

To: Legal Certainty Group members
cc: Martin Thomas, Secretary
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EU Clearing and Settlement

Legal Certainty Group

UNIDROIT preliminary draft Convention on Harmonized Substantive Rules regarding Securities held with an Intermediary

1. Introduction

1.1 At its first meeting, on 31 January 2005, the Legal Certainty Group agreed that a briefing paper should be prepared by those of its members most familiar with the UNIDROIT draft Convention on Harmonized Substantive Rules regarding Securities held with an Intermediary (“*the draft Convention*”). That is the purpose of this note.

1.2 For a fuller treatment of the matters explained in this note, reference should be made to the text of the draft Convention, the associated explanatory notes (“*the Explanatory Notes*”) and the Position Paper published by the UNIDROIT Study Group in August 2003 (the “*Position Paper*”).

2. Development of the UNIDROIT project

2.1 The draft Convention is the product of the work of an Study Group of 13 experts from Argentina, Australia, Canada, China, France, Germany, India, Japan, Luxembourg, Switzerland, the United Kingdom and the United States, supported by two experts from France and the United States, who attended as observers and co-ordinated consultation with the private sector in relation to the project, and by observers from the Hague Conference on Private International Law and UNCITRAL.

2.2 The Study Group held five working meetings of several days each, supplemented by informal discussions and circulation of draft wording and comments between the working meetings. Consultation meetings, arranged by the UNIDROIT secretariat and generally attended by some members of the Study Group, were held in Argentina, Brazil, Canada, China, Denmark, France, Germany, Greece, India, Japan, Malaysia, Mexico, Sweden, Switzerland, the United Kingdom and the United States. In addition, UNIDROIT held a seminar at its headquarters in Rome in November 2003, the purpose of which was to shed light on core aspects of the project, and which was attended by about 80 representatives from 26 states.

3. Key principles underlying the draft Convention

3.1 The key principles which the Study Group considered should determine the scope, nature and formulation of any harmonized rules of substantive law on securities held with an intermediary are explained in the Position Paper and the Explanatory Notes.

Scope of harmonization

3.2 The Study Group recognized that rules of substantive law in this area touch on deeply embedded principles of national law and that any harmonization will be a complex and difficult process requiring both technical and political consensus. It therefore concluded that, however desirable it may in theory be to create a fully harmonized set of rules, a rigorous approach should be adopted and the scope of harmonization should be restricted to those points where it is essential in order to avoid significant legal or systemic risk or to enable market structures to operate efficiently.

3.3 Against the background of these objectives, the Study Group sought to identify the essential needs of each of the principal participants in and users of the market. It focussed in particular on the status of book entry accounts and the need for market participants to be confident that balances on such accounts and dispositions effected by debit and credit of such accounts are legally robust.

3.4 The Study Group then identified a category of issues relating to the characteristics that a legal framework for the holding and transfer of securities through intermediaries must possess in order to be regarded as sound, taking into account in particular objectives of investor protection and market efficiency. This category, which the Study Group called issues of “*internal soundness*”, included the requirements that an investor’s interest must be robust (in particular it must not be exposed to the risk of the intermediary’s insolvency or of interference by unrelated parties) and that it must be subject to simple and clear rules governing acquisition, holding and transfer.

3.5 The Study Group also identified a further objective of “*compatibility*”. This related to the ability of different legal systems to connect successfully where securities are held or transferred across national borders.

“Functional” approach to drafting: the principle of neutrality

3.6 As noted above, the Study Group recognized that the rules of substantive law in this area incorporate fundamental principles and concepts of national law which differ between different systems, and that to conform these principles and concepts is unlikely to be practicable. It therefore concluded that the approach to drafting should be to describe the key features that a system of substantive rules must possess in order to achieve the objectives of soundness and compatibility in language that is functional and neutral, meaning that it describes the practical effects of the various rights and actions involved in words which, because they do not adopt technical terms special to any particular legal framework, are compatible with, and can be incorporated into, a variety of different legal frameworks.

3.7 This principle may be illustrated by an example. There is general agreement that the protection of investors' rights over securities held with an intermediary against creditors of the intermediary is an essential element of a sound legal framework. However, different legal systems achieve this result in different ways. One approach is to treat the investor as continuing to own the underlying securities and to regard the role of the intermediary as that of a record-keeper or depository. Broadly speaking, this is the approach followed in France, Germany and Japan. A second approach, adopted by some systems which recognize the concept of a separation between legal and beneficial ownership, is to treat the intermediary as the legal owner of the underlying securities but as holding them on trust for investors, who are therefore regarded as the beneficial owners and therefore entitled to claim the securities in an insolvency of the intermediary. This is the approach in England and some other common law jurisdictions. Belgium, Luxembourg and Switzerland adopt a somewhat similar approach based on co-ownership of a fungible pool of securities, but without using the concept of a trust. The United States Uniform Commercial Code adopts a different approach again; it resembles the English approach in regarding investors as holders of property rights ("securities entitlements") separate from the underlying securities, but makes these rights *sui generis* rights whose characteristics are laid down by the Code, which also ensures that in an insolvency of the intermediary the underlying securities are appropriated to investors and are not available to meet the claims of the general creditors of the intermediary.

3.8 Since these various approaches all achieve the correct result, the Study Group took the view that the corresponding provision of the draft Convention (article 15) should be framed in terms compatible with each of them. This is achieved by stipulating that securities credited to securities accounts maintained by the intermediary are appropriated to the rights of account holders and do not form part of the property of the intermediary available for its general creditors in an insolvency proceeding, but leaving it to "the applicable law" (that is, the remaining provisions of the relevant substantive law) to determine how this result is to be achieved.

4. Scope and key provisions of the draft Convention; relation with existing EU law

4.1 As a result of the application of these design principles, the scope of the matters covered by the draft Convention is quite close to that outlined in the Mandate of the Legal Certainty Project. In summary, they are as follows –

- (a) the substance¹ of the rights arising from a credit of securities to a securities account (article 2);
- (b) acquisition, disposition and the creation of security interests over such securities by book entry (articles 3 and 4);

¹ but not the legal characterization – see above. In this respect, therefore, the scope of the draft Convention arguably differs from that discussed in the Commission's April 2004 Communication, which refers to the "nature" of the rights.

- (c) finality of debits and credits (in the sense of defining the time at which they are effective) and the circumstances in which they may fall to be reversed (articles 5 and 6);
- (d) the prohibition of upper-tier attachment (article 8);
- (e) priority among competing interests (article 9);
- (f) protection of innocent acquirers² (article 10);
- (g) the effect of insolvency of an intermediary, including the protection of investors' rights and the effect of any shortfall (articles 11, 15 and 16);
- (h) the principal duties of an intermediary with respect to the maintenance and operation of securities accounts (articles 13 and 14);
- (i) the position of issuers of securities held with an intermediary (articles 17 and 18);
- (j) special provisions relating to clearing and settlement systems, giving overriding effect to provisions in their rules directed to systemic stability or the finality of transactions (article 7) and protecting book entry transfers and settlement and payment instructions from reversal or revocation in insolvency proceedings (article 12);
- (k) special provisions on collateral transactions, relating to rights of enforcement, the right to use collateral securities and the protection of collateral provided by way of top-up or substitution (articles 19 to 22). These closely resemble those of the Financial Collateral Directive and differ from the remaining provisions of the draft Convention in being optional, in the sense that a contracting state may elect not to apply them (article 23).

4.2 Further research would be required to establish with confidence the extent to which these provisions would touch on matters already covered by EU law. Of the items in the list at 4.1 above, (a), (b), (d), (e), (f), (h) and probably (i) appear at present to be wholly or predominantly matters of member state law. Items (j) and possibly (c) cover matters at least partially dealt with in the Settlement Finality Directive; though they adopt the same underlying policy and to a great extent the same structure, there are differences of scope and detail. Item (k) covers substantially the same area as the Financial Collateral Directive, on which the relevant provisions are closely modelled, though they are not in all respects identical; as mentioned above, these provisions are optional. Item (g) might at first sight appear to fall within the area covered by the Insolvency Regulation or the directive on the winding-up of credit institutions. On examination, however, this appears not to be so: the Regulation and the Directive lay down rules determining which system of insolvency law will apply to a given issue, whereas the provisions of the draft Convention contain

² This corresponds to the traditional “good faith acquirer” concept, but, for reasons explained in the Explanatory Notes, the term “good faith acquirer” is not used in the draft Convention.

substantive rules which would form part of whichever insolvency law was determined to be applicable.