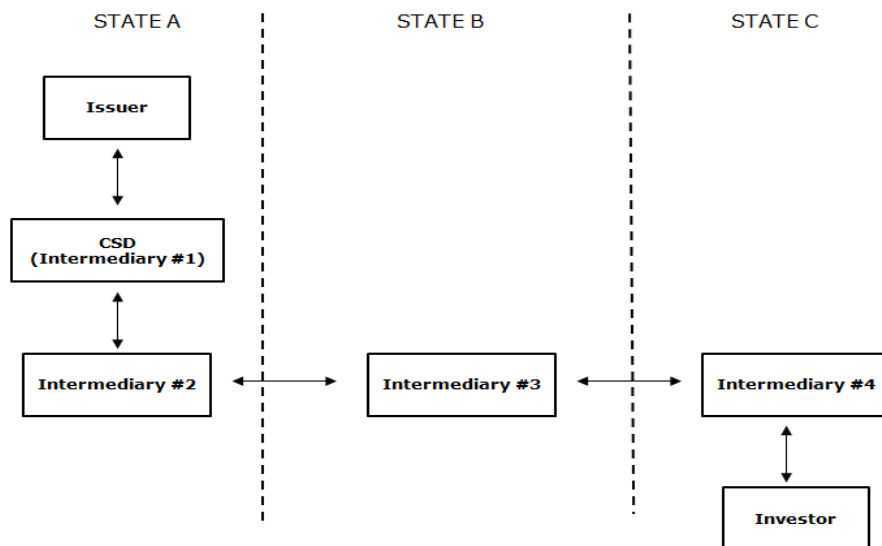
(ii) *International examples*

27. In today's capital markets, investors in securities are no longer confined within domestic boundaries. On the contrary, investors often buy securities from issuers based in other jurisdictions. Cross-border holding chains often involve several intermediaries.

28. In many international holding chains, the CSD is located in the same State as the issuer. As shown in diagram 28-1 below, the securities are issued by an enterprise in State A. Under State A law, all securities issued by enterprises in that State must be kept and registered at State A's CSD. This CSD is the first intermediary and monopolises the market for registering securities in State A. There is another intermediary in State A, a local investment firm (intermediary #2), which has an account with the CSD, to which the securities are credited. The investment firm allocates those securities overseas to an international bank based in State B (intermediary #3), which acts as the responsible sub-custodian for

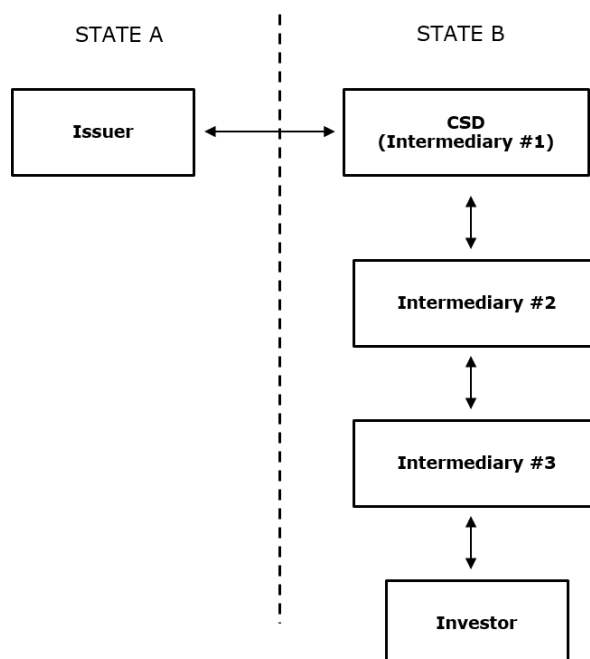
the distribution of securities in foreign capital markets. A local bank in State C (intermediary #4) acquires those securities on behalf of an investor from State C. As soon as the intermediary in State B allocates those securities to the local bank’s securities account, the local bank in turn credits them to the investor’s securities account.

Diagram 28-1:



29. In other international holding chains, the CSD is located in a different State than the issuer. As shown in diagram 29-1 below, for example, an enterprise in State A goes overseas to issue its securities in the capital markets of State B. In such a case, that enterprise registers and deposits the securities with State B’s CSD, which is the first intermediary in the holding chain. Two banks in State B complete the chain as intermediary #2 has an account with the CSD, to which the securities are credited. Intermediary #2 credits those securities to the account that it maintains on behalf of intermediary #3, and intermediary #3 credits those securities to the account it maintains on behalf of the investor.

Diagram 29-1:



30. In these international examples, the investor's exercise of the rights attached to the securities may prove to be difficult. A particular domestic law, for example, may not recognise the interests of investors located in another jurisdiction, may prevent intermediaries from acting on behalf of those investors, or may not facilitate sufficiently the exercise of the investors' rights via the holding chain. In addition, the relationship between intermediaries across borders is governed by contractual arrangements. Subject to laws and regulations in a particular system, it is the contract itself which defines the rights and obligations between the intermediaries involved. If the contract does not contemplate the obligation to pass the corporate rights via those intermediaries, the exercise of such rights by the investor at the end of the chain may be disrupted. These examples, moreover, generally involve simplified, static holdings and not transfers. In reality, securities chains involve many intermediaries and account holders and can fluctuate on a daily basis.

## **5. Insolvency of the intermediary**

31. The proper functioning of the intermediated holding system relies on the financial solvency of intermediaries, which link issuers and investors together. If an intermediary is financially distressed and becomes insolvent, there may be a shortfall in securities, whereby the intermediary does not have enough securities on hand to satisfy those credited to its account holders' securities accounts. In this way, an intermediary's insolvency can both put the holdings of investors at the end of the chain at risk and pull other intermediaries into insolvency as well, thereby threatening systematic effects. Such effects may be compounded where there are multiple intermediaries located in different jurisdictions with different applicable insolvency laws. In some systems, for example, intermediaries may be structured so as to be insolvent remote (i.e. by engaging only in custody activity and not in any other activity).

### ***B. Intermediated securities holding models***

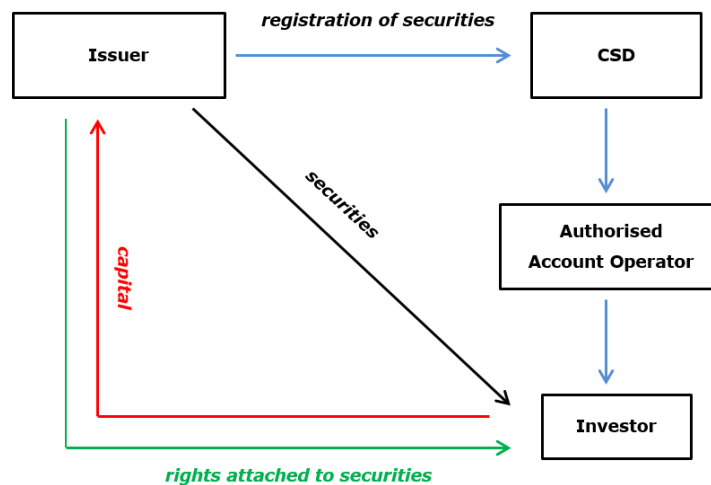
32. At present, there is no international uniform regulation for intermediated securities holding systems. It is possible, however, to identify five general models of holding systems (i.e. individual ownership, co-ownership, trust, security entitlement, and contractual), which are referred to throughout the Guide and are discussed briefly below. After that discussion, an important distinction regarding identification of the investor in the holding chain is discussed and a more complicated cross-border example is provided.

#### **1. Individual ownership model**

33. Under the individual ownership model (e.g. France), all securities issued are immobilised, and in some cases dematerialised, and registered by way of book-entries at the CSD, which acts simply as a register for the issuer and other participants. Neither the CSD nor any of the other intermediaries have any interest in the securities as the investor has full, individual ownership over the securities which are deemed to be located directly in the investor's securities account. The investor accesses its securities through its own account with its intermediary and not through any other intermediary.

34. In the event the CSD or any other intermediary become insolvent, the investor, as owner of the securities, has the right to require re-registration of those securities in the investor's name.

Diagram 34-1: Individual ownership model

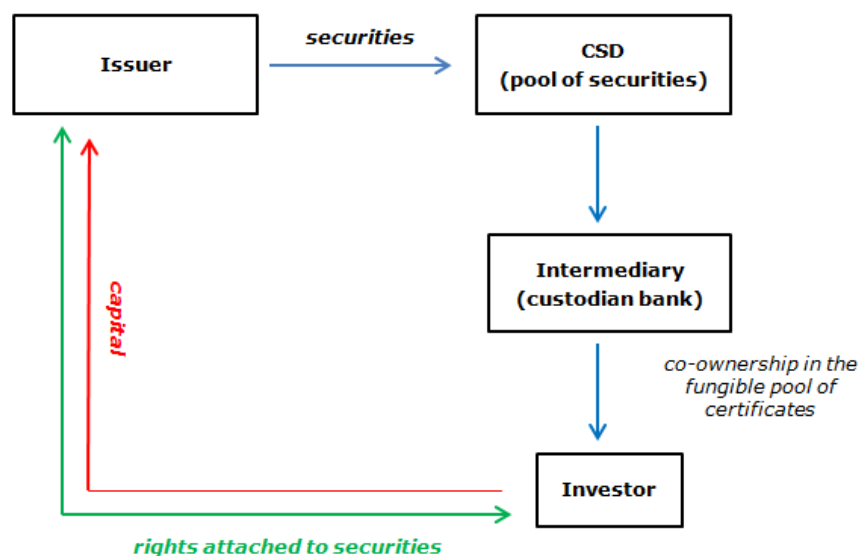


## 2. Co-ownership model

35. Under the co-ownership model (e.g. Austria, Germany and several other civil law jurisdictions), securities are typically deposited by the issuer with the CSD in the form of a global certificate. The CSD, in turn, credits the securities accounts of its participants, typically custodian banks acting as intermediaries for other intermediaries and investors. In this model, an investor has a shared interest corresponding to its holdings in a pool of securities held by the CSD. The investor thus has fractional ownership of that pool of securities or, in other words, co-owns them. The investor accesses its securities through its intermediary and, as a result of the pooling of securities, any intermediaries between the investor’s intermediary (i.e. relevant intermediary) and the CSD would be unable to identify a particular investor’s specific holdings.

36. In the event the CSD or another intermediary become insolvent, an investor’s securities do not become part of the insolvency estate, as neither the CSD nor the other intermediaries own the securities. The investor is entitled to exercise and, if necessary, enforce the rights attached to the securities.

Diagram 36-1: Co-ownership model

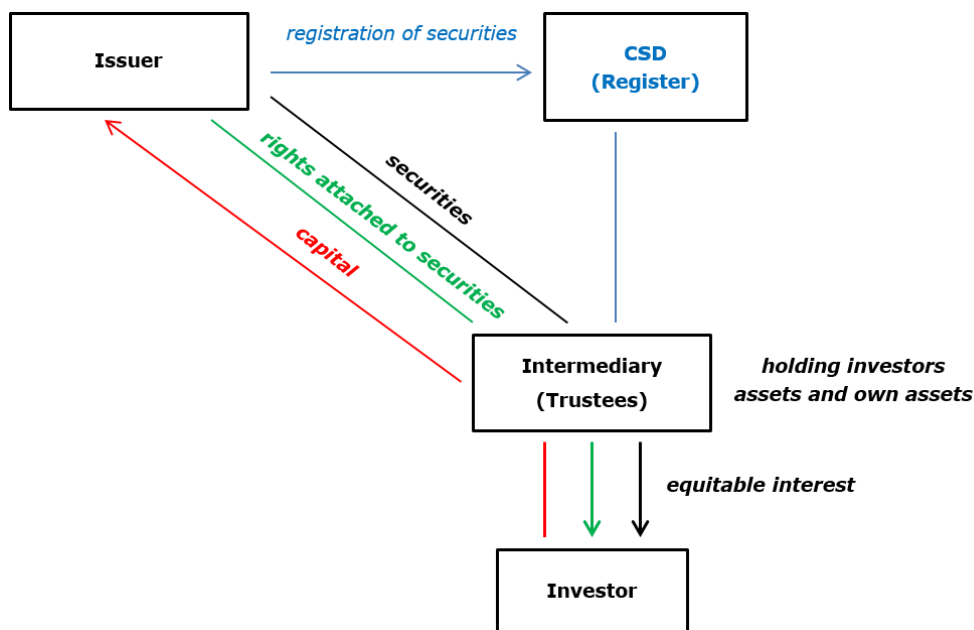


### 3. Trust model

37. In the trust model (e.g. Australia, England and Wales, and Ireland), issuers' securities are provided to the CSD for safekeeping, and the CSD acts as the issuers' register and has no legal interest in the securities. The CSD's participants, typically intermediaries such as banks and other financial institutions, are considered to be the legal owners of the securities, whether for themselves or on behalf of their clients. Once those intermediaries credit those securities to their account holders' accounts, they act as trustees for the account holders, who become beneficiaries and receive an equitable interest in the securities. Investors access their securities through their relevant intermediaries and not through those further up the holding chains.

38. In the event an intermediary becomes insolvent, the investor as a beneficiary has a proprietary right over the securities, which cannot be claimed by the creditors of the intermediary.

Diagram 38-1: Trust model

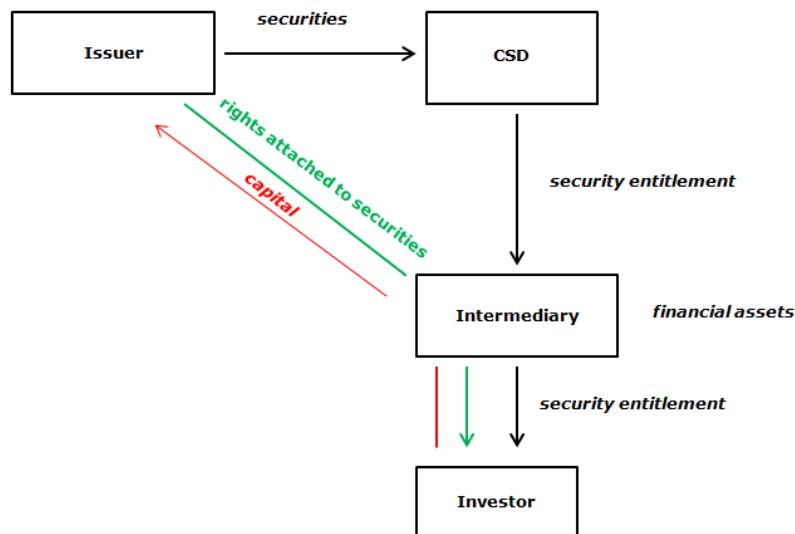


### 4. Security entitlement model

39. Under this model (e.g. Canada and United States of America), every securities account holder receives a security entitlement against its relevant intermediary. In other words, there are security entitlement holders at each level of the holding chain below the CSD. Security entitlements are in some ways similar to equitable interests under the trust model, but they are distinct and do not overlap like equitable interests. In particular, the entitlement holder has no ability to exercise economic or other rights to the financial asset directly against the issuer. The intermediary, however, has an obligation to obtain and pass on those economic rights to the entitlement holder and to exercise such rights on behalf of the entitlement holder. Investors at the end of the holding chain, which hold a security entitlement against their relevant intermediary, access the securities through that intermediary and not through other intermediaries in the chain.

40. In the event an intermediary becomes insolvent, the account holder is protected as security entitlements are separated from the intermediary's estate.

Diagram 40-1: Security entitlement model

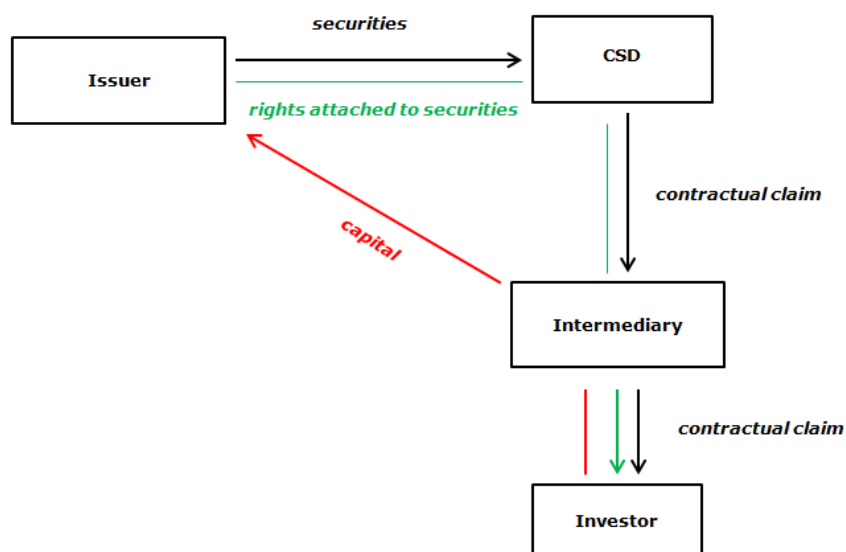


### 5. Contractual model

41. Under the contractual model, found in a few States, investors do not acquire a bundle of property rights to the securities, but instead acquire contractual rights vis-à-vis the relevant intermediary. The entire holding system consists of a network of bilateral contracts among different market participants, from the CSD to the investor. The CSD or other financial intermediaries appear in the book of the company as the registered holders and, thereafter, the rights and benefits are to flow through the holding chain from one intermediary to another, eventually being distributed to the investors.

42. The terms and conditions of the relevant contracts between participants set out the legal framework on various issues, including the exercise of investor rights or the consequences arising out of the insolvency of an intermediary. Domestic insolvency laws, however, usually determine investor rights and claims against the intermediary’s estates with respect to securities.

Diagram 42-1: Contractual model





## 6. Identification of the investor: transparent and non-transparent systems

43. In some intermediated holding systems, an investor's particular holdings are identified, or known to, the CSD primarily because the role of maintaining a securities account is shared between the CSD and another intermediary in a lower-tier of the holding chain. Such systems are known as transparent systems. There are three general categories of transparent systems:

- *When the investor's holdings are held in an account with the CSD:* In such a system, there are separate accounts maintained at the CSD for each investor and the intermediaries merely operate these accounts. Any intermediaries thus serve a technical interface role between the investor and the CSD.
- *When the investor's holdings are identified in an intermediary's account with the CSD:* In this case, the CSD maintains accounts in the name of intermediaries, and these accounts are divided into sub-accounts for each client of the intermediary and reflect each client's holdings.
- *When the investor's holdings are held by an intermediary in an omnibus account at the CSD and account information is registered on a regular basis:* In this type of system, there is an omnibus account at the CSD in the name of intermediaries, which maintain separate accounts for their clients. Information regarding those separate accounts is permanently or regularly consolidated between the intermediaries and the CSD, thereby enabling the CSD to determine what exactly the clients hold.

The common feature of these three categories is that lower-tier account holders and their individual holdings are recognised at the CSD level.

44. Non-transparent holding systems, on the other hand, refer to those in which the investor's interest in securities is not recognised at the level of the CSD, but only at the level of the relevant intermediary.

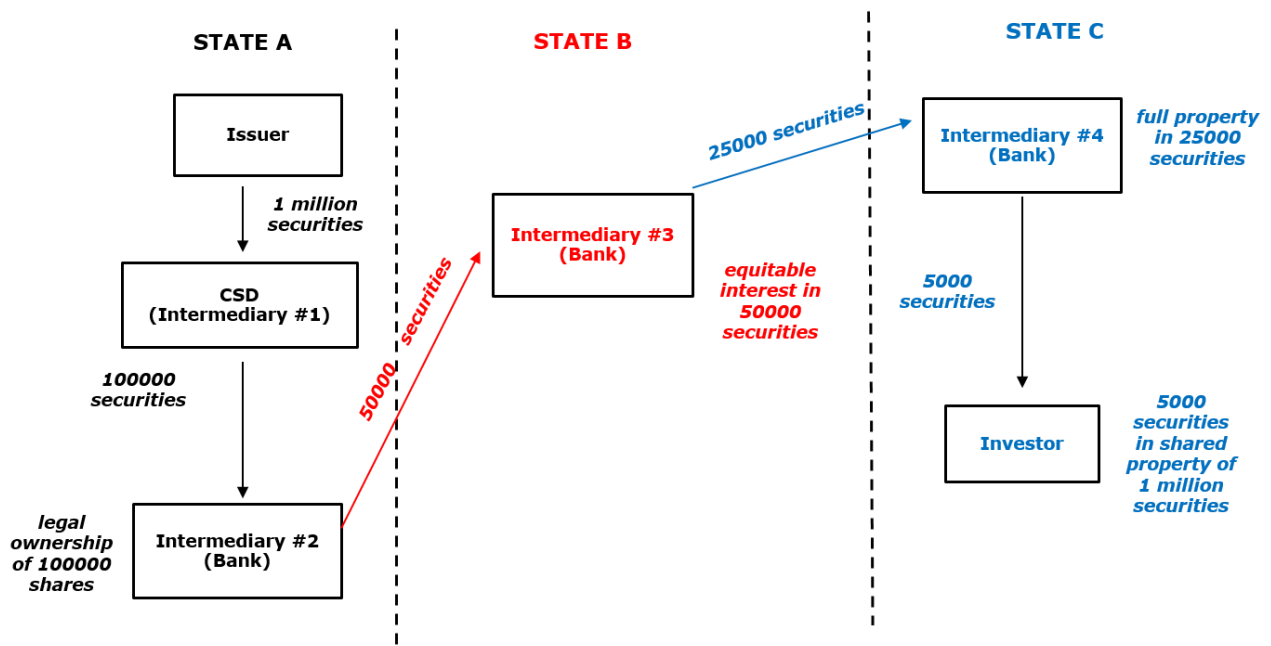
45. In some cases, holding systems may be "mixed systems" (i.e. one part of a holding chain in that system is transparent while the other part is non-transparent). In addition, most cross-border holding chains originating in a transparent system are "mixed," in that a chain generally ceases to be transparent once it reaches across a border and becomes an international one.

## 7. Cross-border holdings involving multiple systems

46. Even between two internally sound and reliable domestic systems, holding securities through a chain of intermediaries across borders may give rise to various problems. First, the legal frameworks in which each market participant (issuers, intermediaries or investors) operates are different and they may not be calibrated to work together, thereby jeopardising the exercise of investors' rights. Second, some jurisdictions have in place legal frameworks based on traditional models of capital markets and concepts of property law. Traditional models, even if perfectly developed from a legal point of view, may not match the standards required by increasingly modern, interconnected, and even paperless capital markets. Third, in most cases, a conflict of law issue may arise when trying to determine the applicable law with respect to particular participants and aspects of the holding chain.

47. As shown in diagram 47-1 below, intermediary #2 holds securities in State A, which has a transparent system. Such securities holding works perfectly under the domestic legal framework because that system is internally sound. Once some of those securities are transferred and held via intermediaries #3 (in State B) and #4 (in State C), however, the exercise of certain rights attached to the securities may become difficult.

Diagram 47-1: Cross-border holding chain



48. In particular, each of the account holders in diagram 47-1 – which includes intermediaries #2, #3, and #4 and the investor as they each have accounts with the respective intermediary above them in the holding chain – receives the legal position attributed to it under the relevant domestic legal analysis. Accordingly, different laws (e.g. property, commercial, insolvency) of different jurisdictions might apply to various parts of the same holding chain, possibly creating incompatibilities and uncertainty.

## II. THE GENEVA SECURITIES CONVENTION

49. This Part describes in brief the Geneva Securities Convention, including its (a) purpose; (b) approach; (c) terminology; (d) scope; and (e) references to law outside of the Convention.

### A. Purpose

50. Intermediation in securities holding and the simultaneous developments of immobilisation and dematerialisation have enabled the rapid expansion of international securities markets by reducing paperwork, allowing for an enormous volume of transactions every day, and promoting economic growth. Specific risks related to the physical existence of the certificated securities have been largely eliminated with the introduction of book-entry systems as such securities are no longer moved. Intermediated securities holding and transactions, however, are not without risks, as there may be significant legal uncertainty and even systemic risk, especially when such holding and transactions are cross-border. This section first describes these risks and then how the Geneva Securities Convention addresses them.

#### 1. Legal and systemic risk

51. Intermediated securities holding is not free from risk. There may be legal risk in the application of existing law, especially when that law is based on traditional legal concepts not tailored to modern securities holding. This risk may be compounded when securities are held and transferred across borders because the various domestic systems may not necessarily be compatible with one another, and different substantive rules may apply to the various participants in a holding chain. Upon the insolvency of an intermediary, moreover, there could be significant risk regarding a potential shortfall in securities and whether the investor's interests in those securities are protected from the claims of the intermediary's general creditors as those issues may be handled differently in various systems. These risks, in some

situations, may dissuade some investors from acquiring particular securities. In many situations, such risks increase transaction costs and hamper economic growth.

52. These risks may even become systemic. In times of financial stress, the insolvency of one intermediary could lead to the insolvency of other intermediaries, thereby triggering systemic effects.

## **2. Harmonisation to reduce risk and promote sustainable economic growth**

53. The Geneva Securities Convention, adopted in October 2009 and tailored to the modern book-entry system, was carefully developed to address and minimise these risks. The Convention provides the core legal framework for a modern intermediated securities holding system, which is both internally sound and compatible with other systems.

54. Regarding internal soundness, the Convention's drafters identified key features of intermediated holding systems which must be present in order for a particular system to be considered as sound, taking into account the objectives of investor protection and efficiency. Holders of intermediated securities should, for example, be confident that their interests are protected and subject to simple and clear rules and procedures regarding holding, transfer, and realisation. It was deemed essential, moreover, that the investor's interest not be exposed to risks such as the insolvency of any intermediary in the holding chain or interference by unrelated third parties.

55. Regarding compatibility, the drafters recognised that different legal systems should be able to interconnect successfully where intermediated securities are held or transferred across borders. In a cross-border context, as differing rules and approaches may apply in respect of property law issues, supervision, company law, etc., it was recognised that harmonisation of at least some core issues was of the utmost importance.

### **B. Approach**

56. In recognising the diversity of legal concepts underlying securities holding around the world, the Convention embraces a core and functional harmonisation approach in order to accommodate different legal systems and traditions within a unitary framework. Only elements essential to the establishment of internal soundness and cross-border compatibility are addressed.

57. The Convention's approach is a core one in that it harmonises certain key matters related, for example, to the rights of account holders, securities transfers, and aspects of the integrity of the intermediated holding system. Other law is thus relied upon to cover matters not harmonised by the Convention.

58. The Convention's approach is functional in that it uses language that is as neutral as possible to formulate rules by reference to their results. Under a functional approach, harmonising rules are formulated by reference to facts rather than particular legal terms or principles to allow operative results to be reached without overriding the underlying domestic legal traditions and doctrine. Thanks to the functional approach, for example, the Convention is compatible with various characterisations of securities' rights and interests.

59. In addition, the Convention's drafters also worked to ensure compatibility with other relevant instruments, including recent domestic reform legislation, EU directives, and international instruments, in particular the Hague Securities Convention, the UNCITRAL Legislative Guide on Secured Transactions, and the [draft] Model Law on Secured Transactions. Whereas the Hague Securities Convention provides conflict of law rules for intermediated securities as addressed in Part VIII, the Geneva Securities Convention provides substantive rules for such securities, and the two Conventions complement one another. The UNCITRAL Legislative Guide on Secured Transactions and the [draft] UNCITRAL Model Law on Secured Transactions, which are to assist States in developing modern secured transactions laws and

are addressed further in Part VII.D, do not apply to security rights in securities and there is thus no overlap with the Geneva Securities Convention.

### **C. Terminology**

60. The Convention's core and functional harmonisation approach is readily apparent when examining the terminology adopted by the Convention's drafters. Article 1 of the Convention sets forth definitions for terms used in the Convention and comprehensive explanation of those terms is provided in the OFFICIAL COMMENTARY. The Guide adopts that terminology as well and, for ease of reference, the following terms describing key participants in intermediated securities holding are briefly described below and together with other important terms in the Glossary at Annex 1:

- *Account holder*: This term is defined in Article 1(e) of the Convention as "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)". It is meant to include not only investors, but also intermediaries, as intermediaries may be account holders who hold securities with a higher-tier intermediary in their own name or on behalf of their account holders. Even the ultimate account holder, at the end of the chain, may not be an investor. That holder may be a person serving as an agent, trustee, or in another capacity, on behalf and for the benefit of one or more other persons. Even though the term is in the singular, it does not purport to prohibit a securities account from being maintained for several persons acting jointly.
- *Intermediary*: This term is defined in Article 1(d) of the Convention as "a person (including a central securities depository) who 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". Intermediaries are usually entities such as banks, brokers, central banks and similar persons that maintain securities accounts for their account holders. In some systems, for example, an intermediary may be referred to an account operator or account provider. Because of the functional definition, virtually any natural or legal person is covered provided that it maintains securities accounts for others in the course of its business. CSDs, which are specifically mentioned but not defined, are intermediaries only in relation to their participants (i.e. its account holders, which may be investors or other intermediaries) but not in relation to the issuer.
- *Securities clearing systems (SCS)*: This term, which is defined in Article 1(o) of the Convention, refers to market infrastructures facilitating and enhancing the efficient settlement of securities transactions among intermediaries. SCSs are those market infrastructure services performing clearing functions (and possibly other functions not covered by the Convention), such as central counterparty, clearing house or clearing system, but not settlement.
- *Securities settlement system (SSS)*: This term, which is defined in Article 1(n) of the Convention, refers to market infrastructures permitting the efficient transfer of securities among intermediaries, in particular by settling or clearing and settling them. Settling or settlement is to be understood as an act which discharges the obligations arising from the agreement of the parties to transfer securities and possibly established or confirmed during clearing. Clearing is to be broadly interpreted to mean the process of transmitting, reconciling, and in some systems, confirming instructions for a securities transfer. SSSs possess certain characteristics (e.g. connect at least three financial participants for purposes of clearing and settlement and operate under a legal, institutional and operational framework established on an ongoing basis and covering standard services for such participants), are regulated, supervised or overseen by a governmental or public authority and, for purposes of the Convention, are identified as such by a Contracting State.
- *Issuer*: This term is not defined in the Convention, as it is widely understood to refer to a government or enterprise which issues securities to raise capital. See paragraph 19 above.

#### **D. Scope**

61. Further to the harmonisation approach adopted by the Convention's drafters, the Convention's scope of application is limited to only core aspects of intermediated securities. In this regard, the Convention's definitions play a key role in establishing the Convention's scope of application. The Convention applies to "securities" (i.e. any shares, bonds or other financial instruments or financial assets (other than cash), Article 1(a)), which are capable of being credited to a "securities account" (i.e. an account maintained by an intermediary to which securities may be credited or debited, Article 1(c)) and of being acquired and disposed of in accordance with the Convention's provisions. In short, the Convention covers any financial assets – except for cash – which are apt to be both held in the intermediated holding system and governed by the Convention. The Convention thus does not provide a laundry list of securities falling within its scope, allowing therefore for the evolution of market practice and the creation of new types of securities capable of being held in the intermediated holding system.

62. The Convention, however, generally excludes the area of law usually (but not necessarily) called corporate law (see Article 8), in particular the relationship between issuers and account holders. While the Convention generally does not cover this area of law, there are a few exceptions, specifically minimal provisions necessary to ensure integrity and achieve compatibility of securities holding systems around the world.

63. Like so-called corporate law, other legal and regulatory aspects fall outside the scope of the Convention. In other words, such aspects are to be addressed by each Contracting State's legal and regulatory system. The only constraint is that such aspects must be addressed in way which does not contravene the Convention's provisions.

#### **E. Law outside of the Convention**

64. As the Geneva Securities Convention addresses the core issues necessary for achieving internal soundness and compatibility in a functional way, there are various matters that are to be addressed by law outside the Convention. In implementing the Convention, States thus retain significant legal and regulatory space, and there are important policy decisions to be made. There are three particular aspects to the way in which the Convention deals with law outside the Convention.

65. First, the Convention contains express references to law outside the Convention. Such references include the following:

- *Non-Convention law*: This term, which is defined in Article 1(m), refers to substantive law in relation to intermediated securities (other than the Convention) of the Contracting State. In many instances, the non-Convention law is to work as a complement to a Convention rule. A list of references to non-Convention law is included in Annex 2.
- *Applicable law*: This term refers to the law applicable by virtue of the private international law rules of the forum. The applicable law may, or may not, be the non-Convention law. A list of references to applicable law is included in Annex 3.
- *Insolvency rules*: Insolvency law would be part of the non-Convention law or the applicable law, but insolvency is dealt with as a separate category because the commencement of an insolvency proceeding may trigger the mandatory application of special rules of law of the jurisdiction where those proceedings are conducted that displace, or deviate from, the rules that would otherwise be applicable. A list of references to insolvency rules is included in Annex 4.
- *Uniform rules of securities clearing systems (SCSs) and securities settlement systems (SSSs)*: The term "uniform rules" is defined in Article 1(p) as rules of an SCS or SSS which are common to the participants or to a class of participants and are publicly accessible. Such rules may derogate from or supplement the Convention's rules. While Contracting States may only have

limited or indirect influence over the rules of SCSs and SSSs, as they are typically private entities, Contracting States generally regulate such entities. Through such regulation, for which the Convention provides no rules, Contracting States could influence the content of these rules. A list of references to uniform rules of SCSs and SSSs is contained in Annex 5.

66. Second, there are references for which Contracting States, in properly implementing the Convention, have to make a declaration. The system of declarations provided for under the Convention gives Contracting States the possibility of making choices regarding these matters so as to achieve the policy objectives that they see fit in respect of intermediated securities and facilitate the coordination between the Convention's provisions and their legal systems. Model declaration forms are included with the Explanatory Memorandum for the Assistance of States and Regional Economic Integration Organisations on the System of Declarations under the Geneva Securities Convention, known as the Declarations Memorandum, which was issued by UNIDROIT in its capacity as Depository for the Convention and is available on UNIDROIT's website (UNIDROIT 2012 – DC11/DEP/Doc. 1 rev.).

67. For example, the Convention, in principle, applies to any securities account maintained by an intermediary. Under Article 5 of the Convention, however, a Contracting State may limit the scope of application of the Convention to the securities accounts maintained by "regulated" intermediaries or those maintained by a central bank. The purpose of this rule is to offer States the possibility of excluding the application of the Convention to the securities accounts that are maintained by "unregulated" intermediaries, if and to the extent Contracting States deem such exclusion appropriate. For more information on this optional declaration, including a model declaration form, see the Declarations Memorandum, Section 4.B and accompanying Form No. 2.

68. Third, there are other particular matters which could have been addressed in the Convention, but were not due to the core and functional harmonisation approach adopted. Such matters, including in the field of corporate and regulatory law, are also to be taken into account, to the extent necessary, by law outside the Convention.

69. Law outside the Convention, in particular these three aspects, is addressed in the following Parts of the Guide, which offers guidance on the important policy choices to be made in evaluating an intermediated securities holding system or evaluating an existing one.

### **III. RIGHTS OF ACCOUNT HOLDERS AND DUTIES AND LIABILITIES OF INTERMEDIARIES**

70. This Part and those that follow identify principles and rules capable of enhancing trading in securities and explain their interaction with law outside the Convention together with various model examples of such law. To do so, each of these Parts identifies key principles, summarises the core Convention rules and, as necessary, discusses the choices to be made by declaration, the matters to be addressed or clarified by law outside the Convention, and matters not mentioned in the Convention. This Part, in particular, addresses (a) the rights of account holders, (b) measures to enable the exercise of account holder rights, and (c) liability of intermediaries.

#### **A. Rights of account holders**

***The Convention provides any account holder with a core set of rights resulting from the credit of securities to a securities account. The law should establish additional rights consistent with how it characterises the legal position of account holders. It may distinguish between the rights enjoyed by an investor (including an intermediary acting for its own account) and those accruing to an intermediary acting in its capacity of intermediary.***

### **1. Core Convention rules**

- All account holders have the right to dispose of the securities credited to their securities account and, to the extent it is permissible and feasible, the right to hold the securities otherwise than through a credit to their securities account. Article 9(1)(b)–(c).
- In addition to these rights, the ultimate account holder must receive and be able to exercise all the rights attached to the securities. Article 9(1)(a)(i).
- The non-Convention law may provide additional rights to all account holders, or to some of them. Article 9(1)(a)(ii) and 9(1)(d).
- The non-Convention law determines the limits to the rights above when the credit in a securities account provides the account holder with a security interest or another limited interest. Article 9(3).

71. In the intermediated holding system, securities are represented by credits made in the securities accounts maintained by the intermediaries at each level of the holding chain. A credit may also represent a security interest or another limited interest.

72. At the bottom of the holding chain is an account holder who is not acting as an intermediary. We call it the ultimate account holder. The ultimate account holder may be–

- an investor (including an intermediary) acting for its own account;
- a secured party holding the intermediated securities (or a limited interest such as a lien, pledge or charge) as the result of a secured transaction;
- the beneficiary of a limited interest, such as an usufruct, other than a security interest; or
- a person holding the intermediated securities as a fiduciary, such as an agent, a trustee, etc.

73. Article 9 defines two basic packages of rights resulting from a credit of securities to a securities account (hereafter: a credit), one for the ultimate account holder, and a less extensive one for other account holders. Under the Convention, the difference between the two packages is the rights attached to the securities, which must accrue to the ultimate account holder, but not necessarily to the intermediaries in the chain.

74. Depending on how it characterises intermediated securities, non-Convention law may extend each package accordingly. Similarly, non-Convention law will restrict such packages in line with the types of limited interests it allows the parties to create.

### **2. Choices to be made by declaration**

75. The Convention requires no declaration in respect of Article 9.

### **3. Matters to be addressed or clarified by law outside the Convention**

- The law should supplement the rights accruing to account holders in a manner consistent with its own characterisation of an account holder's legal position. See Article 9(1)(a)(ii) and 9(1)(d).
- In so doing, it may distinguish between the legal position of the ultimate account holder and the legal position of account holders acting as intermediaries in the chain.

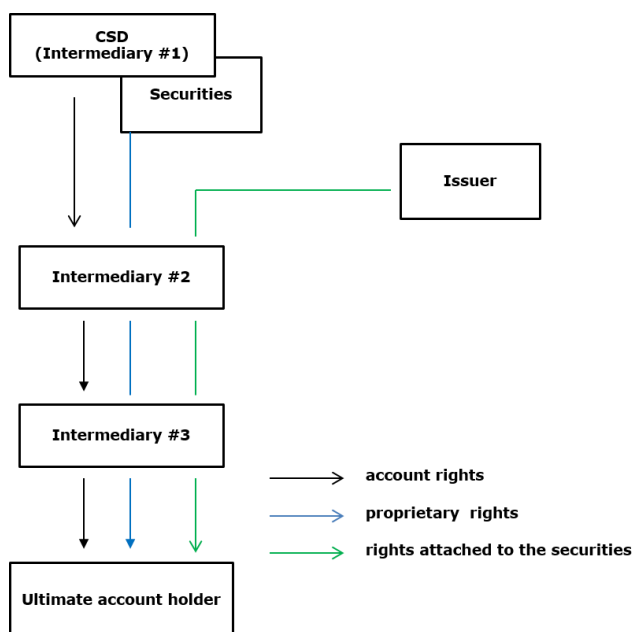
- The law should clearly define which limited interests may be granted in intermediated securities, and how these interests limit the rights of account holders. Article 9(3).
- The law should also provide for cross-border situations, where a domestic intermediary holds securities through a securities account with another intermediary in another jurisdiction, and thus likely under some foreign law.

76. There is a necessary relationship between:

- the characterisation of intermediated securities and the additional rights conferred by the non-Convention law on all or certain account holders; and
- the types of security interests and other limited interests allowed by the non-Convention law and the restriction it imposes on the rights of an account holder when the credit represents such a limited interest.

77. For example, most legal systems of the civil law tradition consider that the ultimate account holder has a direct proprietary right over the (certificated or uncertificated) securities held at the very top of the holding chain. Ultimate account holders are the “owners” or “co-owners” of the securities as well as the creditors (or right holders) against the issuer. Such systems see the intermediaries as depositories and book-keepers. Unless an intermediary has obtained a security interest, it does not have any proprietary right over the securities themselves. Intermediaries do not receive or exercise the rights attached to the securities, except where this is necessary to pass such benefits down the chain all the way to the ultimate account holder.

Diagram 77-1: Individual ownership or co-ownership model



78. In such legal systems, the non-Convention law would typically use Article 9(1)(d) to confer on the ultimate account holder a proprietary right over the securities. The holder of a limited interest would also be recognised as having a (limited) proprietary right over the same securities. In respect of Article 9(1)(a), intermediaries may not be entitled to receive and exercise the rights attached to the securities registered in the name of the investor. For unregistered (bearer) securities, intermediaries would receive and exercise the rights attached subject to an obligation to pass such benefit to their own account holder.

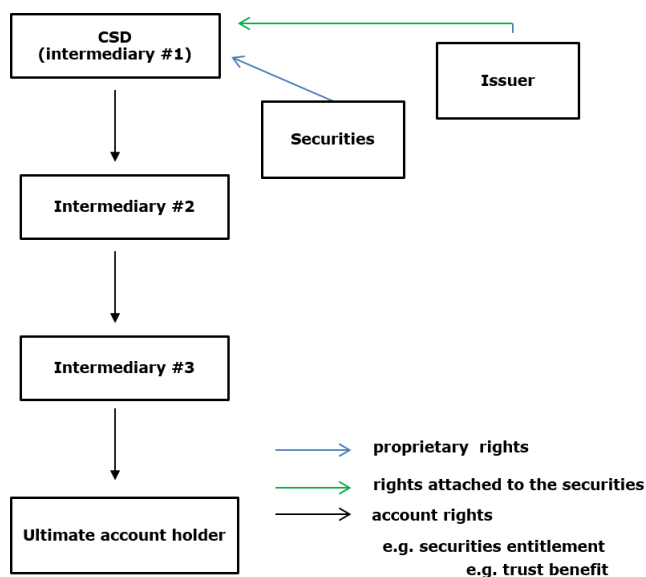
79. Other legal systems, typically of the Anglo-American tradition, characterise the legal position of each account holder as

including a proprietary interest in the securities or intermediated securities held by the relevant intermediary. In some systems, this is based on a cascade of trusts. The upper-most intermediary holds the securities in trust for its account holders. These account holders, who are usually second-tier intermediaries, are the beneficiaries of this trust. The credit of securities in their securities account represents their beneficiary interest under the trust. They in turn hold this beneficial interest in trust for their own account holders, and so on. In some other systems, the credit of securities to a securities account creates a securities entitlement (i.e., a sui generis bundle of rights against the intermediary and over the assets held by the intermediary). What these systems have in common is that each intermediary has a proprietary interest in certain assets (securities, beneficiary interest under a trust, securities



entitlement) and creates a distinct proprietary interest when it makes a credit to the securities account it maintains for a client.

Diagram 79-1: Trust or securities entitlement model



80. In this second group, in accordance with Article 9(1)(a)(ii), the non-Convention law would provide for each intermediary to receive the rights attached to the securities and pass these benefits to its own account holders, so that they finally reach the ultimate account holder. It will also define and characterise the rights (benefit of a trust, securities entitlement, etc.) each account holder obtains in addition to the rights conferred by the Convention. Article 9(1)(d).

#### a. Limited interests

81. As discussed below in paragraphs 109 and 135, the Convention provides various methods for the granting of any type of security interests and other limited interests in intermediated securities, but does not prescribe which types

may be so granted. It is entirely for the non-Convention law to define the types of (consensual and non-consensual) interest that can be granted, such as pledge, lien, charge, title-transfer security interest, usufruct, etc.

82. The non-Convention law may refer this matter to its general provisions governing other types of assets (movable assets, intangible assets, etc.).

83. Alternately, the non-Convention law may define one or more types of limited interests that would apply exclusively to intermediated securities.

84. One way or the other, when drafting or reforming the non-Convention law in this area, lawmakers should be aware that limited interests are likely to limit the rights that arise from the credit of securities to a securities account. For example, if the account holder is the pledgee of the securities credited to its securities account, the non-Convention law regulating pledges is likely to limit the right to dispose of the intermediated securities to certain circumstances. It may also determine whether the pledgee can exercise the voting rights attached to the securities.

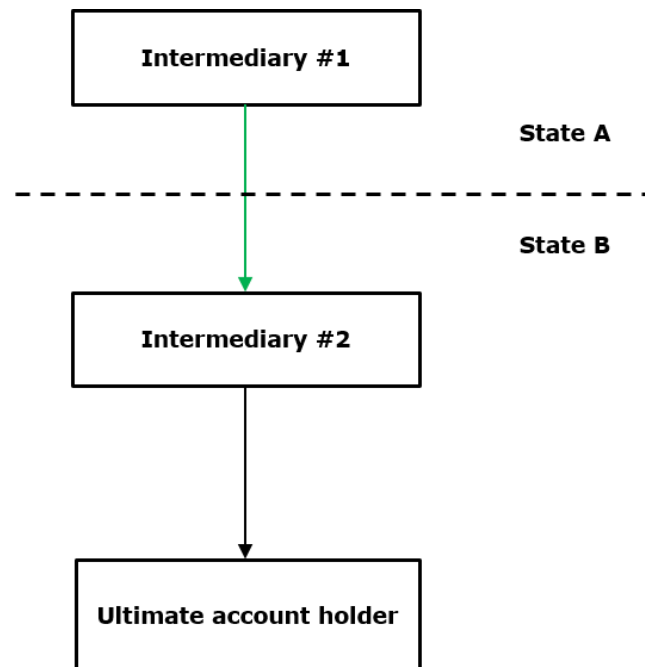
#### b. Cross-border situations

85. When drafting or revising law governing intermediated securities, lawmakers should design the bundle of rights created by a credit to a securities account in a manner consistent with that jurisdiction's characterisation of the rights of investors, collateral takers and other account holders. Top-down consistency may be achieved for holding chains which are purely domestic, from the upper-most to the last intermediary in the chain. However, this is unlikely to be the case where the holding chain begins or ends in another jurisdiction. This is due to the different characterisations (and bundles of rights) that this or these other jurisdictions may attach to a credit of securities.

86. Lawmakers should be aware of this frequent inconsistency in cross-border holding chains, which is inherent in a global intermediated securities holding system. Because non-Convention law differs from one jurisdiction to another, and because it generally provides rights in addition to Convention rights, it is likely that the rights resulting from a credit of securities with intermediary #1 are different from the rights resulting from a credit of the same securities with intermediary #2. While the non-Convention law applicable to intermediary #2 cannot unilaterally expand its application to intermediary #1, it can secure

the position of account holders by providing that, in cross-border situations, an account holder not only has the rights it enjoys under the non-Convention law, but enjoys any additional rights that the relevant intermediary (here: intermediary #2) obtains from its own intermediary at the upper level (here: intermediary #1).

Diagram 86-1:



### **B. Measures to enable the exercise of account holder rights**

87. The Convention provides that certain account holder rights may be exercised only against the intermediary. Article 9(2)(c). However, because it does not make any assumption about the legal structure and characterisation of property rights in intermediated securities, it does not determine whether the rights attached to the securities can or must be exercised by the account holder against its own intermediary (“through the intermediated chain”) or directly against the issuer. See Article 9(2)(b). This is why the law should clearly define the persons entitled to exercise the rights attached to the securities vis-à-vis the issuer and the conditions thereof. See Part V.D below.

88. Even when an account holder may or is required to exercise the rights attached to the securities against the issuer, it often must rely on the assistance of the intermediary chain. In many respects, intermediaries must enable account holders to exercise their rights. They have corresponding duties and liabilities, which are only partially laid down by the Convention. In this area as in many others, the Convention leaves broad space for non-Convention law.

***The Convention lays down one general and four specific obligations of intermediaries to their account holders. The law should provide specific contents for these duties and, if necessary, expand them in a manner consistent with its own characterisation of an account holder’s legal position. The law should also specify the manner in which an intermediary may comply with its obligations. Finally, the law should determine the conditions under which an intermediary becomes liable.***

#### **1. Core Convention rules**

- An intermediary must generally take all appropriate measures to enable its account holders to receive and exercise their rights. Article 10(1).

Specifically, an intermediary:

- must protect securities credited to a securities account (Article 10(2)(a) and 24);
- must allocate securities or intermediated securities to the rights of its account holders so that they cannot be reached by the intermediary's creditors (Article 10(2)(b) and 25);
- must give effect to authorised instructions (Article 10(2)(c) and 23);
- must not dispose of securities credited to a securities account without an authorised instruction (Article 10(2)(d) and 15); and
- may not exclude liability for its gross negligence or wilful misconduct (Article 28(4)).

## **2. Choices to be made by declaration**

89. The Convention requires no declaration in respect of the matters discussed in this section.

## **3. Matters to be addressed or clarified by law outside the Convention**

- The law should determine the extent of information that an intermediary must regularly pass on to account holders relating to intermediated securities.
- The law should determine to what extent an intermediary must pass on to account holders any distribution received in relation to intermediated securities. Article 9(1)(a)(ii).
- More generally, the law should determine how an intermediary must enable account holders to exercise the rights (if any) that they are entitled to exercise vis-à-vis the issuer. Article 9(1)(a).
- The law should specify when a personal representative (such as the guardian of a minor, the administrator of an estate or an insolvency, etc.) may give instructions in lieu of the account holder. Article 23(2)(d).
- The law may impose additional duties on intermediaries as required to support the exercise of account holders' rights. Article 28(1).
- The law should specify the manner in which intermediaries may comply with their legal and Convention duties. Article 28(2).

90. In the provisions discussed in this section, it is worth noting that the Convention refers generally to the non-Convention law and, to the extent allowed by the non-Convention law, to the account agreement between the intermediary and the account holder or to uniform rules of a securities settlement system (see section V.D). It is impossible for legal provisions to cover the entirety of the operational obligations of an intermediary. It is thus quite frequent that legal provisions are supplemented by contractual provisions in the account agreement, and it is always the case that uniform rules of settlement systems contain extensive and minute prescriptive provisions regulating the respective obligations of the operator and the participants to the system.

91. One should also keep in mind that law outside the Convention, including the term "non-Convention law", not only refers to statutory instruments but also to decrees and regulations. In most systems, the duties of intermediaries are the subject-matter of a more or less extensive set of statutory provisions supplemented by sometimes extensive regulations of a technical nature issued by a ministry, a regulatory agency or the central bank within the framework of their respective regulatory powers.

*a. Passing on information and distributions received*

92. For all bearer securities, and often for registered securities (where the shareholder or bondholder is identified in a register maintained by or on behalf of the issuer), information and payments provided by the issuer to the securities holders will actually go through the chain of intermediaries. These “corporate actions” may in turn require or enable the account holder to declare choices (such as voting resolutions proposed to the general meeting, accepting a tender offer, exercising an option, etc.), which must be passed up the holding chain. It is generally so that the law affirms a duty on each intermediary to pass on such information or distribution, but leaves the particulars to be regulated in the account agreement.

93. The duty to pass on distributions needs some qualifications. There may be several reasons why a payment received directly or indirectly from the issuer by an intermediary should not be transferred to the account holder, such as when the intermediary itself or a third party has a security interest in the intermediated securities.

*b. Enabling the exercise of other rights against issuer*

94. Many rights attached to the securities cannot merely be passed on to the account holder. To exercise such rights, the account holder must make a choice or a declaration such as issuing a vote or giving a power to vote to another person. Or the account holder may need to take an action such as filing a claim in the issuer’s bankruptcy or filing a derivative suit against the issuer’s directors. In most cases, the account holder will need the assistance of the relevant intermediary (and possibly other intermediaries in the holding chain) to convey its declaration to the issuer or to certify its position as a shareholder or bondholder.

95. While it is unlikely that all situations can be anticipated, the law should deal with the most common situations and possibly lay out a general principle or test to solve other situations as they may come. More specific provisions in account agreements or in the uniform rules of a securities settlement system could supplement the legal provisions.

*c. Giving effect to authorised instructions*

96. First and foremost, an intermediary owes its duties to the account holder, who is generally authorised to give instructions for the intermediary to take action. Under certain circumstances, however, another person may give binding instructions to the intermediary. That person’s power to give instructions may be additional to the general power of the account holder, or it may limit (e.g., when the other person has negative control over intermediated securities as the result of an interest granted to it) or exclude the validity of instructions given by the account holder (such as when the account holder is legally incapacitated).

97. Article 23(2) contemplates a number of situations where another person is authorised to give instructions to the intermediary. The list includes persons to whom an interest has been granted in the intermediated securities; a person who has power to give an instruction under the account agreement or the uniform rules of a securities settlement system; and a court or administrative authority empowered by law to issue an order in respect of intermediated securities.

98. Many other situations are not contemplated by the Convention but derive from general principles or specific rules of the non-Convention law. They may include the power of a guardian over the assets of its pupil, an executor over the assets of an estate, an insolvency administrator over the assets subject to the insolvency; the power of directors or officers of a corporation; powers of attorney; etc.

99. The law should therefore clarify generally or by specific provisions which and when such powers are effective against an intermediary and to what extent such powers displace the account holder’s own power to give instructions.

*d. Specifying the manner of complying with Convention obligations*

100. The general duty of intermediaries to enable the exercise of their account holders' rights and the four specific obligations laid down by the Convention are expressed in general terms. This may create a certain degree of uncertainty for intermediaries. To reduce this uncertainty, Article 28(1) provides that the non-Convention law may specify the content and the manner in which an intermediary complies with its Convention obligations. The law may alternately allow such issues to be specified in the account agreement or (where applicable) in the uniform rules of a securities settlement system. One should keep in mind that any reference to the law is not limited to statutory instruments but includes regulations as well.

101. Article 28(2) states that where an intermediary complies with such provisions, it satisfies the relevant obligation under the Convention.

**C. Liability of intermediaries**

***The Convention contains no provision about the liability of intermediaries. The law (and the uniform rules of securities clearing and settlement systems) should clearly establish the conditions and the extent of such liability, and whether it may be exempted by way of contractual provisions.***

102. The Convention does not set out the conditions under which an intermediary becomes liable to its account holders or to other persons. Non-Convention law should therefore determine the conditions and the effects of a breach of duty by an intermediary. It may do so by providing a set of rules specific to the functioning of the intermediated holding system, or by referring to its general provisions and, where necessary, supplement or modify them to reflect adequately the specificities of the system. Of particular concern is the liability of an intermediary for the failure of its (own) relevant intermediary.

103. Non-Convention law should specify whether that liability may be modified or excluded by the account agreement or by the uniform rules of a securities settlement system. That law, however, cannot derogate from Article 28(4), which states that an intermediary may not exclude liability for its gross negligence or wilful misconduct.

**IV. TRANSFER OF INTERMEDIATED SECURITIES**

104. The ability to buy and sell intermediated securities and create and grant interests in them is essential to the functioning of financial markets. To promote the sound functioning of markets, as set out in this Part of the Guide, States should establish or revise their laws consistent with the following principles, rules, and related guidance on transfer of intermediated securities, in particular regarding (a) acquisition and disposition of intermediated securities, (b) unauthorised dispositions and reversal, (c) protection of an innocent acquirer, and (d) priorities.

**A. Acquisition and disposition of intermediated securities**

105. The transfer of intermediated securities and any limited interests (e.g. security interests) may occur by various methods. Some methods for transfer rely on book-entries in securities accounts, such as the debit and credit method and the designating entry method. Not all methods for transfer, however, require such entries. This section deals with transfer (1) by the debit and credit method and (2) by other methods.

## 1. Transfer by debits and credits

***The law should allow for the transfer of intermediated securities and any limited interests therein by debit and credit entries to securities accounts.***

### *a. Core Convention rules*

- Intermediated securities are acquired when a credit is entered in the securities account of the transferee, and they are disposed of when a debit is made to the securities account of the transferor. Article 11(1) and 11(3).
- Limited interests in intermediated securities, such as security interests, may also be transferred by debit and credit entries in the securities accounts of the transferor and the transferee respectively. Article 11(4).
- No further steps, such as publicity or registration requirements, are necessary to make such acquisition effective against third parties. Article 11(2).

106. As intermediated securities exist as book-entries in securities accounts, debits to the transferor's account and credits to the transferee's account play an essential role in intermediated holding systems. Such debits and credits, however, do not occur in a void. They are based on the transactions agreed between the transferors and the transferees and generally result from instructions issued by them to their respective intermediaries. Based on that transaction and the underlying rights transferred, the debits and credits may represent the transfer of a full interest in intermediated securities or a limited one.

107. Debits and credits have become the universal method for transferring intermediated securities. As a result, the Convention requires that this method of transfer be available to all account holders. The Convention further requires that, as discussed in Part IV.B, a debit be authorised by the account holder and, to ensure legal certainty for transferees against third parties, no further step may be necessary to render that transfer effective.

108. Apart from these core harmonising rules, because of the diversity of legal rules and operational systems in intermediated holding worldwide, the Convention leaves to non-Convention law various important issues, which are discussed below.

### *b. Choices to be made by declaration*

109. The Convention requires no declaration in respect of Article 11.

### *c. Matters to be addressed or clarified by law outside the Convention*

- The law should determine whether a "no credit without debit" rule, whereby any credit to a securities account must have a corresponding debit to another securities account, is to apply to transfers by this method.
- Although no further steps may be required for effectiveness against third parties, the law should clearly define what constitutes a valid debit or credit and when a debit is or can be made conditional. Articles 11(1)-(2) and 16. For discussion, see paragraphs 141-143 below.
- The law should also determine whether to permit net settlement of intermediated securities transactions. Article 11(5).
- What limited interests may be created or transferred by credits to a securities account is entirely for the non-Convention law to determine, as the Convention is silent in this regard. For discussion, see paragraphs 81-84 above.

(i) *The connection between debits and credits*

110. The connection between debits and credits is an area of significant divergence between various domestic legal and regulatory regimes. Most legal systems of the civil law tradition, for example, consider that the intermediated securities debited from the transferor's account are the very same ones that are credited to the transferee's account. In other words, in a given securities transaction, the same property that is relinquished by the transferor is acquired by the transferee. The book-entries for that transaction should occur at the same time, though this does not always occur in practice. If not simultaneous, the law ensures that there is a single conceptual instance for the acquisition and disposition and that any mismatch between the relevant securities accounts is resolved as soon as possible.

111. Legal systems of the common law tradition, however, do not necessarily make such a connection. In a trust system, for example, account holders acquire an equitable interest in the assets held by their intermediary as beneficiaries of a trust. When an account holder sells securities, that account holder is not legally transferring its equitable interest to the transferee. Instead, that equitable interest – derived from the intermediary's holding – is extinguished, and a comparable interest is created by the transferee's intermediary for the transferee. In a securities entitlement system, as another example, a similar analysis applies. The transferor's entitlement with its intermediary is extinguished, and another entitlement is created by the transferee's intermediary for the transferee.

112. The Convention fully defers on these issues and, depending on how intermediated securities are characterised (see Part III.A), the non-Convention law should determine whether a "no credit without debit" rule is to apply.

(ii) *Netting*

113. As noted in paragraph 17 above, where multiple transactions are made every day, it makes sense not to transfer gross quantities per transaction but, where possible, to net transfer obligations at predetermined times and to transfer only the resulting net amount. In systems where net settlement of intermediated securities transactions is permitted, to the extent that there are matching debits and credits to accounts maintained by the intermediary for its account holders, there need not be precisely matching entries in the intermediary's accounts maintained with its upper-tier intermediary. Such entries, however, should simply reflect the net overall change in the aggregate balance of its account holders taken together.

114. The Convention does not mandate recognition of netting arrangements. See Article 11(5). Non-Convention law thus may allow or disallow debits and credits to be made on a net basis in the accounts of an intermediary with an upper-tier intermediary to reflect, for securities of the same description, the net result of all movements in the accounts maintained by that intermediary for account holders and its own holdings. Such law should address and determine whether to provide for recognition of netting arrangements.

*d. Matters not mentioned in the Convention*

(i) *Definition of debit or credit*

115. It is for the non-Convention law to determine what constitutes entries such as debits and credits as the Convention is silent in this regard. Such a definition, if necessary, may be found in some legal or regulatory provisions of the non-Convention law or, possibly, in the uniform rules of an SSS.

**2. Transfer by other methods**

***In addition to transfer by debit and credit entries, the law may adopt any one or more of the other methods established by the Convention.***

*a. Core Convention rules*

- The Convention expressly recognises three optional additional methods for an account holder to transfer intermediated securities or any interest therein. An account holder may grant an interest:
  - to another person by entering into a valid agreement with that person and having a designating entry made (earmarking) in its security account (Article 12(3)(b));
  - to another person by entering into a valid control agreement with the intermediary that permits that person to exercise control over the securities (Article 12(3)(c)); and,
  - to its intermediary by entering into a valid agreement with that intermediary (Article 12(3)(a)).
- For these three methods, as for the debit and credit method, no further steps may be required for effectiveness against third parties. Articles 12(1)-(2). The non-Convention law should be reviewed to determine whether any further step or steps are required and, if any exist, they should be eliminated. As to the invalidity or reversal of a designating entry or other book-entry, see Article 16 and paragraphs 141-143 below.
- Other methods for transfer may be maintained in non-Convention law. Article 13.

116. The Convention expressly provides four methods for transferring intermediated securities or any limited interests therein: the debit and credit method in Article 11 and three additional methods in Article 12. The three additional methods, although present to varying extents around the world, have not reached the same level of universal acceptance as the debit and credit method. Accordingly, under the Convention, the debit and credit method must be recognised, whereas the three additional methods are optional.

117. Apart from the methods expressly provided in the Convention, Contracting States are entitled to use additional methods under Article 13. Subject to certain limitations described below, Article 13 permits States to accommodate alternative methods for transfer (e.g. an existing one that a State may wish to retain) in that State's legal framework.

*b. Choices to be made by declaration*

118. Article 12 sets out a number of options with respect to the three additional methods, and States may wish to consider whether to provide for one, two, all or none of these methods in their non-Convention law. The additional methods provided by Article 12 are the following.

- *Designating entry (or earmarking)*: besides a valid agreement between parties, this method requires a book-entry in favour of the transferee in the transferor's securities account, made by the relevant intermediary according to the transferor's instructions.
- *Control agreement*: a valid agreement between the parties is accompanied not by a book-entry in the transferor's securities account, but rather it directly states those conditions or obligations under which the relevant intermediary must act to the benefit of the transferee.
- *Agreement with relevant intermediary (or automatic perfection)*: an interest is created when the account holder and its relevant intermediary enter into a valid agreement. There is no other condition to be met because the agreement binds the very same parties that would be needed for a control agreement, and the position of the intermediary is secured by the control it has over the securities account that it maintains for the account holder.

119. All these methods have in common that the intermediated securities over which rights are transferred remain credited to the transferor's securities account. Further, two steps are required for



each: (1) the transferor and the transferee enter into a valid agreement regarding the rights to be created or transferred and (2) the condition specific to the relevant method is satisfied.

(i) *Positive and negative control*

120. Because designating entries are book-entries like debits and credits, they conform in many ways with this universal method for transfer and are preferred in many systems. The book-entry also serves as a form of publicity, but this is generally of limited value because securities accounts are not public registries to be consulted without authorisation. Account statements, moreover, may become out of date within minutes of being generated.

121. Other systems prefer control agreements, which do not require a book-entry in the transferor's account and allow for contractual provisions regulating the relationship between the transferor, transferee and, in typical instances, the relevant intermediary. Such agreements, however, lack the publicity aspect – albeit limited – that designating entries offer.

122. As the intermediated securities upon which an interest is granted by designating entry or control agreement remain in the transferor's securities account, it is not enough that a book-entry be made or an agreement be in place reflecting the existence of that interest. That entry or agreement must also have certain effects protecting the transferee against possible unauthorised actions regarding the relevant securities.

123. For protection in this regard, non-Convention law is to determine whether a designating entry or a control agreement provides the transferee of the interest with "positive" or "negative" control, or both. Positive control requires the intermediary maintaining the transferor's account to comply with any instructions given by the transferee in relation to those intermediated securities as may be provided by the account agreement, control agreement, or the uniform rules of an SSS, without further consent of the transferor. Negative control requires that the intermediary maintaining the transferor's account not comply with any instructions given by the transferor in relation to the relevant intermediated securities without the transferee's consent. See Articles 1(k) and 1(l).

(ii) *Interests transferable by the three methods*

124. In many systems, these three additional methods are typically used to transfer limited interests in intermediated securities, such as security interests. Like the debit and credit method, however, the three additional methods may also be used to transfer intermediated securities as well as any limited interests therein, even though transferees of intermediated securities typically prefer to have them credited to their securities accounts.

125. Under the Convention, these three methods are not restricted to transferring limited interests, despite the fact that they are primarily used for doing so, because such a restriction would require defining particular concepts, such as security interests or collateral interests. This would undermine the Convention's functional approach and interfere with the property notions of various domestic systems.

*Example 125-1: In some markets, both title transfer and non-title transfer collateral transactions are effected by Article 12 methods. Some central banks take intermediated securities from qualifying intermediaries in repurchase operations, known as repos transactions, without debiting the relevant securities from the participants' securities account.*

126. In line with commercial practices in numerous markets, Article 12(4) provides that any of these methods may be used to grant an interest in respect of:

- an entire securities account, so that it applies to all intermediated securities credited from time to time standing to the credit of that account; or

- a specified category of intermediated securities, or a specified quantity or value of intermediated securities, standing to the credit of a given securities account.

(iii) *Declarations*

127. What methods for transfer are available in which legal systems is important information for investors and intermediaries. This is why the Convention promotes three optional methods (in addition to the debit and credit method) and requires Contracting States to make a declaration regarding which methods they have chosen and, if applicable, to specify the type of control resulting from a designating entry or control agreement.

128. A Contracting State may also limit via declaration the possibilities provided under Article 12(4), described above in paragraph 126.

129. The purpose of such declarations is to enhance international transparency and legal predictability, and they may be subsequently modified. For more information, see the Declarations Memorandum, Section 4.D and accompanying Forms No. 4A to 4F.

130. Furthermore, if a State chooses both designating entries and control agreements, it should also consider whether both methods rank equal or if an interest granted by a designating entry always has priority over an interest granted by way of a control agreement, in which case this should be the subject-matter of a declaration. See Article 19(7) and paragraph 161 below.

*c. Matters to be addressed or clarified by law outside the Convention*

(i) *Valid agreement required*

131. Each of the three additional methods for transfer requires that the account holder enter into an agreement with or in favour of the person to whom an interest is granted. Non-Convention law determines the nature, scope, and extent of the interest granted, may establish formal requirements for such agreement, and may distinguish among classes of account holders. It also determines the consequences for an agreement that is invalid or ineffective for reasons such as lack of formality, lack of capacity, mistake, and illegality.

(ii) *Other methods for transfer under non-Convention law*

132. Apart from the four methods for transfer expressly identified in the Convention, additional methods, in accordance with Article 13, are not precluded by the Convention. There are a number of policy choices to be made with respect to such non-Convention methods. States may wish to consider whether these aspects of intermediated securities law are to be standalone (with creation of special methods) or part of existing laws or rules within their domestic system. States may preserve existing methods or consider other approaches to ensure effective transfers of interests.

133. Transfers according to such other methods are not eligible for the protection of an innocent acquirer under Article 18, though they may be protected by a similar provision of non-Convention law (see Part IV.C below). Their priorities are determined by the non-Convention law, except that they are subordinated to all interests that become effective against third parties under Article 12 (see Part IV.D below).

134. A Contracting State should consider existing methods for transfer falling under Article 13 and whether they should be retained.

(iii) *Limited interests that can be granted*

135. What limited interests may be created or transferred by credits to a securities account is entirely for the non-Convention law to determine. For discussion, see paragraphs 81-84 above.

(iv) *Non-consensual security interests*

136. Article 12(8) references non-consensual security interests (e.g. statutory liens, purchase-money liens, etc.), which are not regulated by the Convention. Such interests arise, become effective against third parties and enjoy the priority determined by the applicable law. As discussed in paragraphs 165-168 below, States may wish to consider how these types of interests are addressed in their law.

**B. *Unauthorised dispositions and reversal***

***Under the Convention, an intermediary may only dispose of intermediated securities with the authorisation of the person(s) negatively affected by the disposition. This authorisation may also derive from the non-Convention law.***

***The consequences of unauthorised dispositions should also be established by the 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. This is in accordance with the general rule of that the validity, reversibility and conditionality of book-entries in securities accounts are determined by the non-Convention law and, to the extent permitted by the non-Convention law, the account agreement and the uniform rules of a securities settlement system.***

**1. Core Convention rules**

- Debits of securities to a securities account, designating entries or the removal of designating entries or any other disposition of intermediated securities may only be made with the authorisation of the person(s) negatively affected by the disposition. Article 15(a)-(d).
- The authorisation may also be contained in the non-Convention law. Article 15(1)(e).
- The 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 determine the consequences of dispositions without the authorisation required. Article 15(2).
- Article 15(2) corresponds with the general rule of Article 16 whereby the non-Convention law 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.
- With respect to unauthorised designating entries the consequences of unauthorised dispositions provided in the non-Convention law are subject to the protection of innocent acquirers. Article 18(2).

137. The general idea of Article 15 is that dispositions of intermediated securities must be authorised by the person(s) who are negatively affected by those dispositions. Article 15(1)(a)-(d) specify such dispositions, including dispositions in accordance with Articles 11, 12 and 13, and the persons by whom the intermediary must be authorised. The prerequisites of a valid authorisation are not regulated by the Convention. But the authorisation itself may be given by any kind of (express or implied) consent under the Convention, especially including instructions of the affected person. Article 10(2)(c). The non-Convention law may additionally provide an authorisation (by operation of law and not by the affected person(s)).

138. The consequences of unauthorised dispositions are deferred to non-Convention law. Dispositions under Article 15(1) are not necessarily associated with book-entries (e.g. Articles 12(3)(a), 12(3)(c), 13).

But insofar as unauthorised dispositions implicate a (removal of a) book-entry in a securities account, Article 15(2) replicates the general rule that the validity, reversibility and conditionality of book-entries in securities accounts are determined by the non-Convention law. Article 16. The non-Convention law may permit that the account agreement or the uniform rules of a securities settlement system also determine the consequences of unauthorised dispositions and the question whether book-entries are defective. Articles 15(2), 16, 17(d).

139. The relevance of the non-Convention law is subject to the protection of the innocent acquirer. Articles 15(2), 16, 18. The reason why only unauthorised designating entries are mentioned in Article 15(2) and expressly made subject to Article 18(2) is that only such book-entries may directly result in defective entries. In the case of other unauthorised or defective (credit or designating) book-entries, however, an innocent person may, by a subsequent transaction, also acquire an interest in (intermediated) securities free of adverse claims.

## **2. Choices to be made by declaration**

140. The Convention requires no declaration in respect of Articles 15 or 16.

## **3. Matters to be addressed or clarified by law outside the Convention**

### *a. Defining authorisation of dispositions and the consequences of unauthorised dispositions*

141. The law should state that an intermediary may only dispose of intermediated securities with the authorisation of the person affected by the disposition. This authorisation may also be contained in (general provisions of) the non-Convention law.

*Example 141-1: An interest may arise by an attachment order, Art. 12(8). The debtor's intermediary executes the attachment order by a designating entry in the debtor's securities account without the account holder's authorisation.*

142. The law should clarify the consequences of dispositions that are not authorised by the person who is negatively affected by the disposition. Article 15(2). The non-Convention law may defer this decision to the general provisions of its law, to the account agreement or the uniform rules of a securities settlement system.

143. The non-Convention law may also regard such unauthorised dispositions neither as void nor as liable to be reversed, but, for instance, as mere breach of a contract between the intermediary and the person negatively affected by the unauthorised disposition. The consequences of unauthorised dispositions may be dependent on the model chosen by the respective State.

### *b. Clarifying validity requirements and conditions of book-entries*

144. In general, the law should clarify whether and in what circumstances book-entries are void, are liable to be reversed or are conditional. Article 16.

*Example 144-1 for conditional/invalid entries: Depending on the non-Convention law, credit-entries may be conditional in case of registered shares with restricted transferability before the consent of the issuer. The credit-entries may be invalid if the consent is denied.*

*Example 144-2 for conditional entries: In some States the practice is that provisional book-entries are made before the end of the settlement period. See OFFICIAL COMMENTARY, para. 16-22.*

145. The law should also consider what the consequences of the reversibility of unauthorised or defective (credit or designating) book-entries are. In particular, the law has to determine whether the reversal of book-entries has retroactive effect or *ex nunc* effect. Corresponding decisions have to be

made in case of conditional book-entries when the condition is not fulfilled. The non-Convention law may defer this decision to the general provisions of its law or to the account agreement or the uniform rules of a securities settlement system. Articles 15(2), 16.

146. The law has to make clear that the consequences of unauthorised dispositions and defective (credit or designating) book-entries that are determined by the non-Convention law are subject to the overriding principle of the protection of an innocent acquirer. Article 18 and see also Articles 15(2), 16.

### **C. Protection of an innocent acquirer**

***Under the Convention, an innocent acquirer who acquires for value is protected against adverse claims. This protection covers:***

- (a) instances in which another person has an interest in (intermediated) securities which is violated by the acquisition, and***
- (b) instances in which the acquisition by an innocent acquirer could be negatively affected by an earlier defective entry.***

#### **1. Core Convention rules**

- The innocent acquirer who acquires for value is protected against adverse claims. The innocent acquirer is protected if another person has an interest in (intermediated) securities which is violated by the acquisition. Article 18(1). The innocent acquirer is also protected against the invalidity or reversibility of the acquisition based on an earlier defective entry. Article 18(2). Therefore the innocent acquirer is protected against both the risk of the invalidity and the reversal of the innocently acquired right.
- With regard to earlier defective entries, the acquisition by an innocent person is, to the extent permitted by the non-Convention law, subject to the uniform rules of a securities settlement system or of the account agreement. Article 18(5).
- Article 18 also excludes other claims (e.g. damage claims in tort) that may be asserted against the innocent acquirer by the person who holds the right or interest or would otherwise benefit from the invalidity or reversal of the defective entry. Article 18(1)(c), (2)(b).
- The protection of the innocent acquirer is limited to instances when the acquirer has given (any kind of) value which has to be understood in a broad sense. See Article 18(3), and, as to the interpretation of this term, see OFFICIAL COMMENTARY, paras. 18-15 and 18-16.
- The priority of interests is, however, not regulated by Article 18, but by Article 19, 20(2). See Article 18(6).

The definitions which are relevant for Article 18 are contained in Article 17:

- The term acquirer is defined in a broad sense, including the acquisition of a security interest or a limited interest. Article 17(a).
- A defective entry is a credit of securities or designating entry that is invalid or liable to be reversed. Article 17(d).
- The acquirer is innocent, unless the acquirer actually knows or ought to know, at the relevant time, of another person's interest or of an earlier defective entry. Considering the short time frame of transactions in intermediated securities that are effectuated through impersonal markets, an acquirer has no general duty of inquiry or investigation in order to reach the standard of innocence. See as to the standard of "ought to know", OFFICIAL COMMENTARY, paras. 17-8 to 17-14.

- The question whether organisations actually know or ought to know of an interest or fact has to be determined by reference to the individual responsible for the matter to which the interest or fact is relevant, Article 17(c).
- The relevant time at which the acquirer must be innocent is usually the time that the credit is made. Article 17(e). Since interests in (intermediated) securities may become effective without a credit entry in the securities account, the relevant time is, in this case, determined by the time when those interests have been made effective against third parties. Article 19(3).

147. The general idea of Article 18 is not only to protect the innocent acquirer, but also to immunise onward transfers against the risk of being removed or reversed based on another person's interest in the (intermediated) securities or on an earlier defective entry. The protection of the innocent acquirer covers situations, where the other person's interest in the (intermediated) securities is violated by the acquisition. Article 18(1). Article 18(2) extends this protection to situations, where the earlier defective entry does not constitute an interest in the (intermediated) securities at the relevant time of acquisition, but bears the risk of resulting in the innocent acquisition being reversed. The scope of application of Article 18(1) and Article 18(2) may overlap.

*Example 147-1: A debit of securities to a securities account may be unauthorised by an account holder and therefore void. The (intermediated) securities are transferred to the account of transferee 1 who is not an innocent acquirer. As the non-Convention law of the respective Contracting State regards the credit as void, the credit is defective. The original account holder who is affected by the unauthorised debit entry therefore still has an interest in the securities which may, however, be violated by the later innocent acquisition of transferee 2. In this case, transferee 2 may be protected under paragraph 1 and paragraph 2 of Article 18.*

148. As the results under paragraphs 1 and 2 of Article 18 are identical, the distinction between these paragraphs is usually not relevant. It may become relevant with regard to paragraph 5, however, because the innocent acquisition principle, to the extent permitted by the non-Convention law, is only subject to the uniform rules of a securities settlement system or of the account agreement when the innocent person only meets the requirements of paragraph 2, but not those of paragraph 1. Consequently, an innocent acquirer who meets the requirements of Article 18(1) is protected under this paragraph, even if the respective non-Convention law permits limitations of the innocent acquisition principle under Article 18(2) and the securities settlement system or the account agreement provide for such rules.

149. The function and meaning of Article 18(1) and (2) depend on the (general) provisions of the respective Contracting State especially because of two reasons. First, in a so-called matching system (i.e. a system in which credit entries have to correspond with an equivalent number or amount of debits) Article 18(1) ensures that the innocent purchaser of (intermediated) securities may acquire securities even if a corresponding debit has not been made. However, in a system which allows for the acquisition of (intermediated) securities without corresponding debits, the innocent acquisition principle has more the character of a limitation of the acquisition which is generally possible by the person to whose securities account the credit was made.

150. Second, in a Contracting State that regards the transfer (of rights) as a contract that is separate and abstract from the underlying contract, the transfer of (intermediated) securities is not directly affected by the invalidity (rescission) of the underlying contract (principle of abstraction). Hence, the transfer is, in principle, valid, even though the acquired right or interest has to be returned on the ground of unjust enrichment. The situation is, of course, different if the transfer itself is void. But in this case the acquirer will already be protected under Article 18(1). Consequently, the problem which is envisaged by Article 18(2) is in such a State of no particular relevance.

## 2. Choices to be made by declaration

151. The Convention requires no declaration in respect of Articles 17 or 18.

## 3. Matters to be addressed or clarified by law outside the Convention

152. Under the Convention, the law has to allow for the acquisition by an innocent acquirer in instances when another person has an interest in (intermediated) securities, which is violated by the acquisition. Article 18(1). The non-Convention law has also to protect the innocent acquirer against the invalidity or reversal of its acquisition based on an earlier defective entry. Article 18(2).

153. The non-Convention law should clarify whether and to what extent it permits that the rules of a securities settlement system or an account agreement may limit the innocent acquisition principle of Article 18(2). If so, the consequence is the reversal of (a series of) book-entries. The innocent acquisition principle under Article 18(1), however, is applicable at any rate.

154. The domestic legislator should be aware that the rights and liabilities of acquirers in case they are not protected by Article 18(1) or Article 18(2) are determined by the applicable law. Article 18(4) replicates the general principle that, if the Convention does not provide any special rules, the applicable law will determine the rights and liabilities of the respective persons.

### D. Priorities

***The Convention establishes clear priority rules that apply among competing claimants to the same intermediated securities. A Contracting State may supplement and adjust these priority rules by making optional declarations and by addressing in the non-Convention law priority contests that are not resolved by the Convention's priority rules.***

#### 1. Core Convention rules

- Article 19 sets out the Convention's basic priority rules for interests made effective under Articles 12 and 13 with respect to the same intermediated securities—i.e., securities credited to the same securities account. Article 19(1).
- Article 20 partially determines the priority among an intermediary's collateral taker and its account holder.
- Article 39 contains a general transition rule, which preserves the priority of interests created under the non-Convention law of a Contracting State before the Convention has entered into effect in relation to the Contracting State.

155. Subject to exceptions mentioned below, interests made effective under Article 12 have priority over interests otherwise effective under the non-Convention law (i.e., Article 13 interests). Article 19(2).

156. Exceptions to the Article 19(2) priority rule are made for non-consensual security interests, as to which the Convention defers to priority rules under the non-Convention law under Article 19(5), and for the priority of interests created by an intermediary as against the rights and interests of the intermediary's account holders governed by Article 20.

157. Article 19(3) provides the baseline temporal priority rule. Interests made effective under Article 12 rank according to the time (a) of an intermediary's acquisition of an interest under Article 12(3)(a), (b) of the making of a designating entry, and (c) that a control agreement is entered into or, if applicable, that the relevant intermediary receives notice that a control agreement has been entered into.

158. Article 19(4) provides a special non-temporal priority rule. If an intermediary holds an effective Article 12 interest and subsequently makes a designating entry or enters into a control agreement in favour of another person, the other person's interest has priority unless the parties expressly agree otherwise.

159. Article 19(6) permits parties to vary the otherwise applicable priorities by agreement, except that applicable law governs whether parties may vary the priority of a non-consensual security interest. See paragraphs 165-166 below.

160. Under Article 20, an interest granted by an intermediary under Article 12 has priority over the rights of the intermediary's account holders unless the intermediary's grantee knew or ought to have known that the interest violated the rights of one or more account holders. Article 12(2). This is essentially the same test of innocence provided in Article 18(1). The Convention leaves to the non-Convention law the relative priorities in the case of the grant of an interest by the intermediary under Article 13. See paragraph 170 below.

## **2. Choices to be made by declaration**

### *a. Declaration regarding priority of interests granted by designating entry*

161. A Contracting State may declare that an interest made effective by a designating entry has priority over interests granted by other methods, subject to the priority rule in Article 19(4). See paragraph 158 above. The Article 19(7) declaration is optional and not mandatory. For more information, see the Declarations Memorandum, Section 4.E and accompanying Form No. 5.

### *b. Declaration regarding transitional provision*

162. Under the transition rule variation in Article 39(2), a Contracting State may declare that a pre-existing interest will retain its priority under Article 39(1) only if it is made effective under Article 12 before the relevant date.

163. Pre-existing interests are defined in Article 39(3)(a) to mean consensual interests granted under the non-Convention law other than by a credit to a securities account. The relevant date is defined in Article 39(3)(b) to mean the date stated by the Contracting State in its declaration, but not later than two years after the declaration's effective date.

164. The Article 39 declaration is optional and not mandatory. For more information, see the Declarations Memorandum, Section 4.J and accompanying Form No. 10.

## **3. Matters to be addressed or clarified by law outside the Convention**

### *a. Non-consensual security interests*

165. Because Article 19(5) leaves the priority of non-consensual security interests to the applicable law a Contracting State should reconsider any such applicable priority rules for consistency with and conformity to the policies embodied in the Convention.

166. In particular, a Contracting State should consider whether the priority of any or all applicable non-consensual security interests may be varied by agreement. See Article 19(5), (6).

167. If the non-Convention law of a Contracting State provides, or if a Contracting State is giving consideration to the enactment of a law which provides, that an intermediary acting as an agent or broker obtains a non-consensual security interest in securities to secure an account holder's obligation to pay for the securities, then the Contracting State should consider the priority given (or to be given) to that security interest. The Contracting State should consider giving first priority to such a non-consensual security interest, subject to the operation of Article 19(4).



168. A Contracting State should consider whether a right of retention or similar right or interest provided under the state's civil code, commercial code, or both applies to intermediated securities for the benefit of the relevant intermediary. The State should consider clarifying such provisions with respect to the applicability or non-applicability to intermediated securities and, if applicable, the priority of such a right or interest.

*b. Priorities regarding interests granted by non-Convention methods*

169. If and to the extent that the priority rules applicable to interests created under the non-Convention law of a Contracting State differ from those applicable under the Convention, the Contracting State should consider conforming those rules to the Convention's rules.

170. In particular, a Contracting State should consider conforming the priority rule for an interest granted by an intermediary under the non-Convention law (i.e., an Article 13 interest) to be consistent with Article 20(2).

## **V. INTEGRITY OF THE INTERMEDIATED HOLDING SYSTEM**

### ***A. Prohibition of upper-tier attachment***

***The law should prohibit any attachment of intermediated securities of an account holder against, or so as to affect: (a) a securities account of any person other than that account holder; (b) the issuer of any securities credited to a securities account of that account holder; or (c) a person other than the account holder and the relevant intermediary.***

#### **1. Core Convention rules**

- Article 22(1) prohibits upper-tier attachment with an exception specified under Article 22(3).
- The phrase "upper-tier attachment" is commonly used where a creditor of an account holder attempts to attach securities credited to a securities account maintained by an intermediary which is not the account holder's relevant intermediary.
- In other words, upper-tier attachment indicates that the creditor tries to attach at an inappropriate tier of the holding chain.

171. The prohibition of upper-tier attachment is based on an important policy consideration. Permitting such attachment would undermine the ability of an intermediary to perform its functions and disrupt the integrity of the intermediated securities holding system. What should be avoided is that such an attachment order blocks securities accounts of other account holders who have nothing to do with the subject matter of the attachment. If upper-tier attachment is permitted, such blockage could happen because upper-tier intermediaries usually do not know and are unable to specify what part of the securities or intermediated securities are the relevant securities that should be subject to the attachment. Even if upper-tier intermediaries can identify the relevant securities or intermediated securities, permitting upper-tier attachment could produce enormous costs for the relevant upper-tier intermediary in identifying the relevant securities or intermediated securities and could prevent efficient operations of the intermediated securities holding system.

172. This policy is particularly important in the cross-border context, inasmuch as if some systems permit upper-tier attachment and others do not, it would seriously harm compatibility and thus efficiency of cross-border holding of intermediated securities.

173. The definition of attachment should be broad. Article 22(2) defines "attachment of intermediated securities of an account holder" as any judicial, administrative or other act or process to freeze, restrict or impound intermediated securities of that account holder in order to enforce or satisfy a judgment,

award or other judicial, arbitral, administrative or other decision or in order to ensure the availability of such intermediated securities to enforce or satisfy any future judgment, award or decision.

*Example 173-1. AH has a securities account with IM-1. IM-1 has a securities account with IM-2 which it uses as global custodian. Therefore, IM-1 pools all securities which it holds for account holders in its account with IM-2. A creditor of AH tries to obtain an attachment order against IM-2 in order to seize securities belonging to AH.*

*In this case, the court of a Contracting State cannot issue an attachment order against IM-2. Even if it is clear that all securities of IM-1's account holders are part of the pool in the account with IM-2, there is no account maintained by IM-2 for AH. IM-2 usually does not have any means of knowing how many, if any, securities belong to AH. However, the result does not change under Article 22(1) even if IM-2 for some reason has a means of knowing how many securities belong to AH. See OFFICIAL COMMENTARY, ex. 22-2.*

## **2. Choices to be made by declaration**

174. As an exception to the general prohibition of upper-tier attachment, Article 22(3) allows a situation where an attachment is permitted to be made against a person other than the relevant intermediary. This is often the case in the context of holding patterns (the so-called "transparent systems") where the relevant intermediary shares its functions with a third person. See Article 7. However, the exception of Article 22(3) can also apply where there is no holding pattern built on such shared functions in the sense of Article 7.

175. A Contracting State would have to declare that, under its non-Convention 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. Any such declaration would also have to identify that other person by name or description and shall specify the time at which such an attachment becomes effective against the relevant intermediary.

*Example 175-1: In a given State, the CSD is the relevant intermediary and broker firms act as "account operators" vis-à-vis the investors (who are account holders). The sharing of functions between the CSD and the "account operators" is acknowledged by means of a declaration under Article 7. The national law prescribes that an attachment order aimed at impounding intermediated securities of an account holder has to be addressed to the account operator. See OFFICIAL COMMENTARY, ex. 22-5.*

*Example 175-2: State A maintains a transparent system in which the CSD participants rather than the CSD itself are considered to be the relevant intermediaries for lower-tier account holders. The participants maintain the accounts for and have direct relationships with the account holders, have legal responsibility to the account holders and receive and act upon instructions from the account holders. However, credits, debits and designating entries to the lower-tier accounts, though performed by the participants, are recorded in the CSD's computer systems (including in sub-accounts that fully identify the lower-tier account holders), and the intermediated securities are registered in the issuers' books in the name of the CSD as a fiduciary. The sharing of functions between the CSD and the relevant intermediary is acknowledged by means of a proper declaration under Article 7 and Article 22(3). The national law and regulations prescribe that an attachment order has to be addressed to the CSD. This attachment shall not be considered an upper-tier attachment under the Convention as the exemption of Article 22(3) applies. See OFFICIAL COMMENTARY, ex. 22-6.*

*Example 175-3: In State B, the holding patterns in place do not involve the sharing of functions and the CSD is not the relevant intermediary. However, the law prescribes that an attachment has to be made against the CSD and identify the debtor and the debtor's*

*relevant intermediary. It also prescribes that the CSD has to communicate to and check with the debtor's relevant intermediary what the debtor's holdings are before freezing the intermediated securities in both the relevant intermediary's and the CSD's securities accounts simultaneously.*

*Both States would have to make a declaration under Article 22(3) in order to be able to maintain the practice described in the above examples. Without such declaration, their laws would not properly reflect the substance of Article 22. See OFFICIAL COMMENTARY, ex. 22-7.*

176. The rationale for this exception lies in the general purpose of the prohibition of upper-tier attachment (i.e., upper-tier attachment bears the risk of disrupting the holding chain). However, this detrimental effect can be avoided where the applicable law provides for special safeguards avoiding such disruption, in particular reconciliation mechanisms which allow the relevant intermediary and the other person to communicate with each other and have procedures in place which guarantee that an attachment made at the level of one entity is correctly reflected in the accounts maintained by the other entity.

177. In many (probably most) cases, a Contracting State making a declaration under Article 22(3) will also have made a declaration under Article 7(1) with respect to the sharing of intermediary functions, as contemplated by Example 175-1 above. However, Article 22(3) does not limit its applicability to such Contracting States. It is based on the assumption that a Contracting State that elects to become a party to the Convention and that also elects to make a declaration under Article 22(3) will do so rationally. A Contracting State should make such a declaration only if a system is in place (through the use of information technology or otherwise) which ensures that the problems and risks that Article 22(1) is intended to prevent are adequately addressed. See Example 175-3 above.

178. Where a declaration under Article 22(3) is made, it must identify the other person by name or description. Furthermore, it must specify the time at which such an attachment becomes effective against the relevant intermediary. The latter requirement shows that the decisive account at which to look remains under all circumstances the one held for the debtor by the relevant intermediary. Only if and when the attachment of intermediated securities standing to the credit of that account takes legal effect, the intermediated securities are validly frozen, restricted or impounded. Until that point, the intermediated securities can be disposed of. For more information, see the Declarations Memorandum, Section 4.C and accompanying Forms 3.A and 3.B (regarding Article 7) and Section 4.F and accompanying Form No. 6 (regarding Article 22(3)).

### **3. Matters to be addressed or clarified by the non-Convention law**

179. To make a declaration under Article 22(3), a Contracting state should make sure that under its non-Convention 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.

## **B. Prevention of shortfalls and allocation of securities**

***The law should ensure that intermediaries are required to prevent shortfalls, notably by holding or having available sufficient securities to cover credits to securities accounts that these intermediaries maintain, and that securities are properly allocated to account holders' rights, which may be achieved by way of segregation.***

### **1. Core Convention rules**

- An intermediary should hold or have available sufficient securities to cover credits made to securities accounts it maintains. Article 24.
- An intermediary should allocate securities to account holders' rights. A common way to do this is segregation. Article 25.

180. It is crucial for the integrity of an intermediated securities holding system to prevent shortfalls as much as possible, to provide for correction mechanisms when they occur, and to have rules in place for the distribution of losses due to shortfalls in insolvency. The Convention addresses these issues in Articles 24-26. Lawmakers should ensure that intermediaries hold or have available sufficient securities (Article 24) and that securities are allocated to account holders, notably by way of segregation (Article 25). The Convention rule regarding the distribution of losses in insolvency (Article 26) and alternative solutions are dealt with in paragraphs 233-234 and 236 below.

#### *a. Sufficient securities*

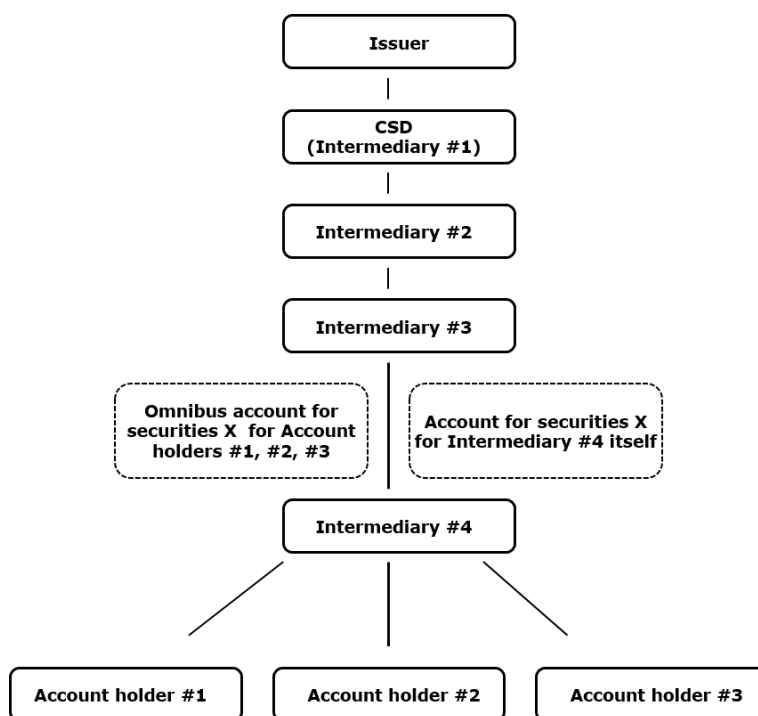
181. Lawmakers should ensure that an intermediary holds or has available sufficient securities to cover credits to securities accounts it maintains or, in technical and more precise terms, "hold[s] or [has] available securities and intermediated securities of an aggregate number or amount equal to the aggregate number or amount of securities of that description credited to: (a) securities accounts that it maintains for its account holders other than itself; and (b) if applicable, securities accounts that it maintains for itself". Article 24(1).

#### *b. Allocation*

182. In addition to ensuring that intermediaries hold or have available sufficient securities and intermediated securities (Article 24), lawmakers should also make sure that these securities are allocated to the rights of the account holders of the intermediary concerned (Article 25). This allocation is an important tool in determining which assets belongs to whom. The allocation should take place to account holders other than the intermediary itself. The default policy set out in the Convention is that securities are deemed to be allocated to such account holders up to the aggregate number or amount of their credits, and that these securities are *not* available to the intermediary's other creditors in case of its insolvency. States may, however, deviate from this policy by making a declaration.

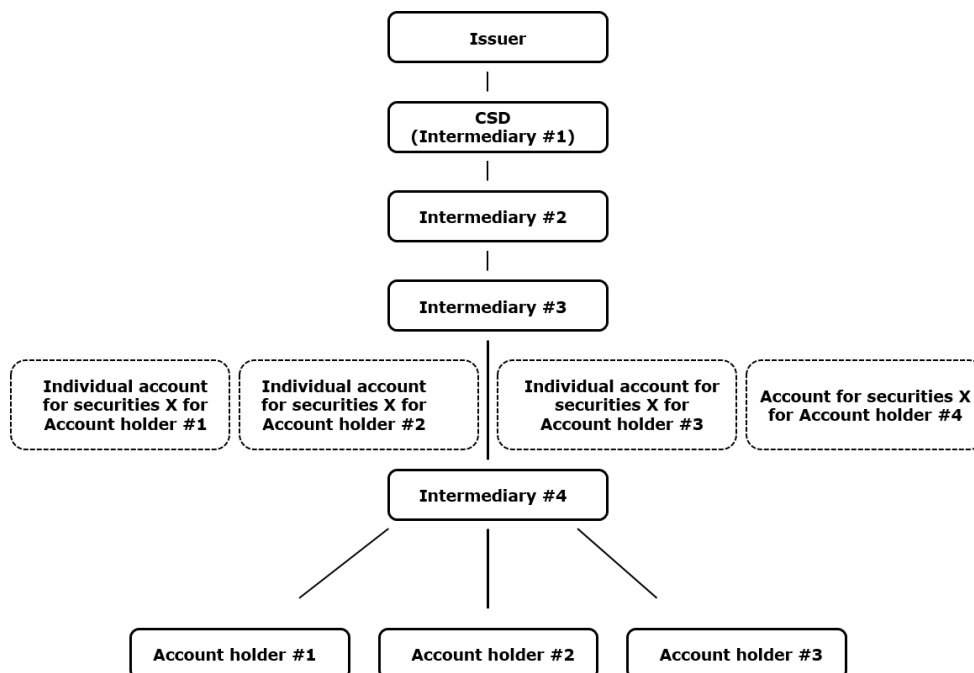
183. The Convention does not determine exactly how allocation takes place, which is thus left to domestic lawmakers. Article 25(3). However, the Convention does mention the commonly applied method of segregation. Article 25(4). Two different types of segregation are distinguished. In the first case of pooled "omnibus accounts", the intermediary distinguishes the securities of a certain description that it holds for itself from those of all other account holders, whose securities of that description are pooled in an omnibus account. In the second case of so-called "individual segregation", the intermediary distinguishes between its own securities and of those of particular account holders or groups of account holders individually. It should be noted that these different methods of segregation can also be combined: an intermediary can distinguish between securities of a certain description that it holds for (i) itself, (ii) a number of account holders individually, and (iii) remaining account holders in an omnibus account.

Diagram 183-1: Omnibus account



In Diagram 183-1, intermediary #4 holds securities X in two accounts with intermediary #3. An omnibus account reflects securities X held for account holders #1, #2, and #3; another account reflects securities X that intermediary #3 intends to hold for itself. Intermediary #3 only knows intermediary #4, not the identity of account holders #1, #2, and #3.

Diagram 183-2: Individual segregation



In Diagram 183-2, intermediary #4 holds accounts with intermediary #3 for each of its account holders individually, as well as for securities it holds for its own account. Intermediary #3 knows the identity of intermediary #4 and of its account holders. In order for the individual segregation to be effective throughout the chain, it must also be ensured at upper-tier levels (intermediary #2, etc.).

## 2. Choices to be made by declaration

### *a. Sufficient securities*

184. No declarations can be made in relation to the requirement to hold or have available sufficient securities.

### *b. Allocation*

185. The default rule of the Convention is that securities that are available under Article 24 are *ex Conventione* allocated to account holders and are not available to the intermediary's other creditors in its insolvency. However, a State may decide to protect the intermediary's other creditors instead of the intermediary's account holders by giving "proprietary effect" to the segregation by an intermediary of securities that it holds for its own account. If the non-Convention law of a State so provides and if a declaration is made to this end, only the securities allocated to the intermediary's account holders will be available to these account holders, whereas all other "own account" securities are available to the intermediary's other creditors. See Article 25(5) and the Declarations Memorandum, Section 4.G and accompanying Form No. 7.

## 3. Matters to be addressed or clarified by law outside the Convention

### *a. Sufficient securities: Available methods, timeframe for action, and allocation of costs and other consequences*

186. Lawmakers should decide on the different methods that are made available for complying with the requirement to hold or have available sufficient securities. Different methods are listed in Article 24(2) and include registration in the register of the issuer (either in the name or for the account of account holders or in the intermediary's own name), possession of certificates or other documents of title, holding intermediated securities with another intermediary, or any other appropriate method. The suitability of these methods depends on the set-up of a given intermediated system.

187. Lawmakers should also consider the timeframe within which action should be undertaken in case the requirement to hold or have available sufficient securities is not complied with at any given moment. Article 24(3). Again, this policy decision depends on the set-up of a given system. Some systems envisage an inseparable link between credits and debits (the so-called "no credit without debit" approach) and any mismatch within the system is therefore conceptually inadmissible. Other systems envisage some leeway as long as there is a form of financial backup to protect account holders.

188. Another matter that is left to domestic lawmakers is the allocation of cost and any other consequences of non-compliance with the requirement to hold or have available sufficient securities. Article 24(4).

### *b. Allocation/segregation*

189. Lawmakers should decide on the available methods of allocation / segregation. See paragraphs 233-234 below.

### **C. Securities clearing systems (SCSs) and securities settlement systems (SSSs)**

***The Convention acknowledges the systemic importance of SCSs and SSSs, and in some instances allows derogations to the rules of the Convention to the extent permitted by the law applicable to the system. The non-Convention law should only allow for derogations to the Convention rules where such derogations are necessary to ensure the integrity of the local SCSs or SSSs.***

***The Contracting State should seriously consider introducing rules on irrevocability of instructions and finality of transactions done through an SSS or SCS, even in case of the insolvency of the SCS, SSS or a participant to any such system.***

## 1. Core Convention Rules

- Article 1(n) and (o) contain the definitions of an SSS and an SCS.
- SSSs are defined broadly to include systems that connect multiple participants for the purposes of securities settlement and, as the case may be, clearing.
- SCSs are similar infrastructures, but they only cover the clearing leg of a securities transaction, and settlement is done outside the system.
- Only SSSs or SCSs that (a) are central to the reduction of risk to the stability of the financial system (i.e. systematically important institutions) and (b) have been identified as an SSS or SCS in a declaration of the Contracting State qualify as such under Convention.

190. The effective and safe operation of systematically important systems requires their internal rules and procedures to be enforceable with a high degree of certainty.

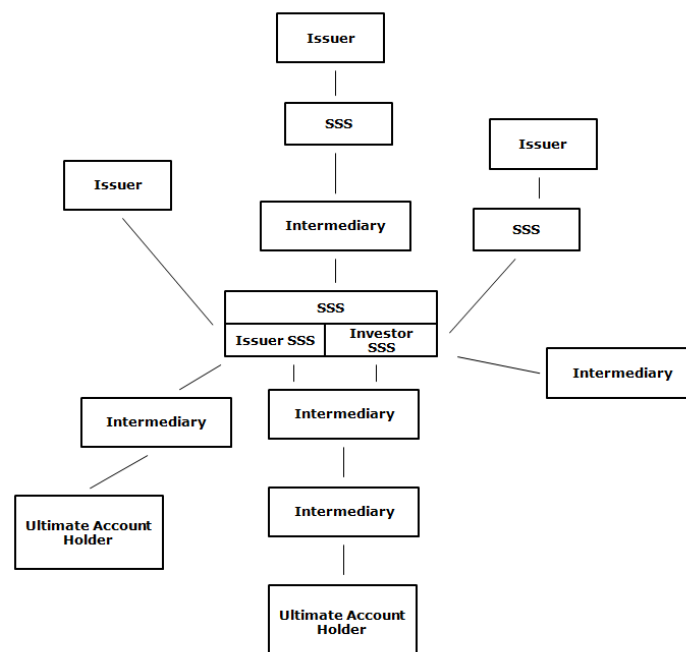
191. This is why Articles 9(1)(c), 10(2)(c), (e), (f), 15(1), 16, 18(5), 23(2)(e), 24(4), 26(3), 27(a)-(b), 28(1)-28(2) and 28(3) of the Convention provide that the uniform rules of an SSS may contain rules which either derogate from the Convention or the ordinary laws of the Contracting State.

192. Article 27 recognises the effects of the law applying to an SSS or SCS which provide for the irrevocability of instructions and the finality of recordings in SSSs or SCSs in an insolvency scenario of a participant to any such system or of the system itself.

193. SSSs which meet the above criteria can benefit from the exemptions of the Convention and hold securities in a securities account for their participants whether they act as a so-called Issuer-SSS or Investor-SSS.

194. An SSS acts as an Issuer-SSS if it is the top-tier intermediary in a securities holding chain, and as an Investor-SSS if it is not acting as top-tier intermediary.

Diagram 194-1:



195. As it appears from diagram 194-1 above, the SSS is, as an Issuer-SSS, dealing with the issuer of securities and serves as platform through which securities are introduced first into the book-entry system.

196. In its dealings with the issuer, the SSS is often identified as a “central securities depository”. Such dealings, which include the creation, recording and reconciliation of securities, are, pursuant to Article 6, excluded from the scope of the Convention.

## **2. Choices to be made by declaration**

197. To ensure predictability for intermediaries, it is important that they can easily identify whether an entity or system can derogate, either pursuant to the law applicable to it or by virtue of its uniform rules, from the rules of the Convention. To that effect, each Contracting State must identify in a declaration the SSSs or SCSs which are subject to its laws.

198. Only the Contracting State, whose laws govern a system, may make a declaration, not the Contracting State whose laws govern the agreement between the SSS/SCS and their participants (if different).

199. Only SSSs and SCSs that are central in the reduction of risk to the stability of the financial system may be included in a declaration. This means that only systematically important institutions may be listed in a declaration. For more information, see the Declarations Memorandum, Section 4.A and accompanying Form No. 1.

## **3. Matters to be addressed or clarified by law outside the Convention**

200. Contracting States should, with respect to each instance mentioned in paragraph 191, carefully consider which derogations to the Convention or to its national law they shall allow for the operation of SSSs and SCSs.

201. They should only allow derogations to the Convention rules if such derogations are essential to ensure the integrity of the SSS or SCS in light of their systemic importance.

202. Contracting States are encouraged to introduce rules on irrevocability of instructions and finality of recordings with respect to transactions done through an SCS or SSS, and in particular in the case of an insolvency proceeding of an SCS or SSS, in order to ensure the integrity of both the national and international financial system.

### ***D. Issuers and set-off***

***The Convention generally does not deal with the relationships between account holders and issuers. The law should clearly define the persons entitled to exercise the rights attached to the securities vis-à-vis the issuer and the conditions thereto when the securities are held through one or more intermediaries. It should facilitate the exercise of those rights by the ultimate account holder, in particular, by allowing intermediaries who act on behalf of third parties to exercise voting rights or other rights in different ways.***

### **1. Core Convention rules**

- The Convention generally does not deal with the relationships between account holders and issuers. Article 8.
- However, Articles 29 and 30 contain a few exceptions to that principle that are considered necessary to achieve compatibility of intermediated securities holding systems around the world.



- Contracting States should permit the holding of publicly traded securities through one or more intermediaries, and the effective exercise of the rights attached to such securities that are so held; in particular, they shall recognise the holding of such securities by a person acting in its own name but on behalf of another person or other persons and shall permit such a person to exercise voting or other rights in different ways. Article 29.
- Contracting States should not discriminate between non-intermediated and intermediated securities with regard to set-off rights in relation to the insolvency of the issuer. Article 30.

203. As discussed in paragraph 73 above, securities give investors certain rights that the Convention refers to as "the rights attached to the securities". See, e.g., Articles 8(2), 9(1)(a)).

204. In the intermediated holding systems, investors may be unable to directly exercise those rights against the issuer, since the person who appears in the issuer's register or in the CSD (when this institution replaces that register) may not be the ultimate account holder. Issuers may not know who the investors are and, accordingly, investors may not be entitled to exercise the rights attached to the securities directly against the issuers.

205. In this context, the Convention takes as a starting point the difference between the exercise of the rights attached to the securities (i) vis-à-vis the relevant intermediary and (ii) vis-à-vis the issuer. As detailed in Part III, the Convention focuses on the relationship between the account holder and its intermediary and establishes that the rights attached to the securities belong to the account holder and that the intermediary must ensure the exercise of those rights (Articles 9 and 10).

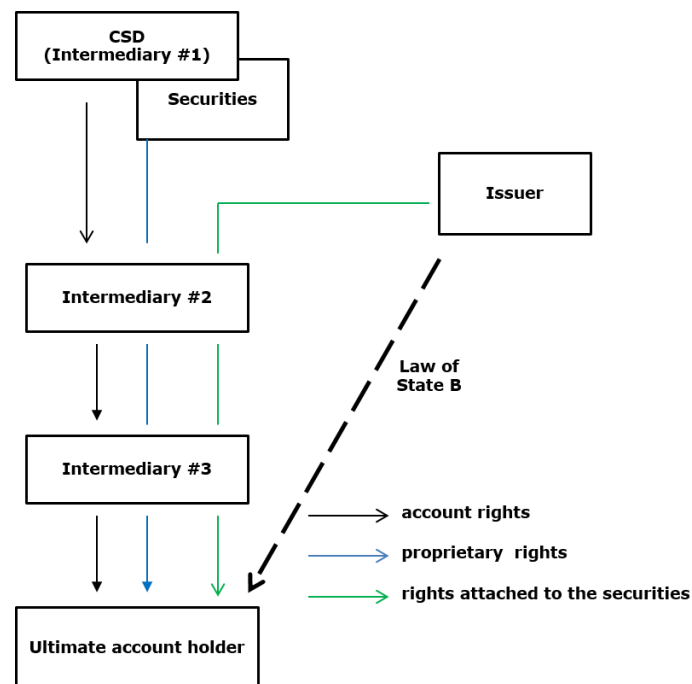
206. However, the Convention, in principle, does not deal with the relationship between account holders and issuers. Article 8 enshrines this principle. On the one hand, from the account holder's standpoint: the Convention does not affect any right of the account holder against the issuer of the securities. Article 8(1). And, on the other hand, from the issuer's standpoint, the Convention 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. Article 8(2).

207. The Convention is therefore neutral as to whether the rights attached to the securities are to be exercised by the ultimate investor, its intermediary or any other upper-tier intermediary. This is an issue governed by the law applicable to the securities. This law also governs the conditions to exercise those rights. Thus, for example, the law governing the enterprise may establish that when the shareholders exercise their voting rights by proxy, a valid proxy card must be prepared, signed and submitted to the issuer within a certain number of days before the shareholders meeting. These rules are not affected by the Convention.

208. This law will usually be the law of the issuer with regard to shareholders and the law governing the bonds with regard to bondholders. This law can be the law of a Contracting or of a non-Contracting state. That is why on this point Article 9(1)(c) refers, among others, to the "law applicable" and the terms of the securities.

209. As shown in diagram 209-1 below, for example, an account holder has a securities account with an intermediary. The account is located in State A, but the securities credited to that account are issued under the law of State B. The Convention does not say anything about whether the ultimate account holder, his intermediary (intermediary #3) or any other intermediary at an upper-tier level (intermediary #2) is entitled vis-à-vis the issuer to exercise the rights attached to those securities. The law of State B may, for example, only recognise as shareholder the persons whose names appear on the issuer's register at a certain date. Unless and until the name of the account holder appears on such register, the issuer is not obliged to treat the account holder as shareholder. This means the account holder's right over the securities are effective against the intermediary and third parties (see Article 9), but the account holder will not be entitled to exercise those rights against the issuer.

Diagram 209-1:



210. Even if under the law governing the securities, however, the account holder is not entitled to exercise the rights attached to such securities against the issuer, Article 10 establishes that the intermediaries must take appropriate measures to enable their account holders to receive and exercise those rights, for example, intermediaries should exercise voting rights following their instructions or should appoint them as proxy holders to attend and vote at the general meeting (*infra*).

211. Articles 29 and 30 are exceptions to the principle laid down by Article 8. Though the Convention does not generally apply to the relationships between the issuers and account holders, Articles 29 and 30 contain certain exceptions to this principle that were considered necessary to achieve compatibility of the securities-holding systems around the world.

212. Article 29(1) establishes an element that is crucial for the well-functioning of exchanges or regulated markets in particular to ensure cross-border compatibility of the holding systems: the recognition of the intermediated holding systems. Contracting States shall permit publicly traded securities (i.e. the securities traded on exchanges or regulated markets of the corresponding Contracting State), to be held through one or more intermediaries and recognise the effective exercise of the rights attached to those securities. However, Contracting States are not obliged to require that all securities are issued on terms that allow them to be held through intermediaries (Article 29(1) *in fine*).

213. Furthermore, Article 29(2) adds that Contracting States shall recognise the holding of securities by a person acting in its own name but on behalf of another, and to permit that person to exercise voting rights or other rights in different ways. In particular in cross-border scenarios, it is common that intermediaries act in their own name (as nominees) but also on behalf of third parties (beneficiaries). The purpose of this provision is to ensure recognition of this nominee holding fact-pattern to ensure the interoperability of different systems.

214. The Convention, however, does not prevent the non-Convention law from establishing certain conditions for a person (the nominee) to be able to exercise those rights. For instance, the law governing the issue (State B in diagram 209-1) may require the nominee to disclose the name of his clients in order to vote in different ways.

215. Article 30 provides an equal footing rule between intermediated and non-intermediated securities with regard to set-off but only in relation with the insolvency of the issuer. If a set-off right would have

existed and would have been exercisable in a non-intermediated context (e.g. when the investors hold a certificate of the bonds), such rights must also exist and be recognised where the securities are held through one or more intermediaries. The reach of this provision is very limited: it only prevents Contracting States from discriminating *on the mere fact* of the intermediation. Whether set-off rights exist and are enforceable in the insolvency of the issuer is outside the scope of the Convention.

## 2. Choices to be made by declaration

216. The Convention requires no declaration to be made under Articles 8, 29, or 30.

## 3. Matters to be addressed or clarified by the non-Convention law

217. The non-Convention law must define the persons entitled to exercise the rights attached to the securities vis-à-vis the issuer and the conditions thereto when the securities are held through one or more intermediaries. From a conflict of laws perspective, the Contracting State should make it clear that these provisions only apply to the securities governed by its own law.

218. The conditions for the exercise of those rights vis-à-vis the issuer should be clearly stated so that they provide legal certainty and predictability to: (i) the issuer regarding whom it is required to recognise as entitled to exercise those rights, (ii) and the intermediaries and account holders regarding who is entitled to exercise them against the issuer. This includes the determination of the date relevant for the identification of the person entitled to a specific corporate action.

219. Furthermore, the non-Convention law should facilitate the exercise of the rights attached to the securities by the ultimate investors, in particular establishing a transparent, smooth and effective process of proxy voting. Thus, if the person entitled to exercise the corporate rights vis-à-vis the issuer is acting as a nominee:

- The law should clearly establish under what conditions such person may exercise the rights stemming from the securities on behalf of clients. Thus, for example, the EU Directive on the exercise of certain rights of shareholders in listed companies (Directive 2007/36/EC) establishes that in the case of a person who is recognised as a shareholder by the applicable law acts on behalf of another person, "*Where the applicable law imposes disclosure requirements as a prerequisite for the exercise of voting rights by a shareholder referred to in paragraph 1 [a nominee], such requirements shall not go beyond a list disclosing to the company the identity of each client and the number of shares voted on his behalf*" (Article 13(2)); and "*Where the applicable law imposes formal requirements on the authorisation of a shareholder referred to in paragraph 1 [a nominee] to exercise voting rights, or on voting instructions, such formal requirements shall not go beyond what is necessary to ensure the identification of the client, or the possibility of verifying the content of voting instructions, respectively, and is proportionate to achieving those objectives*" (Article 13(3)).
- The law should also clearly establish that nominees will not be prevented from granting a proxy to each of their clients or to any third party designated by a client. Thus, for example, Article 13(5) of said Directive establishes: "*Where the applicable law limits the number of persons whom a shareholder may appoint as proxy holders [...] such limitation shall not prevent a shareholder referred to in paragraph 1 of this Article [a nominee] from granting a proxy to each of his clients or to any third party designated by a client*".

220. As a corollary of the recognition of intermediated securities systems, the non-Convention law should ensure a general principle of non-discrimination with regard to the exercise of the rights attached to the securities wider than the simple exercise of voting rights. The law governing the securities should not discriminate against the exercise of the rights attached to the securities *on the sole grounds* that the securities are held through a chain of intermediaries. And this principle should apply not only to nominee

systems but also to alternative systems of holding securities indirectly (e.g. by means of omnibus accounts).

## **VI. INSOLVENCY PROTECTION**

***The Convention establishes important insolvency proceeding-related rules on the effectiveness of interests made effective under Articles 11, 12, and 13 and provides loss-sharing rules in case of a shortfall of account holder securities. However, non-Convention law should address many other important and relevant features of insolvency and regulatory law that the Convention leaves to it.***

### **A. Core Convention rules**

- Article 14 deals generally with the effectiveness of interests made effective under Articles 11, 12, or 13 as against an insolvency administrator and creditors in an insolvency proceeding.
- Article 20 partially determines the priority among an intermediary's collateral taker and its account holders. See Part IV.D.2 above.
- Article 21 deals generally with the effectiveness of interests made effective under Articles 11, 12, or 13 as against an insolvency administrator and creditors in an insolvency proceeding of the relevant intermediary.
- Article 26 provides a loss-sharing mechanism in case of a shortfall of securities credited to account holders' securities accounts in an insolvency proceeding on an intermediary.

#### **1. Effectiveness in insolvency in general**

221. Article 14(1) provides affirmatively that interests made effective under Articles 11 and 12 are effective in an insolvency proceeding.

222. Article 14(2) provides that Article 14(1) does not affect substantive or procedural rules applicable by virtue of an insolvency proceeding such as ranking of categories of claims, avoidance powers for preferences and fraudulent transfers, and the enforcement of rights to property under the control or supervision of an insolvency administrator.

223. Article 14(3) provides that Article 14(1) does not apply to the situation of an intermediary insolvency proceeding addressed by Article 21.

224. Under Article 14(4) the Convention does not impair the effectiveness of an interest that is effective under Article 13.

#### **2. Effectiveness in the insolvency of the relevant intermediary**

225. Article 21(1) provides affirmatively that interests made effective under Articles 11 and 12 are effective in an insolvency proceeding of the relevant intermediary.

226. Article 21(2) provides that Article 21(1) does not affect rules applicable in an insolvency proceeding of the relevant intermediary relating to avoidance powers for preferences and fraudulent transfers and procedural rules relating to the enforcement of rights to property under the control or supervision of the insolvency administrator. The exceptions in Article 21(2) are narrower than those provided by Article 14(2).

227. Under Article 21(3), the Article does not impair the effectiveness of an interest that is effective under Article 13.

### **3. Loss sharing in case of insolvency of the intermediary**

228. Article 26 applies regarding loss sharing unless there is a conflicting rule applicable in the insolvency proceeding of the intermediary. Article 26(1).

229. If the securities of a description (i.e., a particular issue) allocated under Article 25 are insufficient to cover the securities of that description credited to securities accounts, the shortfall is to be borne (a) if the securities are allocated to a single account holder, by that account holder, and (b) otherwise by the account holders who whom the securities have been allocated in proportion to the number or amount of securities credited to securities accounts. Article 26(2). This is a *pro rata* allocation on an issue-by-issue basis.

230. If the intermediary is the operator of a SSS, the uniform rules of the SSS determine who bears the shortfall if the rules so provide.

#### ***B. Choices to be made by declaration***

231. The Articles primarily addressed here do not involve choices to be made by declaration. However, the optional declaration under Article 25(5) regarding segregation is relevant in the context of an intermediary's insolvency proceeding. See paragraph 238 below and Part V.B.2 above.

#### ***C. Matters to be addressed or clarified by law outside the Convention***

##### **1. General observations**

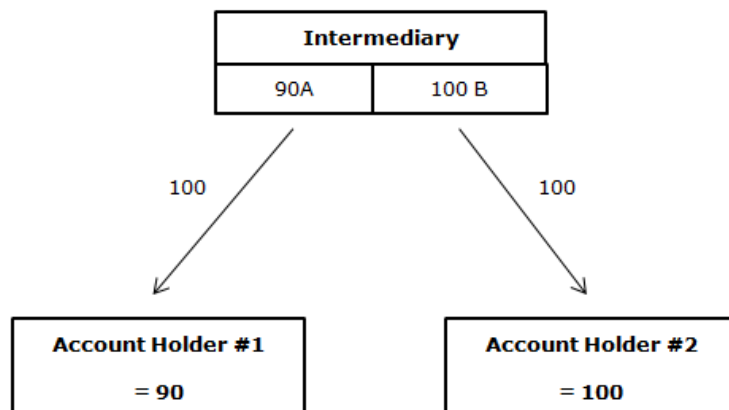
232. Many of the matters that must be addressed by the non-Convention law may fall within the realm of securities regulation—the regulation of securities markets and market participants such as intermediaries, exchanges and other trading systems, SCSs, and SSSs. Other matters are squarely in the field of insolvency law, but involve many complex and highly technical issues in the context of the insolvency of an intermediary. In this connection, many lessons have been learned through the recent financial crisis and in particular from the insolvency proceedings of various Lehman Brothers entities. There is a wealth of recent literature that should be consulted as well as much information available from the websites and publications of various NGOs. A State wishing to reform its legal and regulatory infrastructure should consult these resources. While this section of the Guide endeavours to identify the most important areas of inquiry for such a reform process, it cannot provide detailed specific recommendations.

##### **2. Loss sharing**

233. As Article 26 defers to a conflicting loss-sharing rule applicable in an intermediary insolvency proceeding, a Contracting State should consider whether it should retain or adopt any such different rule.

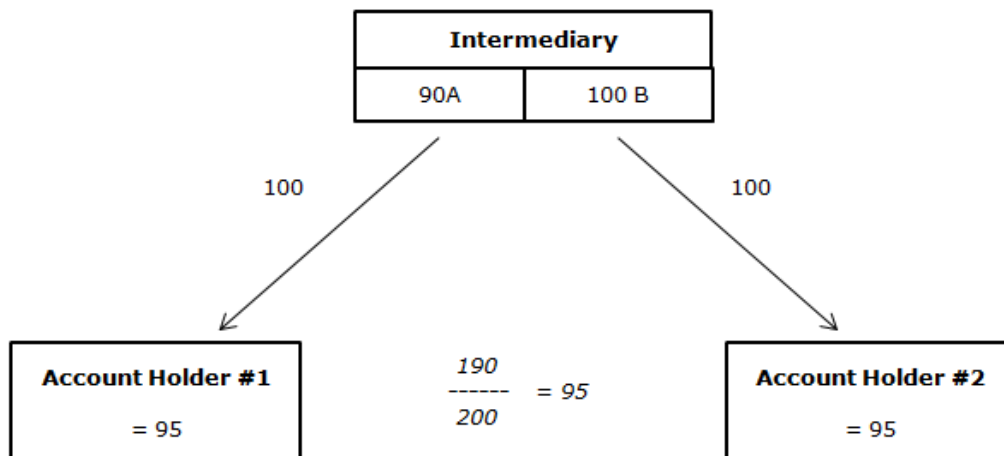
234. By way of example, assume that the intermediary has two account holders, #1 and #2. The intermediary has credited 100 units of A securities valued at 100 to account holder #1. It has credited 100 units of B securities valued at 100 to account holder #2. However, the intermediary only has 90 units available of A securities. Under the loss-sharing rule of Article 26(2), account holder 1 would bear the loss of the shortfall. Diagram 234-1 illustrates this result.

Diagram 234-1:



Under the loss-sharing rule in the United States Securities Investor Protection Act, all account holders share in the entire pool of securities to the extent of their net equity, which is the value of the securities credited to their accounts. This is so even if there is a shortfall. Diagram 234-2 illustrates this result. It reflects the fact that it normally would be purely fortuitous that there would be a shortfall in one issue of securities as opposed to another and would treat similarly situated account holders in the same manner.

Diagram 234-2:



### 3. Priority of interests granted by intermediary

235. The priority of intermediary-granted interests as against the rights of the intermediary’s account holders is relevant primarily in the case of an intermediary insolvency proceeding. See generally Part IV.D.3 above.

### 4. Account holder protection fund/insurance

236. A Contracting State should consider adopting a scheme that provides a fund or insurance for the protection of “retail” account holders up to a specified value of securities carried in a securities account. If a Contracting State already has such a system, it should consider and assess its adequacy.

## **5. Transfer of account holder securities accounts to solvent intermediary**

237. An important technique for the protection of account holders in the insolvency proceeding of an intermediary is the transfer of securities accounts (and the underlying securities) to a solvent intermediary that assumes the insolvent intermediary's duties and obligations to the account holders. An account holder protection fund or insurance typically would provide assurances against losses to the transferee intermediary. A Contracting State should ensure that the relevant insolvency law accommodates this approach.

## **6. Rights of intermediary's creditors and segregation**

238. A Contracting State's decision on whether or not to make a declaration under Article 25(5) regarding segregation and the corresponding impact on an intermediary's account holders and unsecured creditors primarily is relevant in an intermediary's insolvency proceeding. See generally Part V.B.2 above.

## **7. Limitations on ranking of categories of claims and avoidance powers**

239. A Contracting State should consider whether to adjust ranking of claims and whether to adopt or retain protection from avoidance as a preference or fraudulent transfer certain transfers as a prophylactic mechanism to reduce systemic risk in the financial markets. For example, payments made to or within a SSS for the settlement of securities transactions might be protected. The appropriateness and effectiveness of such protections is controversial.

## **8. Stay of enforcement and close-out netting**

240. Related to the limitations discussed in Part VII below and as a means of reducing systemic risk, in some states enforcement against securities collateral and in connection with repo transactions and the operation of close-out netting are exempt from any stay or other injunction in an insolvency proceeding. A Contracting State should consider whether to adopt or retain any such exemption. The appropriateness and effectiveness of such exemptions is controversial.

## **9. Special provisions in relation to collateral transactions**

241. If a Contracting State declares under Article 38 that Chapter V does not apply, it may nonetheless consider whether it should enact as a part of the non-Convention law the protection of collateral takers in connection with insolvency proceedings under Articles 33, 36, and 37. See generally Part VII.A below.

## **10. Return of account holder assets and funds**

242. As to securities accounts that are not transferred to a solvent intermediary, a Contracting State should ensure that insolvency law provides means of promptly returning to account holders securities credited to their securities accounts and credit funds balances in such accounts. The law should provide for flexible solutions such as partial returns pending resolution of complex relationships and the potential for an insolvency administrator to claw back securities and funds to the extent returns were not justified or were made in error. Ensuring that an account holder's rights are respected in an intermediary's insolvency proceeding, as under Article 14(1), is a necessary but not a sufficient means of protecting the rights of account holders.

## **11. Intermediary access to SCSs and SSSs and assets held in such systems or otherwise as collateral**

243. In order to provide proper protection and treatment of account holders and creditors generally, insolvency law should ensure that an insolvency administrator of an intermediary has access to information and records and access to assets held in such systems or otherwise held as collateral, such as by a clearing lender or derivatives counterparty. Of course, the interests of the operators of and

participants in such systems and of those holding collateral must be protected as well. But it is important to ensure the transparency of all of these relationships. As to the insolvency of SCSs and SSSs, see Article 27 and paragraphs 200-202 above.

### **12. Intermediary access to information, records, and information technology systems**

244. An intermediary's insolvency administrator must have access to all relevant information, records, and information technology systems. This is especially problematic in the case of a multinational financial enterprise group in which an affiliate other than the intermediary manages information centrally and may be subject to a separate insolvency proceeding.

### **13. Requirement of advance plan for liquidation or reorganisation**

245. A Contracting State should consider imposing a requirement on intermediaries mandating periodic submission to a supervisory or regulatory authority of a plan of liquidation or reorganisation of the intermediary in case of financial distress—a so called "living will." In particular, advance planning and organisation would assist in addressing the matters discussed in paragraphs 242-244 above.

### **14. Enhanced regulation and supervision of intermediaries, exchanges and alternative trading systems, SCSs, and SSSs**

246. The optimal approach to the problem of intermediary financial distress would be to ensure that an intermediary does not suffer from financial distress in the first place. Ex ante regulation and supervision of intermediaries and the market structures and participants with which they interact may play an important role in this respect.

## **VII. SPECIAL PROVISIONS IN RELATION TO COLLATERAL TRANSACTIONS**

***Clear rules concerning transactions involving collateral in the form of securities are essential. The Geneva Securities Convention contains optional rules in case such collateral is transferred or provided by way of a security interest. Other international law instruments provide further guidance on private and regulatory law issues involved.***

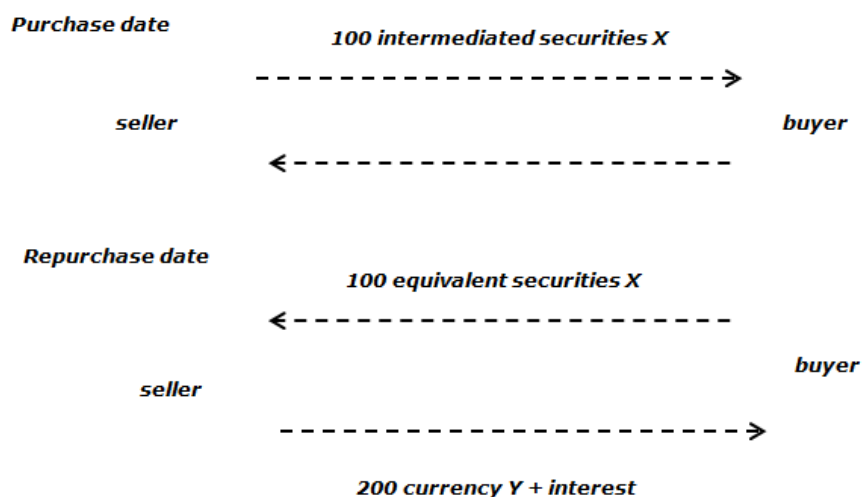
#### **A. Core Convention rules**

- The Convention covers collateral consisting of intermediated securities provided by way of transfer of title or security interest. See Article 31.
- A title transfer of collateral should not be re-characterised as a security interest. Article 32.
- Enforcement of collateral may be effected by way of sale, or, if agreed, appropriation or close-out netting. Article 33(1)-(2).
- It should be possible to enforce collateral relatively easily and quickly (i.e., without prior notice, approval by a court or other person, or a public auction), also in case of insolvency. Articles 33(3) and 35.
- The collateral taker may be given the right to "use" or "re-hypothecate" the collateral, i.e., to dispose thereof as if it were the owner. Article 34.
- Collateral agreements and the provision of collateral thereunder are protected against timing claw back rules in insolvency (such as "zero hour rules"). Articles 36 and 37.



247. Chapter V of the Geneva Securities Convention contains optional, private and insolvency law oriented rules on transactions with collateral consisting of intermediated securities, including repurchase (or “repo”), securities lending, and collateralised derivatives transactions. The choice to incorporate the rules of Chapter V in a given jurisdiction can be made independent of the choice to adopt the other rules of the Convention concerning basic features of the intermediated system. If opted into, the detailed character of the rules set out in Chapter V means that there are only a few instances for States to make declarations or determine the content of non-Convention law.

*Example 247-1: Repurchase transaction*



In a repo, a seller in need of cash transfers securities to a buyer outright in exchange for cash at the purchase date, while the seller returns the cash together with an interest component at the repurchase date in exchange for equivalent securities.

248. The global financial crisis of 1998 and onwards has triggered a range of regulatory standards in relation to securities financing transactions and other transactions involving financial collateral [(in the regulatory-inspired debate on shadow banking the term “securities financing transactions” is common, which overlaps largely, but not entirely, with the transactions covered by Chapter V of the Geneva Securities Convention)]. Among other things these standards envisage enhanced transparency obligations regarding securities financing transactions entered into, providing regulators with data to detect and address systemic risk; limits on the right of use / re-hypothecation [a report of an FSB working group on this issue was planned for March 2016, but has not yet been published (20 April 2016)]; minimum regulatory haircuts for non-centrally cleared securities financing transactions; and a temporary “regulatory stay” that enables resolution authorities to administer effectively financial institutions in distress. These regulatory standards are developed at the international level by bodies such as the Basel Committee on Banking Supervision and the Financial Stability Board, and are subsequently translated into regional and domestic guidelines and legislation.

249. This new regulatory approach poses limits on, and at times even contradicts, the liberal private and insolvency law oriented rules of Chapter V of the Geneva Securities Convention. For example, the Convention’s rules that enable immediate enforcement in insolvency imply that a temporary stay or moratorium is not allowed; this is opposed to the regulatory approach that resolution authorities should be provided with a window for decision-making in the form of a regulatory stay. See paragraph 240 above. Lawmakers should take both the rules of the Convention and the new regulatory framework into account when considering rules on collateralised transactions.

**B. Choices to be made by declaration**

- The personal scope of Chapter V may be limited. Article 38(2)(a).

- Intermediated securities that are not permitted to be traded on an exchange or a regulated market may be excluded. Article 38(2)(b).
- Categories of relevant obligations (i.e., the obligations of a collateral provider or another person for whom collateral is provided) may be excluded. Article 38(2)(c).
- Top-up or substitution arrangements may not receive protection if they are triggered by criteria relating to creditworthiness, financial performance, or the financial condition of the collateral provider. See Article 36(2).

250. Article 38 provides lawmakers with three possibilities to limit the scope of Chapter V. The first option is to limit the personal scope in order to protect natural persons or other categories of entities, notably entities that are not financial market participants, which are deemed to need protection. The second option is to apply the regime of Chapter V only to intermediated securities that are traded on an exchange or a regulated market (i.e. to securities that potentially have a significant impact on the liquidity of the financial markets). The third issue that lawmakers should decide on is whether there are relevant obligations that should not fall within the regime of Chapter V of the Convention. For more information, see the Declarations Memorandum, Section 4.I and accompanying Form No. 9.

251. Article 36 protects the provision of collateral in the course of a transaction under “top-up” and substitution arrangements against timing claw back rules. The declaration envisaged in Article 36(2) addresses the specific situation where top-up collateral should be provided as a consequence of changes to the creditworthiness, financial performance, or the financial condition of the collateral provider or another person owing the relevant obligations concerned. Such changes may be a prelude to the insolvency of the collateral provider. Lawmakers should decide on the policy question of whether in such a case the collateral taker receives the top-up collateral, or whether it is left to the collateral provider’s general creditors. See paragraph 241 above and, for more information, see also the Declarations Memorandum, Section 4.H and accompanying Form No. 8.

### ***C. Matters to be addressed or clarified by law outside the Convention***

#### **1. Extra rights for collateral takers**

252. The basic approach underlying Chapter V is that the liquidity of financial markets should be enhanced by eliminating traditional rules of private and insolvency law that strike a balance between collateral provider and collateral taker, and by extending extra rights to the collateral taker. Chapter V contains a minimum regime. Article 31(2) allows additional rights and powers of collateral takers and additional obligations of collateral providers. In their decision to go beyond the minimum regime envisaged in Chapter V, lawmakers should take into account the lessons learnt during the global financial crisis (notably the debate on the effects of liberalisation versus the necessity of regulatory intervention).

#### **2. Commercial reasonableness**

253. The concept of commercial reasonableness is key where securities need to be valued, notably in the context of enforcement. Article 35 determines that non-Convention rules regarding commercial reasonableness are not affected by the Convention rules on enforcement and the right of use. The content of the concept of commercial reasonableness is not specified in the Convention, and it is thus up to the domestic lawmaker to determine whether a specification of this content is necessary in the context of securities markets.

#### **D. Matters not mentioned in the Convention**

##### **1. New regulatory framework**

254. As mentioned in paragraphs 0-249, lawmakers should take into account new regulatory standards regarding securities financing transactions and other transactions involving financial collateral as developed by bodies such as the Basel Committee for Banking Supervision and the Financial Stability Board on issues such as transparency, the right of use / re-hypothecation, minimum haircuts, and the regulatory stay. Ideally, when lawmakers devise rules for financial collateral transactions, these regulatory standards and the policy considerations underlying the rules in Chapter V of the Geneva Securities Convention are both taken into account.

##### **2. Netting**

255. Lawmakers can find specific guidance on close-out netting in the UNIDROIT Principles on the Operation of Close-Out Netting Provisions. These Principles take the regulatory stay into account.

##### **3. Secured transaction law**

256. In case lawmakers decide not to adopt Chapter V as a whole, but only to draw inspiration from its provisions in structuring their legal framework, they could also look at guidelines regarding general secured transactions law in the UNCITRAL Legislative Guide on Secured Transactions and the [draft] UNCITRAL Model Law on Secured Transactions. It should, however, be noted that the Legislative Guide does not cover securities at all, whereas the Model Law contains rules for non-intermediated securities only. Policy considerations relating to intermediated securities markets, such as those enshrined in the Geneva Securities Convention, therefore merit special attention. For example, besides the provisions of the UNCITRAL instruments on the creation of interests and their third party effectiveness, the considerations underlying Articles 11, 12, 13 of the Geneva Securities Convention remain relevant; where priority contests are concerned, Articles 19 and 20 of the Convention should be considered; and in the case of enforcement, Articles 33 and 35 of the Convention should be taken into account.

#### **VIII. CONFLICTS OF LAW ASPECTS**

***The Convention lays down harmonised substantive rules on intermediated securities but does not contain uniform conflict of laws rules. Furthermore, the application of the Convention is determined by the conflict of laws rules of the forum. Contracting States should therefore accompany the Convention by the adoption of modernised conflict of laws rules that respond to the way intermediated securities are held and transferred.***

- A large part of transactions in intermediated securities are connected to more than one State and this circumstance raises problems of conflict of laws.
- The Convention establishes uniform rules on intermediated securities but does not completely eliminate such problems.
- Furthermore, the Convention does not contain conflict of laws rules. Thus, its sphere of application is not determined by itself but by the conflict of laws rules applicable in each State (i.e. the conflict of laws rules of the forum).
- The ratification of the Convention or its incorporation into domestic law must therefore be accompanied by a set of clear and sound conflict of laws rules that reflect the reality of how securities are held and transferred.

### **A. Introduction: the conflict of laws dimension**

257. A relevant part of transactions in securities takes place in an international context and therefore entails the presence of foreign elements. Thus, for example, the issuer may be incorporated in another State, the securities may be governed by a foreign law or the holding chain may begin or end in another State. These situations raise a problem of conflict of laws.

258. The conflict of laws problems are resolved by what are known as *conflict of laws rules*. These rules determine which State law applies to a transaction or to one particular aspect of the transaction. Conflict of laws rules usually employ one or more elements of the transaction, the so called “connecting factor”, to link the transaction or the legal issue to a particular State law.

259. The harmonisation of substantive rules provided by the Convention reduces but does not eliminate the conflict of laws problems. As the Convention is based on a core and functional harmonisation approach, it leaves various issues to be governed by State laws, and these laws may still vary to a large extent. With regard to these non-harmonised aspects the identification of the applicable law becomes critical.

### **B. The Convention’s sphere of application**

260. The Convention does not lay down conflict of laws rules. Its application is determined instead by the conflict of laws rules of the forum. This idea is stated in Article 2(a) of the Convention. The Convention applies whenever the conflict of laws rules of the forum designate the law in force in a Contracting State as the applicable law.

261. The reason for this approach is clear. Once the Convention has been ratified by a State or incorporated into its domestic law, it becomes part of the substantive domestic law of that State. Therefore, the rules of the Convention will apply *insofar as* the substantive law of that State is the applicable law under the conflict of laws rules of the forum.

262. As a consequence, even if the forum is a Contracting State to the Convention, the Convention does not apply when its conflict of laws rules point to the law of a non-Contracting State as the law applicable on an issue. And *vice versa*, even if the forum is a non-Contracting State, the Convention will apply if the conflict of laws rules of the forum point to the law of a Contracting State as the applicable law. As an example, let us assume that State A is the forum state and its conflict of law rules point to State B’s law as applicable: If State B has ratified the Convention, the Convention will apply, regardless of whether State A has ratified the Convention or not.

263. Together with Article 2, Article 3 clarifies the effect of conflict of laws rules on declarations. Because the declarations established by the Convention are related to its substantive rules – mainly allowing Contracting States to opt into or out of the uniform rules – the application of such declarations is also determined by the conflict of laws rules of the forum.

### **C. Conflict of laws rules for intermediated securities**

- The application of traditional conflict of laws rules to intermediated securities has raised serious difficulties in practice.
- The law should therefore establish modernised conflict of laws rules to address the particularities raised when the securities are not held directly but with an intermediary.

264. The core elements of the Convention are related to the effectiveness against the intermediary and third parties of the account holder’s rights over the securities and transfer of those rights, which in some jurisdictions may be characterised as “proprietary rights” in respect of intermediated securities.

265. The application of traditional conflict of laws rules – mainly based on the *lex rei (cartae) sitae* principle – to intermediated securities has not proved to be very useful, because it entails the attribution of an artificial location to an asset which by its nature has no physical manifestation. Furthermore, it has also resulted in legal uncertainty and serious practical difficulties, because a *prima facie* application of that principle may lead to the law of the State where the issuer of the securities is incorporated or where the original securities are physically held by a CSD or registered (“look-through approach”), even though the entitlement of the ultimate account holder is not registered there.

266. Some States have therefore modernised their conflict of laws rules to go beyond that principle and offer a more appropriate solution taking into account the way intermediated securities are held and transferred. In the EU, for example, the Directives on Settlement Finality and Financial Collateral provide conflict of law rules based on the Place of the Relevant Intermediary Approach (PRIMA principle), that is, the law of the place where the account holder’s relevant intermediary maintains the securities account for the account holder.

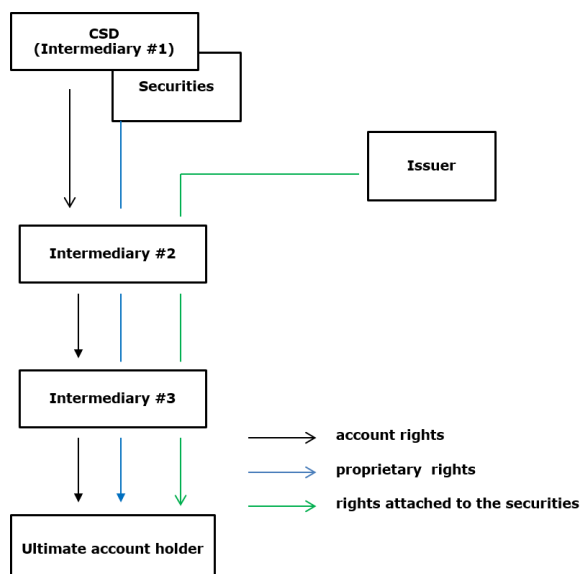
267. At the international level, the Hague Securities Convention, which was concluded on 5 July 2006, is the most important instrument. Specifically, this instrument has gone further than the initial formulation of the PRIMA principle (“PRIMA 1”). The Hague Securities Convention avoids any attempt to locate a securities account and instead gives effects to an agreement on governing law between an account holder and its intermediary (“PRIMA 2”). A qualifying office requirement is however added: the State law chosen by the parties only applies if the relevant intermediary has an office – involved in the maintenance of securities accounts – in that State. See Hague Securities Convention, Article 4.

268. The application of this approach, either PRIMA 1 or PRIMA 2, to transparent systems may require additional clarifications. In principle, in these systems, the “relevant intermediary” for the purpose of determining the applicable law may be the CSD where the accounts are maintained in the name of the ultimate investors.

#### ***D. Interaction between the Convention and conflict of laws rules: the “tier by tier” approach***

269. The Convention follows a “tier-by-tier” approach. It divides the holding chain into tiers and looks at each link in that chain: *for each account holder there is one, but only one, relevant intermediary*. The building block of the Convention is each relationship between an account holder and *its relevant intermediary*.

Diagram 270-1: Who owns what in a cross-border context



270. This substantive approach works well with a conflict of laws approach whereby the applicable law is determined separately for each tier of the chain of intermediaries, as in any version of the PRIMA principle (PRIMA 1 or 2). Both the Hague Securities Convention rule and the EU rule determine the applicable law separately for each tier of the holding chain (i.e. for each relationship between an account holder and its relevant intermediary). There may only be one applicable law for each tier and, therefore, in a multi-tier structure there may be two or more layers of laws. And this perfectly suits a substantive law regime that focuses on establishing the rules governing each relationship.

Let us imagine that intermediary #1 is in Spain, intermediary #2 in Luxembourg and intermediary #3

in Canada. According to the PRIMA (1 or 2) approach: (i) the law governing the rights of the ultimate account holder vis-à-vis the securities account maintained by intermediary #3 is Canadian Law, (ii) the law governing the rights of intermediary #3 vis-à-vis the securities account maintained by intermediary #2 is Luxembourg law; (iii) and the law governing the rights of intermediary #2 vis-à-vis the securities account maintained by intermediary #1 is Spanish law. *There are, therefore, three layers of rights governed each of them by a different law.* It can be said that the ultimate account holder has a set of rights governed by Canadian Law over a set of rights acquired by intermediary #3 with intermediary #2 under Luxembourg law, and over a set of rights acquired by intermediary #2 with intermediary #1 under Spanish law.

271. Lawmakers should modernise the conflict of laws rules to avoid the ambiguities raised by traditional solutions (i.e. the *lex rei (carta) sitae* principle), and introduce a solution based on the relevant intermediary approach as main connecting factor (i.e. the intermediary that maintains the securities account for the account holder). Additionally a specification of that approach may be recommendable, focused on either (a) an objective element, the location of the securities account, or (b) a subjective element, an agreement between the account holder and the relevant intermediary.

#### **E. PRIMA approach and other conflict of laws rules**

272. Either version of the PRIMA principle determines the law applicable to intermediated securities, but only for certain issues; for example, in the Hague Securities Convention, only for the issues enumerated in its Article 2(1)(a)-(g). If according to the Hague Securities Convention, the law applicable is that of a Contracting State to the Convention, this instrument will govern all substantive issues included in Article 2(1)(a)-(g) of the former.

273. However, the substantive scope of application of the Hague Securities Convention is not exactly the same as the substantive scope of the Convention. Article 2(1)(a)-(g) of the Hague Securities Convention contains an exhaustive list of all the issues falling within the scope of the Hague Securities Convention, which is narrower than the scope of the Convention. Although the concept is avoided, the Hague Securities Convention applies mainly to “proprietary” issues. However, purely contractual or personal rights which arise solely from the contractual relationship between the account holder and its intermediary or the parties to a disposition *inter se* are not included within the scope of the Hague Securities Convention. See Hague Securities Convention, Article 2(3)(a)).

274. The law applicable to other issues that are outside the substantive scope of the Hague Securities Convention but which may fall within the scope of the Convention is determined by the corresponding conflict of laws rules of the forum. For example, the law applicable to the contractual obligations of the intermediary vis-à-vis its account holder is determined by the conflict of law rules on contractual obligations. In the EU, this is the Rome I Regulation, which is based on the principle of party autonomy (“A contract shall be governed by the law chosen by the parties”). The same principle inspires the Hague Principles on Choice of Law in International Commercial Contracts. In application of this principle, if the law chosen by the parties is that of a Contracting State to the Convention, the provisions of this instrument on contractual obligations (e.g. Article 10) would apply.

275. Finally, the determination of the law applicable in insolvency proceedings (i.e. “insolvency conflict of laws rules”) should be designed to ensure the effectiveness of the rights over intermediated securities in such proceedings as established, in particular, by Articles 14 and 21 of the Convention. See, e.g., Hague Securities Convention, Article 8).

## **IX. IMPLEMENTATION AND OTHER INSTRUMENTS AND REGULATIONS**

### **A. Link to other international instruments or regulations**

276. The modernisation of domestic legislation on financial markets is essential to a State’s development. At the international level, many standard-setting bodies have adopted standards to ensure

financial stability and mitigate risk, to improve efficiency and to favour cross-border transactions. The Financial Stability Board (FSB), for instance, keeps a regularly-updated compendium of standards relating to financial markets. In particular, the FSB selected a number of “Key Standards for Sound Financial Systems”, concerning three macro-areas: (a) macroeconomic policy and data transparency, (b) financial regulation and supervision, and (c) institutional and market infrastructure. These are elaborated by different international standard-setting bodies, according to relevant competences, but are jointly used as a basis for evaluation of the soundness of a State (e.g. FSAP by the IMF and the WB are based on those standards).

277. These exercises are done to reduce systemic risk and to prevent financial distress from spreading from one State to another, but also to support foreign investments and reinforce the infrastructure of domestic markets. On the other hand, emerging markets offer extremely interesting opportunities for foreign investments, which in turn may favour the development of domestic sectors of the economy. In order to strengthen their internal markets, as well as incentivise foreign investments by accruing trust, Governments endeavour to sustain their own economies with adequate infrastructures according to such standards.

278. International standards consider as a first requirement to attaining the above objectives of development and stability that a sound legal system be in place. For instance, Principle One of the CPMI/IOSCO Principles for Financial Markets Infrastructures (2014), which are included in the FSB Key Standards, establishes that any FMI needs to have a sound legal basis. This requirement, however, should not be simply interpreted as meaning that legal obstacles to the working of specific systems or business schemes be eliminated. This is of course one of the priorities to reduce risk and its diffusion to foreign markets, but it cannot stand alone: a State needs to have modern legislation that offers a legally sound environment, conducive to modernisation, and in which operators can act on a level playing field whilst relevant interests are duly protected and stability adequately taken care of. International standards nowadays not only require elimination of legal barriers, but also the building of a sound legal environment conducive to development and stability.

279. Many States use international standards, and in particular those concerning or affecting their internal legal order, as an effective benchmark for reform. On the other hand, it is generally understood that a State that respects international standards and possesses a sound legal environment receives positive rankings in the various international comparative exercises that are performed by international bodies (such as the World Bank Doing Business Indexes), that can make a difference as for foreign investments actually received in the State, since respect of such standards has proven to concretely favour market development and ensure stability. The World Bank Doing Business Indexes include evaluation of the legal environment of a State in many contexts, and uses international Conventions and other international instruments for harmonisation as benchmarks.

280. Indeed, the exercises done at the international level by international organisations and bodies to harmonise domestic legislation in specific fields has the objective, among others, to offer guidance in this direction, and offer models that are the result of international harmonisation. It is not a specific State’s model that is diffused by these bodies, but the synthesis of various legal experiences and traditions. Because of this, they usually reflect balanced solutions to take into serious consideration in any domestic reform efforts.

281. The adoption of international instruments such as the Geneva Securities Convention is thus a fundamental step within a wider scenario of domestic legal reforms for modernisation and openness of a State’s economy using international standards as benchmarks, and international instruments for harmonisation of law as the most balanced and unbiased models to be used to that end.

### ***B. Overview of implementation in domestic legal framework***

282. Each State has its own tradition and is situated within a specific regional context. As a result, each needs to implement a tailor-made legal reform. However, there are high-level principles that are usually

recognised as commonly shared, and thus included in international instruments. When principles are generally shared and can be sufficiently detailed, a Convention is adopted. In other cases, a Model Law or a Legislative Guide is issued because these instruments, although not offering hard law solutions, permits convergence by leaving more flexibility in the means to be used to reach such convergence.

283. Ways to adopt a Convention, a Model Law or a Legislative Guide into a domestic legal order are different, but in all cases the international instrument has to be understood within the more general context of both other fields of legislation that are not covered by the specific international instrument, and the very institutional and legal order of the State, with its own existing legal tradition and institutions.

284. As mentioned, in the case of financial markets a number of international standards and measures exist of a regulatory nature. The Convention recognises this and excludes such matters from its own scope, as well as it does so for others of a purely legal nature (such as corporate law).

285. However, these regulations and standards need to be considered by the domestic lawmaker not only to avoid the risk of leaving essential aspects unregulated, but also because each piece of reform needs to be drafted in a consistent manner and policy choices taken as much as possible under an holistic approach. When other international instruments exist in these fields, these need to be adequately implemented. When international standards do not exist, there is still a need for modernisation, and the State shall rely on its own general principles of law and institutional framework. This may involve cooperation by many public bodies in the State according to their individual functions and scope of responsibility.

286. While the Convention generally does not touch upon corporate law, that law affects the working of book-entry systems for securities and some rights and duties of holders found in such body of law might unpredictably affect the application of the Convention. In the same vein, rules on money laundering or market abuse, which are excluded by the scope of the Convention, need to be put in place if concrete modernisation wants to be realised.

287. Finally, legal reform coming from international instruments may require the adoption of articulated implementing measures. Indeed, international rules may be better reflected in a legal system by way of a statutory act, a secondary measure, contractual agreements by the market, or finally a combination of these options. Adoption of a reform not only implies evaluation of rules to be adopted into a legal system, amendment of existing specific provisions or adaptation of legal institutions, but also articulation of the most appropriate legal instruments to be adopted.

288. In the specific matters governed by the Convention, some provisions need to be included in a statutory act, because they would establish rights and obligations against third parties. Other provisions can be addressed by regulations or other secondary measures by relevant authorities. This is surely the case for regulatory matters outside the scope of the Convention but still to be covered by a wider legal reform of the sector. In this case, as briefly mentioned, the issue would also raise which relevant authorities would be competent for such exercise. Finally, standard contractual rules by the market are often the best normative tool, as the Convention recognises in the case of internal rules of securities systems or other bodies, usually authorised to operate following satisfaction of a number of conditions verified by the regulator. All these choices need to be made according to principles of efficiency but also in light of the existing institutional framework of the State.

289. Whereas technical assistance can substantially help the State to flag consider all of these elements and address them consistently and in light of international best practice, the reform belongs to the individual State and is its own product, as a result of efforts usually involving many domestic players.



**ANNEX 1**

**GLOSSARY**

[Placeholder]

## ANNEX 2

## REFERENCES TO “NON-CONVENTION LAW”

| References in the Convention  | For discussion  |
|---|---|
| <p><b>Preamble, recital 7:</b></p> <p><i>HAVING due regard for <u>non-Convention law</u> in matters not determined by this Convention,</i></p>  | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Para P-8</p>  |
| <p><b>Article 1(k):</b></p> <p><i>“control agreement” means an agreement in relation to intermediated securities between an account holder, the relevant intermediary and another person or, if so provided by the <u>non-Convention law</u>, between an account holder and the relevant intermediary or between an account holder and another person of which the relevant intermediary receives notice, which includes either or both of the following provisions: [...]</i></p>    | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 1-52 and 1-54</p> <p><b>Legislative Guide:</b></p> <p>Para 123</p>  |
| <p><b>Article 1(l):</b></p> <p><i>“designating entry” means an entry in a securities account made in favour of a person (including the relevant intermediary) other than the account holder in relation to intermediated securities, which, under the account agreement, a control agreement, the uniform rules of a securities settlement system or the <u>non-Convention law</u>, has either or both of the following effects: [...]</i></p>  | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 1-53 and 1-54</p> <p><b>Legislative Guide:</b></p> <p>Para 123</p>  |
| <p><b>Article 1(m):</b></p> <p><i>“non-Convention law” means the law in force in the Contracting State referred to in Article 2, other than the provisions of this Convention;</i></p>  | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 1-55 to 1-59</p> <p><b>Legislative Guide:</b></p> <p>Para 65</p>  |
| <p><b>Article 1(p):</b></p> <p><i>“uniform rules” means, in relation to a securities settlement system or securities clearing system, rules of that system (including system rules constituted by the <u>non-Convention law</u>) which are common to the participants or to a class of participants and are publicly accessible.</i></p>  | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 1-100 and 101</p> <p><b>Legislative Guide:</b></p> <p>Para 65</p>   |
| <p><b>Article 7(1):</b></p> <p><i>A Contracting State may declare that under its <u>non-Convention law</u> 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, either generally or in relation to intermediated securities, or securities accounts, of any category or description.</i></p>   | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Para 7-19</p> <p><b>Legislative Guide:</b></p> <p>Paras 174 to 178</p> <p><b>Declarations Memorandum:</b></p> <p>Section 4.C and accompanying Forms 3.A and 3.B</p> |
| <p><b>Article 9(1)(a)(ii):</b></p> <p><i>The credit of securities to a securities account confers on the account holder:</i></p> <p><i>(a) the right to receive and exercise any rights attached to the securities, including in particular dividends, other distributions and voting rights: (i) if the account holder is not an intermediary or is an intermediary acting for its own account; and (ii) in any other case, if so provided by the <u>non-Convention law</u>;</i></p> | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Para 9-16</p> <p><b>Legislative Guide:</b></p> <p>Bullets above para 71 et seq.</p>   |

|   |  |
|---|--|
| <p><b>Article 9(1)(c):</b></p> <p><i>The credit of securities to a securities account confers on the account holder: [...] (c) the right, by instructions to the relevant intermediary, to cause the securities to be held otherwise than through a securities account, to the extent permitted by the applicable law, the terms of the securities and, to the extent permitted by the <u>non-Convention law</u>, the account agreement or the uniform rules of a securities settlement system;</i></p>   | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 9-21 to 9-24</p> <p><b>Legislative Guide:</b></p> <p>Bullets above para 71, and para 208</p>                                     |
| <p><b>Article 9(1)(d):</b></p> <p><i>The credit of securities to a securities account confers on the account holder: [...] (d) unless otherwise provided in this Convention, such other rights, including rights and interests in securities, as may be conferred by the <u>non-Convention law</u>.</i></p>   | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 9-27 and 9-28</p> <p><b>Legislative Guide:</b></p> <p>Bullets above para 76 et seq.</p>  |
| <p><b>Article 9(3):</b></p> <p><i>If an account holder has acquired a security interest, or a limited interest other than a security interest, by credit of securities to its securities account under Article 11(4), the <u>non-Convention law</u> determines any limits on the rights described in paragraph 1 of this Article.</i></p>   | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 9-31 and 9-32</p> <p><b>Legislative Guide:</b></p> <p>Bullets above para 76, and paras 81 to 84</p>                              |
| <p><b>Article 10(2)(c), (e), and (f):</b></p> <p><i>An intermediary must, at least: [...] (c) give effect to any instructions given by the account holder or other authorised person, as provided by the <u>non-Convention law</u>, the account agreement or the uniform rules of a securities settlement system; [...] (e) regularly pass on to account holders information relating to intermediated securities, including information necessary for account holders to exercise rights, if provided by the <u>non-Convention law</u>, the account agreement or the uniform rules of a securities settlement system; and (f) regularly pass on to account holders dividends and other distributions received in relation to intermediated securities, if provided by the <u>non-Convention law</u>, the account agreement or the uniform rules of a securities settlement system.</i></p> | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 10-10, 10-13 and 10-15 to 10-17</p> <p><b>Legislative Guide:</b></p> <p>Paras 88 to 101, 191</p>                                 |
| <p><b>Article 11(2):</b></p> <p><i>No further step is necessary, or may be required by the <u>non-Convention law</u> or any other rule of law applicable in an insolvency proceeding, to render the acquisition of intermediated securities effective against third parties.</i></p>  | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 11-17 to 11-19</p> <p><b>Legislative Guide:</b></p> <p>Bullets above para 106 et seq.</p>  |
| <p><b>Article 12(2):</b></p> <p><i>No further step is necessary, or may be required by the <u>non-Convention law</u> or any other rule of law applicable in an insolvency proceeding, to render the acquisition of intermediated securities effective against third parties.</i></p>  | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Para 12-31, which also refers to Paras 11-17 to 11-29</p> <p><b>Legislative Guide:</b></p> <p>Bullets above para 116, and para 160</p> |
| <p><b>Article 13:</b></p> <p><i>This Convention does not preclude any method provided by the <u>non-Convention law</u> for: (a) the acquisition or disposition of intermediated securities or of an interest in intermediated securities; or</i></p> <p><i>(b) the creation of an interest in intermediated securities and for making such an interest effective against third parties, other than the methods provided by Articles 11 and 12.</i></p>  | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 13-5 and 13-6</p> <p><b>Legislative Guide:</b></p> <p>Paras 132-134</p>  |
| <p><b>Article 15(1)(e):</b></p> <p><i>An intermediary may make a debit of securities to a securities account, make or remove a designating entry or otherwise dispose of intermediated securities only if it is authorised to do so: [...] (e) by the <u>non-Convention law</u>.</i></p>  | <p><b>OFFICIAL COMMENTARY:</b> Para 15-17</p> <p><b>Legislative Guide:</b></p> <p>Bullets above para 137 et seq.</p>   |

|  |   |
|--|---|
| <p><b>Article 15(2):</b></p> <p><i>The non-Convention law and, to the extent permitted by the <u>non-Convention law</u>, the account agreement or the uniform rules of a securities settlement system determine the consequences of: an unauthorised debit; an unauthorised removal of a designating entry; subject to Article 18(2), an unauthorised designating entry; or any other unauthorised disposition.</i></p>  | <p><b>OFFICIAL COMMENTARY:</b> Paras 15-18 to 15-21</p> <p><b>Legislative Guide:</b><br/>Paras 141-146</p>  |
| <p><b>Article 16:</b></p> <p><i>Subject to Article 18, the <u>non-Convention law</u> and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system determine 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.</i></p>  | <p><b>OFFICIAL COMMENTARY:</b><br/>Paras 16-9 to 16-12</p> <p><b>Legislative Guide:</b><br/>Paras 141 to 146</p>  |
| <p><b>Article 18(5):</b></p> <p><i>To the extent permitted by the <u>non-Convention law</u>, paragraph 2 is subject to any provision of the uniform rules of a securities settlement system or of the account agreement.</i></p>   | <p><b>OFFICIAL COMMENTARY:</b><br/>Paras 18-11 to 18-14</p> <p><b>Legislative Guide:</b><br/>Bullets above para 147, and para 191</p>   |
| <p><b>Article 19(2):</b></p> <p><i>Subject to paragraph 5 and Article 20, interests that become effective against third parties under Article 12 have priority over any interest that becomes effective against third parties by any other method provided by the <u>non-Convention law</u>.</i></p>   | <p><b>OFFICIAL COMMENTARY:</b><br/>Para 19-13</p> <p><b>Legislative Guide:</b><br/>Paras 155 to 156</p>   |
| <p><b>Article 19(7):</b></p> <p><i>A Contracting State may declare that under its <u>non-Convention law</u>, subject to paragraph 4, an interest granted by a designating entry has priority over any interest granted by any other method provided by Article 12.</i></p>   | <p><b>OFFICIAL COMMENTARY:</b><br/>Para 19-17</p> <p><b>Legislative Guide:</b><br/>Paras 130, 161</p> <p><b>Declarations Memorandum:</b><br/>Section 4.E and accompanying Form No. 5</p>              |
| <p><b>Article 22(3):</b></p> <p><i>A Contracting State may declare that under its <u>non-Convention law</u> 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. Any such declaration shall identify that other person by name or description and shall specify the time at which such an attachment becomes effective against the relevant intermediary.</i></p> | <p><b>OFFICIAL COMMENTARY:</b><br/>Paras 22-19 and 22-20</p> <p><b>Legislative Guide:</b><br/>Paras 174 to 179</p> <p><b>Declarations Memorandum:</b><br/>Section 4.F and accompanying Form No. 6</p> |
| <p><b>Article 23(2)(d):</b></p> <p><i>Paragraph 1 [which states that "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"] is subject to: [...] (d) any applicable provision of the <u>non-Convention law</u>; and</i></p>  | <p><b>OFFICIAL COMMENTARY:</b><br/>Paras 23-26 and 23-27</p> <p><b>Legislative Guide:</b><br/>Bullets below para 89</p>   |
| <p><b>Article 24(3):</b></p> <p><i>If at any time the requirements of paragraph 1 are not complied with, the intermediary must within the time permitted by the <u>non-Convention law</u> take such action as is necessary to ensure compliance with those requirements.</i></p>   | <p><b>OFFICIAL COMMENTARY:</b><br/>Paras 24-20 and 24-21</p> <p><b>Legislative Guide:</b><br/>Para 187</p>  |

|  |   |
|--|---|
| <p><b>Article 24(4):</b></p> <p><i>This Article does not affect any provision of the <u>non-Convention law</u>, or, to the extent permitted by the <u>non-Convention law</u>, any provision of the uniform rules of a securities settlement system or of the account agreement, relating to the method of complying with the requirements of this Article or the allocation of the cost of ensuring compliance with those requirements or otherwise relating to the consequences of failure to comply with those requirements.</i></p>   | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Para 24-22</p> <p><b>Legislative Guide:</b></p> <p>Para 188</p>   |
| <p><b>Article 25(3):</b></p> <p><i>The allocation required by paragraph 1 shall be effected by the <u>non-Convention law</u> and, to the extent required or permitted by the <u>non-Convention law</u>, by arrangements made by the relevant intermediary.</i></p>   | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Para 25-15</p> <p><b>Legislative Guide:</b></p> <p>Para 183</p>   |
| <p><b>Article 25(5):</b></p> <p><i>A Contracting State may declare that, if all securities and intermediated securities held by an intermediary for its account holders, other than itself, are in segregated form under arrangements such as are referred to in paragraph 4, under its <u>non-Convention law</u> the allocation required by paragraph 1 applies only to those securities and intermediated securities and does not apply to securities and intermediated securities held by an intermediary for its own account.</i></p>  | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 25-19 and 25-20</p> <p><b>Legislative Guide:</b></p> <p>Paras 185, 231, 238</p> <p><b>Declarations Memorandum:</b></p> <p>Section 4.G and accompanying Form No. 7</p> |
| <p><b>Article 26(3):</b></p> <p><i>To the extent permitted by the <u>non-Convention law</u>, if the intermediary is the operator of a securities settlement system and the uniform rules of the system make provision in case of a shortfall, the shortfall shall be borne in the manner so provided.</i></p>  | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Para 26-11</p> <p><b>Legislative Guide:</b></p> <p>Para 191</p>   |
| <p><b>Article 28(1) and (2):</b></p> <p><i>(1) The obligations of an intermediary under this Convention, including the manner in which an intermediary complies with its obligations, may be specified by the <u>non-Convention law</u> and, to the extent permitted by the <u>non-Convention law</u>, the account agreement or the uniform rules of a securities settlement system.</i></p> <p><i>(2) If the substance of any such obligation is specified by the <u>non-Convention law</u> or, to the extent permitted by the <u>non-Convention law</u>, the account agreement or the uniform rules of a securities settlement system, compliance with it satisfies that obligation.</i></p> | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 28-10 to 28-13</p> <p><b>Legislative Guide:</b></p> <p>Paras 90 to 101, 191</p>   |
| <p><b>Article 28(3):</b></p> <p><i>The liability of an intermediary in relation to its obligations is governed by the <u>non-Convention law</u> and, to the extent permitted by the <u>non-Convention law</u>, the account agreement or the uniform rules of a securities settlement system.</i></p>   | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 28-15 and 28-16</p> <p><b>Legislative Guide:</b></p> <p>Paras 90 to 101, 191</p>  |
| <p><b>Article 31(2):</b></p> <p><i>Nothing in this Chapter impairs any provision of the <u>non-Convention law</u> which provides for additional rights or powers of a collateral taker or additional obligations of a collateral provider.</i></p>   | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 31-17 and 31-18</p> <p><b>Legislative Guide:</b></p> <p>Para 252</p>  |
| <p><b>Article 34(4):</b></p> <p><i>The exercise of a right of use shall not render invalid or unenforceable any right of the collateral taker under the relevant security collateral agreement or the <u>non-Convention law</u>.</i></p>   | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Para 34-17</p> <p><b>Legislative Guide:</b></p> <p>Bullets above para 247</p>   |

|   |  |
|---|--|
| <p><b>Article 35:</b></p> <p><i>Articles 33 and 34 do not affect any requirement of the <u>non-Convention law</u> to the effect that the realisation or valuation of collateral securities or the calculation of any obligations must be conducted in a commercially reasonable manner.</i></p> | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 35-8 and 35-9</p> <p><b>Legislative Guide:</b></p> <p>Para 253</p> |
| <p><b>Article 36(1)(a)(iii):</b></p> <p><i>If a collateral agreement includes: (a) an obligation to deliver additional collateral securities: [...] (iii) to the extent permitted by the non-Convention law, in any other circumstances specified in the collateral agreement; or</i></p>       | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Para 36-21</p> <p><b>Legislative Guide:</b></p> <p>Para 251</p>          |

## ANNEX 3

## REFERENCES TO “APPLICABLE LAW”

| References in the <i>Convention</i>   | For discussion   |
|---|--|
| <p><b>Article 2(a):</b></p> <p><i>This Convention applies whenever: (a) the applicable conflict of laws rules designate the law in force in a Contracting State as the <u>applicable law</u>;</i></p>   | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 2-6 to 2-9</p> <p><b>Legislative Guide:</b></p> <p>Para 260</p>                                      |
| <p><b>Article 3:</b></p> <p><i>If the law of the forum State is not the <u>applicable law</u>, the forum State shall apply the Convention and the declarations, if any, made by the Contracting State the law of which applies, and without regard to the declarations, if any, made by the forum State.</i></p>  | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 3-5 to 3-7</p> <p><b>Legislative Guide:</b></p> <p>Para 263</p>                                      |
| <p><b>Article 9(1)(c):</b></p> <p><i>The credit of securities to a securities account confers on the account holder: [...] (c) the right, by instructions to the relevant intermediary, to cause the securities to be held otherwise than through a securities account, to the extent permitted by the <u>applicable law</u>, the terms of the securities and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system;</i></p> | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 9-8 and 9-21 to 9-26</p> <p><b>Legislative Guide:</b></p> <p>Bullets above para 71, and para 208</p> |
| <p><b>Article 9(2)(b):</b></p> <p><i>Unless otherwise provided in this Convention: [...] (b) the rights referred to in paragraph 1(a) may be exercised against the relevant intermediary or the issuer of the securities, or both, in accordance with this Convention, the terms of the securities and the <u>applicable law</u>;</i></p>   | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Para 9-17</p> <p><b>Legislative Guide:</b></p> <p>Paras 87 to 88</p>                                       |
| <p><b>Article 12(8):</b></p> <p><i>The <u>applicable law</u> determines in what circumstances a non-consensual security interest in intermediated securities may arise and become effective against third parties.</i></p>  | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Para 12-20</p> <p><b>Legislative Guide:</b></p> <p>Para 136</p>  |
| <p><b>Article 18(4):</b></p> <p><i>If an acquirer is not protected by paragraph 1 or paragraph 2, the <u>applicable law</u> determines the rights and liabilities, if any, of the acquirer.</i></p>   | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 18-17 to 18-18</p> <p><b>Legislative Guide:</b></p> <p>Para 154</p>                                  |
| <p><b>Article 19(5):</b></p> <p><i>A non-consensual security interest in intermediated securities arising under the <u>applicable law</u> has such priority as is afforded to it by that law.</i></p>   | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Para 19-15</p> <p><b>Legislative Guide:</b></p> <p>Paras 165 to 168</p>                                    |
| <p><b>Article 19(6):</b></p> <p><i>As between persons entitled to any interests referred to in paragraphs 2, 3 and 4 and, to the extent permitted by the <u>applicable law</u>, paragraph 5, the priorities provided by this Article may be varied by agreement between those persons, but any such agreement does not affect third parties.</i></p>  | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Para 19-16</p> <p><b>Legislative Guide:</b></p> <p>Para 159</p>  |

## ANNEX 4

## REFERENCES TO RULES RELATING TO INSOLVENCY

| References in the Convention   | For discussion  |
|--|---|
| <p><b>Preamble, recital 9:</b></p> <p><i>Emphasising that this Convention is not intended to harmonise or otherwise affect insolvency law except to the extent necessary to provide for the effectiveness of rights and interests governed by this Convention,</i></p>   | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Para P-10</p>   |
| <p><b>Article 1(h):</b></p> <p><i>"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;</i></p>   | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Para 1-46</p>   |
| <p><b>Article 1(i):</b> <i>"insolvency administrator" means a person (including a debtor in possession if applicable) authorised to administer an insolvency proceeding, including one authorised on an interim basis;</i></p>   | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Para 1-47</p>   |
| <p><b>Article 11(2):</b></p> <p><i>No further step is necessary, or may be required by the non-Convention law or any other rule of law applicable in an <u>insolvency proceeding</u>, to render the acquisition of intermediated securities effective against third parties.</i></p>   | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 11-17 to 11-19</p> <p><b>Legislative Guide:</b></p> <p>Bullets above para 106 et seq.</p> |
| <p><b>Article 12(2):</b></p> <p><i>No further step is necessary, or may be required by the non-Convention law or any other rule of law applicable in an <u>insolvency proceeding</u>, to render the interest effective against third parties.</i></p>  | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Para 12-12</p> <p><b>Legislative Guide:</b></p> <p>Bullets above para 116 and para 160</p>      |
| <p><b>Article 14(2):</b></p> <p><i>Paragraph 1 [i.e. Rights and interests that have become effective against third parties under Article 11 or Article 12 are effective against the insolvency administrator and creditors in any insolvency proceeding] does not affect the application of any substantive or procedural rule of law applicable by virtue of an <u>insolvency proceeding</u>, such as any rule relating to: (a) the ranking of categories of claims; (b) the avoidance of a transaction as a preference or a transfer in fraud of creditors; or (c) the enforcement of rights to property that is under the control or supervision of the insolvency administrator.</i></p>   | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Para 14-6 to 14-11</p> <p><b>Legislative Guide:</b></p> <p>Para 222</p>                         |
| <p><b>Article 21:</b></p> <p><i>(1) Rights and interests of account holders of a relevant intermediary that have become effective against third parties under Article 11 and interests granted by such account holders that have become effective under Article 12 are effective against the insolvency administrator and creditors in any <u>insolvency proceeding</u> in relation to the relevant intermediary or in relation to any other person responsible for the performance of a function of the relevant intermediary under Article 7.</i></p> <p><i>(2) Paragraph 1 does not affect: (a) any rules of law applicable in the <u>insolvency proceeding</u> 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 that is under the control or supervision of the insolvency administrator.</i></p> <p><i>(3) Nothing in this Article impairs the effectiveness of an interest in intermediated securities against the insolvency administrator and creditors in any insolvency proceeding referred to in paragraph 1, if that interest has become effective by any method referred to in Article</i></p> | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 21-10 to 21-14</p> <p><b>Legislative Guide:</b></p> <p>Para 225 to 227</p>                |



|   |   |
|---|---|
| 13.   |   |
| <p><b>Article 26(1):</b></p> <p><i>This Article applies in any <u>insolvency proceeding</u> in relation to an intermediary unless otherwise provided by any conflicting rule applicable in that proceeding.</i></p>   | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 26-1 and 26-9</p> <p><b>Legislative Guide:</b></p> <p>Para 228</p>                  |
| <p><b>Article 27:</b></p> <p><i>To the extent permitted by the law governing a system, the following provisions shall have effect notwithstanding the commencement of an <u>insolvency proceeding</u> in relation to the operator of that system or any participant in that system and notwithstanding any invalidation, reversal or revocation that would otherwise occur under any rule applicable in an insolvency proceeding: (a) any provision of the uniform rules of a securities settlement system or of a securities clearing system in so far as that provision precludes the revocation of any instruction given by a participant in the system for making a disposition of intermediated securities, or for making a payment relating to an acquisition or disposition of intermediated securities, after the time at which that instruction is treated under the rules of the system as having been entered irrevocably into the system; (b) any provision of the uniform rules of a securities settlement system in so far as that provision precludes the invalidation or reversal of a debit or credit of securities to, or a designating entry or removal of a designating entry in, a securities account that forms part of the system after the time at which that debit, credit, designating entry or removal of a designating entry is treated under the rules of the system as not liable to be reversed.</i></p> | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 27-1 to 27-3 and 27-19</p> <p><b>Legislative Guide:</b></p> <p>Paras 192 to 194</p> |

## ANNEX 5

## REFERENCES TO UNIFORM RULES OF SCSs AND SSSs

| References in the Convention  | For discussion   |
|---|--|
| <p><b>Article 1(l):</b></p> <p><i>"Designating entry" means an entry in a securities account made in favour of a person (including the relevant intermediary) other than the account holder in relation to intermediated securities, which, under the account agreement, a control agreement, the <u>uniform rules of a securities settlement system</u> or the non-Convention law, has either or both of the following effects:</i></p> <p>[...]</p> <p><i>(ii) that the relevant intermediary is obliged to comply with any instructions given by that person in relation to the intermediated securities as 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 <u>uniform rules of a securities settlement system</u>, without any further consent of the account holder;</i></p> | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 1-53 to 1-54</p> <p><b>Legislative Guide:</b></p> <p>Para 123</p>  |
| <p><b>Article 1(n):</b></p> <p><i>"securities settlement system" means a system that: (i) settles, or clears and settles, securities transactions; (ii) is operated by a central bank or central banks or is subject to regulation, supervision or oversight by a governmental or public authority in relation to its rules; and (iii) has been identified as a securities settlement system in a declaration made by the Contracting State the law of which governs the system on the ground of the reduction of risk to the stability of the financial system;</i></p>  | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 1-61 to 1-88</p> <p><b>Legislative Guide:</b></p> <p>Para 60, and bullets above para 190 et seq.</p> <p><b>Declarations Memorandum:</b></p> <p>Section 4.A and accompanying Form No. 1</p> |
| <p><b>Article 1(o):</b></p> <p><i>"securities clearing system" means a system that: (i) clears, but does not settle, securities transactions through a central counter-party or otherwise; (ii) is operated by a central bank or central banks or is subject to regulation, supervision or oversight by a governmental or public authority in relation to its rules; and (iii) has been identified as a securities clearing system in a declaration made by the Contracting State the law of which governs the system on the ground of the reduction of risk to the stability of the financial system;</i></p>  | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 1-89 to 1-99</p> <p><b>Legislative Guide:</b></p> <p>Para 60, and bullets above para 190 et seq.</p> <p><b>Declarations Memorandum:</b></p> <p>Section 4.A and accompanying Form No. 1</p> |
| <p><b>Article 1(p):</b></p> <p><i>"uniform rules" means, in relation to a securities settlement system or securities clearing system, rules of that system (including system rules constituted by the non-Convention law) which are common to the participants or to a class of participants and are publicly accessible.</i></p>   | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 1-100 to 1-107</p> <p><b>Legislative Guide:</b></p> <p>Para 65</p>   |
| <p><b>Article 9(1)(c):</b></p> <p><i>The credit of securities to a securities account confers on the account holder: [...] (c) the right, by instructions to the relevant intermediary, to cause the securities to be held otherwise than through a securities account, to the extent permitted by the applicable law, the terms of the securities and, to the extent permitted by the non-Convention law, the account agreement or the <u>uniform rules of a securities settlement system</u>;</i></p>   | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 9-23 to 9-25</p> <p><b>Legislative Guide:</b></p> <p>Bullets above para 71, and para 208</p>   |

|  |  |
|--|--|
| <p><b>Article 10(2)(c), (e) and (f):</b></p> <p><i>An intermediary must, at least: [...] (c) give effect to any instructions given by the account holder or other authorised person, as provided by the non-Convention law, the account agreement or the <u>uniform rules of a securities settlement system</u>; [...] (e) regularly pass on to account holders information relating to intermediated securities, including information necessary for account holders to exercise rights, if provided by the non-Convention law, the account agreement or the <u>uniform rules of a securities settlement system</u>; and (f) regularly pass on to account holders dividends and other distributions received in relation to intermediated securities, if provided by the non-Convention law, the account agreement or the <u>uniform rules of a securities settlement system</u>.</i></p> | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 10-13, 10-15 and 10-16</p> <p><b>Legislative Guide:</b></p> <p>Para 191</p>                      |
| <p><b>Article 15(2):</b></p> <p><i>The non-Convention law and, to the extent permitted by the non-Convention law, the account agreement or the <u>uniform rules of a securities settlement system</u> determine the consequences of: an unauthorised debit; an unauthorised removal of a designating entry; subject to Article 18(2), an unauthorised designating entry; or any other unauthorised disposition.</i></p>  | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 15-18 and 15-19</p> <p><b>Legislative Guide:</b></p> <p>Paras 141-146</p>                        |
| <p><b>Article 16:</b></p> <p><i>Subject to Article 18, the non-Convention law and, to the extent permitted by the non-Convention law, the account agreement or the <u>uniform rules of a securities settlement system</u> determine 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.</i></p>  | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Para 16-1 and 16-22</p> <p><b>Legislative Guide:</b></p> <p>Paras 141 to 146</p>                       |
| <p><b>Article 18(5):</b></p> <p><i>To the extent permitted by the non-Convention law, paragraph 2 (i.e. "Unless an acquirer actually knows or ought to know, at the relevant time, of an earlier defective entry: (a) the credit or interest is not rendered invalid, ineffective against third parties or liable to be reversed as a result of that defective entry; and (b) the acquirer is not liable to anyone who would benefit from the invalidity or reversal of that defective entry") is subject to any provision of the <u>uniform rules of a securities settlement system</u> or of the account agreement.</i></p>  | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 18-11 and 18-12</p> <p><b>Legislative Guide:</b></p> <p>Bullets above para 147, and para 191</p> |
| <p><b>Article 23(2)(e):</b></p> <p><i>Paragraph 1 [which states that "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"] is subject to [...] (e) if the intermediary is the operator of a securities settlement system, <u>the uniform rules of that system</u>.</i></p>  | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Para 23-28</p> <p><b>Legislative Guide:</b></p> <p>Para 191</p>  |
| <p><b>Article 24(4):</b></p> <p><i>This Article does not affect any provision of the non-Convention law, or, to the extent permitted by the non-Convention law, any provision of the <u>uniform rules of a securities settlement system</u> or of the account agreement, relating to the method of complying with the requirements of this Article or the allocation of the cost of ensuring compliance with those requirements or otherwise relating to the consequences of failure to comply with those requirements.</i></p>  | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Para 24-22</p> <p><b>Legislative Guide:</b></p> <p>Para 188</p>  |
| <p><b>Article 26(3):</b></p> <p><i>To the extent permitted by the non-Convention law, if the intermediary is the operator of a <u>securities settlement system and the uniform rules of the system</u> make provision in case of a shortfall, the shortfall shall be borne in the manner so provided.</i></p>  | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Para 26-12</p> <p><b>Legislative Guide:</b></p> <p>Para 191</p>  |

|   |   |
|---|---|
| <p><b>Article 27:</b></p> <p><i>To the extent permitted by the law governing a system, the following provisions shall have effect notwithstanding the commencement of an insolvency proceeding in relation to the operator of that system or any participant in that system and notwithstanding any invalidation, reversal or revocation that would otherwise occur under any rule applicable in an insolvency proceeding:</i></p> <p><i>(a) any provision of the <u>uniform rules of a securities settlement system</u> or of a <u>securities clearing system</u> in so far as that provision precludes the revocation of any instruction given by a participant in the system for making a disposition of intermediated securities, or for making a payment relating to an acquisition or disposition of intermediated securities, after the time at which that instruction is treated under the rules of the system as having been entered irrevocably into the system;</i></p> <p><i>(b) any provision of the <u>uniform rules of a securities settlement system</u> in so far as that provision precludes the invalidation or reversal of a debit or credit of securities to, or a designating entry or removal of a designating entry in, a securities account that forms part of the system after the time at which that debit, credit, designating entry or removal of a designating entry is treated under the rules of the system as not liable to be reversed.</i></p> | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 27-1 to 27-8</p> <p><b>Legislative Guide:</b></p> <p>Paras 192 to 194</p>     |
| <p><b>Article 28 (1), (2) and (3):</b></p> <p><i>(1) The obligations of an intermediary under this Convention, including the manner in which an intermediary complies with its obligations, may be specified by the non-Convention law and, to the extent permitted by the non-Convention law, the account agreement or the <u>uniform rules of a securities settlement system</u>.</i></p> <p><i>(2) If the substance of any such obligation is specified by the non-Convention law or, to the extent permitted by the non-Convention law, the account agreement or the <u>uniform rules of a securities settlement system</u>, compliance with it satisfies that obligation.</i></p> <p><i>(3) The liability of an intermediary in relation to its obligations is governed by the non-Convention law and, to the extent permitted by the non-Convention law, the account agreement or <u>the uniform rules of a securities settlement system</u>.</i></p>   | <p><b>OFFICIAL COMMENTARY:</b></p> <p>Paras 28-1 to 28-3</p> <p><b>Legislative Guide:</b></p> <p>Paras 90 to 101, 191</p> |