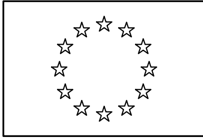

EUROPEAN COMMISSION
Internal Market and Services DG

FINANCIAL SERVICES POLICY AND FINANCIAL MARKETS
**Financial markets infrastructure**
Head of Unit

Brussels, 11th August 2005
MARKT/G2//KL/cc D(2005)

**Subject: EU Clearing and Settlement**
**UNIDROIT – update on the new version of the draft Convention**

On 23 December 2004, UNIDROIT released its original version of the "Preliminary draft Convention on harmonised substantive rules regarding securities held with an intermediary" (the draft Convention), together with explanatory notes[1].

The draft Convention and the explanatory notes constitute the result and conclusion of the work of a Study Group[2], which was composed in 2001 to study the possibility and scope of a future international instrument capable of improving the legal framework for securities holding and transfer, with a special emphasis on cross-border situations. The goal is to promote internal soundness and cross-border system compatibility of the legal framework underlying the holding and disposition of securities held through intermediaries. The effectiveness of book-entry transfers and the finality of transfers made by book-entry debits and credits are seen as being crucial to reduce uncertainty and systemic risk.

The Convention will be negotiated in a series of meetings of government experts. The first such meeting of a Committee of Governmental Experts took place in May 2005[3]. The Commission participated with three designated Commission observers to the UNIDROIT Committee of Governmental Experts.

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1 *Cf.*, in particular, the UNIDROIT *Preliminary draft Convention on Harmonised Substantive Rules regarding Securities Held with an Intermediary*, November 2004 together with the related *Explanatory Notes and Preparatory Papers*, <http://www.unidroit.org/english/workprogramme/study078/item1/main.htm>.

2 *Cf.* also the UNIDROIT Study LXXVIII Doc. 8 (Position Paper on *Harmonised Substantive Rules regarding Indirectly Held Securities*), August 2003.

3 *Cf.* the summary report of the May meeting, < http://www.unidroit.org/english/publications/proceedings/2005/study/78/s-78-23-e.pdf>.

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The meeting of the UNIDROIT Committee of Governmental Experts was convened with the aim to discuss the issue of harmonisation of substantive law relating to the holding and transfer of securities held with an intermediary, focussing on the draft Convention.

The discussions centred first on trying to get a better understanding of the way that the proposed Convention is intended to operate and what its precise coverage would be.

The core of the debates was dealing with Articles 2 to 5 of the draft Convention, which deal with the content of rights in securities credited to a securities account, the transfer of these rights and the establishment of security interests over such rights as well the effectiveness of credits and debits. Furthermore, an initial discussion took place as regards Articles 9, 10 and 14 to 16, dealing with priorities, acquisitions by innocent acquirers and duties of intermediaries including shortfall situations. The other articles have not been discussed due to a lack of time.

Based on the discussions in the main group, a drafting group was established with the mandate to convert the outcome of the discussions into a revised draft. The Commission did participate upon invitation in the drafting group with an observer status.

The work of the drafting group resulted in a revised version of the draft Convention, which was originally presented on the last day of the May meeting and was since published in a slightly modified form on UNIDROIT's website[4].

The new draft Convention is reflecting the debates.

- **Article 1**

The only substantial change in the definitions relates to the definition of "account holder", where it is intended to clarify that account holders can be intermediaries (acting for clients or on their own account) as well as final investors acting for its own account. The definition of "disposition", although disputed, was left for the time being. Furthermore, the concepts of "designating entry" and "control agreement", which are central for security interests under the new Article 6 have been added.

- **Articles 2 and 3 (new):**

Two new articles dealing with the scope of application and the principles of interpretation have been introduced. Both are standard provisions for international agreements.

- **Article 4 new (old Article 2):**

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4 *Cf.* the latest version of the UNIDROIT *Preliminary draft Convention on Harmonised Substantive Rules regarding Intermediated Securities*, June 2005, <http://www.unidroit.org/english/publications/proceedings/2005/study/78/s-78-24-e.pdf>.

The new version reflects the fundamental debate on the legal status and effect of the introduction of a concept based on a bundle of defined rights of an account holder in respect of securities credited to an account. The new terminology for this bundle is now "intermediated securities". Proposals to use the term "account rights" in order to clarify the distinction of the new concept to traditional securities have not found sufficient support. The titles of the draft Convention, chapter II and the article itself were altered accordingly.

In paragraph 1(a), the term "fruits of ownership", which was deemed unclear was replaced by "receive and exercise rights attached to the securities".

In paragraph 1(b), the previous concept of "disposal" has been replaced by the "right to cause securities to be debited" and subsequently credited or delivered in the possession or control of an a collateral taker (see new Article 6). The term disposal was deemed to be too unprecise, with the new terms reflecting better the function of book-entries.

Similarly, the use of the term "held" in paragraph 1(c) in connection with a transfer of rights was replaced by a reference to debits and credits.

Article 1(e) was basically left untouched. However, it triggered the fundamental discussion on the interference of the Convention with existing domestic concepts of law, i.e. the interoperability of systems based on intermediated rights arising exclusively or partly against the intermediary and concepts based on direct rights of the ultimate investor against the issuer as well as hybrid systems. The draft Convention still follows the basic principle of a system based on intermediated rights arising exclusively or partly against the intermediary, whilst allowing other systems to have additional (e.g. ownership) rights of the ultimate investor against the issuer. The same idea is underlying the change in paragraph 3(b), however without referring to an enforcement vis-à-vis third parties. It remains unclear whether the mechanism of the Convention will ultimately achieve that aim.

As a result, however, a new paragraph 2 was introduced in respect of the corporate rights under paragraph 1(a). It tries to clarify the mechanism by which shareholder's rights are acquired. According to the new scheme, an account holder (e.g. the investor) can only acquire corporate rights such as the right to vote directly against the issuer, if such right as constituted by the *lex societatis* is effectively passed on through all layers of the chain of holding. It appears that a direct acquiring of such right by the ultimate investor under the law governing his position in respect of the securities will no longer be possible otherwise. This would strengthen indirect holding schemes.

In the same context, a new set of paragraphs 4 to 6 has been introduced in two versions. Both should address the way that intermediaries should enable account holders to receive and exercise the bundle of rights specified in paragraph 1. Both try to specify that an intermediary can only pass on rights if he has the power to do so and what his liability

towards the account holder is in this respect. Version A is formulated in a catch all format, also taking into account the possibility of the investor to acquire direct rights against the issuer. It is therefore closer to the systems based on direct rights. Version B is more detailed as to the source and extent of the intermediaries obligations, emphasising more the possibility to limit its obligations, either contractually or by reference to undefined "reasonable commercial standards" (whereas version A also refers to (mandatory) statutory law as a source for the scope of the obligations).

- **Article 5 new (old Article 3):**

Paragraph 4 tries to reflect the concerns of some countries as regards the nexus between credits and debits to an account were another central issue. Of particular interest for a number of EU delegations was the question on whether there should be or not a requirement for corresponding credits and debits, on an individual or aggregate level and the related question of whether a tracing of specific securities (rights) should be permitted. Paragraph 4 tries to reflect this.

The old paragraph 6 was deleted and transferred in substance into Article 6 new dealing with security interests.

- **Article 6 new (old Article 4):**

Article 6 was redrafted in full to reflect the new mechanism for granting security interests. Without choosing a completely new set-up, the article is now much more specific and structured more clearly.

It stipulates that constitutive requirements for a security interest are an agreement and delivery into the possession or control of the collateral taker. The later is fulfilled automatically if the securities are transferred to another account or the collateral taker is the intermediary itself. In all other cases, a designating entry and/or (depending on the national requirements) a control agreement as defined in Article 1 is necessary. It is still disputed whether alternative means to establish a security interest may remain valid (paragraph 2(f), possibly in conjunction with a designation mechanism, paragraph 4(b)). If alternative means would not be included in paragraph 2, it would lose its priority in accordance with Article 10.

The new paragraph 3 clarifies that a security interest over an account or, if permitted under domestic law, parts of the securities held on an account, is permissive.

Paragraph 5 gives room for further deviations by permitting states to opt out partially or in full.

As regards security interests, the question remains open whether the current draft could be understood as privileging transfer of title against pledge structures. This could result in secured lenders changing established collateral techniques. The same issue might arise

as regards a possible preferred treatment of transfers involving a change of intermediary to those that take place within one intermediary.

- **Article 7 new (old Article 5):**

The heading does no longer refer to the "effectiveness" of debits and credits.

Paragraph 1 was redrafted to clarify the need for an authorisation of the intermediary to make entries on an account, which can be now given either by the account holder or by domestic law.

Paragraph 2 and 3 are new and were inserted to disentangle the moment that an entry to an account takes effect in general from the specific situations for conditional and reversible bookings, which are now in paragraphs 4 and 5 (old 2 and 3), respectively.

For conditional bookings (paragraph 4), the conditionality can now also be constituted by law. It is effective against third parties, but not expressly against the intermediary. The issue of conditional debits and credits, which are crucial in some systems to avoid gridlocks, will require further elaboration.

For reversals, the basis can now also be in the rules of a system or in the account agreement (paragraph 5).

In general, the appropriate interrelation of the rules addressing effectiveness of transfers and reversal, also in view of a generally acceptable concept of (settlement) finality still needs to be found.

- **Old Article 6:**

Old Article 6 was deleted as it is now contained in new Article 7(2)..

- **Article 9 new (old Article 8):**

The Article (upper-tier attachments) was basically uncontroversial, however small editorial clarifications were introduced.

- **New Article 14:**

A new Article 14 relating to the effects of insolvency was introduced. The article is standard and was taken from the Capetown Convention.

- **Article 15 new (old Article 13):**

In paragraph 2(e) extend the source for instructions which the intermediary has to comply with to the system rules.

- **Article 16 new (old Article 14):**

A small but significant change is to be found in paragraphs 2 and 5 (old paragraph 6). It is now to be decided whether an intermediary has to "immediately" or only "promptly

remedy an insufficiency of underlying securities. This can have major practical implications for the conduct of business of intermediaries.

The duties of intermediaries, and in particular the obligation of an intermediary to have sufficient assets to cover its clients' positions at all times, have been strongly discussed. The unresolved question is whether such obligation is without exceptions and whether it is a precondition to a credit to a client account will determine operational features impacting on stability or efficiency. In this respect, the role of provisional bookings and imbalances on accounts will be central.

A new and short paragraph 4 replaces the old paragraphs 4 and 5, dealing with the allocation of costs of the intermediary resulting from its compliance with its duties. The previous exhaustive list of details has been deleted in favour of a general catch all clause.

- **Article 16 new (old Article 14):**

The term "appropriation" has been replaced by "allocation" of shortfalls.

A new paragraph 4 is introduced to reflect that some countries require a segregation of accounts, by allowing those countries to declare that no pro-rata allocation of shortfalls between segregated accounts shall take place. By implication, this means that in paragraphs 1 and 2, normally client assets and own assets are to be jointly considered.

As regards the allocation of shortfalls, a balance still needs to be found between the socialisation of losses between clients and the inclusion of the intermediaries' own assets. This interrelates with the question of whether there will be a mandatory rule for segregation of accounts as well as with a prohibition to trace. Ultimately, this will necessitate a decision on the degree of mutual liability of investors, also for intermediaries' defaults and the treatment of general creditors of an intermediary.

- **Article 20 new (old Article 18):**

Paragraph 1 has been clarified as to the extent of the right of set-off.

- **Article 22 new (old Article 20):**

Paragraph 5 has been changed to use the terminology found in the Collateral Directive.

- **Article 23 new (old Article 21):**

Paragraph 2 has amended to specify what constitutes equivalent securities.

- **Article 24 new (old Article 22):**

In respect of top-up collateral, (a) now contains three options, either only market value related top-up (as in the Collateral Directive) or all top-up triggers (e.g. rating) or leave it to the respective state's legal framework to define the permissive scope for top-up collateral.

- **Article 25 new (old Article 23):**

In respect of the whole chapter on collateral, a new opt-out clause (paragraph 2) has been introduced to limit the personal scope of application (e.g. as to conform with the Colletral Directive).

- **Other changes:**

Throughout the draft Convention, the term applicable law has been replaced by new precise terms, based on the work of a subgroup of the expert committee meeting, in which the Commission observers participated. Article 4(2)(d) now refers to the "law under which the securities are constituted, the terms of the securities and the account agreement". Articles 4(2)(e), 5(2) and (6), 10, etc. now contains the standard formulation "domestic non-Convention law" as clarifying that a sole reference to substantive (non private international) law other than the one within the scope of the Convention is meant.

Furthermore, terminology changes have been introduced throughout the text.

The further articles have been left mostly unchanged for the time being, given the lack of time for a conclusive debate. This left a number of core issues that did arise during the debates unresolved.

In addition to the ones mentioned above, the most relevant one is the interplay of rules regarding priorities (first in time rule), good-faith acquisition (last in time rule) and allocation of shortfalls (pro-rata rule) is still open. The result will impact on the existing structures applied in the member states.

Furthermore, the treatment of corporate actions and voting rights has not yet been addressed in detail beyond a general agreement to require acceptance of indirect holding structures (without details as to what this could mean).

The provisions in the draft Convention that address issues of systemic risk and could potentially affect the Settlement Finality Directive have not been discussed on the concerted request of the Member States as coordinated by the Presidency and the Commission. It was seen as important to avoid the development by UNIDROIT of definitions which would jeopardise the existing EU structure. As a result, the EU obtained to reserve its position with discussions postponed until after there is a Commission mandate to negotiate the SFD related issues.

As regards the suggested provisions regarding collateral, which overlap with the Collateral Directive, it was felt that the proposed text was considerably more limiting than the Collateral Directive. Although no fundamental regime change should be contemplated in the short term as regards the Collateral Directive, yet non-EU countries seem to be keen of addressing those issues, which are currently foreseen to be optional.

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