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UNIDROIT PRELIMINARY DRAFT CONVENTION ON SUBSTANTIVE RULES REGARDING SECURITIES HELD WITH AN INTERMEDIARY

SOME COMMENTS

MIGUEL GALVÃO TELES

In memoriam
Professor Isabel de Magalhães Collaço,
with devotion (*)

Foreword

In May 2004 I gave a lecture in the post-graduation course on securities law organized by the Faculty of Law of the University of Lisbon and the Securities Institute *(Instituto de Valores Mobiliários)*. The subject matter was "Custody and sub-custody of dematerialised securities", but, when preparing the lecture, I changed its title to "Holding of securities on behalf of third parties and reflex securities". The text of the UNIDROIT Preliminary Draft Convention on Substantive Rules Regarding Securities held with an Intermediary, dated April 2004, had just been published in UNIDROIT's website (www.unidroit.org/). During the lecture I made a reference to it.

Afterwards, it was decided, within Morais Leitão, Galvão Teles, Soares da Silva & Associados, at the time in a merger procedure including my

(*) My teacher and very dear friend Professor Isabel de Magalhães Collaço was particularly keen on UNIDROIT, of which Governing Council she was a member from 1983 until 2003.

former law firm, that I would prepare some comments on the Preliminary Draft Convention to be sent to UNIDROIT, following an invitation made in its website. So I did and the comments were sent, in the beginning of September 2004.

It is those comments which are now published. Some minor changes have been introduced in the text for the purpose of the present publication. In addition to small refinements, the beginning of the text has been adjusted to this foreword, an appendix on a summary of Portuguese law has been deleted and references to it have been replaced by direct references to Portuguese provisions. Footnote 17, on specific points of Portuguese law, has been added and in footnote 9 I have included a reference to a Portuguese book. For the convenience of the reader, the text of the UNIDROIT Preliminary Draft Convention, in the version of April 2004, is published as an annex.

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Just when the present text was ready for printing, UNIDROIT made available, on its website, the final version, prepared by the Study Group, of the Preliminary Draft Convention (November 2004), together with Explanatory Notes (December 2004). Such text will now be submitted to a Committee of Government Experts, which will meet in May 2005.

There was no time to re-arrange the comments by reference to the final Preliminary Draft. I believe that, globally, the comments regarding the April 2004 version ~~helps~~ their *raison d'être*. Therefore, I decided to maintain the publication of such comments, just adding a very short *postscript*.

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The comments were addressed to people highly specialised and fully familiar with all the issues involved. For the purposes of publication, some preliminary words on the so-called "indirect holding of securities" are of convenience.

The "indirect holding of securities" emerged from practice. Traditionally, securities were certificated. The increase both of investment and of trade in securities made the paper circulation unbearable. Because of it.

very often the certificates representing securities "owned" by clients were kept in the possession of financial intermediaries or registered in their name, the clients' rights being credited into the intermediaries' accounts. A second step has been the *immobilisation* of securities by the issue of permanent global certificates. An intermediary subscribes the whole of the issue and "re-sells" the rights to other intermediaries and (or) to the public. The "rights" are credited into the accounts of the "selling" intermediary.

Cross-border investment converted the scheme of "indirect holding" into a chain. If, for instance, a United States investor wishes to invest in Denmark, he will use a United States bank, who has a correspondent or an affiliate bank in London, who, in turn, keeps some relationship with a local intermediary. If the certificates are in the possession of the local intermediary or if the securities are registered in his name, in his account he will credit rights of the London intermediary, who, in his turn, will credit rights of the United States bank. Only in the account with this last intermediary do the investor's rights appear (**).

That is why the simple admission, by certain jurisdictions (such as France, Spain and Portugal), of dematerialised securities did not change substantially things in this respect. Supposing that the investment is now in Portugal, the London bank will open an account with a Portuguese authorized financial intermediary. But, according to practice, the securities will be credited to the London bank, in a jumbo account, not to the investor. Dematerialised securities will suppress one link in the chain, but not more than that.

The holding of securities in one's own name but on behalf of third parties is not at all new. It suffices to think of agency and, in general, of fiduciary ownership. What is new is the widespread and systematic use of it, through the "indirect holding of securities". The problem is that the investor believes that he owns the securities. In legal systems that recog-

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(**) On these points see Sir Roy Goode "The Nature and Transfer of Rights in Dematerialised and Immobilised Securities", in Fidelis Oditah (ed.), *The Future of the Global Securities Market*, 1996, pp. 107 ff.; A. O. Austen-Peters, *Custody of Investments: Law and Practice*, 2000, pp. 1-20; Steven Schwarcz, "Indirectly held securities and intermediary risk", *Uniform Law Review*, VI (2001-2), pp. 283-299 and "Intermediary risk in the indirect holding system for securities", *Duke Journal of Comparative & International Law*, 12-2 (2002), pp. 309 ff.; Philipp Paech, "Harmonising substantive Rules for the Use of Securities Held with Intermediaries as Collateral: the UNIDROIT Project", *Uniform Law Review*, VII (2002-4), pp. 1142-1150 (available also on the UNIDROIT website).

nise trust he may eventually be said to have beneficial ownership. But in civil law systems he will normally just be a creditor. What happens in the event that one intermediary becomes insolvent? If the securities or the rights relating to securities which the intermediary holds ultimately on behalf of the investors are within the reach of the intermediary's creditors, the "indirect holding of securities" is under a high systemic risk. But there are other problems. What if one intermediary "sells" more rights than those he owns? How can vote instructions from the ultimate investors be fulfilled in legal systems that do not allow the vote split?

It was the awareness of the risks and problems involved in the so-called "indirect holding of securities" that brought some jurisdictions to issue or to consider issuing special rules regarding it. The first movement was the 1994 revision of the United States Uniform Commercial Code, which introduced, in Article 8, provisions on entitlements to securities. At the international level, the matter started to be addressed from the conflicts of laws point of view. The Hague Conference on Private International Law adopted, in December 2002, the text of a *Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary* (***). On its side, the Governing Council of UNIDROIT decided, in 2001, to consider the matter from the point of view of substantive rules. A Study Group has been appointed in the second half of 2002, which produced, in August 2003, a *Position Paper* and, in April 2004, a Preliminary Draft of a Convention on Substantive Rules Regarding Securities held with an Intermediary, which is the subject matter of the comments.

"Indirect holding of securities" is a fruit of globalisation. Globalisation, in itself, is neither good nor bad. It is just a contemporary *datum*. As referred to in the Comments, not all reasons for the "indirect holding" practice are good and unavoidable; and the system reduces market transparency. The legality of indirect holding is based on private autonomy. But one possible way of dealing with it is not to encourage it through protective provisions. I believe however that there are also compelling reasons of practicality for the "indirect holding" and that the investor's trust demands specific protection. The other side of the coin is that regulatory

(***) Note that until August 1st, 2004 no State has yet signed it. On the Hague Convention see Maria Helena Brito, "A Convenção da Haia sobre a lei aplicável a certos direitos respeitantes a valores mobiliários depositados num intermediário", *Direito dos Valores Mobiliários*, Instituto dos Valores Mobiliários, vol. V, 2004, pp. 91 ff..

provisions are also needed. The Draft Convention does not and cannot address the issue (worldwide regulation is impossible). But it has to be considered whether the Convention should allow reservations referring to compliance with regulatory requirements by the intermediaries.

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Since the comments have been directly drafted in English, they are published in such language, as well as the present foreword and the *postscript*.

Comments

Introduction

1. The comments on the Preliminary Draft Convention on Substantive Rules regarding Securities held with an Intermediary, April 2004 (hereinafter, the *"Draft Convention"*), will concentrate basically on the Convention's scope and on the *status* of the securities held with an intermediary, as well as on the relationship between the account holders and intermediaries, which relates mainly to some definitions and Articles 2 to 8.

2. Before coming to the discussion of particular provisions of the *Draft Convention*, some reflections on the nature of the so-called "indirect holding of securities" and on the rights and duties involved are advisable. Therefore the text will be divided in two parts. the first one on background aspects. The main issues within such background are:

a) Should the rights of the account holder be given proprietary effects and to what extent?
b) What kind of relationship exists between the rights of the account holders and those of the securities holders, as well as between the rights of one account holder and those of a higher-tier and of a lower-tier account holder, and what is the role of the intermediaries' duties?

The second part shall contain comments on specific provisions of the *Draft Convention* and some suggestions.

I — Background aspects

A) Preliminary remarks

3. I consider the *Draft Convention* as the fruit of a remarkable work and much of the following text is in support of the adopted solutions. There are, however, points which still deserve to be discussed.

4. The wide use of the "indirect holding of securities" is a contemporary fact, which raises specific legal problems, both substantive and of conflicts of laws, requiring specific answers. This is shown by the issue of substantive legal rules on the matter, starting by the revised (1994) Article 8 of the Uniform Commercial Code, as well as by the adoption of the Hague Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary (2002) (hereinafter, the "Hague Convention").

The reasons for the use of the "indirect holding of securities" are in part avoidable, in part unavoidable; in part reasonable and strong, in part not so relevant.

The "paper jam", by itself, is avoidable by ways other than the "indirect holding of securities". It suffices to replace, in whole or in part, certificated by dematerialised securities, as has been done, for instance, in France, in Spain and in Portugal. Dematerialised securities may be "directly" held, as, for example, they are in Portugal (1).

The not so relevant reason for, and the consequence of, the use of "indirect holding" is that it allows "in-house trading". "In-house trading" reduces costs and, in part, displaces them: instead of paying both the bank and stock exchange fees, the investor just pays bank fees. The latter may become higher than otherwise, but they will be lower than the two kinds of fees together. However, "in-house trading" reduces market transparency. The issue has to be dealt with at the regulatory level (2).

The unavoidable cause of the "indirect holding of securities" is the

(1) See Código dos Valores Mobiliários (hereinafter, Portuguese Securities Code), Articles 46 and 61 and ff.

(2) Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments deals already with the issue, regarding MTF (Multilateral Trade Facilities) and internalisation. But the regulatory scope should be enlarged.

expansion of cross-border investment and the reason for such "indirect holding" is practicality. It is impossible to request that proxies and sub-proxies are issued all over the world, allowing intermediaries to purchase and sell securities and to exercise rights inherent to them. Furthermore, proxies may be insufficient, if they are too narrow, or dangerous, if too broad. The legality of the "indirect holding of securities" derives from private autonomy. The point is, however, that, since and when the investor does not use the "direct holding" because of impracticability, the protection of his trust requires that he be placed, as much as reasonably possible, in a position similar to the one he would have if he was a "direct" holder. This may imply the granting to the investor of a stronger protection than the one he would have under the general rules of particular legal systems. Such is, in part, the trend of the *Draft Convention*.

Obviously, there are investment-exporting and investment-importing countries and most of the ultimate investors are domiciled in the investment-exporting countries. But the investment-importing countries have an interest that investment made in their companies and financial assets is secure — and, therefore, in the protection of the trust of ultimate investors, as well as of those with whom they deal.

As what is basically at stake is cross-border investment, common rules are welcome.

5. In Portugal, we have had some experience with the legal difficulties raised by the "indirect holding of securities", fortunately not regarding the insolvency of financial intermediaries ([3]), but regarding the fulfilment of voting instructions.

The Portuguese Companies Code (*Código das Sociedades Comerciais*, of 1986) establishes, for the companies limited by shares (*socieda-*

([3]) There has been none of relevance. Furthermore, Portugal being mainly an investment-importing country and taking into account the Portuguese legal regime of securities, when the Portuguese banks intervene as sub-custodians what they really do is to register the dematerialised securities in the name of the custodian or of a lower-tiered sub-custodian or to have certificated securities in deposit in the name of one of them. In no sense are the securities held by the Portuguese banks. As Portuguese banks are normally not sub-custodians of one another, the problem of what kind of rights an account holder has under Portuguese law would only arise in the event of insolvency of a lower-tier intermediary, which would normally be a foreign company, if, under the rules on conflict of laws of the *forum*, Portuguese law was considered applicable (as the law of the issuer or the law of the "location" of the securities).

des anónimas), the rule of *voting unity* (Article 385). Such rule means that one and the same shareholder cannot vote with some of his shares and to abstain with others or to vote in a sense with some and in another sense with others. The consequence of the breach of the rule of voting unity is the nullity of all the votes which have been split. There are some exceptions provided for to the rule of voting unity, the main one being that relating to representatives of the shareholders.

Under Portuguese law, in listed companies the shares have to be dematerialised or deposited with a centralised system; and, for the purpose of general meetings, the shareholder is the one in whose name the shares are registered or deposited (4). If an intermediary has shares registered or deposited in his name, even if he owns the shares on behalf of his clients, he cannot be said to be a representative of them, precisely because he owns the shares in his name. Therefore, how can he split the votes in accordance with the clients' instructions?

The awareness of the question came with the *American Depositary Receipts* (ADRs). During the nineties, some Portuguese companies or one shareholder (the State) of some Portuguese companies issued or sold shares underlying ADR issues. There were complex ways of overcoming the problem of the vote split. But, as the main seller was the State, by privatization, and the Privatization Law (Law 11/90, of 5 April) requires each privatization to be authorized by a decree-law, which has force of law, some privatization decrees, which foresaw ADRs issues, provided that the depositary was to be considered as the representative of the ADRs holders. It was obviously a *fictio juris*, but the provisions solved the difficulty. One may infer, for ADRs, a rule which allows the splitting of vote. But there is no ground to apply such rule outside ADRs.

6. Quite often, financial intermediaries appear as shareholders in the general meetings of Portuguese companies and split their votes. Normally, the number of shares at stake is low and immaterial for the final outcome so that the chairman of the general meeting of shareholders (5) may simply

(4) Portuguese Securities Code, Articles 62 and 99, paragraph 2 (a), and Articles 78, 83 and 104.

(5) Portugal has had for a long time a peculiar system according to which the chairman of the general meeting of shareholders is elected separately and does not belong to other corporate bodies. Very often chairpersons of the general meeting of shareholders are lawyers.

put on the record that he does not determine the question of the validity of the votes because it is irrelevant. But what if the split votes are or may be decisive for the outcome of the voting (6)?

B) Proprietary effects of the account holders' rights

7. The basic *datum* in an "indirect holding of securities" is that the highest-tier intermediary holds the securities *in his own name*, although *on behalf of third persons* (the beneficiaries).

In English law and, in general, in legal systems which adopt the notion of trust, it does not seem difficult to attribute proprietary nature, as beneficial ownership, to rights of the account holder, even without a specific provision. Although its applicability depends on the terms of the deeds, the rules on trust and sub-trust, if not excluded, will suffice (7).

In civil law systems the framework is quite different. The situation is one of *fiduciary ownership* (or, at least, quite close to it). In such systems the rights of the beneficiary in fiduciary ownership are, in principle, rights *in personam* (credit rights against the fiduciary owner).

The obstacle can always be overcome by specific provisions, as those contained in the *Draft Convention*. In any event, in order to test the justification and compatibility of the *Draft Convention* with the general principles of civil law systems, one has to ask for what purposes it is necessary or seems to be necessary to grant to account holders rights some kind of proprietary effect.

That account holders' rights are effective against third parties or opposable to them, although its contents refer to an intermediary's behaviour, corresponds to the common feature of credit rights. Any civil law system

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(6) In one case I have declared, as chairman of a general meeting of shareholders, the nullity of the split votes of an intermediary, because, although remotely (there were other legal issues), they could be relevant for the outcome. Two shareholders challenged in court the shareholders meeting resolution, on other grounds, but, depending on the decision on the other issues, the court could have to determine on the nullity of the split votes. However, both proceedings were terminated before a judgment was entered and there is no judicial precedent in Portugal on the matter.

(7) Sir Roy Goode, "The Nature and Transfer of Rights in Dematerialised and Immobilised Securities", in Fidelis Oditah (ed.), *The Future of the Global Securities Market*, 1996, pp. 125-126; Joanna Benjamin, *Interests in Securities*, 2000, pp. 303 ff., and (in co-authorship with Madeleine Yates and Gerald Montagu) *The Law of Global Custody*, 2nd. ed., 2002, pp. 22 ff.

knows the concurrence of credit rights in insolvency, the prevalence of some and the "reduction" *pro rata*.

Therefore, the purposes of attributing proprietary effects to the account holders' rights seem to be twofold: first, to exclude, for the benefit of the account holder and of his creditors, the securities, or the rights of the immediate higher-tier intermediary, from the reach of the intermediary's creditors, at least in the case of insolvency of the latter; and, second, to ensure that, in the event the account holder's rights are provided as collateral, such collateral (more precisely, the rights of the collateral taker) follow the rights provided as collateral.

8. For this last purpose, however, nothing has to be changed in the civil law systems' principles. Civil law systems know very well the *pignus* of credit rights. And the *pignus* of a credit right follows such right. The only supplementary protection needed is that the rights of the intermediary to which the rights of the account holder refer be outside the reach of the intermediary's creditors. But such supplement is involved in the first purpose.

9. The main point to be underlined is that to exclude the intermediaries' rights from the reach of its own creditors is justified by the requirement of investors' trust protection. As referred to above, the investor should, as much as reasonably possible, be placed in a position similar to the one he would have if the securities were "directly" owned. And it is reasonably possible to protect the investor from the intermediaries' creditors. One could say that also those who deposit cash with a credit institution are not protected. But that money deposits be irregular is of the essence of banking. And the depositor receives a consideration (the interest), whilst, regarding the investor, the intermediary just provides a service.

The reason for excluding the intermediaries' rights in an "indirect holding of securities" from the reach of their creditors is of the same kind as the one that makes some laws establishing that the ownership of the deposited securities is not transferred to the depositary ("regular" deposit) (8).

10. It is quite clear that the general rules in force at least in most civil law countries (the qualification derives from limits of knowledge) would

(8) See, for Portuguese law, Article 100 of the Securities Code.

not allow that securities held by the highest-tier intermediaries do not respond for his debts or that the rights of higher-tier intermediaries than the account holder do not respond for their debts. However, there are, in civil law systems, precedents of excluding assets held by someone in his name from his creditors reach for the benefit of third persons in whose behalf the assets are held and their creditors. Such precedents relate to the "non-representative mandate", i.e., the kind of agency, disclosed or undisclosed, where the agent acts in his own name.

Some laws govern specifically the "non-representative mandate" ([9]). It is what happens with the Italian Civil Code, of 1943 (Articles 1705 to 1707), and the Portuguese Civil Code, of 1966 (Articles 1180 to 1184). Our interest is only on the mandate to acquire. In Italy there was and I believe still is strong debate on whether the effects of the acts executed in performance of the mandate produce in the legal sphere of the agent or directly in the legal sphere of the principal, and, in the first hypothesis, on whether the agent has to transfer the rights to the principal or the transfer is automatic ([10]). We had the same discussion in Portugal, under the Civil Code of 1867 ([11]). However, even those who support the thesis of the direct or automatic effect in the principal's legal sphere have to admit that such effect would not be produced if, a special form *ad substantiam* (notarial deed) or registration being required, the agent executes

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([9]) The "cut" between the quality of being a representative of some other person *(Vertretung)* and the power of attorney *(Vollmacht)*, on the one side, and the mandate *(Auftrag)*, on the other, has been introduced by the German *Bürgerliches Gesetzbuch* (BGB). The first ones are governed by §§ 164 to 181, inserted in a section on *Rechtsgeschäfte*. The contract of mandate is ruled by §§ 662 to 674, inserted in a section on "particular credit relationships" (particular contracts). The Italian *Codice Civile* followed somehow (just somehow, because it has a title on contracts in general, not on *Rechtsgeschäfte*) the BGB by dealing with "representation" (Articles 1387 to 1400) in the general part of contracts and with the mandate, as a particular contract (Articles 1703 to 1730), within a title on particular contracts. The Portuguese Civil Code is closer to the BGB, "representation" (Articles 258 to 269) being dealt with in a chapter on *Rechtgeschäft* ("negócio jurídico") and mandate (Articles 1157 to 1184) in a title on "particular contracts". § 667 of BGB refers to the agent's duty to transfer to the principal what he has received from the other party. See, in the Portuguese literature but with a wide comparative law approach, Pedro Albuquerque, *A Representação Voluntária em Direito Civil*, Coimbra, 2004.

([10]) See *Commentario al Codice Civile* diretto da Paolo Cendon, vol. IV, 1991, pp. 1273 ff.

([11]) The author claiming that the effects were produced directly in the legal sphere of the principal was Pessoa Jorge, *Mandato sem Representação*, 1961, rep. 2001.

the act in his own name. In the current Portuguese Civil Code, of 1966, it seems quite clear that, in general, the effects of the act performing the mandate to acquire produce directly only in the legal sphere of the agent, the latter being under the obligation to transfer them to the principal (Articles 1180 and 1181).

Nevertheless, both the Italian *Codice Civile* (Article 1707) and the Portuguese *Código Civil* (Article 1184, based on the Italian provision) exclude from the agent's creditors' reach the assets acquired by the agent in performance of the "non-representative mandate", provided the latter is in written form and prior to the moment when the assets would be apprehended, and provided also that, if the acquisition of the assets is subject to inscription in public registry, such inscription has not yet been carried out.

I brought these examples for comfort. They show that to attribute, in civil law countries, for the purpose of excluding assets from the reach of creditors, some "proprietary" effects to rights which, at their origin, are credit rights, on the basis that the assets are owned on behalf of a third person, is not fully unprecedented.

C) Relationship between the rights of the account holders and those of the "direct" holders, as well as between the rights of the higher and lower-tier account holders, and linkage with the intermediaries' duties

11. The "representation" of securities and of each of the account holders' rights is different, in the sense that each security or set of securities and each right or set of rights of account holders has a specific representation. The rights are also different. Those of the "direct" security holder are rights against the issuer: the right to receive dividends or interests from the issuer, the right to vote in the shareholder or bondholder meetings... Those of the account holders are rights against the immediate intermediary: to receive from him the product of the exercise of the rights by the holder of the securities, to direct such exercise...

The account holder's rights being rights against the intermediary with whom he holds the account is not just a matter of *enforceability* of such rights. It is also a matter of their *content*. When the account holder is allowed to exercise rights against intermediaries higher-tier than the one with whom it holds the account (as foreseen in Article 8 (2) of the *Draft Con-*

vention) he is doing so by *subrogatio*, i.e., by exercising the rights of the intermediary ([12]).

12. Account holders' rights are *derivative* from the ("direct") security holders' rights and lower-tier account holders' rights are *derivative* from higher-tier account holders' rights ([13]).

To the extent that the account holders' rights have a proprietary nature. their derivative character means that *"no holder of an interest can have rights to securities greater than those possessed by the holder of the higher-tier interest from which the former interest is derived"* ([14]).

To the extent they are credit rights, their derivative nature means that *the possibility of the satisfaction of such rights by specific performance depends on the ownership and exercise by the intermediary of the "corresponding" rights*. In the event that the intermediary does not have (and does not obtain) such rights or fails to exercise them, the account holder can only claim damages.

This shows the crucial place of the intermediary's duties and, in particular, of his *duty to exercise the rights he owns on the account holder's behalf*. The intermediary's duty to exercise his own rights against his intermediary is the prerequisite for the account holders' rights to be satisfied.

The "chain" in the so-called "indirect holding of securities" does not depend only on the successive rights. It depends also on *each intermediary's duty to exercise his own rights for the benefit of his account holders*.

13. What struck me when for the first time I considered the "indirect holding of securities" was a strong similarity with ADRs. Both the ADR holders' and the account holders' rights are rights to receive the economical product of the exercise of the securities rights by a third party (in ADRs, the depositary) and to direct the exercise of such rights. What is peculiar in ADRs is that they are denominated in a currency different from the one of the underlying securities.

([12]) See below, paragraph 30.

([13]) Sir Roy Goode, "The Nature and Transfer of Rights in Dematerialised and Immobilised Securities", pp. 120-122.

([14]) Sir Roy Goode, *loc. cit.*, p. 122.

ADRs are themselves securities — they are traded in the stock exchange. The underlying assets are also securities. In the ADRs system, at least two levels of securities exist (I say at least because an "indirect holding" of ADRs may also exist).

14. The rights of the account holders being different between themselves and from those of the ("direct") securities holder, are themselves financial instruments and have as their object financial assets. This means that they are or may be (depending on the applicable law) themselves securities, different from the underlying rights or securities, although connected to them and each connected with the higher and lower-tier ones. They may already be traded on MTF ([15]), as well as traded over-the-counter, often "in-house". If one looks to the *Draft Convention*'s provisions on the "acquisition and disposition of securities held with an intermediary" (Chapter IV), on the "protection from adverse claims" (Chapter V) or on collateral (Chapter VII), those are typically provisions on securities.

I call these kinds of rights and of securities *reflex rights* and *reflex securities*, insofar they "reflect" the contents of other rights or securities, by allowing their owner to appropriate the economic product of the *reflected rights* or *securities*, to direct the exercise of the rights inherent to them and eventually to convert them into basic rights or securities ([16]).

As the rights or securities are linked in a chain, the highest-tier rights or securities (the *basic* rights or securities) are just reflected rights or securities and the lowest-tier ones just reflex rights or securities. All the others (owned on behalf of third parties) are both reflex and reflected. The reflex relationship is established through the intermediary's obligations. The placement of reflex securities implies their issue ([17]).

([15]) Directive 2004/39/EC, Article 4, 15), which refers to buying and selling *interest* in financial instruments.

([16]) Regarding ADRs and other financial "products", Joanna Benjamin speaks of "repackaged securities" and characterizes them as interests in securities — *Interests in Securities*, pp. 251-261. See also, from the author, the 1st ed. of *The Law of Global Custody*, 1996, pp. 117 ff.

([17]) In Portuguese legal language, the words "valores mobiliarios" (securities) have two meanings. In a first one, they refer to documents (whether paper documents or electronic documents, in both cases including registrations into accounts) which "represent" rights or legal situations. In a second meaning they refer to the rights or legal situations as "represented" by documents. Article 1 of the Portuguese Securities Code, as amended, after identifying some securities (shares, bonds, equity instruments ("*títulos de participação*",

15. The language "indirect holding of securities" is, at least in legal systems which do not adopt the notion of trust, somehow misleading, and that is why I have always used it between brackets. What one holds are reflex securities (or reflex rights) and through them one just has the right to the economic product of other securities, to direct the exercise of the rights inherent to them and eventually to convert them into basic securities. "Entitlement to securities", used by Article 8 of the UCC, where the word "securities" refers only to basic securities, shows that the account holder's rights are different from the ones on the basic securities, although the meaning concentrates too much on the idea of a right to acquire the (basic) securities ([18]). The concept of "indirect holding" is economic, rather than legal. Anyway, its use is comfortable and it emphasizes the idea that the investor should be placed, as much as reasonably possible, in a position similar to the one he would have if he owned the basic securities.

The wording "securities held with an intermediary" is equivocal regarding which securities are held (what may be an advantage) and too broad,

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"titres de participation"], units in collective investment undertakings, naked warrants, detached rights), includes a general clause characterizing as securities *"other documents representing homogeneous legal situations, provided they are susceptible of transfer in market"*. Reflex rights, insofar as they refer to the same basic securities and have the same contents (similar or standardized account agreements), are homogeneous legal situations; and, by themselves, they are appropriate for trading in market. But the concept of securities flowing from Article 1 has to be completed with the rules governing "representation". Regarding conflicts of laws, Article 39 provides that the "representation" of securities is governed by the personal law of the issuer, i.e., the law of his head office. Since the placement of basic securities through "indirect holding" implies the issue of reflex rights, the law governing the "representation" of such reflex rights as securities is the personal law of each intermediary. Insofar as Portuguese law is applicable, the "representation" through an account with the issuer (and financial intermediary) is a proper representation (Articles 46 and 61, *c)*). One thing, however, is for some right to be a security, because it is capable of being traded in market, another thing is for the securities to have been admitted for trading in some market. According to the Portuguese provisions, reflex securities could only be admitted for trading in non-regulated markets; and, until now, no reflex securities have been admitted (nor applied for admission). Another consequence arising from the implication relationship between the placement of basic securities through "indirect holding" and the issue of reflex securities is that a placement specifically directed to the Portuguese territory and to undetermined persons or to more than 200 persons not being exclusively institutional investors will require the procedure for a public offer (Articles 108 and 160). The link between basic and reflex securities would, houever, justify an adjustment of supervisory provisions applicable to the latter.

([18]) Note, however, that Article 8 of the UCC also talks of *direct* and *indirect holding* (§§ 8-108 and 8-109).

because it literally covers also the dematerialised basic securities. But it has already been adopted by the Hague Convention and is therefore established. The extension in which the concept is to be employed may be dealt with in the Convention's provisions.

II — Specific provisions

A) The scope of the Convention (Article 2)

16. Article 2. on the Scope of the Convention, is not yet drafted. A note refers that its purpose is *"to exclude arrangements under which account holder's rights consist solely of purely contractual or personal rights against the intermediary"*.

The Hague Convention already provides, in Article 2 (3), (a) and (b), that it *"does not determine the rights and duties arising from the credit to a securities account to the extent that such rights or duties are purely contractual or otherwise purely personal"*, nor *"the contractual or other personal rights and duties of parties to a disposition of securities held with an intermediary"*. But paragraph 3 is subject to paragraph 2, which establishes the issues governed by the applicable law determined by the Convention.

Obviously there are matters to be determined by the account agreement, or by the disposition or collateral agreements: for instance, fees, time and prerequisites for instructions and their performance, consideration for a disposition of securities, which debts are collateralised and in which terms...

As for "purely personal rights" ([19]), the *Draft Convention* refers to some, as the account holder's right that the intermediary acts in the manner determined by Articles 4 and 5. And, in my view, as referred to below, some "purely personal rights" are of the essence of an "indirect holding of securities" ([20]).

17. What I believe should be said in Article 2 is that the Convention is *without prejudice of purely contractual or otherwise purely personal*

([19]) Sir Roy Goode defines *purely personal right* as *"one which does not involve the delivery or transfer to the obligee of an identified asset or funds of assets but is to be satisfied by the obligor's personal performance in some other way, such as payment of a debt or damages from his general assets"* (*Commercial Law*, 3rd ed., 2004, p. 26).

([20]) See below, II, D).

rights and duties of the account holders and intermediaries, arising from the account agreements or from other agreements, as well as from the law applicable to them, which are not inconsistent with the mandatory provisions of the Convention. What will become necessary is to identify which provisions are mandatory.

18. Another issue is whether ADRs are or not covered by the *Draft Convention* and whether they should be.

In my view, ARDs are also reflex securities and correspond to a modality of "indirect holding" of the underlying securities, being held with an intermediary. But they are in certificated form (with or without Global Depositary Receipt) and, therefore, the depositary is not an account holder. Account holders will be those to whose accounts ADRs, but not the underlying securities, are credited.

As it is, the *Draft Convention* applies to ARDs account holders, but not to the depositary. And it seems that, ADRs being limited (as far as I know) to one legal system, there is no need to amend the *Draft Convention* on this point.

The situation would change if dematerialised ADRs were adopted. In such case the Convention would apply, unless it was determined that, for its purposes, securities accounts are only those where the securities are credited in the same currency they are issued (basic securities currency). But I do not think it is worthwhile. Whether the Convention will or will not apply to ADRs, and to which extent, is somehow indifferent.

19. In the next section, I shall deal with a remaining point that may be located in Article 2.

B) The need to exclude the basic securities or entitlements as against the issuer from the Convention's scope (Article 1 (1), (b) and (f), and Article 2)

20. Article 1 (1) (b) defines securities account as *"an account maintained by an intermediary to which securities may be credited or debited"*. An account maintained by an intermediary to which basic securities are credited or debited and which "represents" dematerialised basic securities falls within the definition. As a consequence, dematerialised basic securities fall within the definition of "securities held with an intermediary". As referred to above, the definitions are too broad for the purposes

of the *Draft Convention*. However, in both cases they are similar to the ones used by the Hague Convention. For the sake of consistency between the two conventions, they should not be changed.

The Hague Convention addresses the point of basic dematerialised securities in Article 1 itself. What is of interest here is paragraph 5, which reads:

> *"In relation to securities which are credited to securities accounts maintained by a person in the capacity of operator of a system for the holding and transfer of such securities on records of the issuer or other records which constitute the primary record of entitlement to them as against the issuer, the Contracting State under whose law those securities are constituted may, at any time, make a declaration that the person which operates that system shall not be an intermediary for the purposes of this Convention".*

I am interpreting the words *"operator of a system for the holding and transfer of securities"* as including the financial institutions that credit the basic securities to accounts (as happens in Portugal with directly dematerialised securities ([21])), provided they are integrated into a system for the holding and transfer of securities.

21. There is an important difference between the way the question of "primary entitlements" presents itself from a conflicts of law point of view and from a substantive one. It is not unreasonable to apply Articles 4 to 6 of the Hague Convention to "directly held" securities, although other conflicts of law rules may be more appropriate. Therefore, Article 1 (5) made the application of the Hague Convention rules to "directly held" securities just optional.

Regarding the *Draft Convention*, its intended scope relates only to "indirectly held securities" ([22]). And it does not make any sense whatsoever to apply to "directly held securities" for instance Articles 3 (1) (a) (ii), (2), (3) (b), 4 (3), and 5 to 8. Therefore, the exclusion of the "direct hol-

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([21]) See Portuguese Securities Code, Articles 61, 91, 1 (b), 289, 291 and 295.

([22]) Philipp Paech, "Harmonising substantive Rules for the Use of Securities Held with Intermediaries as Collateral: the UNIDROIT Project", *Uniform Law Review*, VII (2002-4), pp. 1142 ff.; "The UNIDROIT Study Group on Harmonised Substantive Rules Regarding Indirectly Held Securities", *Position Paper*, August 2003.

ding of securities" from the *Draft Convention*'s scope should be directly determined and not optional.

22. Again for the sake of consistency with the Hague Convention, the same basic wording should be used.

The provision could be included in a new paragraph of Article 1, with reference to the definition of "intermediary", or in Article 2, as for the determination of the scope of the Convention. The second solution seems to me more appropriate.

In any event, rights which, according to the applicable law, may be exercised directly and without *subrogatio* against the issuer (see, for instance, Articles 9 bis and 10 of the "Arrêté royal" from Belgium, as amended) should also be excluded from the Convention's scope.

C) Description of securities (Article 1 (1) (p))

23. Article 1(1) (p) states that "*securities are "**of the same description**" as other securities if they are securities of the same issuer, of the same currency and denomination, and form part of the same issue, as those other securities, and references to securities of a particular description shall be construed accordingly*".

The expression "securities of the same description" appears only once in the *Draft Convention* (Article 22 (2)). But there are several references to "description of securities": "each description" (Article 6 (1)), "a given description" (Article 7 (2)), "that description" (Articles 6 (1) and 7 (2)).

The restriction to "the same issue" in the definition is incompatible with laws, as the Portuguese one, where securities of several issues belong to the same category. In the "individualized" accounts the securities are simply not identified by the issue and securities of several issues are traded indistinctly. After trading of securities of an issue starts, it is simply impossible to identify securities of one or of another issue. The identification of the appurtenance to an issue is possible only during thirty days as from the issue resolution and, afterwards, if the resolution is challenged in court (Portuguese Securities Code, Article 25). Without reference to the issue, we just have the "same contents" (Article 45 of the Portuguese Securities Code) or, as the Portuguese Companies Code (Article 302, paragraph 2) says, regarding shares, "comprising equal rights". But, even that, apart from being vague, is insufficient. For an account holder or a colla-

teral taker it is obviously not the same thing to have securities subject to one or to another tax regime (23).

The *Draft Convention* is a Convention on "indirect holding of securities", not a Convention on securities in general. The only way to define securities "of the same description" in a manner compatible with the diversity of national laws is to say that:

> *"securities are "**of the same description**" as other securities if, according to the applicable law, they are fungible between themselves...".*

Whether fungibility means, in a particular law, *indifferentiation* or *indifference* or both (24) is irrelevant for the purposes of the Convention.

It will be up to the applicable law to determine the prerequisites of the fungibility of the securities between themselves.

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(23) According to Article 204, paragraph 2 (a), of the Portuguese Securities Code, *"[f]or the purposes of trading on a market, the securities which belong to the same category, obey to the same form of representation, **are objectively subject to same tax regime** and from which different rights have not been detached are considered fungible"*.

(24) I have dealt with the concepts of fungibility in an article "Fungibilidade de valores mobiliários e situações jurídicas meramente categoriais" ("Fungibility of securities and merely categorial rights") published in the *Estudos em Homenagem ao Professor Doutor Inocêncio Galvão Telles*, vol. I, 2002, pp. 579-628 (first publication), and also in *Direito dos Valores Mobiliários*, Instituto dos Valores Mobiliários, vol. IV, 2003, pp. 165-217. Fungibility of securities is linked with the irrelevance of the securities order number or the inexistence of any securities order number. In Portugal, directly dematerialised securities do not have a securities order number. Therefore, they are fungible. For certificated securities deposited with a centralised system, the securities order number is irrelevant. They are also fungible. As an *absolute* concept, fungibility means that the securities have *no individuality* (and are, therefore, not traceable); they are simply *ideal quantities of a class*, they have the nature of *merely categorial rights*. The *relative* concept determines the relevant (complex) classes to which ideal quantities may belong and which characterize them. Both the absolute (which corresponds to a spurious use of the word "fungibility") and the relative concept of fungibility used by the Securities Code are different from the fungibility concept relating to "things" employed by Article 207 of the Civil Code (see also paragraph 91 of the German BGB), which may also be relevant for some certificated securities. As applied to "things", fungibillity means *indifference*. As applied to ideal quantities, it means *indifferentiation*. My ultimate submission is that "fungible" securities, as merely categorial rights, are *particulars* (as opposed to universals), but not *individuals*.

D) The account holders' rights and the intermediaries' obligations (Articles 3 to 6)

24. A crucial issue for the reliability of the "indirect holding" system is that of the obligations of the intermediary and of their extent. It is the intermediary's duties that link the chain and the consistency of the account holders' rights, as well as of the whole "indirect holding" mechanism, depends on them.

The *Draft Convention*'s proposed solutions are basically the following:

a) The intermediary is bound to give effect to any instructions of an account holder and not to give effect to any instructions of another person, but always subject to the account agreement (Article 4 (1) and (2));

b) the intermediary is bound to hold (or to acquire and hold) sufficient securities in respect of account holder's rights (Article 5 (1) to (4));

c) each intermediary guarantees that the next higher-tier intermediary has enough securities, except as otherwise provided, possibly within certain limits, by the account agreement (Article 5 (5));

d) the manner of performance of the obligations of the intermediary in providing assistance to the account holder and the extent of the liability of the intermediary for any failure to perform those obligations are governed by the account agreement (Article 3 (2) (b)), which means the account agreement and the law applicable to it.

25. The point is that the satisfaction of the ultimate investor's interests depends not on one account agreement, but on several, linked in a chain. The higher-tier account agreements are normally agreements between intermediaries, often belonging to a same economical "group". It is to be expected that they shall try to reduce, as much as possible, the extent of their duties and liability. Obviously, the ultimate investor may try to have an account agreement which fully guarantees him. But account agreements are normally standard agreements, prepared by the intermediary.

Since the reliability of the "indirect holding of securities" depends on the extent of the intermediaries' obligations and liability, it seems to me that the Convention must include more and stronger provisions on the

intermediaries' duties than is currently the case in the *Draft Convention*.

26. Regarding the extent of the intermediaries' obligations, two kinds of solutions are possible.

The first one would mean that each intermediary would *guarantee results*, without prejudice of his right of recourse against upper-tier intermediaries, the non fulfilment of their obligations by upper-tier intermediaries not being opposable to the account holder. For a weaker provision, the formula of UCC Article 8 could be used: *"due care in accordance with reasonable commercial standards"* (§ 8-506 (2) and -507 (a) (2)).

Another issue would be whether the rules on the intermediaries' duties should be mandatory or could be superseded by the account agreements and to what extent.

27. Now, let us assume that the intermediary does not guarantee the fulfilment, by the upper-tier intermediaries, of their obligations. And let us imagine that the issuer has paid dividends or interest, but the account holder has not received the corresponding amount; or that he gave instructions to the intermediary for convertible bonds to be converted or bonds to be redeemed and he does not find in his account the result therefrom; or that he gave instructions for shares credited to his account to vote in some sense and no shares have voted in that sense; or that he gave instructions to subscribe a capital increase based on rights, he has even paid for such subscription, but no new shares are found in his account... He asks his intermediary what happens. This one answers: I have not received the money from my intermediary; or I have transmitted the instructions (and eventually the money) upstream... I have done what I should...

The relevant intermediary has fulfilled his obligations. Perhaps it is the next intermediary who has failed or a higher-tier one. Each intermediary will have some rights against the next one. But such are rights of each intermediary, not of the (ultimate) account holder.

The exercise by the intermediary of his rights against the higher-tier intermediary is a prerequisite for the satisfaction of the account holders' rights by specific performance. The intermediary's *duty to exercise* his rights against the higher-tier intermediary is a prerequisite for the satisfaction of the account holders' rights by whatever means.

28. The only way to protect the account holder, allowing him to claim even damages, is, first of all, to establish that **the intermediaries have**

the duty to exercise their rights against higher-tier intermediaries, to the extent such exercise is required by the account holder's rights.

But it is also necessary that the intermediaries' duties have a minimum content. Otherwise, the intermediaries' duty to exercise their rights could be practically void. Therefore, I suggest that a formula as the UCC's one is used, but, contrary to what happens with UCC's Article 8, as a mandatory minimum standard. The steadiness and the reliability of the system depend on it.

Mandatory provisions limiting clauses excluding or reducing intermediaries' liability would also have to be inserted.

Another way, suggested by my partner João Soares da Silva, would be the following: each intermediary would guarantee to his account holder duties of higher-tier intermediaries owed to him with the same contents as the duties that, according to the account agreement, he owes to the account holder.

E) Upper-tier attachment, *subrogatio* and insolvency of an intermediary (Articles 4 (3) and 8)

29. Preclusion of "upper tier attachment", except in the event of an intermediary's insolvency, was one of the principles defined as from the *Position Paper*, and it is a sound principle.

The relevant reason is that accounts are not integrated into a system and it is impossible to integrate them into a worldwide system. Without a system, one cannot know whether the lower-tier intermediary has enough securities or whether Article 7 has to apply. Therefore, an upper-tier attachment could grant the account holder more than he would be entitled to as effective in relation to the other account holders, without being possible to know whether such is the case or not. In insolvency proceedings all the claims are brought together so that such risk vanishes.

30. Some countries recognise what could be called a "subrogatory" or "oblique" *actio* (*"action oblique"* in French, *"acção subrogatória"* in Portuguese, *"azione surrogatoria"* in Italian). By it, one person is allowed to file a claim on the basis of another person's (claimed) right. If relief is granted, it may produce its effects just on such person's legal sphere (the subrogatory *actio* will be *indirect*, as is the French *"action oblique"*) or also in the claimant's legal sphere (*direct* "subrogatory" *actio*).

Normally, "subrogatory" *actio* is attributed to creditors, to protect them against the debtor's inaction and the risk of the debtor's insolvency

and is *indirect*. But there are other cases where it is open, as *indirect* or *direct actio*. For instance, the Portuguese Companies Code allows shareholder's holding, at least, 5% of the company's equity to claim, by indirect "subrogatory" *actio*, the liability of directors towards the company (Article 77). Article 1181 (2) of the Portuguese and Article 1705 of the Italian Civil Code allow the principal to substitute himself to the agent in claiming the credit rights arising from the performance of the agency agreement. And Article 13 (2) (a) of the UNIDROIT Convention on Agency in the International Sale of Goods allows the undisclosed principal to exercise the rights against a third party, subject to any defences which the third party may set up against the agent, acquired by the agent on the principal's behalf, where the agent, whether by reason of the third party's failure of performance or for any other reason, fails to fulfil or is not in a position to fulfil his obligations to the principal (*direct* "subrogatory" *actio*).

Should not a solution of the same kind be adopted regarding claims for intermediaries' and even issuer's liability? Since only liability is at stake, the reason against upper-tier attachment does not operate.

It is a matter that, at least, deserves some thought. I note that such a solution would require disclosure duties more complex than the ones foreseen in the Convention on Agency in the International Sale of Goods.

31. The circumstance that the issue regards liability is not, by itself, a ground for excluding the matter from the *Draft Convention*'s scope. In any event, if such was the case, the language of Articles 3 (3) (b) and 4 (3) should be narrower.

Postscript

As referred to in the foreword, a final version of the Preliminary Draft Convention prepared by the Study Group, dated November 2004, has been very recently made available on UNIDROIT's website. Time is too short for an accurate evaluation of the new text. But I cannot conceal some *prima facie* perplexity.

The new draft improves the former one in several respects. For instance, taking into account only the subjects considered in the Comments, the definition of "securities of the same description" is now much better — even though I continue to ask whether securities subject to different objective tax regimes can be considered of the same description for the pur-

poses of the Convention. The new text also deals explicitly with the issue of vote split (Article 17, 2 (a)).

Regarding the duties of intermediaries, the sole improvement is the insertion, in what became Article 2, 3 (b) (formerly, Article 3, 2 (b)), of an explicit reference, between square brackets, to the "applicable law". I maintain my belief that the *minimum minimorum* is to impose to each intermediary the duty to exercise, for the benefit of his account holders, the rights he holds against the next higher-tier intermediary, or against the issuer if the intermediary at stake is the highest-tier. I also think that some further contents of the duties of the intermediaries should have to be determined by the Convention. It cannot be overlooked that, for each investor, not just one, but several account agreements may be involved. The Explanatory Notes refers to the "integrity of the account holder/intermediary relationship" (3.4.4). However, such integrity is considered mainly from the intermediary's side.

The major cause for perplexity lies in that I became aware that the purpose is to include within the Convention's scope the holding of *basic* securities, whenever (but only when) such basic securities are held with an intermediary. The purpose is confirmed by the Explanatory Notes, when stating that *"in order to come within the scope of the future Convention, securities need to be credited to an account held with an intermediary. They exit the regime of this instrument from the moment that they are withdrawn from the system of holding through intermediaries. It should be stressed that the decisive factor is the acquisition of the legal position by the credit of the securities to an account with an intermediary. Thus, it is irrelevant for the application of the Convention whether the intermediary itself retains any legal position in the securities. Consequently, securities are held with an intermediary even if, as is the case notably in jurisdictions following the proprietary legal concept, the intermediary has no position at all and the investor has the full right "in his hands""* (note to Article 1, (1), (f)). This means that dematerialised basic securities "represented" by registration through accounts with intermediaries (as they can be, for example, in Portugal (*), in France (**), and in Spain (***)) would

(*) *Código dos Valores Mobiliários* (Securities Code), Article 61.

(**) *Code Monétaire et Financier*, Article L211-4, according *to Ordonnance 2004-604 du 24 juin 2004*.

(***) *Real Decreto* 116/1992, 14th February, as amended, Article 31.

be covered by the Convention. There is not even a general escape clause of the kind of Article 1 (5) of the Hague Convention.

The point is that the issues relating to basic securities, whether certificated or dematerialised and whatever the form of dematerialisation, are different from the ones related to the so-called "indirect holding". The essential rights of an account holder, when the account "represents" basic securities, are rights against the issuer, not against the intermediary. For instance, should the attachment of basic dematerialised securities be forbidden, as results from the letter of Article 8, even though it is not an upper-tier attachment?

Furthermore, dematerialised basic securities imply particular requirements. They can only be credited to accounts with authorised intermediaries; and, in the event of several intermediaries, they have to be integrated into a system. What became Article 2 (2) (b) (formerly, Article 3 (3) (b)) states (now between square brackets) that the rights resulting from the credit of securities, *"except as otherwise provided by this Convention, by the terms of issue of any securities or by the law under which any securities are constituted, may be enforced only against the relevant intermediary"*. Any law under which basic securities are constituted has to grant rights against the issuer — it is of the very essence of the basic securities. But such law will recognise as basic securities only those which fulfil certain pre-requisites. Does the Draft Convention allow it? The answer would have to be affirmative. But this shows that basic securities, whether they are dematerialised or certificated, belong to a different realm. Will countries adopting dematerialised basic securities systems be prepared to give up their regimes outside a framework where basic securities are considered in general? The possibility of reservations would, at least, be required. And, in any event, specific provisions for basic securities would be necessary.

Other matters need review. For instance, contrarily to what the definition states, the applicable law may have to be the law of a non-party State. Regarding the new version of Article 2 (1) (a) (formerly, Article 3 (1) (a)), it is correct to say that only the account holder acting for its own account has the right to *enjoy* the fruits of the ownership of the securities; but also the intermediary who does not act on its own account is entitled to claim and receive such fruits, in order to transfer them to the lower-tier account holders. In Article 17 it should be made clear that in particular the provisions of paragraph 2 (c) are without prejudice of what may be necessary to verify the compliance with prudential requirements, relating to companies subject to them. And the language of Article 17 should also take

into consideration that there are jurisdictions in which the effects of treaties do not depend on incorporation.

To sum up, I believe that the Committee of Government Experts will have a lot of work to do before the text is suitable for signature (****).

January 12, 2005

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INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW

STUDY GROUP FOR THE PREPARATION OF HARMONISED SUBSTANTIVE RULES ON TRANSACTIONS ON TRANSNATIONAL AND CONNECTED CAPITAL MARKETS

Restricted Study Group on Item 1 of the Project: Harmonised Substantive Rules regarding Securities Held with an Intermediary

Draft convention on substantive rules regarding securities held with an intermediary

(Preliminary discussion draft)

Notice

This draft is a work in progress and it has been released at this time for discussion purposes only. The draft will undergo future revisions as regards both substance and form on the basis of ongoing feedback received from the UNIDROIT project on Harmonised Substantive Rules Regarding Securities Held with an Intermediary.

(****) The period elapsed between the time when the present text was sent for publication (January, 2005) and when the proofs returned for revision (September, 2005) allowed for a third version of the Draft Convention to be issued, renamed *Preliminary Draft Convention on Harmonised Substantive Rules Regarding Intermediated Securities*, Rome, 9/20 May 2005, adopted by the Committee of Governmental Experts (www.unidroit.org/). Several significant improvements have been made, but the text is unclear and insufficient in crucial points. The analysis of this new version has to be left for another occasion

Members of the UNIDROIT Restricted Study Group for this project who have participated in the development of this draft have done so on a strictly personal basis. While their collaboration on the project brings extensive experience in the field from around the world, their views as expressed in this draft do not necessarily reflect the views of the institutions they represent.

Comments on substantive issues raised by this draft may be sent by mail to the International Institute for the Unification of Private Law (UNIDROIT), attn. Philipp Paech, Via Panisperna 28, I-00184 Rome, Italy, or by e-mail to ph.paech@unidroit.org.

Convention on substantive rules
regarding securities held with an intermediary

(Preliminary discussion draft)

CHAPTER I

Interpretation

Article 1

[Definitions and interpretation]

(1) In this Convention:

(a) ***"securities"*** means any shares, bonds or other financial instruments or assets (other than cash) or any interest therein;

(b) ***"securities account"*** means an account maintained by an intermediary to which securities may be credited or debited;

(c) ***"intermediary"*** means a person that 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;

(d) ***"account holder"*** means a person in whose name an intermediary maintains a securities account;

(e) ***"account agreement"*** means, in relation to a securities account, the agreement with the relevant intermediary governing that securities account;

(f) ***"securities held with an intermediary"*** means the rights of an account holder resulting from a credit of securities to a securities account;

(g) ***"relevant intermediary"*** means the intermediary that maintains the securities account for the account holder;

(h) ***"disposition"*** means any transfer of title, whether outright or by way of security, and any grant of a security interest, whether possessory or non-possessory;

(i) ***"perfection"*** means, in relation to a disposition, completion of any steps necessary to render the disposition effective against third parties, and ***"perfected"*** has a corresponding meaning;

(j) ***"adverse claim"*** means, with respect to any securities, a claim that a person has an interest in those securities that is effective against third parties and that it is a violation of the rights of that person for another person to hold or dispose of those securities;

(k) ***"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 a thority for the purpose of reorganization or liquidation;

(l) ***"insolvency administrator"*** means a person authorized to administer a reorganization or liquidation, including one authorized on an interim basis, and includes a debtor in possession if permitted by the applicable insolvency law;

(m) ***"the applicable law"*** means, in relation to the application of this Convention in a Contracting State, the provisions of the law of that Contracting State, other than those provided by this Convention, in relation to the subject matter of this Convention;

Explanatory note

This definition reflects the fact that the Convention is not drafted as a comprehensive code covering all substantive rules relevant to its subject matter, but as a set of key provisions to be incorporated by Contracting States into their existing laws, with whatever modifications of their existing laws are appropriate. As is made clear in various provisions of the Convention, the rules of the Convention must have priority.

(n) ***"enforcement event"*** means, in relation to a relevant collateral agreement, an event on the occurrence of which, under the terms of the relevant collateral agreement, the collateral taker is entitled to enforce its security;

(o) ***"relevant collateral agreement", "collateral provider", "collateral taker", "collateral securities"*** and ***"secured obligations"*** have the meanings respectively given in article 21;

(p) securities are ***"of the same description"*** as other securities if they are securities of the same issuer, of the same currency and denomination, and form part of the same issue, as those other securities, and references to securities of a particular description shall be construed accordingly.

(2) For the purposes of this Convention a person acts with notice of an adverse claim if that person:

(a) knows of the adverse claim; or
(b) is aware of facts sufficient to indicate that there is a significant probability that the adverse claim exists and deliberately avoids information that would establish the existence of the adverse claim.

(3) For the purposes of paragraph (2):

(a) knowledge received by an organization is effective for a particular transaction from the time when it is brought to the attention of the individual conducting that transaction, and in any event from the time when it would have been brought to his attention if the organization had exercised due diligence;
(b) an organization exercises due diligence if it maintains reasonable routines for communicating significant information to the person conducting the transaction and there is reasonable compliance with the routines. Due diligence does not require an individual acting for the organization to communicate information unless such communication is part of his regular duties or unless he has reason to know of the transaction and that the transaction would be materially affected by the information.

CHAPTER II

Scope of the convention

Article 2

Scope of the Convention

[Scope article — to exclude arrangements under which account holders' rights consist solely of purely contractual or personal rights against the intermediary.]

CHAPTER III

Securities accounts and account holders' rights

Article 3

[Rights arising from credit of securities to a securities account]

(1) Subject to the following provisions of this article, the credit of securities to a securities account with an intermediary confers on the account holder the following rights:

(a) the right to receive and enjoy the fruits of ownership of the securities and in particular:

(i) to receive all dividends, distributions and other benefits receivable in respect of the securities;
(ii) to direct the exercise of all voting and other rights exercisable in respect of the securities;

(b) the right, by instructions to the intermediary, to dispose of the securities in any of the ways provided by Chapter IV;
(c) the right, by instructions to the intermediary, to cause the securities to be held by the account holder with a different intermediary;
(d) the right, by instructions to the intermediary, to withdraw the securities so as to be held by the account holder otherwise than with an intermediary, to the extent that the securities may be so held under the law under which the securities are constituted and the terms of issue of the securities;
(e) subject to this Convention, such other rights as may be conferred by the applicable law.

(2) To the extent that the rights referred to in paragraph (1)(a) above are dependent on the assistance of the intermediary:

(a) the rights do not entitle the account holder to receive or effect more than can be received or effected through such assistance as is within the power of the intermediary to provide; and
(b) the manner of performance of the obligations of the intermediary in providing such assistance and the extent of the liability of

the intermediary for any failure to perform those obligations are governed by the account agreement.

(3) The rights referred to in paragraph (1):

(a) are effective against the intermediary and third parties; but
(b) except as otherwise provided by this Convention, by the terms of issue of any securities or by the law under which any securities are constituted, may be enforced only against the relevant intermediary.

Article 4

[Duties of intermediary with respect to the operation of securities accounts]

(1) Subject to paragraph (2), an intermediary:

(a) is bound to give effect to any instructions of an account holder with respect to securities held by that account holder with that intermediary;
(b) is neither bound nor entitled to give effect to any instructions with respect to such securities given by any other person; and
(c) is not bound by or compelled to recognize any interest in any securities credited to a securities account held with it other than the interest of the account holder.

(2) Paragraph (1) is subject to:

(a) the provisions of the account agreement and of any other agreement or undertaking entered into by the intermediary;
(b) the rights of any person (including the intermediary) who holds a security interest created by a disposition effected in the manner specified in article 9(4); and
(c) subject to paragraph (3), any requirement imposed by an order of a court of competent jurisdiction.

(3) The courts of a Contracting State shall not make an order which would enforce or assist in the enforcement, in a manner inconsistent with article 3(3)(b), of any right or claim of:

(a) an account holder;

(b) a person holding or claiming an interest in securities held with an intermediary under any disposition effected by an account holder; or

(c) a person, including without limitation an attachment or execution creditor, seeking to enforce any judgment or claim against a person referred to in (a) or (b) above.

Explanatory note

Paragraph (3) prohibits the making of orders, such as so-called "upper tier attachment" orders, which would disrupt the system of holding securities through intermediaries by permitting an account holder holding securities with an intermediary, or a creditor seeking to enforce a judgment or claim against such an account holder by attaching securities held by the account holder, to obtain an order against a higher-tier intermediary compelling the higher-tier intermediary to freeze or segregate securities held in an account in which the account holder is indirectly interested. The risk of such an order undermines the integrity of the intermediated holding system, because a higher-tier intermediary will typically have no means of identifying any interest of an account holder holding securities with a lower-tier intermediary, but will merely operate an omnibus securities account, in the name of the lower-tier intermediary. The freezing of such an account will therefore damage the interests of all account holders of the lower-tier intermediary and severely disrupt the operation of the system.

Article 5

[Duty of intermediary to hold securities in respect of account holders' rights]

(1) Subject to the following provisions of this article, an intermediary must [acquire and at all times hold][promptly acquire and thereafter maintain] sufficient securities in respect of account holders' rights.

(2) Accordingly an intermediary:

(a) subject to paragraph (3), may not credit securities to a securities account;

(b) may not dispose of securities held by it;

if it would as a result hold insufficient securities in respect of account holders' rights.

[(3) Paragraph (2) does not preclude an intermediary, in circumstances permitted by the applicable law for the promotion of liquidity in a system for the settlement of transfers of securities, from crediting securities to a securities account in anticipation of a related credit of securities.]

(4) The fact that a credit or disposition is made in contravention of paragraph (2) does not render that credit or disposition ineffective, but:

(a) the intermediary must immediately take steps to ensure that it holds sufficient securities in respect of account holders' rights; and
(b) this paragraph does not affect any liability of the intermediary to compensate an account holder for any loss arising from the contravention.

(5) If an intermediary holds insufficient securities in respect of account holders' rights because it holds or has held securities with another intermediary (***"the higher-tier intermediary"***) and the number or amount of the securities so held has been reduced under article 5 as a result of the insolvency or other default of the higher-tier intermediary, the intermediary is obliged to eliminate the deficiency by acquiring securities out of its own resources, except to the extent that the account agreements between the intermediary and its account holders provide otherwise [in circumstances where the intermediary is obliged by those agreements to hold securities of the relevant kind with the higher-tier intermediary or there is no intermediary other than the highertier intermediary with which the intermediary is able to hold securities of the relevant kind].

(6) For the purposes of this article an intermediary holds insufficient securities in respect of account holders' rights if the number or amount of securities appropriated to the rights of account holders under article 6 is less than the number or amount required by that article to be so appropriated.

Explanatory notes

(1) Paragraph (3) provides a limited exception to the general prohibition on any mismatch between the balances on securities accounts maintained by an intermediary and the underlying securities held by the intermediary and appropriated to account holders. The exception reflects the operational practice in some securities settlement systems, where large volumes of transactions are processed and credits may be made in the

expectation of matching receipts of cash or securities, generally in the same day or processing cycle. This exception will apply only where the applicable law so provides and will be subject to the regulatory requirements applicable to the relevant system.

(2) The effect of paragraphs (4) and (5) is that a lower-tier intermediary underwrites the solvency and integrity of a higher-tier intermediary except to the extent that this duty is excluded or limited by its agreements with its account holders. If the words within square brackets at the end of paragraph (5) are included, provisions excluding or limiting this duty will be permitted only in certain fairly narrowly defined circumstances — essentially where the intermediary has no choice but to hold securities of the kind in respect of which the deficiency arises with the particular highertier intermediary which has become insolvent, for example because they are securities which, under the law or holding system of a particular jurisdiction, may be held only through one intermediary such as a CSD. The scope for contractual modification in this paragraph contrasts with paragraphs (2) and (3), which do not leave any flexibility for account agreements to permit deliberate "overcrediting" by the intermediary. These provisions raise policy questions which need to be discussed.

Article 6

[Appropriation of securities to account holders' rights: securities so appropriated not property of the intermediary]

(1) Securities of each description held by an intermediary (whether or not with another intermediary) are appropriated to the rights of account holders to the extent necessary to ensure that the aggregate number or amount of the securities of that description so appropriated is equal to the aggregate number or amount of such securities credited to securities accounts maintained by the intermediary.

(2) The securities so appropriated do not form part of the property of the intermediary available for distribution among or realization for the benefit of its creditors in the event of an insolvency proceeding in respect of the intermediary or otherwise subject to claims of creditors of the intermediary.

(3) The means by which securities are appropriated in accordance with this article are determined by the applicable law.

Explanatory note

Paragraph (3) recognizes that different legal systems use different techniques for ensuring that securities held for account holders are protected from the insolvency of the intermediary. In particular, such protection may be conferred by creating a segregated pool of account holders' securities. A segregation requirement may also be imposed as a matter of regulation. Segregation is not imposed by the Convention, but Contracting States remain free to provide for it, either as a regulatory requirement or as part of the legal mechanism by which the appropriation required by this article is achieved (or both).

Article 7

[Effect of insufficiency of securities held in respect of account holders' rights]

(1) This article applies where an intermediary holds insufficient securities in respect of account holders' rights.

(2) A deficiency in respect of securities of a given description shall for all purposes (including without limitation that of allocating among account holders any loss arising from the deficiency on the insolvency of the intermediary or otherwise) be treated as allocated to the account holders to whose securities accounts securities of that description are credited, in proportion to the respective numbers or amounts of securities so credited.

(3) In any allocation required under paragraph (2) no account shall be taken of:

(a) the origin of, or any past dealings in, any securities held by the intermediary in respect of account holders' rights; or

(b) the order in which or time at which any securities are credited or debited to the respective securities accounts of account holders.

(4) Paragraph (3) does not preclude any rule of law or provision of an account agreement requiring or permitting securities to be debited to the securities account of a particular account holder in circumstances where:

(a) the account holder has delivered or transferred to an intermediary, for credit to the account holder's securities account, securities which had not previously been held with an intermediary; and

(b) it is subsequently shown that those securities are not free from adverse claims following that delivery or transfer.

Article 8

[Protection of rights of account holders on insolvency of intermediary]

(1) This Chapter applies notwithstanding the opening of an insolvency proceeding in respect of an intermediary; and accordingly the rights of an account holder constituted by the credit of securities to a securities account are effective against the insolvency administrator and creditors in the insolvency proceeding.

(2) Following the opening of an insolvency proceeding in respect of an intermediary, article 3(3)(b) does not prevent an account holder who holds securities with that intermediary from himself taking any action which the intermediary is, or would but for the opening of the insolvency proceeding be, obliged to take for the purpose of giving effect or assisting in giving effect to the rights of the account holder under article 3(1).

Explanatory note

Paragraph (2) constitutes an exception to the general rule that account holders may enforce their rights only against their immediate intermediary. In order to ensure that account holders are not deprived of the ability to enforce their rights where their intermediary has become insolvent, the normal rule is disapplied so that account holders may, for example, be able to give instructions for the transfer of their securities to another intermediary even if there is no insolvency administrator of the former intermediary able or willing to act on their behalf.

CHAPTER IV

Acquisition and disposition of securities held with an intermediary

Article 9

[Acquisition and disposition of securities held with an intermediary]

(1) Securities held with an intermediary are acquired by an account holder by the credit of those securities to a securities account of that account holder.

(2) Without limiting paragraph (1), no further step or event is necessary, or may be required by law, as a condition of the vesting of securities held with an intermediary in an account holder.

(3) An account holder may dispose of securities held with an intermediary:

(a) by causing them to be debited to his securities account on terms that the securities will be transferred to the intermediary for its own account;
(b) by causing them to be debited to his securities account on terms that a corresponding credit will be made to a securities account of another person with the intermediary or with another intermediary.

(4) An account holder may create a security interest over securities held with an intermediary, or over a securities account, by causing the securities or the account to be delivered into the control of another person.

(5) A security interest so created with respect to a securities account has effect with respect to all securities from time to time credited to the relevant account, without the need for any further identification or appropriation of particular securities.

(6) The above rules do not preclude any other method provided by the applicable law for the acquisition or disposition of securities held with an intermediary, provided always that the priority of an interest created by any such other method is subject to the rules in article 13.

Explanatory note

As paragraph (6) makes clear, it is not envisaged that the Convention would set out an exhaustive rule on the possible forms of disposition or attempt to ban "informal" dispositions (dispositions effected otherwise than by book entry). The principle of supremacy of book entry dispositions over other dispositions is reflected in the rules on priorities in article 13.

Article 10

[Netting and tracing of debits and credits to securities accounts]

(1) Debits and credits to securities accounts may be effected on a net basis.

(2) A debit or credit of securities to a securities account is not ineffective because it is not possible to identify a securities account to which a corresponding credit or debit is effected.

Article 11

[Control]

(1) The following rules determine when an account holder is to be treated as causing securities held with an intermediary, or a securities account, to be delivered into the control of another person.

(2) If an account holder agrees with an intermediary to grant to that intermediary a security interest in securities, or in a securities account, held by the account holder with that intermediary, he thereby delivers those securities or that securities account into the control of the intermediary.

(3) If an account holder causes securities, or a securities account, held by the account holder with an intermediary to be designated or appropriated in a manner such that the intermediary will give effect to any instructions that it may receive from another person for the further disposition or transfer of the securities, or of the securities from time to time credited to the securities account, [and enters into arrangements which provide for the securities account and any account statements relating to the securities account to be annotated in such manner as to indicate that such designation or appropriation has been made,] he thereby delivers the securities, or the securities account, into the control of that other person.

[Explanatory note]

The effect of the words included in square brackets is to make the effectiveness of control created by agreement with the intermediary dependent on an element of publicity, requiring that the securities account and any account statements be annotated in such a manner as to make the control arrangement apparent. It is for discussion whether this should be a necessary element of control.

Article 12

[Perfection of dispositions of securities held with an intermediary]

(1) A disposition of securities held with an intermediary which is effected in a manner specified in article 9(3) or (4) is thereby perfected.

(2) Paragraph (1) does not preclude any other rule of the applicable law relating to the perfection of a disposition of securities held with an intermediary, provided always that the priority of an interest perfected otherwise than by one of the methods referred to in paragraph (1) is subject to the rules in article 13.

Article 13

[Priority among competing dispositions]

(1) The following rules determine priority among interests arising under dispositions of securities held with an intermediary, subject to any contrary agreement between persons entitled to any such interests.

(2) Subject to paragraph (5), an interest which has been perfected has priority over an interest which has not been perfected.

(3) Interests created by dispositions perfected under article 12(1):

(a) have priority over any interest created by a disposition perfected in any other manner permitted by the applicable law; and

(b) rank among themselves in the following order:

(i) first, a disposition perfected in the manner specified in article 9(3);

(ii) second, a disposition perfected by the delivery of control of the securities to the relevant intermediary;

(iii) third, a disposition perfected by the delivery of control of the securities to a person other than the relevant intermediary.

(4) Two or more dispositions perfected by the delivery of control of the securities to a person other than the relevant intermediary rank among themselves in the order in which they were so perfected.

(5) An interest arising by operation of law under any mandatory rule of the applicable law has such priority as is afforded to it by the rule in question.

(6) Subject to the preceding provisions, the priority of any competing interests is determined by the applicable law.

Explanatory note

This article creates a "cascade", ranking interests in five tiers for purposes of priority – (a) interests perfected by book entry transfer to a new

account; (b) perfected interests of the intermediary; (c) interests of other persons perfected by control (with precedence among competing interests at this level being determined by time (paragraph (4)); (d) other perfected interests (paragraph (2)); and (e) unperfected interests. Mandatory liens imposed by law have the priority given by the relevant law (paragraph (5)).

CHAPTER V

Protection from adverse claims

Article 14

[Protection of intermediary]

(1) An intermediary which, otherwise than by a credit to a securities account held by it with another intermediary, acquires securities for credit to a securities account maintained or to be maintained by it, or otherwise in pursuance of an obligation under article 5, is not subject to any adverse claim subsisting with respect to those securities at the time of the acquisition if the intermediary does not at that time have notice of the adverse claim.

(2) An intermediary which disposes of securities (whether or not held with another intermediary) in pursuance of instructions given by an account holder or by a person who holds a security interest perfected in accordance with article 12 is not liable to a person having an adverse claim with respect to those securities unless:

(a) the intermediary acts in contravention of an order of a competent court;
(b) the adverse claim arises from an interest created by a disposition perfected under article 12(1) or under the applicable law; or
[(c) the intermediary acts in collusion with another person and with the intention of violating the rights of the adverse claimant.]

Article 15

[Acquisition from intermediary]

(1) A person who acquires an interest in securities (whether or not securities held with an intermediary) from an intermediary under a disposition effected in contravention of article 5(2) is not subject to any adverse

claim in respect of the rights of account holders of that intermediary if that person does not at that time have notice that the disposition is effected in contravention of article 5(2).

(2) This does not apply where the interest is acquired by way of gift or otherwise gratuituously.

Article 16

[Acquisition by account holder]

(1) An account holder who acquires securities by credit to his securities account is not subject to any adverse claim subsisting with respect to those securities at the time of the credit if the account holder does not at that time have notice of the adverse claim.

(2) This does not apply where the interest is acquired by way of gift or otherwise gratuituously.

Article 17

[Acquisition from account holder by delivery of control]

A person who acquires or perfects a security interest in securities held with an intermediary by obtaining control of those securities in accordance with article 11 is not subject to an adverse claim subsisting with respect to those securities at the time that he obtains control if that person does not at that time have notice of the adverse claim.

Article 18

[Reversal of debits and credits to securities accounts]

Without prejudice to any special rule of the applicable law regarding the finality of dispositions effected through securities accounts (including securities accounts maintained by an intermediary acting in the capacity of central securities depository or operator of a clearing or settlement system):

(a) a debit or credit of securities to a securities account may not be reversed so as to prejudice an intermediary who, without notice of any defect in or with respect to that debit or credit,

has effected a further debit or credit which is dependent on it; and

(b) a credit of securities to a securities account of an account holder may not be reversed so as to prejudice that account holder if the account holder, without notice of any defect in or with respect to that credit, has effected a further disposition of the securities thereby credited to the securities account.

CHAPTER VI

Position of issuers of securities held with an intermediary

Article 19

[Position of issuers of securities]

(1) Any rule of law of a Contracting State, and any provision of the terms of issue of securities constituted under the law of a Contracting State, which would prevent the effective exercise by an account holder of the rights specified in article 2(1)(e) shall be modified to the extent required to make possible the effective exercise of those rights.

(2) Subject to paragraph (1), nothing in this Convention makes an issuer of securities bound by, or compels such an issuer to recognize, a right or interest of any person in or in respect of such securities to an extent greater, or in circumstances more extensive, than is provided by the law under which the securities are constituted and the terms of issue of the securities.

Explanatory note

Paragraph (1) requires Contracting States to make limited changes to their corporate law to the extent that their corporate law currently incorporates rules which inhibit the effective enjoyment of rights in securities held with an intermediary. An example would be a corporate law rule which does not permit a holder of a block of shares, for example a nominee or custodian acting for an intermediary, to split the votes on the shares so as to reflect the voting instructions of different account holders. Paragraph (2) makes it clear, however, that Contracting States are not obliged to make more radical changes so as to treat account holders as if they were direct holders of the securities.

Article 20

[Rights of set-off]

(1) Subject to paragraph (2), if:

(a) an insolvency proceeding has been commenced in respect of an issuer of debt securities;
(b) an account holder holds debt securities of that issuer with an intermediary; and
(c) a set-off would, or could at the election of the account holder, be effected between the rights of that account holder and any claim of the issuer against the account holder if the account holder held a document of title to those securities or were recorded in a register of title as the holder of those securities;

then such a set-off shall be effected, or, as the case may be, be to the same extent and in thesame manner capable of being effected, notwithstanding the fact that the account holder holds the securities with an intermediary.

(2) This article does not affect any express provision of the terms of issue of the relevant securities, save to the extent that any such express provision is overridden by any mandatory rule of law applicable in the relevant circumstances.

Explanatory note

The effect of this article is that, in insolvency proceedings against an issuer of debt securities, the fact that such securities are held through one or more intermediaries does not, of itself, affect any mandatory or optional set-off which would have occurred or been available had the securities been held directly; but this is subject (paragraph (2)) to any express provision to the contrary in the terms of issue (e.g. a provision that the issuer is entitled to ignore rights of indirect holders or that rights under the securities are immune from set-off against extraneous claims), save to the extent that such provisions may themselves be invalidated as being contrary to mandatory rules of law (e.g. a rule making set-off obligatory in the insolvency proceedings).

CHAPTER VII

Collateral: enforcement and right of use

Article 21

[Special provisions on enforcement]

(1) This article applies in respect of an agreement (a ***"relevant collateral agreement"***) under which a person other than a natural person (the ***"collateral provider"***) creates a security interest in favour of another person (the ***"collateral taker"***) in securities held with an intermediary which are of a kind regularly traded on a financial market (the ***"collateral securities"***) in order to secure the performance of financial obligations of any kind referred to in paragraph (2) (the ***"secured obligations"***).

(2) The secured obligations may consist of or include any obligation of a financial character, including:

(a) present or future, actual or contingent or prospective obligations (including obligations arising under a master agreements, whether under a provision for the acceleration or close-out of obligations or otherwise);
(b) obligations to deliver securities or other property;
(c) obligations owed to the collateral taker by a person other than the collateral provider;
(d) obligations of a specified description arising from time to time.

(3) On the occurrence of an enforcement event, the collateral taker may realize the collateral securities:

(a) by selling them and applying the net proceeds of sale in or towards the discharge of the secured obligations;
(b) by appropriating the collateral securities as the collateral taker's own property and setting off their value against, or applying their value in or towards the discharge of, the secured obligations, provided that the relevant collateral agreement provides for realization in this manner and specifies the basis on which collateral securities are to be valued for this purpose.

(4) Collateral securities may be realized under paragraph (3):

(a) subject to any contrary provision of the relevant collateral agreement, without any requirement that:

(i) prior notice of the intention to realize shall have been given;
(ii) the terms of the realization be approved by any court, public officer or other person; or
(iii) the realization be conducted by public auction or in any other prescribed manner;
and

(b) notwithstanding the commencement or continuation of an insolvency proceeding in respect of the collateral provider or the collateral taker.

(5) Realization under paragraph (3) shall be effected in a commercially reasonable manner.

Article 22

[Special provisions on the right to use collateral securities]

(1) If and to the extent that the terms of a relevant collateral agreement so provide, the collateral taker shall have the right to use and dispose of the collateral securities as if it were the owner of them (a ***"right of use"***).

(2) Where a collateral taker exercises a right of use, it thereby incurs an obligation to replace the collateral securities originally transferred (the ***"original collateral securities"***) by transferring the same number or amount of securities of the same description to the collateral provider not later than the performance of the secured obligations.

(3) Securities transferred under paragraph (2) at a time before the secured obligations have been fully discharged:

(a) shall, in the same manner as the original collateral securities; be subject to a security interest under the relevant collateral agreement, which shall be treated as having been created at the same time as the security interest in respect of the original collateral securities was created; and
(b) shall in all other respects be subject to the terms of the relevant collateral agreement.

(4) The exercise of a right of use shall not render invalid or unenforceable any right of the collateral taker under the relevant collateral agreement.

(5) The relevant collateral agreement may provide that, if an enforcement event occurs before the secured obligations have been fully performed, either or both of the following shall occur, or may at the election of the collateral taker occur, whether through the operation of netting or set-off or otherwise:

(a) the respective obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value or are terminated and replaced by an obligation to pay such an amount;
(b) an account is taken of what is due from each party to the other in respect of such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party.

Article 23

Declarations in respect of Chapter VII

A Contracting State may, at the time of signature, ratification, acceptance, approval or accession, make a declaration that this Chapter shall not apply in respect of the law of that Contracting State.

CHAPTER VIII

Special provisions on settlement finality

[to be added]

CHAPTER [IX]

Final clauses

Article 24

[Modification of conflicting principles or rules of law]

If any principle or rule of the law of a Contracting State would be contrary to or inconsistent with any provision of this Convention, the relevant

provision of this Convention shall prevail and any such principle or rule is modified to the extent required to ensure that the provisions of this Convention have effect in accordance with their terms.

Explanatory note

This article makes it clear that the express terms of the Convention prevail over any contrary result which would otherwise follow from the general rules of the domestic law of a Contracting State. The Convention is not intended to require wholesale harmonization of the substantive laws of Contracting States, and in particular is structured to as to permit the core substantive provisions embodied in the Convention to be incorporated into the laws of Contracting States which adopt different conceptual frameworks and characterizations of the rights arising from the holding of securities with intermediaries; but some of the consequences which would generally flow from such concepts and characterization will sometimes be modified by the express terms of the Convention.

[Other final clauses to be added]