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**LEGAL CERTAINTY GROUP  
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SUBJECT 1 ("BOOK ENTRY")**

**Monitoring Report on the UNIDROIT draft**

**Preliminary Discussion Draft**

*Observations by Lars Afrell, Olaf Christmann, Klaus Löber, Ulrik R. Bang-Pedersen and Martin Thomas are reflected in this version. Where useful, these observations are identified separately.*

**1. PRESENTATION OF THE UNIDROIT DRAFT**

The key parameters of the UNIDROIT *preliminary draft Convention on Substantive Rules regarding Intermediated Securities*, hereinafter: "the draft", or "the draft instrument", are (a) to enhance internal soundness of the law underlying holding and transfer of securities; and (b) ensure cross-border compatibility of all systems in this regard.

**1.1. Scope of the UNIDROIT draft**

In order to find the balance between the necessary degree of harmonisation and the intrusion into national law UNIDROIT decided to take the needs of the market as guidelines and to propose harmonisation where (and only where) it was necessary to achieve the goals of internal soundness and compatibility. As to the needs of the market, the following elements were identified:

- 1.1.1. the effective domestic and cross-border exercise of rights flowing from the securities (dividends, voting rights, etc.);
- 1.1.2. the “effectiveness” of credit and debit entries, in particular vis-à-vis third parties and good faith acquirers;
- 1.1.3. clear and practicable methods for transactions, including creation of security and other limited interests;
- 1.1.4. integrity of the intermediated holding system (prohibition of disrupting attachments or instructions; avoidance of loss or inflation of the number of securities);
- 1.1.5. issues of corporate law which might encroach with the concept of intermediated holding (prohibition of split voting, preclusion of set-off);
- 1.1.6. predictable and market oriented methods of creation and realisation of securities collateral.

## **1.2. Level of harmonisation**

An important issue is the level of integration provided by the future UNIDROIT Convention. Three different levels are theoretically possible: (a) supranational law; (b) uniform (domestic) law; and (c) harmonised (domestic) law. In the global context, solutions (a) and (b) were probably too ambitious because the law of securities holding and transfer is closely linked to other areas of law (corporate, tax, insolvency law and supervisory rules) and a uniform solution would not provide enough flexibility to fit the international instrument into the overall architecture of domestic laws given the fact that countries from all continents participate. Therefore, the best solution is seen to be a harmonisation of the most important legal aspects of securities holding and transfer. Domestic law needed to be adopted in certain points in order to comply with the aims of harmonisation. As a result, the domestic law (after having in the course of implementation been modified to a smaller or greater extent) would still govern the legal situation of intermediated securities, i.e. there would not be any compelling reason to change the overall concepts of the relevant domestic law.

## **1.3. Functional and neutral approach**

For a similar reason, the UNIDROIT draft attempts to use neutral and functional language and to avoid references to legal terms stemming from one or the other system. It would be dangerous to draw on a supposedly common understanding of legal concepts as for example “property”, “possession”, “good faith” or “pledge” which in detail may differ from country to country. Therefore, the option for a descriptive language which is not imported from one or the other legal tradition was a strategic decision which is considered crucial for the success of this instrument.

#### **1.4. Nature of this instrument**

UNIDROIT aims at the adoption, signature, ratification and implementation of an international treaty. After its signature the treaty will be binding vis-à-vis the other Contracting States. Most countries' Constitution requires ratification by the Parliament before a treaty is to be implemented. The design of the UNIDROIT draft is such that it is not self-executive, i.e. in order to apply properly, the national legislator is called upon transforming it into national law or change pre-existing national law accordingly. The future UNIDROIT convention will not be a "stand alone" text.

#### **1.5. Implementation of the future UNIDROIT Convention "in the EU"**

The more difficult issue is by what means the outcome of the UNIDROIT negotiations will be "combined" with the results of the LCG and how the end-result is channelled to national legislators in order to align national law. At the moment, no decision has been taken on what form future EU legislation in the field of intermediated securities will take (Directive? Regulation?). One possible solution is that future EU legislation sets out a full set of rules which are drafted to remain within the (relatively wide) frame of future UNIDROIT Convention but go at the same time well beyond the latter in terms of level of harmonisation.

Issues of share of competence between the Commission and the EU Member States etc. are not within the mandate of the LCG.

## **2. MONITORING OF THE UNIDROIT DRAFT**

The aim of the exercise of monitoring the UNIDROIT draft instrument is to make sure that both instruments move forward in a co-ordinated way. This is to avoid conflicting regional and global harmonisation which would lead to cutting off any global harmonisation effort which would not be in the interest of the EU.

The LCG addresses its task of monitoring the UNIDROIT draft not so much by looking for "differences" between both texts. In fact, there would be many given the different level of technicality and the fact that the UNIDROIT draft is a legislative text, as opposed to the Advice given by the LCG.

Probably, the right approach is to check whether the principles stated in the LCG Advice would "fit into" the framework set by UNIDROIT and that there are no contradictions. This formula illustrates that the level of harmonisation provided for by the UNIDROIT draft Convention is supposed to represent the minimum necessary to minimise in particular threats to the stability of the financial system which are due to legal risk, and that the UNIDROIT draft is relatively broad and leaves the solution of many issues to the domestic non-Convention law. This means that future EU harmonisation could go, if so decided, well beyond this level of harmonisation though complying fully with the UNIDROIT draft. The leading question therefore is whether the LCG Advice "fits into", "is covered by" or "does not conflict with" the rules of the UNIDROIT draft.

However, the issue is two-fold: the purpose of the monitoring includes also checking whether the EU, supposing legislation along the lines developed by the

LCG would be created, would be in a position to adhere to the future UNIDROIT Convention. This would not be the case if issues which were addressed in the latter would not figure in the former instrument. I.e. the LCG is called upon monitoring whether all minimum features required by the UNIDROIT draft figure in the blueprint for future EU legislation.

In case incompatibilities emerge, the LCG will notify the Commission

It is worth noting that the LCG is formally not in a position to determine the Commission's or the Member States' position towards the UNIDROIT negotiations.

## **2.1. First Monitoring Question: Are there contradictions with the UNIDROIT draft?**

- Advice 5.2.1.1., disposition of or creation of a security interest over the book-entry right – remains within the limits of UNIDROIT Article 5.1(b).
- Advice 5.2.1.2., retrieval of paper certificate – remains within the limits of UNIDROIT Article 5.1(c);
- Advice 5.2.1.3., intermediary assistance in exercising corporate rights – remains within the limits of UNIDROIT Articles 5.1(a) and 6;
- Advice 5.2.1.4., channelling of corporate information – remains within the limits of UNIDROIT Article 6;
- Advice 5.2.2., acquisition and disposition – covered by UNIDROIT Article 7.1, 2;
- Advice 5.3., priorities [scope not sufficiently elaborated] – probably covered by UNIDROIT Article 13;
- Advice 5.4., bona fide [scope not sufficiently elaborated] – probably covered by UNIDROIT Article 12.
- Advice 5.5., prohibition of upper tier attachment – remains within the limits of Article 17.
- Advice 5.6., account provider insolvency – within the limits of UNIDROIT Article 15;
- Advice 5.7, different forms of “invalidity” [not sufficiently elaborated] – probably covered by UNIDROIT Article 11.
- Advice 5.8., option to prohibit conditional settlement [not sufficiently elaborated] – probably covered by UNIDROIT Article 11.
- Advice 5.9., duties of the account provider (different aspects) – all within the framework of several UNIDROIT Articles.

Result: All principles set out in the 2006 Advice fit with the requirements of the UNIDROIT draft.

**2.2. Are all elements required by the UNIDROIT draft included in the blueprint for future EU legislation?**

– [to be done]

– ...

**2.3. Result**

[to be done]

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