



UNIDROIT INITIATIVE

HARMONIZATION PROJECT OF SUBSTANTIVE RULES OF SECURITIES HELD THROUGH THE INTERMEDIARIES

Important explanation: This document was prepared by the ACSDA's Legal Committee. Nevertheless, it does not constitute a recommendation or suggestion regarding the convenience or not of the execution or adoption of the Convention.



Report on the Harmonization Project of Substantive Rules of Securities Held Through the Intermediaries - UNIDROIT¹

Background – The relevance of the Convention within the securities market

In September 2002, UNIDROIT (International Institute for the Unification of Private Law) started a project called “*Harmonized Substantive Rules Regarding Intermediated Securities*” which aim is to create an International instrument (Convention) that will develop the legal structure regarding the holding and transfer of securities, with special emphasis on cross-border situations.

The objective of this convention is to reduce the lack of legal certainty, protect investors and enhance the economic efficiency through the harmonization of substantive laws that regulate the property of assets and rights of investors. The First draft of the Convention was completed by a world group of specialists in the year 2004; and in May 2005 the first intergovernmental plenary meeting was held in the city of Rome.

The importance of this convention comes from the need of guarantying the stability of the financial system in a more globalized market, in which the transactions with assets and their derivatives² involve individual and financial instruments regulated by different jurisdictions. In fact, the increasing of legal uncertainty and the potential effect it has on systemic risk has played an increasing role in the discussion carried out in diverse international forums of regulators (i.e. the strong task performed by CPSS/IOSCO) and the market (i.e. The G-30 group). A clear example of the importance of the subject is the legal protection given in the case of the execution of collaterals deposited abroad with the aim of covering the risk of transactions executed in the Clearing Houses, in the event of insolvency of one or more participants.

The same concern has led to the creation of the Hague Convention, approved in 2002, which aim was to define the rules that allowed to identify, in an objective way, the applicable law in cases of dispute on property of assets and priority criteria in the execution of collaterals in the event of insolvency (without implying, in the meantime, any substantive modification in the legislation of each jurisdiction).

¹ This report has been prepared after the 3rd. Session of intergovernmental Experts held in Rome during November 2006.

² Futures, options, forwards.



Regarding the Hague Convention, it is worth mentioning that it was included in the recommendations of the *CPSS-IOSCO Task Force* for central counterparties (CCPs), of November 2004 and of the G-30 published in 2003. Also, the Convention was signed by the USA and Switzerland on 5 July 2006.³ On the same day, the European Commission released the results of its “*legal assessment of certain aspects*” of the Convention. The Commission concludes in particular that “*adoption of the Convention would be in the best interest of the Community*” and recommends that Convention “*be signed after or with at least two of its main trading partners, the USA included.*”

The UNIDROIT Convention: presumptions, main topics and activities agenda

Although the Hague Convention has taken an important step, its scope is limited when it does not respond satisfactorily to the two key questions that ensure the reduction of the legal uncertainty in a cross-border transactions context:

- (1) Is the legal base of the selected jurisdiction from the application of the convention’s rules clear and reliable?
- (2) Is the domestic law compatible with the law of other jurisdictions in a global context?

This is the challenge that UNIDROIT is set to face: promote the basic harmonization of the substantive legislation regarding the asset property and the rights that origin from it, in intermediated systems.

Among the subjects approached by the Convention, these are the most important:

- (i) Description of the rights of the investor in intermediate systems
- (ii) Protection of the investor in the event of insolvency of intermediaries.
- (iii) Intermediaries’ duties.
- (iv) Finality of transactions.
- (v) Recognition of the securities settlement systems, and its prevalence on other devices in the event of insolvency and others circumstances.
- (vi) Constitution and execution of collaterals or other types of guarantees on assets.

³This joint signing gave the Convention its date (5 July 2006) although the final text of the Convention was adopted in December 2002.



- (vii) Rights of property and priority criteria in the execution of collaterals in the event of insolvency and others circumstances.

The basic presumptions adopted by UNIDROIT are neutrality and functionality (respect for the different legal customs) and the compatibility (with other existing instruments such as the Hague Convention and the European Union Directives).

UNIDROIT expects the closing of the work for this convention in 2007/2008. The chronogram for this project is the following:

2002/2004: drafting of the first version of the convention by a Group of Specialist;

2004: Preliminary meeting in selected countries.

2005: March – 1st Intergovernmental Plenary Meeting in Rome

- Meetings / Regional Seminars
- Europe: September, Switzerland.
- Latin America: October, Sao Paulo

2006: March – 2nd Intergovernmental Plenary Meeting in Rome

- November - 3rd Intergovernmental Plenary Meeting in Rome
Creation of Transparent Systems Working Group

2007: May – 4th. Intergovernmental Plenary Meeting in Rome

Introduction of the project for its approval in a diplomatic environment.

The Position of Countries Regarding their Legal System

In order to encourage the participation of representatives from every country, a detailed analysis of every section of the convention is made prior to the meeting, comparing it with every national legal structure and the practices established in the market. This allows the delegates to make suggestions taking into consideration their own systems.

It is important to recognize therefore, the existence of two main systems of securities holding:

- Non - Transparent Systems. These are the systems in which the securities are registered in omnibus accounts on behalf of the intermediaries of the CSD.⁴ The final investors

⁴ These intermediaries can be brokers, banks, and financial institutions.



only exert their rights when dealing with issuers or third parties, through their intermediary. These systems are called Non – Transparent Systems, since they only accept omnibus accounts on behalf of the intermediaries, without identifying the final holder of securities. Under these systems the intermediaries play the most important role.

- Transparent Systems. In these systems, the final holders are identified, since the identification system organizes the holder's structure in accounts on behalf of the intermediaries, and sub accounts on behalf of the final holders, and this is why the ownership and the exertion of rights of the securities registered in such a way differs substantially from the systems of global/omnibus accounts. In these transparent systems where the final holder is identified, the rights of such holders enjoy the necessary attention from issuers and third parties.

The Main Characteristics of the Convention

During the debate of different articles of the convention's project, the two above mentioned principal models were highlighted.

As we have already mentioned, the solutions about different aspects regarding the holding of such securities through intermediaries and the execution of such rights, differs in function of the registration model and the custody that they adopt.

This is how through the meetings, several discussions arose when adopting measures under the global accounts systems that are not applicable in the final holder identification system, or vice versa.⁵

The following principal aspects are included in The Convention, in the below mentioned sections⁶:

- Section I: this section contains definitions, scope of application of the Convention and principles for its interpretation.
- Section II: contains scope of propriety rights of securities' account owners.

⁵ e.g. Collateral execution, pledges, upper – tier attachment.

⁶ The document containing the current version of the Convention, as approved by the 3rd Intergovernmental Plenary Meeting in Rome, can be seen in the UNIDROIT website (www.unidroit.org – Study LXXVIII – Doc. 57)



- Section III: defines the ways of acquiring securities and perfection of collaterals on them. It also includes the validity of other ways of acquiring securities, and presumptions for invalidity and reverse of credits and/or debits. Lastly, it regulates the provisions on good faith acquisition and priorities.
- Section IV: this section regulates the circumstances related to intermediaries and its different solutions, such as bankruptcy and its effects, prohibition of upper-tier attachment, instructions and loss sharing. It also includes solutions that limit the intermediaries' responsibility, and finality rules for instructions delivered before the opening of bankruptcy processes.
- Section V: this chapter contains dispositions that rule the position of securities issuers.
- Section VI; the whole section regulates the diverse situations related to constitution of collaterals on securities, its effect and rights of the different parties. It must be mentioned that any State, when signing the Convention, is able to declare that this Section is not applicable at all (opt-out clause), or that it is not applicable to certain persons or transactions.⁷

Lastly, the Secretariat of UNIDROIT prepared a paper regarding the format that the document should have to be binding on the member countries. Two possibilities were foreseen:

- a) HARD LAW implies a convention or treaty that, once approved by the states, becomes compulsory for the whole territory.

The advantage of this mechanism is the automation reached in the harmonization, but the disadvantage is that lots of states will delay the confirmation until they are sure of the impact on the legislation, or even worse, it can occur that the treaty is never ratified.

- b) SOFT LAW implies that its format becomes model law or best practice as based on the recommendations of UNIDROIT. If this route were to be taken, countries would be free with respect to implementation..

It can be implied that in this case, it would be easier for the states to adopt it, but the possibility of leaving it without effect at any moment creates a bigger weakness in the harmonization.

⁷ e.g. transactions between natural persons, or for certain securities defined by the contracting State.



Nevertheless, the debate continues and notwithstanding the importance of the study of the format that the convention may have, it was decided to wait for the final version of the convention before the final decision is made.

Conclusions and goals

Whilst recognizing that a deeper analysis of the last draft of the project is needed, the Legal Committee can conclude at this stage that the aim of the Convention is met with regard to acknowledging the two main stream holding patterns of registration and custody systems of securities..

Related to this topic, a working group has been set in order to analyze the impact of the Convention in those countries which have the so called Transparent Systems.⁸

It is also of paramount importance that each country encourages debate about the Convention, and should also get involved in joint discussions with other important institutions of the Capital Markets (Stock Exchanges, Money Markets, regulatory bodies, Ministry of Economy, etc.)

Finally, and even though controversial aspects might remain unresolved, , it is foreseen that consensus regarding the harmonization rules could be obtained, and that the abovementioned law will be approved either as a convention or as a law model.

However, in the market's globalization context, the acceptance of the specific standard that comes into force will be determined by each market.

Consequently, it will be advisable to examine the last version of the Convention's Project to confirm the consistency of the proposed solutions with the different legal holding systems and its custody of securities.

⁸ See www.unidroit.org – Study LXXVIII – Doc. 44