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from: General Secretariat of the Council
to: Committee on Civil Law Matters (UNIDROIT Coordination)
Subject: Draft Official Commentary on the draft Convention on substantive rules regarding intermediated securities

Delegations will find herewith the draft Official Commentary on the draft Convention on substantive rules regarding intermediated securities with a view to the meeting of the Committee on Civil Law Matters (UNIDROIT Coordination) on 13 July 2009.



INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW
INSTITUT INTERNATIONAL POUR L'UNIFICATION DU DROIT PRIVE

**DIPLOMATIC CONFERENCE TO ADOPT A
CONVENTION ON SUBSTANTIVE RULES
REGARDING INTERMEDIATED SECURITIES
Final session**

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DRAFT OFFICIAL COMMENTARY

on the

draft Convention on Substantive Rules regarding Intermediated Securities

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Introductory note by the Secretariat

1. By its Resolution No. 2, adopted with the Final Act of its first session (CONF. 11 - Doc. 47 Rev.), the diplomatic Conference to adopt a Convention on Substantive Rules regarding Intermediated Securities requested the preparation of a draft Official Commentary on this text by the Chairperson of the Drafting Committee, in close co-operation with no more than three members of the Drafting Committee, the Chairperson of the Commission of the Whole, the Chairperson of the Final Clauses Committee, the Chairperson of the Credentials Committee, the Co-Chairpersons of the Committee on Emerging Market Issues, Follow-up Work and Implementation, the Chairperson of the Working Group on Insolvency and the Co-Chairpersons of the Working Group on Settlement and Clearing Systems, as well as with the UNIDROIT Secretariat.

2. A "Steering Committee", consisting of Mr Hans Kuhn (Chairman of the Commission of the Whole), Mr Sébastien Cochard (Chairperson of the Final Clauses Committee), Mr Mohammed Kawu Ibrahim / Mr Edosa Kennedy Aigbekaen (Chairperson of the Credentials Committee), Mr Antonio Paulo Cachapuz de Medeiros and Ms Huang Cheng (Co-Chairpersons of the Committee on Emerging Market Issues, Follow-up Work and Implementation), Ms Karin Wallin-Norman (Chairperson of the Working Group on Insolvency) and Ms Joyce Hansen and Mr Konstantinos Tomaras (Co-Chairpersons of the Working Group on Settlement and Clearing Systems), co-ordinated the work of the Editors (Mr Hideki Kanda, Mr Charles Mooney, Mr Luc Thévenoz and Mr Stéphane Béraud, assisted by Mr Thomas Keijser of the Secretariat) and reviewed the draft Official Commentary submitted to the Steering Committee by the Editors. The Editors invited a number of additional experts to write initial drafts of parts of the draft Official Commentary, which were subsequently edited by the Editors in respect of content and style, resulting in a text for which the Editors take full responsibility.

3. The draft Official Commentary explains the substantive law provisions set out in Chapters I-VI of the draft Convention.

4. In line with the requests of the Commission of the Whole during the first session of the diplomatic Conference, as set out in the Daily Report of the first session, the draft Official Commentary gives specific attention to the following issues:

With respect to the issue as to whether the rules of Central Securities Depositories should be given recognition by the Convention and in which way that recognition ought to be expressed, the Commission favoured option 1, i.e. to clarify the issue in the Official Commentary to the Convention. (See CONF. 11 – Doc. 21, Report (1 September), section 9.)

It was agreed that the expression 'third parties' in Article 14(2) [new Article 18(2)] would not cover issuers and that this issue of scope would be reflected in the Official Commentary. (See CONF. 11 – Doc. 25, Report (4 September), section 3.)

It was agreed that if an intermediary acquires intermediated securities and enters a corresponding credit to its account holder's account, the acquisition is not "made by way of gift or otherwise gratuitously" within the meaning of Article 14(3) [new Article 18(3)]. This should be clarified in the Official Commentary. (See CONF. 11 – Doc. 25, Report (4 September), section 4.)

In respect of Article 14(4)(c) [new Article 17(c)] it was decided that organisations should, as a principle, be treated in the same manner as individuals. The text was left unchanged. Who qualifies as an organisation and the situation of a principal whose knowledge could be attributed to a nominee should be treated in the Official Commentary. (See CONF. 11 – Doc. 25, Report (4 September), section 6.)

[T]he word ‘creation’ in Article 4 [new Article 5] was retained, and its content will be described in detail in the Official Commentary. (See CONF. 11 – Doc. 29, Report (5 September), section 7.)

A more detailed explanation regarding the meaning of ‘instruction’ and ‘irrevocability’ [in new Article 27] will be given in the Official Commentary. (See CONF. 11 – Doc. 30, Report (6 September), section 2).

[I]t was decided that the Official Commentary should reflect that the whole of Chapter VI [new Chapter V] is subject to the rules of non-Convention law relating to rights concerning restitutions, errors or lack of capacity, etc. (See CONF. 11 – Doc. 34, Report (8 September), section 5.)

[T]here was support for the view that the Official Commentary should make clear that a right of use [new Article 34] could not only be exercised in financing transactions, but, for example, also in prime brokerage structures. (See CONF. 11 – Doc. 34, Report (8 September), section 4.)

With respect to Article 13bis [new Article 16] it was decided to delete the reference to Article 15 and to request the Drafting Committee to review the wording ‘subject to’. The Official Commentary would provide more detailed explanations regarding the policy choices made. (See CONF. 11 – Doc. 42, Report (11 September), section 2.)

Article 25 [new Article 28] was discussed in conjunction with Article 8 [new Article 10] taking into account CONF. 11 – Doc. 37, was adopted and transmitted to the Conference. The Official Commentary shall address the liability issues. (See CONF. 11 – Doc. 42, Report (11 September), section 8.)

5. In accordance with Resolution No. 2, negotiating States and participating observers are invited to submit comments on the draft Commentary. States and observers are requested to submit such comments no later than 24 August 2009 to the UNIDROIT Secretariat.

DRAFT OFFICIAL COMMENTARY
on the
draft Convention on Substantive Rules regarding Intermediated Securities

CHAPTER I – DEFINITIONS, SCOPE OF APPLICATION AND INTERPRETATION

Contents and Outline

I-1. *Chapter I* contains definitions and other general provisions, including provisions relating to the scope of the Convention's application and its interpretation. The provisions in Chapter I generally apply to the Convention as a whole.

I-2. *Article 1* contains the Convention's general definitions. These definitions are essential to the application of the Convention's substantive provisions and also to the scope of its application.

I-3. *Article 2* determines the sphere of application of the Convention. It applies when the applicable conflicts of laws rules point to the law of a Contracting State and when circumstances do not lead to the application of any other law.

I-4. *Article 3* specifies several criteria that provide guidance for the implementation, interpretation and application of the Convention. These are the Convention's purposes, the general principles on which it is based, its international character and to the need to promote uniformity and predictability in its application.

I-5. *Article 4* permits Contracting States (by declaration) to limit the scope of application of the Convention to the securities accounts maintained by "regulated" intermediaries and/or those maintained by a central bank. This offers a Contracting State the option to exclude the application of the Convention to securities accounts that are maintained by "unregulated" intermediaries.

I-6. *Article 5* excludes from the scope of the Convention several functions vis-à-vis the issuer of securities. These functions may be carried out by a central securities depository, central bank, transfer agent, registrar or any other person.

I-7. *Article 6* is intended to clarify the concept of an intermediary in a situation in which the task of "maintaining" a securities account is divided between two or more persons. (See also Article 1(d), defining "intermediary"). Article 6 ensures the proper application of the Convention to the holding patterns where a third person ("other person") is involved in the relationship between the relevant intermediary and its account holders. This is important, in particular, in the case of certain legal systems sometimes referred to as "transparent" systems.

I-8. *Article 7* provides a baseline rule for the relationship between the Convention and the rules applicable in insolvency proceedings. Unless it provides otherwise, the Convention does not affect such rules.

I-9. *Article 8* generally provides that the Convention does not affect the relationship between an issuer of securities and an account holder. In general, this means that the Convention does not regulate the body of law usually called "corporate law".

Article 1
Definitions

In this Convention:

(a) "*securities*" means any shares, bonds or other financial instruments or financial assets (other than cash) which are capable of being credited to a securities account and of being acquired and disposed of in accordance with the provisions of this Convention;

(b) "*intermediated securities*" means securities credited to a securities account or rights or interests in securities resulting from the credit of securities to a securities account;

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

(d) "*intermediary*" means a person (including a central securities depository) who 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;

(e) "*account holder*" means a person in whose name an intermediary maintains a securities account, whether that person is acting for its own account or for others (including in the capacity of intermediary);

(f) "*account agreement*" means, in relation to a securities account, the agreement between the account holder and the relevant intermediary governing the securities account;

(g) "*relevant intermediary*" means, with respect to a securities account, the intermediary that maintains the securities account for the account holder;

(h) "*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 authority for the purpose of reorganisation or liquidation;

(i) "*insolvency administrator*" means a person (including a debtor in possession where applicable) authorised to administer an insolvency proceeding, including one authorised on an interim basis;

(j) securities are "*of the same description*" as other securities if they are issued by the same issuer and:

(i) they are of the same class of shares or stock; or

(ii) in the case of securities other than shares or stock, they are of the same currency and denomination and are treated as forming part of the same issue;

(k) "*control agreement*" means an agreement in respect of intermediated securities between an account holder, the relevant intermediary and another person or, if so provided by the non-Convention law, between an account holder and the relevant intermediary or between an account holder and another person of which notice is given to the relevant intermediary, which includes either or both of the following provisions:

(i) that the relevant intermediary is not permitted to comply with any instructions given by the account holder in respect of the intermediated securities to which the agreement relates without having received the consent of that other person;

(ii) that the relevant intermediary is obliged to comply with any instructions given by that other person in respect of the intermediated securities to which the agreement relates in such circumstances and as to such matters as may be provided by the agreement, without any further consent of the account holder;

(l) "*designating entry*" means an entry in a securities account made in favour of a person (including the relevant intermediary) other than the account holder in respect of intermediated securities, which, under the account agreement, a control agreement, the uniform rules of a securities settlement system or the non-Convention law, has either or both of the following effects:

(i) that the relevant intermediary is not permitted to comply with any instructions given by the account holder in respect of the intermediated securities in relation to which the entry is made without having received the consent of that other person;

(ii) that the relevant intermediary is obliged to comply with any instructions given by that other person in respect of the intermediated securities in respect of which the entry is made in such circumstances and as to such matters as may be provided by the account agreement, a control agreement or the uniform rules of a securities settlement system, without any further consent of the account holder;

(m) "*non-Convention law*" means the law in force in the Contracting State referred to in Article 2, other than the provisions of this Convention;

(n) "*securities settlement system*" means a system which:

(i) settles, or clears and settles, securities transactions;

(ii) is operated by a central bank or central banks or is subject to regulation, supervision or oversight by a governmental or public authority in respect of its rules; and

(iii) has been identified as a securities settlement system in a declaration made by the Contracting State the law of which governs the system on the ground of the reduction of risk to the stability of the financial system;

(o) "*securities clearing system*" means a system which:

(i) clears, but does not settle, securities transactions through a central counterparty or otherwise;

(ii) is operated by a central bank or central banks or is subject to regulation, supervision or oversight by a governmental or public authority in respect of its rules; and

(iii) has been identified as a securities clearing system in a declaration made by the Contracting State the law of which governs the system on the ground of the reduction of risk to the stability of the financial system;

(p) "uniform rules" means, in relation to a securities settlement system or securities clearing system, rules of that system (including system rules constituted by the non-Convention law) which are common to the participants or to a class of participants and are publicly accessible.

Commentary

1-1. Article 1 contains a list of definitions that are applied throughout the Convention. The Convention also contains some definitions for specific purposes, notably in the context of Chapter IV on the integrity of the intermediated holding system (see Article 17), upper-tier attachment (Article 22(2)) and collateral transactions (see Article 31(3) of Chapter V).

Article 1(a) – "securities"

1-2. The definition of "securities" is very broad and includes any financial assets which are apt to be held in the intermediated holding system and governed by this Convention. However, the definition of securities does not cover cash (e.g., money deposited with a bank) or certain categories of financial assets, including some categories of derivatives, which do not meet the two functional criteria described below. For information on derivatives, see UNIDROIT 2006 – Study LXXVIII – Doc. 37, p. 2; UNIDROIT 2006 – Study LXXVIII – Doc. 45(g) and UNIDROIT 2008 – CONF. 11 – Doc. 4, section 31.

1-3. To qualify as "securities", such financial assets must meet two functional criteria. First, they must be capable of being credited to securities accounts (Article 1(c)) maintained by an intermediary (Article 1(d)). Second, they must be capable of being acquired and disposed of in accordance with the provisions of the Convention, mostly Articles 11 and 12.

1-4. As far as these two functional criteria are satisfied, the definition includes bearer and registered securities. It also includes securities represented by individual certificates, those by a single (global) certificate and purely dematerialised securities. This definition does not however affect or modify the regulatory power of a Contracting State as to whether it permits the issuance of securities in any of these forms.

1-5. The Convention does not provide a "laundry list" of securities qualifying under this definition. This allows for the evolution of market practice and the creation of new types of securities capable of being held in the intermediated holding system.

1-6. The two functional criteria were developed by the CGE. The CGE set out the requirement that securities must be "transferable" (UNIDROIT 2005 – Study LXXVIII – Doc. 24), added the words "capable of being credited" (UNIDROIT 2006 – Study LXXVIII – Doc. 42) and replaced the word "transferable" by the current reference to acquisition and disposition in accordance with this Convention (UNIDROIT 2006 – Study LXXVIII – Doc. 57).

1-7. At its third session, the CGE deleted the words "or any interest therein", which had been included in the original draft (UNIDROIT 2004 – Study LXXVIII – Doc. 18). At the same time, the definition of "intermediated securities" was changed to its current language (UNIDROIT 2006 – Study LXXVIII – Doc. 57), which includes the "rights or interests in securities resulting from the credit of securities to a securities account". These related changes reflect the fact that, under market practices, a book-entry in a securities account may not represent full ownership, but a mere limited interest such as a security interest, or an usufruct or life interest. The fact that one can acquire a limited interest in securities and that this limited interest may be credited to a

securities account does not qualify the notion of securities, but the rights and interests that an account holder derives from the credit of such securities.

1-8. The definition of “securities” was not modified during the first session of the diplomatic Conference except for a linguistic adjustment to the French version where “qui peuvent être [...] aliénés” was substituted by “dont on peut disposer” to maintain consistency with the French language of other provisions.

Article 1(b) – “intermediated securities”

1-9. “Intermediated securities”, together with “securities account” and “intermediary”, sets the field in which this Convention primarily applies. Thus, “intermediated securities” is the central notion for this Convention. The defined term refers to rights which arise from the credit of securities (Article 1(a)) to a securities account (Article 1(c)). In accordance with the non-Convention law (Article 1(m)), such rights may include direct ownership or joint ownership rights in the underlying securities or some other proprietary interests or contractual rights in respect of the securities. The definition of intermediated securities in Article 1(b) is closely connected with eponymous Article 9. It is best understood in the light of its drafting history.

1-10. Article 1(f) of the initial draft of this Convention (UNIDROIT 2004 — Study LXXVIII — Doc. 18) defined “securities held with an intermediary” as “the rights of an account holder resulting from a credit of securities to a securities account”. Article 2 of the same draft described these rights as resulting partially from the Convention itself and partially from non-Convention law. At its first meeting, the CGE maintained that definition but changed the defined term to the shorter phrase of “intermediated securities” (see UNIDROIT 2005 — Study LXXVIII — Doc. 24). Over the next two sessions, the definition itself was modified in order to properly account for those legal systems in which account holders may have a direct ownership interest in the underlying securities, as opposed to rights only against their respective intermediary (for the “relevant intermediary”, see Article 1(g)).

1-11. At its third session, the CGE significantly changed the definition to the language now contained in Article 1(b) while retaining the articulation between the definition and the substantive provision (UNIDROIT 2006 — Study LXXVIII — Doc. 57). That definition has not been modified since, either by the CGE or by the first session of the diplomatic Conference.

1-12. The present definition might be viewed as offering an alternative: intermediated securities can be either “securities credited to a securities account *or* rights or interests resulting from the credit of securities to a securities account” [emphasis added]. However, this “or” is inclusive, because the definition must be read in the light of Article 9. Under the Convention, the credit of securities to a securities account confers on the account holder rights, such as the right to effect a disposition of intermediated securities. These Convention rights arise in addition to the rights conferred by the non-Convention law. The definition in Article 1(b) is thus clearer if read in the reverse order, i.e., as rights or interests in securities (or, one might add, in respect of securities) resulting from the credit of securities to a securities account, and the securities themselves where so provided by the non-Convention law.

1-13. Intermediated securities are created when certificated or uncertificated securities are brought into the intermediated holding system and are credited to a securities account. They are extinguished when (if possible) securities are withdrawn from the intermediated system to be held directly by an investor. In particular, the definition of intermediated securities excludes certificated securities held physically and directly by an investor as well as securities registered directly with an issuer in the name of investors.

1-14. A credit of securities to a securities account does not necessarily produce a full interest in the underlying securities. Partial or limited interests, such as a security interest or a usufruct, may also be credited to a securities account and become “intermediated securities”. In such cases, the non-Convention law determines any limits to the rights conferred on the account holder (Article 9(3)).

Article 1(c) – “securities account”

1-15. “[S]ecurities account” is defined as an account maintained by an intermediary to which securities may be credited or debited. Securities accounts are essential to the operation of this Convention because they are necessary to book-entries and acquisitions and dispositions relying on book-entries, e.g., credits and debits (see Article 11) and designating entries (see Articles 1(l) and 12(3)(b)).

1-16. A securities account makes it possible to record credits and debits, as well as designating entries, where allowed by the non-Convention law of a Contracting State. How book-entries and balances are recorded is typically the subject-matter of domestic regulatory provisions, which are unaffected by the provisions of this Convention. As a matter of fact, it must be noted that, unlike a cash or currency account recording a single monetary balance to the credit or debit of the account holder, a securities account must record as many balances as there are securities of different descriptions credited to the account. Only securities of the same description, as defined in Article 1(j), are fungible among themselves and may be aggregated and netted so as to produce one number representing the holding in the relevant securities.

1-17. For the purpose of the definition, it is not necessary that securities are actually credited to the securities account at any given time. A securities account may be opened in anticipation of some future transaction.

1-18. The definition of securities accounts applies *inter alia* to accounts maintained:

- by an intermediary in the name of a natural or legal person who is not an intermediary;
- by an intermediary in the name of another intermediary;
- by a central securities depository in the name of an intermediary; or
- in a so-called transparent system, by a central securities depository in the name of a natural or legal person.

1-19. This definition does not apply, however, to accounts maintained directly by issuers in the name of their shareholders or bondholders, or to issuer accounts (or registers) maintained by central securities depositories or other persons such as transfer agents on behalf of issuers.

1-20. A Contracting State may exclude securities accounts maintained by unregulated, unlicensed or unsupervised intermediaries from the scope of application of this Convention (see Article 4(a)).

Article 1(d) – “intermediary”

1-21. Intermediaries are sometimes referred to as “custodians” or “account providers”. The function of intermediaries is a central element of the intermediated holding system. The application of this Convention requires that at least one intermediary is involved in the holding of the securities in question.

"a person (including a central securities depository)"

1-22. In practice, roughly speaking, intermediaries are entities such as banks, brokers, central banks and similar persons which maintain securities accounts for their clients. However, from a purely functional perspective, the definition does not set any limit as to who could be an intermediary. Virtually any natural or legal person is covered, including any kind of association, partnership or other person, provided that it maintains securities accounts for others in the course of its business.

1-23. The term "intermediary" includes both regulated and unregulated entities. The Convention does not infringe upon the powers of States to restrict or regulate the activity of maintaining securities accounts for others. In addition, Article 4 permits a Contracting State to limit the circle of intermediaries covered by the Convention.

1-24. While, in general, the Convention relies on a functional description in Article 1(d), central securities depositories (CSDs) are mentioned specifically, although they are not defined. This specification was inserted at the occasion of the fourth session of the CGE with a view to confirming the inclusion of securities accounts held by CSDs in the scope of the Convention (see UNIDROIT 2007 – Study LXXVIII – Doc. 95, section 13 *et seq.*). The background was that some negotiating States had raised doubts regarding the status of CSDs as intermediaries, mainly because of their special role and relationship with the issuer. The insertion now clarifies that CSDs are intermediaries under the Convention. However, CSDs are intermediaries only in relation to their participants (clients) but not in relation to the issuer, i.e., CSD and issuer are not tied to each other by means of a securities account to which securities are credited and debited.

"in the course of a business or other regular activity"

1-25. Additional criteria are needed to delineate the scope of the Convention. The notion of intermediary is reserved for persons that maintain securities accounts for others, roughly speaking, on a professional basis. Maintaining a securities account must be in the course of a business or other regular activity of the intermediary. This requirement is a functional one. It does not matter, for example, what legal, operational or regulatory set-up the intermediary has.

"maintains securities accounts for others or both for others and for its own account"

1-26. The term "for others" refers to legally distinct natural or legal persons. This is important to consider in a context where securities accounts are kept by integrated parts of a legal entity for other parts of the same legal entity. However, legally distinct subsidiaries can maintain securities accounts for their parent company or subsidiaries even if they are fully integrated from an economic and operational point of view, for example, where the parent company keeps 100% of ownership.

1-27. The second part makes clear, as a complement to Article 9(1)(a), that an intermediary can at the same time be an investor itself without losing the status of intermediary for this reason. The text uses the formula of "maintaining a securities account for its own account". However, this wording does not prescribe how such securities shall be held from an operational, accounting or legal point of view. It may well be that the non-Convention legal or regulatory framework sets different parameters for the treatment and evidence of securities accounts maintained for account holders (clients) and own holdings of the intermediary.

"and is acting in that capacity"

1-28. The "acting in that capacity" formulation recognises that the same entity may act in the capacity of an intermediary and in other capacities, such as the recipient or provider of collateral.

Article 1(e) – "account holder"

1-29. An "account holder" is defined as a person in whose name an intermediary maintains a securities account, whether that person is acting for its own account or for others (including in the capacity of intermediary).

1-30. Not all account holders are investors. Under current market practices, it is probable that most securities accounts are maintained in the name of intermediaries, whether acting in that capacity or on their own behalf. An intermediary holding securities with a higher tier intermediary, whether it is acting on its own behalf, on behalf of its clients (including in the capacity of an intermediary), or both, is the account holder of the securities account maintained by the higher tier intermediary.

1-31. Even the "ultimate" account holder, at the lowest tier of the holding chain, may not be an investor as understood by financial markets. In many instances, the ultimate account holder holds intermediated securities for its own account and benefit. However, it is not uncommon that it is serving as an agent, trustee or in another capacity on behalf and for the benefit of one or more other persons.

1-32. For any particular securities account, only the account holder identified as such is relevant to the operation of this Convention. Persons on whose behalf an account holder may be acting are strangers to the securities account. The relevant intermediary is not required to concern itself with strangers, except in the circumstances described in Articles 22 and 23(2), such as a power of attorney, legal authority to act in the name of the account holder, a control agreement, a designating entry and the like.

1-33. While the Convention consistently uses "account holder" in the singular, it does not purport to prohibit that a securities account be maintained for several persons acting jointly. Whether such joint account holders may exercise their rights individually or whether they must act jointly may be regulated by the account agreement or the rules of a securities settlement system, subject to the non-Convention law.

1-34. The Convention contemplates that an intermediary will maintain records so as to identify its account holder(s) for whom it is maintaining a securities account. However, it does not affect in any manner the application of know-your-customer rules set out by States exercising their legislative and regulatory powers, for example, for the purpose of fighting money laundering or financing of terrorism.

Article 1(f) – "account agreement"

1-35. An "account agreement" is a contract between an account holder and its relevant intermediary governing a securities account, in which their respective rights and obligations are specified.

1-36. An account agreement may be oral or in writing or in any other form. It may consist of several linked contractual documents. The Convention does not set out the formal requirements the agreement must meet in order to be effective and contains a number of references to the

rights and obligations under the account agreement (see Articles 1(l), 9(1)(c), 15(2), 16, 18(5), 23(2)(a), 24(4) and 28). Formal requirements and any other issues are subject to the provisions of the non-Convention law and, if so provided by the rules of conflict of the forum, of as any other law that may otherwise govern the account agreement, such as the *lex contractus* (if different from the non-Convention law), the law governing the capacity of parties, etc.

1-37. In a so-called transparent system, where a central securities depository (CSD) maintains accounts in the name of individual investors but securities brokers or banks are responsible for the performance of certain functions of the intermediary, the CSD maintains accounts for and in the name of individual investors who may not have a contractual relationship with the CSD. The relationship with the account holder is handled by the securities broker or bank performing certain functions of an intermediary in accordance with Article 6. While it may be that there is no account agreement at all, it is likely that an account agreement is entered into by the account holder and by the broker which is the party responsible for the performance of that function. Under Article 6(2)(b)(ii), the relevant Contracting State should identify the parties to such account agreement, if any.

Article 1(g) – “relevant intermediary”

1-38. The defined term “relevant intermediary” is used throughout the Convention in respect of “an account holder”, “a securities account” or “intermediated securities” to identify the intermediary maintaining a particular securities account for a particular account holder, where particular intermediated securities are credited, and to distinguish that intermediary from any other intermediary in the holding chain.

1-39. In a transparent system, where a CSD maintains accounts in the name of individual investors but securities brokers or banks are responsible for the performance of certain functions of the intermediary, “relevant intermediary” may mean the CSD or the securities broker or bank, depending on which function is the subject matter of the relevant provision using the defined term. See Article 6(3).

Article 1(h) – “insolvency proceeding”

1-40. The Convention contains a broad definition of “*insolvency proceeding*”, which covers collective proceedings, including interim proceedings, aimed at reorganisation or liquidation. In an insolvency proceeding, the assets and affairs of a debtor are subject to control or supervision by a court or other competent authority.

Article 1(i) – “insolvency administrator”

1-41. An “*insolvency administrator*” is the person who is authorised to administer the insolvency proceeding, including a trustee appointed by the court or a so-called “debtor in possession”, such as the manager of a company that continues to exercise its tasks as a fiduciary to the insolvent estate or another administrator. The definitions relating to insolvency are particularly important for Articles 7 and 14, and for Chapter IV on the integrity of the intermediated holding system and for Chapter V, which contains special provisions for collateral transactions.

Article 1(j) – securities “of the same description”

1-42. This definition is necessary to recognise the fungibility of securities to the extent appropriate. If securities are of the same description, those securities are fungible. If securities are of the same description, rights or interests in securities are of the same description, too, so that

intermediated securities (defined in Article 1(b)) are of the same description. The definition of “of the same description” matters, for instance, under Article 24 with respect to an intermediary’s duty to hold (or have available) sufficient securities (see the commentary on Article 24, especially at 24-12). It also matters in Articles 11(5), 25, 26, 29(2) and 31(3)(i).

1-43. Securities are of the same description only if their issuers are the same. For shares or stock (usually called equity securities), securities are of the same description only if their classes are the same. Thus, common shares and preference shares are not of the same description. Voting shares and non-voting shares are not of the same description. For securities other than shares or stock (usually called debt securities), securities are of the same description only if they are of the same currency, denomination, maturity and interest and are treated as forming part of the same issue.

Article 1(k) (I) – “control agreement” / “designating entry”

1-44. Control agreements and designating entries are two methods which, subject to a declaration by the relevant Contracting State, may be used by an account holder to grant an interest in intermediated securities to another person (hereafter: the other person) so as to make it effective against third parties (see Article 12 and its commentary).

1-45. A control agreement is typically a three-party contract between the account holder, the relevant intermediary and the other person. Through the control agreement, the relevant intermediary allows the other person to exercise control over the intermediated securities subject to the interest granted. In certain jurisdictions, control agreements may be made bi-laterally, entered into by the account holder and the relevant intermediary for the benefit of the other person. In other jurisdictions, a control agreement may be executed by the account holder and the other person and, under the non-Convention law, is binding upon the relevant intermediary who received notice of the agreement.

1-46. A designating entry has the same effects as a control agreement. The main difference between the two is that the former, unlike the latter, is “an entry [made] in a securities account” by the relevant intermediary, so that it is not only a private matter between the account holder, the intermediary and the other person, but it is or should be visible on any account statement and to any person authorised to review the account. However, persons relying on the existence or absence of designating entries in the account must at all time remain aware that an account statement or print-out is but a snapshot of the account at a given point in time and may change at any time thereafter.

1-47. The type of control required by the non-Convention law for control agreements and/or designating entries to make an interest effective against third parties may vary among jurisdictions. The non-Convention law may require “negative control”, so that the “the relevant intermediary is not permitted to comply with any instructions given by the account holder in respect of the intermediated securities [...] without having received the consent of that other person” (see sub-paragraph (i) of Article 1(k) and (I)). Alternately or cumulatively, the non-Convention law may require “positive control”, so that “the relevant intermediary is obliged to comply with any instructions given by that other person in respect of the intermediated securities [...] in such circumstances and as to such matters as may be provided [...]” (see sub-paragraphs (ii) of Article 1(k) and (I)). Whenever a Contracting State makes a declaration in respect of control agreements or designating entries, that declaration must specify the type of control required by its non-Convention law (see Article 12(3), (6) and (7)).

Article 1(m) – “non-Convention law”

1-48. In many instances, this Convention refers to substantive law (other than the Convention) of the Contracting State. The term “non-Convention law” is a generic term to describe these other rules of law. The language (but not the purpose) of this definition has evolved over time and a consensus on the current wording was achieved at the first session of the diplomatic Conference.

1-49. The provisions of this Convention are part of the law of any State that is a Contracting State. On many issues, the Convention refers to substantive law (other than the Convention) of the Contracting State, which may apply or be relevant to such issues. These other rules of law are referred to as the non-Convention law. In some instances, the Convention prevails over these rules (e.g., Article 11(2)); in other instances, the Convention contemplates that its provisions may be supplemented by these rules (e.g., Article 13); in yet other instances, these rules may derogate from the provisions of the Convention (e.g., Article 23(2)(d)). It must be emphasised, however, that certain provisions of the Convention will displace any other domestic rule to the contrary even if such provisions do not specify that they pre-empt the non-Convention law but where the context and the purpose of these provisions dictate such result (see, for example, Article 22 on the prohibition of upper-tier attachment).

1-50. In a multi-unit State whose territorial units have legislative authority on the matters dealt with in the Convention, the reference to the non-Convention law will be a reference to the internal law of the relevant territorial unit (see Article 43(5)).

1-51. The non-Convention law is not necessarily the substantive law of the forum State; indeed, it may be the law of a State other than the forum State. This is the case where the conflict of laws rules of the forum State point to the application of the law of another State which is a Contracting State (see the commentary on Article 2).

1-52. The definition of non-Convention law does not specify that it excludes the conflict of laws rules of the relevant Contracting State. However, the context in which the term is used in the Convention mandates such exclusion.

1-53. The term “non-Convention law” should not be confused with the term “applicable law” used in some provisions of the Convention (Articles 2, 9(1)(c), 9(2)(b), 12(8), 18(4), 19(5) and 19(6)). The term “applicable law” is not defined and must be given its ordinary meaning. It is the law that is applicable by virtue of the private international law rules of the forum. The applicable law may, or may not be, the non-Convention law.

Article 1(n) – “securities settlement system”

1-54. Securities settlement systems (SSSs) are market infrastructures permitting the efficient transfer of securities amongst intermediaries. SSSs may perform a wide range of different services and consequently, their operational make up is often complex. The sound and efficient functioning of many SSSs is of systemic importance for the financial system. Therefore, many national laws provide for or allow SSSs to operate under specific legal rules, which may contain provisions differing from generally applicable law on crucial issues such as the insolvency of a participant in that system.

1-55. The present Convention takes the special role of SSSs and their rules into consideration in Articles 1(l), Article 9(1)(c), Article 15(2), Article 16, Article 18(5), Article 23, Article 24(4), Article 26(3), Article 27, and Article 28.

1-56. The starting point of the definition is the term of *system* in the chapeau of the definition. The three sub-paragraphs describe the characteristics of an SSS, first with respect to its functions (sub-paragraph (i)), second with respect to the necessity of some form of public control over an SSS, and third with respect to the need for identification of qualifying SSSs by declaration.

(i) System (chapeau of Article 1(n))

1-57. The term “system” as such is not defined in the Convention. It should be understood in a broad sense to be compatible with the different types of clearing and settlement arrangements existing in the Contracting States. However, from the context of the Convention, it can be derived that a system in the sense of Article 1(n) has to have certain minimum characteristics.

1-58. First of all, a system has to connect a multitude of financial actors for purposes of securities clearing and settlement. A good description of the basic idea of a system is the term of infrastructure (network) providing standardised securities clearing and/or settlement services.

1-59. The users of such infrastructure are generally called participants. Participants may be legal entities (generally, but not necessarily, financial institutions subject to public supervision or oversight) or even natural persons. In respect of the clearing and settlement of securities within a system, participants may act on their own account or, to the extent permitted by applicable law, on behalf of others, i.e., as an intermediary.

1-60. For the purposes of the present Convention, the minimum number of participants in the above sense should be three or more. This is because a “system” which would consist of only two participants would not need the special protection that is attributed to systems in order to mitigate systemic risk, i.e., the risk that the inability of one participant in a system to meet its obligations will cause other participants to be unable to meet their obligations when due, with possible spill-over effects such as significant liquidity or credit problems that may threaten the stability of or confidence in the financial markets. Opposed to this, the unwinding of transfer instructions or dispositions between two parties is a classical scenario to be resolved by general commercial and insolvency law. The particular difficulties in unwinding instructions and/or dispositions occur only once rights and obligations of three or more parties are settled multilaterally in a standardised legal and operational environment.

1-61. Many systems have an operator, i.e., an entity responsible for its legal and operational set-up and the provision of technical and other infrastructure support. Often, CSDs, stock exchanges or central banks perform such role. There may also be other entities which have an ancillary function in the process of clearing and settlement of securities within a system, in particular, central counterparties, clearing houses and settlement agents. Finally, systems may be interconnected, e.g., by (cross-)participation of their operators.

1-62. Within the exercise of their function of operator (or other entity having an ancillary function), these entities are not regarded as participants in the system. However, they may, outside the scope of their function of operator (or ancillary entity), also participate as participants in the system concerned.

1-63. Finally, a system must operate under a legal, institutional and operational framework established on an ongoing basis and covering standardised services for a multitude of participants. A core part of this framework is formed by the rules of the system governing the activities of clearing and settlement, in this Convention referred to as “uniform rules” (see Article 1(p)).

(ii) Function of the SSS (sub-paragraph (i))

1-64. An SSS is defined by the Convention as a system that “settles, or clears and settles, securities transactions”. Clearing and settlement intervenes, in the course of a transaction, where an agreement about the transaction is reached (for example, a trade has been concluded on a stock exchange or a collateral transaction has been agreed) but obligations arising from this agreement are still open.

1-65. Thus, the notion of SSS refers to those market infrastructure services relating to the settlement (and possibly clearing) of securities in a system environment as described above. Whereas “settlement” of securities is a sufficient and necessary condition for the qualification of an SSS, “clearing” is only a possible ancillary function. This is meant to encompass within the definition of SSS those markets, where the reduction of transactions to be settled has been achieved through the structure of the SSS processes itself rather than by relying on additional entities.

1-66. In the post-trade environment, as a first step, clearing may but does not have to intervene: “clearing” is to be understood widely as the process of transmitting, reconciling and, in some systems, confirming instructions aiming at a disposition of securities. In some systems, clearing may also include the bilateral (i.e., between identical participants) or even multilateral (i.e., between all participants) netting of these instructions and the establishment of final positions for settlement.

1-67. Often, but not necessarily, clearing involves a so-called central counterparty (CCP), which is an entity which interposes itself as the buyer to every seller and as the seller to every buyer for some specific or all kinds of transactions. Through the involvement of CCPs, market participants only bear the standard credit risk of the CCP, and not that of individual market participants. Further, a so-called clearing house may cause the completion of the majority of the underlying transactions by discharging the obligations in respect of securities transfers and payments by way of netting, meaning the conversion of a potential multitude of claims and obligations of each participant into one net claim or obligation (as regards its cash position as well as every securities issue bought and/or sold).

1-68. Ultimately, the transactions are settled: “settlement” is to be understood as an act which discharges the obligations arising from the agreement of the parties and possibly established and/or confirmed during clearing. Settlement comprises those acts that ultimately entail disposition of securities on one hand and acquisition on the other. At times when securities certificates still circulated, settlement consisted of the physical delivery into the possession of the acquirer or its representative, e.g., a bank. In the paperless world, the manifestation of settlement is the making of credits, debits and designating entries to securities accounts, resulting in titles to securities or interests in securities being transferred, to fulfil the underlying obligations. The term applies regardless of whether securities are transferred dependent on a corresponding payment or (possibly) securities delivery obligation.

1-69. Thus, a SSS in the sense of this Convention either fulfils both functions or only the settlement function, in which case the clearing may be ensured by a separate entity, usually referred to as CCP, clearing house or clearing system. The notion of SSS may also encompass parts of the activities of a central securities depository (CSD), to the extent that such CSD is performing settlement (and clearing) functions as defined herein.

(iii) Operated by a central bank or subject to public control (sub-paragraph (ii))

1-70. Because systems form infrastructure networks linking all those who participate in them, it is important that they are designed and operated in such a way that the probability of financial difficulties spreading from one participant to another is very small. Those systems must address the risk that the inability of one participant to meet its obligations will cause other participants to be unable to meet their obligations when due, with possible spill-over effects such as significant liquidity or credit problems that may threaten the stability of or confidence in the financial markets, are considered to be systemically important. (See section 1-79.)

1-71. The effective and safe operation of a systemically important system requires its internal rules and procedures to be enforceable with a high degree of certainty. Their function, i.e., the settlement (and possibly clearing) of transactions on a multilateral basis and their processes (e.g., processing of orders or batches of orders at a given point in time) should be immune against certain rules generally contained in insolvency law and possibly leading to the revocation of instructions or the unwinding of a clearing or settlement process. This entails that certain legal privileges may stipulate that the statutory and contractual rules related to the operation of the system will be enforceable even in the event of the insolvency of a system participant or of the operator, whether the participant is located in the jurisdiction whose law governs the system, or that of the operator of the system, or in another jurisdiction altogether.

1-72. Against the background of both aspects, systems functions should be monitored and/or controlled by competent public authorities, to contain systemic risks and to avoid any abuse of legal privileges. Therefore, sub-paragraph (ii) requires that SSSs in the sense of this definition are regulated, supervised or overseen by a governmental or public authority. This broad formula has been adopted, recognising that in a number of countries there is a distinction between regulation, supervision and oversight and the different entities which might conduct them. It is meant to cover any form of continued processes of monitoring of the activity and rules of an SSS, both existing and planned, assessing them against pre-set standards, and, where necessary, inducing change.

1-73. The definition does not require that the entirety of the activities of an SSS is monitored in such manner but at least the uniform rules (see Article 1(p)) governing its settlement (and possibly clearing) related activities and the activities performed in accordance with such rules.

1-74. SSSs operated by central banks (either by a single central bank or jointly by more than one central bank) qualify even if they are not as such subject to monitoring by a governmental or public authority as central banks are as a consequence of their public tasks and functions well placed to ensure the required degree of control over the settlement (and possibly clearing) related activities of SSSs operated by themselves.

(iv) Identification by declaration (sub-paragraph (iii))

1-75. The text of the present Convention preserves in the articles cited above the specific protection afforded by the uniform rules of an SSS, even if these rules might contain provisions that deviate from provisions of the Convention. Consequently, it is necessary to notify the exemption of certain systems from the application of certain rules of the Convention to all Contracting States. This is done by declaration (for the details of the declaration mechanism, see Article 45 *et seq.*).

1-76. The declaration must be made by the Contracting State the law of which governs the system, as opposed to, e.g., the Contracting State the law of which governs the contractual relationships of the system with its participants or the Contracting State in whose jurisdiction the operator of the system is established.

1-77. This declaration mechanism is meant to provide clarity also for cases of multiple systems operated by one and the same entity, a situation that is not uncommon in the financial markets. For example, there are cases where public authorities and/or financial market participants in a State have decided not to create the relevant technical infrastructure for the settlement of securities covered by their national law but rather to entrust (under proper authorisation and supervision or recognition) its setting-up and operation to an operator located in a different State. In such cases, while the technical infrastructure is operated by an entity situated in another State, the first State will (under its local law) put in place statutory provisions to support the validity and effect of electronic transfer orders sent into the system. In such type of situations, it is necessary to distinguish between the law that gives validity, enforceability and binding effect to a transfer order within any given system and the law that might govern the contractual relationship between the system operator and the system participants in relation to their participation in that system, including their acceptance. These two laws may coincide, but not necessarily.

1-78. Further, the declaration must be made on the ground of the reduction of risk to the stability of the financial system. This is to make clear that not all kinds of SSSs, but only systemically important ones may benefit from the recognition of their uniform rules (see Article 1(p)) by the provisions of the Convention.

1-79. An SSS is systemically important if it has the potential to trigger systemic risk in the event of it being insufficiently protected against the risks to which it is potentially exposed, such as the insolvency of a participant or a disrupted functionality of the SSS. Systemic risk is the risk that there are possible spill-over effects (such as significant liquidity or credit problems) affecting other participants in the system or even other parts of the financial infrastructure that may ultimately threaten the stability of the financial system.

1-80. The declaration under Article 1(n) should be made with the intention to increase the effective and safe operation of a systemically important system by providing (parts of) their uniform rules with immunity as to the application of certain rules generally contained in insolvency laws or in the present Convention and possibly leading to the revocation of instructions or the unwinding of a clearing or settlement process, in order to ensure that the uniform rules will be enforceable even in the event of the insolvency of a system participant or of the operator.

1-81. Whether or not there are grounds for the reduction of risk to the stability of the financial system is a matter to be judged by the declaring Contracting State. See in this respect also the principles for systemically important systems as established by the Committee for Payments and Securities Settlement of the Bank of International Settlement.

Article 1(o) – “securities clearing system”

1-82. Securities clearing systems (SCSs) are market infrastructures permitting the efficient holding by and transfer of securities amongst intermediaries. SCSs may perform a wide range of different services and consequently, their operational make up is often complex. The sound and efficient functioning of many SCSs is of systemic importance for the financial system(s) in which it operates. Therefore, many national laws provide for or allow SCSs to operate under specific legal rules, which may contain provisions differing from generally applicable law on crucial issues like insolvency of a participant in that system.

1-83. The present Convention takes the special role of SCSs and their rules into consideration in Article 27(a).

1-84. The starting point of the definition is the term of *system* in the chapeau of the definition. The three sub-paragraphs describe the characteristics of an SCS, first with respect to its functions (sub-paragraph (i)), second with respect to the necessity of some form of public control over an SCS, and third with respect to the need for identification of qualifying SCSs by way of declaration.

(i) System (chapeau of Article 1(o))

1-85. *The commentary on Article 1(n) applies correspondingly.*

(ii) Function of the SCS (sub-paragraph (i))

1-86. A SSSs is defined by the Convention as a system that “clears, but does not settle, securities transactions”.

1-87. The notion of SCS is referring exclusively to those market infrastructure services performing clearing functions (and possibly other functions not covered by the present Convention, but no settlement).

1-88. *The commentary on Article 1(n) regarding “clearing” and “settlement” applies correspondingly.*

1-89. Often, but not necessarily, clearing involves a so-called central counterparty (CCP), which is an entity which interposes itself as the buyer to every seller and as the seller to every buyer for some specific or all kinds of transactions. Through the involvement of CCPs, market participants only bear the standard credit risk of the CCP, and not that of individual market participants. Further, a so-called clearing house may cause the completion of the majority of the underlying transactions by discharging the obligations in respect of securities transfers and payments by way of netting, meaning the conversion of a potential multitude of claims and obligations of each participant into one net claim or obligation (as regards its cash position as well as every securities issue bought and/or sold).

1-90. Thus, a SCS in the sense of the present Convention may perform exclusively the clearing function, e.g., as a CCP, clearing house or clearing system. If it were to perform also the settlement function, it will be considered as an SSS in accordance with Article 1(n) of the Convention.

(iii) Operated by a central bank or subject to public control (sub-paragraph (ii))

1-91. *The commentary on Article 1(n) applies correspondingly.*

(iv) Identification by declaration (sub-paragraph (iii))

1-92. *The commentary on Article 1(n) applies correspondingly.*

Article 1(p) – “uniform rules”

1-93. The definition of “uniform rules” serves the purpose to delimit those rules of an SSS or SCS which are recognised by and protected from certain conflicting provisions of the Convention from

those internal or contractual rules of a system (SSS or SCS) which are not. As a general principle, the uniform rules should be clearly stated, understandable, internally coherent and unambiguous. The effective operation of a system requires its internal rules and procedures to be enforceable with a high degree of certainty.

1-94. The term “uniform rules” is understood to be wide, and may encompass *inter alia* all forms of statutory laws, regulation, system rules and by-laws and generally applicable, non-negotiable conditions and contractual agreements that may provide rules concerning the clearing and settlement functions of systems.

1-95. The term “uniform rules” is used in many provisions of the Convention, and it should be noted that the contents of the uniform rules are not limited to the matters relating to clearing or settlement but include other matters referred to in those provisions.

1-96. The uniform rules have to be common to the participants or to a class of participants. This is the case to the extent that uniform rules may include general laws such as property and insolvency laws, and may also include laws specifically related to the operation of the system. In some jurisdictions, the general laws governing property rights and insolvency may not apply to, or may contain special provisions related to, the clearing and settlement of securities transactions. Laws applicable to securities settlement may also be augmented by regulations or other administrative acts.

1-97. Another important component of the uniform rules are the rules and procedures of the various parts of the system, many of which represent contractual arrangements between the operators and the participants. These define the relationships, rights and interests of the operators, the participants and their customers and the manner in which and time at which rights and obligations, both in respect of contractual obligations and regarding proprietary aspects of the holding of securities, arise through the operation of the system. Here, the necessary degree of uniformity, commonality and transparency to override otherwise applicable laws and Convention rules is only achieved to the extent that non-negotiable, generally applicable rules and contractual arrangements are concerned. It excludes, however, non-uniform bilateral agreements between the system and individual participants.

1-98. The uniform rules (but only those) also have to be publicly accessible. Public accessibility is a tool to ensure the necessary degree of transparency and certainty concerning the rules applicable to the holding and transfer of securities involving a system, if such uniform rules of a system derogate from the principles of this Convention for reasons of systemic stability. System participants and their respective customers, as well as interested third parties, should have a high degree of certainty regarding the scope and nature of rights and interests in the securities and other assets held in the system, including rights to use collateral or transfer property interests, notwithstanding the insolvency of a participant or of the operator. To be able to assess these aspects, full transparency of the applicable rules is prerequisite. See on this issue the CPSS-IOSCO recommendations for SSSs and CCPs concerning the transparency of system rules.

1-99. Finally, the Convention does not require to declare the actual content or scope of uniform rules and does not oblige a Contracting State to identify divergences of such uniform rules from the present Convention. However, as a minimum, Contracting States should be encouraged to identify the source (e.g., the system’s website) where the respective uniform rules can be publicly accessed.

Article 2
Sphere of application

This Convention applies where:

- (a) the applicable conflict of laws rules designate the law in force in a Contracting State as the applicable law; or**
- (b) the circumstances do not lead to the application of any law other than the law in force in a Contracting State.**

Commentary

I. Introduction

2-1. The purpose of Article 2 is to determine the sphere of application of the Convention. The fact that a State is a Contracting State does not necessarily result in the application of the Convention on an issue involving intermediated securities which may arise in that State. The Convention applies only if the conflict of laws rules of the forum State point to the law in force in a Contracting State as the applicable law.

2-2. Article 2 must be read together with the definition of “non-Convention law” (Article 1(m)), as the non-Convention law is also a component of the body of law governing matters with respect to intermediated securities.

II. History

2-3. As is the case for the definition of non-Convention law, the formulation of Article 2 has been the subject of variations (or proposed variations) and the current text results from discussions at the diplomatic Conference. There has never been, however, any disagreement as to the sphere of application of the Convention and the evolution in the text of Article 2 is only due to a desire for better expressing its goal.

2-4. After the first session of the CGE, the provision consisted of one paragraph only (see UNIDROIT 2005 – Study LXXVIII – Doc. 24, Appendix 1, Article 2). No changes were made during the second session of the CGE (UNIDROIT 2006 – Study LXXVIII – Doc. 42, Appendix 1, Article 2). During the third session of the CGE, a second paragraph was added (UNIDROIT 2007 – Study LXXVIII – Doc. 57, Appendix 1, Article 2). Some revisions were made during the fourth session of the CGE (UNIDROIT 2007 – Study LXXVIII – Doc. 94, Appendix 1, Article 3).

III. Analysis

III-1. Article 2(a)

2-5. This Convention is intended to be part of the substantive law of a Contracting State. Therefore, the Convention will be applied in such a State on the matters dealt with in the Convention to the extent that the substantive law of that State is the applicable law for such matters. The purpose of Article 2(a) is to make this clear.

2-6. Ascertaining the applicable law in a State is made through the conflict of laws rules of that State. The conflict of laws rules to be used are those of the State in which the case has to be examined. Thus, if litigation takes place in State A, a court of State A (the forum court) will look at the conflict of laws rules of State A to determine if the issues giving rise to the dispute are to be governed by the law of State A or the law of another State, for example, State B. If the applicable law is the law of State A and State A is a Contracting State, the Convention will apply to the issues, and if the applicable law is the law of State B and State B is a Contracting State, the Convention will apply to the issues.

2-7. This Convention is not a private international law convention and does not set out the conflict of laws rules that a Contracting State will apply. These rules are left to the law of the Contracting State outside the Convention. For the same reason, the Convention does not specify whether or not the doctrine of *renvoi* may apply. This question is a conflict of laws issue and is to be resolved under the conflict rules of the forum State.

2-8. It is worth noting that the Convention could apply in a non-Contracting State. This could be so, not by virtue of paragraph (a) of Article 2 (which indeed cannot apply as such in a non-Contracting State), but because the conflict of law rules of a non-Contracting State could point to a Contracting State as being the State whose law will be applicable. For example, if the forum State is State A (a non-Contracting State) and its conflict rules refer to the law of State B (a Contracting State) on an issue dealt with in the Convention, then the forum State will resolve the issue using the relevant provisions of the Convention. In such a case, the forum State will apply the Convention, not because of Article 2(a), but because its conflict rules direct the application of the law of a Contracting State, State B. However, the result will be the same as if paragraph (a) had applied and, in this sense, this paragraph may be viewed as merely expressing a principle of private international law which is generally in effect in most States, whether or not they are Contracting States.

III-2. Article 2(b)

2-9. Article 2(b) is a clarification provision intended to direct the application of the Convention in a Contracting State which is the forum State where the situation does not involve “internationality”. In such a case, the conflict rules of the Contracting State would point to its own substantive law with the result that the Convention would apply.

2-10. There is however a school of thought in private international law holding that the circumstances must have a connection with more than one State (i.e., an “international” element) in order to refer to conflict of laws rules. Under that approach, in a purely domestic situation, reference is not to be made to conflict rules and Article 2(a) would not provide guidance as to the application of the Convention: under Article 2(a), the application of the Convention is determined by conflict of laws rules and these rules would be of no assistance if an international element is a prerequisite to using them.

2-11. Article 2(b) therefore establishes that the Convention will apply in a Contracting State where the situation presents no international element, even if in such a situation the private international law of that State does not dictate a conflict of laws analysis. Article 2(b) needs not to be relied on in a Contracting State in which the application of conflict rules is not conditional on the existence of an international element in the case. In such a State, Article 2(a) will be sufficient to mandate the application of the Convention.

Article 3
Principles of interpretation

In the implementation, interpretation and application of this Convention, regard is to be had to its purposes, the general principles on which it is based, its international character and the need to promote uniformity and predictability in its application.

Commentary

I. Introduction

3-1. Article 3 lists a number of criteria for the implementation, interpretation and application of the Convention. The provision refers specifically to the Convention's purposes, to the general principles on which it is based, to its international character and to the need to promote uniformity and predictability in its application. Further sources to define these criteria are the Preamble to the Convention, as well as the documents prepared in the course of the work on the text of the Convention.

II. History

3-2. The first version of the principles of interpretation can be found in the preliminary draft Convention produced by the Study Group (see UNIDROIT 2004 – Study LXXVIII – Doc. 18, Article 1(2) and 1(4)). See also the explanations set out in UNIDROIT 2004 – Study LXXVIII – Doc. 18, p. 25.

3-3. During the first session of the CGE, the rules on principles of interpretation were moved to a separate provision, consisting of two paragraphs, without substantive change (see UNIDROIT 2005 – Study LXXVIII – Doc. 24, Appendix 1, Article 3).

3-4. The provision was not changed during the second session of the CGE (see UNIDROIT 2006 – Study LXXVIII – Doc. 42, Appendix 1, Article 3).

3-5. During the third session of the CGE, the original two paragraphs were integrated into a single, shortened paragraph (see UNIDROIT 2006 – Study LXXVIII – Doc. 57, Appendix 1, Article 4; UNIDROIT 2006 – Study LXXVIII – Doc. 58, sections 30, 31, 132).

3-6. No substantive changes were made during the fourth session of the CGE (see UNIDROIT 2007 – Study LXXVIII – Doc. 94, Appendix 1, Article 6) and the first session of the diplomatic Conference.

III. Analysis

3-7. Article 3 sets out principles which should be taken into account when implementing, interpreting and applying the Convention. A similar provision is found in other international instruments, such as Article 7(1) of the *1980 United Nations Convention on Contracts for the International Sale of Goods* (hereinafter cited as CISG), Article 6 of the *1988 UNIDROIT Convention on International Financial Leasing*, Article 4 of the *1988 UNIDROIT Convention on International Factoring* and Article 5(1) of the *2001 Cape Town Convention on International Interests in Mobile Equipment*.

3-8. In general, the purposes and general principles on which the Convention is based include, as stated in the Preamble, the growth and development of global capital markets, the protection of persons acquiring or holding intermediated securities, the reduction of legal and systemic risk, the increase of liquidity of securities markets and internally sound and compatible legal systems for the holding and disposition of intermediated securities. Other guiding principles are the reference to the Convention's international character and the promotion of uniformity and predictability in the Convention's application.

3-9. However, it must be noted that Article 3 does not have a provision like Article 7(2) of the CISG, which states: "Questions concerning matters governed by this Convention which are not expressly settled in it are to be settled *in conformity with the general principles* on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law."

3-10. The lack of such a provision is intended to avoid possible confusion with respect to the relationship between the general principles and the non-Convention law, since this Convention often defers matters to the non-Convention law. This means that Article 3 provides for the following interpretation principles.

3-11. Where any given matter is governed by the Convention, the answer is provided by interpreting the Convention autonomously. If such autonomous interpretation does not provide the answer, the matter is deferred to the non-Convention law. In other words, every time this Convention is silent on an issue, the issue constitutes a gap which is to be filled by the non-Convention law.

Article 4 ***Central bank and regulated intermediaries***

A Contracting State may declare that this Convention shall apply only to securities accounts maintained by:

(a) intermediaries falling within such categories as may be described in the declaration, which are subject to authorisation, regulation, supervision or oversight by a government or public authority in respect of that activity; or

(b) a central bank.

Commentary

I. Introduction

4-1. Article 4 permits Contracting States to limit the scope of application of this Convention to the securities accounts maintained by "regulated" intermediaries and/or those maintained by a central bank. The purpose of the rule is to offer the possibility to exclude the application of the Convention to the securities accounts that are maintained by "unregulated" intermediaries, if and to the extent Contracting States deem it appropriate.

I. History

4-2. Article 4 was added during the first session of the diplomatic Conference upon discussion of the point brought forward in CONF. 11 – Doc. 16, section 2.3 and Annex 2.

III. Analysis

4-3. In some countries only regulated intermediaries are permitted to maintain securities accounts whereas in other countries there is no such regulatory requirement.

4-4. On the one hand, there may be reasons for applying the Convention to both regulated and unregulated intermediaries. In a globalised environment of the financial market with countless cross-border links, a uniform application of the Convention rules may be called for. Unregulated intermediaries may stand in the cross-border holding chain of intermediated securities, and if in such situation the Convention does not apply to unregulated intermediaries and “something goes wrong” at that level, all lower-tier parts of the holding chain, and ultimately, investors, may suffer from lack of harmonisation of rules and legal certainty.

4-5. On the other hand, there are reasons for permitting Contracting States to limit the application of the Convention to regulated intermediaries. In many jurisdictions, intermediaries are regulated and, for instance, intermediaries who do not obtain necessary authorisation or otherwise do not comply with regulatory requirements are typically subject to fines or other sanctions. If the Convention applies to such unregulated (or illegal) intermediaries, the effectiveness of regulatory requirements and the enforcement of sanctions may be jeopardised. Moreover, many jurisdictions offer various safeguards for investor protection, such as compensation funds, and they apply only to regulated intermediaries. If the Convention applies to unregulated intermediaries, the investor protection policy in that jurisdiction may be negatively affected. Also, the policy with respect to the insolvency law in certain jurisdictions may vary, depending on whether the law applies to regulated entities or not. Since the Convention provides rules affecting insolvency, if it applies to unregulated intermediaries, such policy in insolvency law in that jurisdiction may be affected. Finally, in a cross-border context mentioned above, lower-tier intermediaries may often be regulated and they may often be bound to hold intermediated securities exclusively through other regulated intermediaries. Thus, following the debates and negotiations at the diplomatic Conference, Article 4 has been decided to be in place.

III-1. General mechanism

4-6. Article 4 deploys a declaration mechanism by the operation of which the scope of the Convention can be narrowed. The formalities of a declaration under Article 4 follow the provisions of Articles 45-47.

4-7. Two different scenarios can be distinguished:

- The Contracting State has made a declaration under Article 4 and the intermediary in question fulfils the specifications of the declaration, i.e., it is part of the described category. In this case, the applicable law comprises that Contracting State's non-Convention law plus the Convention law;
- The Contracting State has made a declaration under Article 4 and the intermediary in question does not fulfil the specification of the declaration, i.e., it is not part of the described category. In this case, the applicable law comprises exclusively the non-Convention law.

EXAMPLE 4-1: In a multi-jurisdictional case involving Intermediary A, the conflict of laws rules identify the law of Country X as the applicable law. Country X has made a declaration under Article 4, excluding unregulated intermediaries from the scope of the Convention.

If Intermediary A is unregulated, the non-Convention law of Country X applies but the rules of the Convention do not apply. If Intermediary A is regulated, the non-Convention law of Country X plus the Convention law apply.

III-2. Regulated intermediaries

4-8. The Contracting State, in its declaration under Article 4(a), must describe the category or categories of intermediaries which maintain securities accounts to which the Convention shall apply. The Contracting State is free to determine any category of intermediaries. The Contracting State thus may declare that only intermediaries who are regulated (“subject to authorisation, regulation, supervision or oversight by a government or public authority in respect of that activity”) are included in the category.

4-9. The requirement of being a regulated intermediary should be read against the purpose of Article 4. Therefore, Article 4 cannot be understood as permitting a general possibility to exclude intermediaries from the scope of the Convention. Rather, the scope of application can be narrowed in order to accommodate a Contracting State’s concerns regarding the modification, by the Convention, of the legal framework applicable to unregulated intermediaries. Article 4 is not intended to permit a Contracting State to exclude all or even the great majority of intermediaries from the application of the Convention rules. Such a blanket exclusion would be inconsistent with the purpose of this Convention and thus is not permitted.

4-10. Article 4 targets intermediaries which are authorised, supervised or otherwise regulated by a Contracting State. Paragraph (a) expresses this understanding by reference to the three methods generally used to ensure the influence of the State, i.e., by reference to being subject to “authorisation, regulation, or supervision or oversight by a government or public authority”. Authorisation refers to a prior permission to conduct the business of intermediary; regulation means that there are specific rules in place governing the business of intermediaries; supervision and oversight are both referring to the surveillance of the business of an intermediary by a governmental or public authority. In practice, intermediaries are often subject to all three requirements. However, under Article 4, a category of intermediaries can be designated provided it is subject to just one of these requirements.

4-11. The regulation requirement must exist in respect of the activity of maintaining securities accounts (“in respect of that activity”). It is not sufficient that an entity is authorised for other parts of its business, for example, as an insurance broker or for the business of extending credit.¹

III-3. Central banks

4-12. Central banks regularly maintain securities accounts. Consequently, there should be the possibility to include central banks in the scope of the Convention where a declaration is made under Article 4. However, their status would not necessarily be adequately covered by paragraph a), because in most countries they are not regulated entities in that sense. Quite to the contrary, they very often have regulatory or oversight competencies themselves. Given that they

¹ *Note of the Editors:* in this respect the reference to “that activity” may not be sufficiently clear. The Editors have therefore suggested a revision of the Convention text that would address this problem. See CONF. 11/2 – Doc. 6, section 1.

form part of the “public authorities” category, there should be the possibility to include them in a declaration under Article 4.

4-13. For the same reason noted above, a Contracting State cannot make a declaration designating only its central bank as intermediary to which the Convention applies.

Article 5 **Excluded functions**

This Convention does not apply to the performance of functions of creation, recording or reconciliation of securities, *vis-à-vis* the issuer of those securities, by a person such as a central securities depository, central bank, transfer agent or registrar.

Commentary

I. Introduction

5-1. Article 5 excludes from the scope of application of this Convention a number of functions *vis-à-vis* the issuer of securities which may be carried out by a central securities depository, central bank, transfer agent, registrar or any other person.

II. History

5-2. The first version of the provision on excluded functions was inserted during the third session of the CGE upon a proposal by a number of States and observers. See UNIDROIT 2007 – Study LXXVIII – Doc. 57, Appendix 1, Article 3, and UNIDROIT 2007 – Study LXXVIII – Doc. 58, sections 155 and 175 and Appendix 7.

5-3. During the fourth session of the CGE, no changes were made (see UNIDROIT 2007 – Study LXXVIII – Doc. 94, Appendix 1, Article 4).

5-4. During the first session of the diplomatic Conference the provision was refined by explicitly mentioning the exclusion of functions and by mentioning additional examples of entities carrying out the functions concerned. See UNIDROIT 2008 – CONF. 11 – Doc. 26.

III. Analysis

5-5. Coupled with Article 1(d) (the definition of “intermediary”) and Article 1(e) (the definition of “account holder”), Article 5 is intended to delineate the scope of application of this Convention by excluding certain functions specified in the article. Those functions are not characteristic of the activities of an intermediary as defined in Article 1(d), which typically include maintaining securities accounts, making credits, debits or designating entries to securities accounts, entering into control agreements and enabling account holders to receive and exercise their rights.

5-6. Article 5 reflects the Convention's functional approach and looks at the functions, rather than the entities, which are excluded from the scope of application of this Convention. Specifically, Article 5 excludes the functions of creation, recording or reconciliation of securities, *vis-à-vis* the issuer of those securities by anyone, including (but not limited to) a central securities depository (CSD), central bank, transfer agent or registrar. In practice, those persons may perform different

functions in different jurisdictions, and they may be intermediaries and/or account holders if they fall within the definitions under Article 1(d) and/or Article 1(e), even though at the same time they perform other functions specified in Article 5 and such functions are excluded from this Convention.

5-7. The functions of creation, recording or reconciliation of securities in Article 5 are those *vis-à-vis* the issuer of the securities. In contrast, reconciliation in the securities accounts maintained by a CSD or other person is the function performed by such CSD or person as an intermediary, to which function this Convention applies.

5-8. The functions of a registrar typically include maintenance of the securities register and the handling of corporate actions on behalf of the issuer. The registrar is thus essentially a record keeper for the issuer and its functions are excluded from the scope of this Convention under Article 5. The function of registrar is usually combined with that of transfer agent, whose role is to handle transfers on behalf of the issuer, by recording the name of the transferee on the register of the issuer in place of the name of the transferor. This function is excluded from the scope of this Convention under Article 5.

5-9. Certain provisions of this Convention apply to the register of the issuer of the securities (see Articles 24(1) and 24(2)(a)(b)). This does not mean that the Convention applies to the *functions* of creation, recording or reconciliation of securities within the meaning of Article 5. This application to the register of the issuer is simply the result of the necessary application of the functions of an intermediary. In other words, for an intermediary in the highest tier of the holding chain (typically a CSD, but not necessarily in certain jurisdictions) to comply with the obligations under Article 24(1), one must look at the register of the issuer in order to know how many securities such intermediary holds or has available for its account holders (see also Article 24(a)(b)).

5-10. Similarly, Article 5 excludes the functions of creation and issuance of securities from the scope of this Convention. However, under Article 29(1), every Contracting State must recognise an intermediated holding system for securities that are traded on an exchange or regulated market (see the commentary on Article 29(1)).

5-11. Finally, Article 5 does not preclude a person whose functions are excluded from this Convention under the article with respect to one account from being an intermediary with respect to another account.

EXAMPLE 5-1: A bank acting in the capacity of agent agrees with its customer to manage the customer's investments by arranging for a securities account to be opened with a third party in the name of the customer. The agent bank itself maintains a parallel record of the customer's holdings. This does not make the bank itself an intermediary, since it is not the party holding the securities for the customer, nor can transfers be effected across the bank's books, which merely record what is held for the customer in the records of the third-party intermediary. The position of the bank is thus to be contrasted with that of a CSD or other person who maintains securities accounts across which transfers may be effected.

Article 6***Performance of functions of intermediaries by other persons***

1. A Contracting State may declare that under its non-Convention law a person other than the relevant intermediary is responsible for the performance of a function or functions (but not all functions) of the relevant intermediary under this Convention, either generally or in respect of intermediated securities, or securities accounts, of any category or description.

2. A declaration under this Article shall:

(a) specify, if applicable, the category or description of intermediated securities or securities accounts, to which the declaration relates;

(b) identify, by name or description:

(i) the relevant intermediary;

(ii) the parties to the account agreement; and

(iii) the person or persons other than the relevant intermediary who is or are responsible as described in paragraph 1; and

(c) specify, with respect to each such person:

(i) the functions for which such person is so responsible;

(ii) the provisions of this Convention that apply to such person, including whether Article 9, Article 10, Article 15 or Article 23 applies to such person; and

(iii) if applicable, the relevant category or description of intermediated securities or securities accounts.

3. Unless otherwise provided in this Convention, where a declaration under this Article applies, references in any provision in this Convention to an intermediary or the relevant intermediary are to the person or persons responsible for performing the function to which that provision applies.

Commentary**I. Introduction**

6-1. The purpose of Article 6 is to clarify the notion of intermediary in a situation where the task of “maintaining” a securities account is split between two, or even more, persons (see also the definition of “intermediary” in Article 1(d)). Article 6 is necessary in order to ensure the proper application of the Convention to the holding patterns where a third person (“other person”) is involved in the relationship between the relevant intermediary and its account holders, in particular in the scenario of a so-called “transparent” holding pattern.

EXAMPLE 6-1: In Country X, all government bonds are held with the National Bank. Investors in government bonds open a securities account with the National Bank with the assistance of a commercial bank which acts for the account of the National Bank in this context. All instructions are given to the commercial bank which, through a technical

interface and under specific arrangements with the National Bank, causes government bonds to be credited and debited to the securities account.

6-2. In the situation like the one described in Example 6-1, there is a need for clarification as to how and to whom the provisions of the Convention apply. Therefore, Article 6 is intended to identify:

- the person who is the relevant intermediary for the account holder;
- the functions which are performed by the *other person*;
- the provisions of the Convention which apply to that *other person* instead of the relevant intermediary.

6-3. The rule of Article 6(1) makes clear that holding patterns involving persons other than the relevant intermediary and the account holder do actually exist and are covered by the scope of the Convention. Article 6(2) sets out a declaration mechanism which aims at specifically identifying and mapping holding patterns with shared functions where they exist in Contracting States. Article 6(3) provides that where a declaration under paragraph 2 is made, references in the provisions of the Convention to an intermediary or relevant intermediary are to the person who performs the function in question.

II. History

6-4. A provision addressing a split of the performance of intermediary duties was included in the draft Convention on the occasion of the fourth session of the CGE. Although this provision was inserted at a relatively late stage of the work, extensive preparatory work had been undertaken earlier.

6-5. The issue was first discussed in the context of the prohibition of upper-tier attachment (see UNIDROIT 2005 – Study LXXVIII – Doc. 23 rev., section 96; and UNIDROIT 2006 – Study LXXVIII – Doc. 43, sections 29-32 and 161-165 and Appendices 9 and 16).

6-6. The issue was next discussed during inter-sessional work between the second and the third session of the CGE (see UNIDROIT 2006 – Study LXXVIII – Doc. 44, and the follow-up document UNIDROIT 2007 – Study LXXVIII – Doc. 44 Add.) and between the third and fourth session of the CGE (see UNIDROIT 2007 – Study LXXVIII – Docs. 60-67, 70, 71, 77, 78, 81, 85, 88, 91). This resulted in the addition of a provision to the draft Convention during the fourth session of the CGE (see UNIDROIT 2007 – Study LXXVIII – Doc. 94, Article 5; and UNIDROIT 2007 – Study LXXVIII – Doc. 95, sections 6-70).

6-7. During the first session of the diplomatic Conference, some clarifications and editorial changes were made to the provision.

III. Analysis

III-1. Paragraph 1: recognition and specification of the sharing of functions by declaration

6-8. Article 6(1) has three purposes: (a) it generally recognises the existence of holding patterns involving shared functions of an intermediary, (b) it specifies that the other person may be responsible for the performance of some, but not all, functions, and (c) it states that a declaration may be made in this regard.

(i) General recognition of shared functions

6-9. The starting point is the general understanding that for any account holder there is one (and only one) relevant intermediary, who maintains a securities account for that account holder. This understanding is the kernel of the practice of modern securities holding and mirrored in the logic underlying all provisions of the Convention. Paragraph 1 recognises that this two-party relationship can be extended, under certain circumstances, to a three- (or more) party relationship by making sure that the borderlines between the functions are not blurred in legal terms.

(ii) Quality of involvement of the other person

6-10. Article 6(1) specifies the quality of the involvement of the person other than the relevant intermediary in a number of ways.

"other than the relevant intermediary"

6-11. Typically, the *other person* is a privately or publicly owned entity which provides services in the financial market. However, it is conceptually irrelevant whether the person is a natural or a legal person. In addition, it is irrelevant whether the person exclusively performs intermediary functions or whether the person offers other services as well. It must be distinct from the relevant intermediary ("other than"). Consequently, subsidiaries or affiliate companies of the relevant intermediary can be such other person as far as they are legally distinct persons, because the economic or organisational relationship between the relevant intermediary and the other person is irrelevant.

6-12. Once a declaration has been made which identifies the relevant intermediary and the other person or persons (Article 6(2)), the declaration is final and binding as to their identity and there is no need for further analysis.

"responsible for the performance of a function or functions of the relevant intermediary under this Convention"

6-13. The "function or functions" of the relevant intermediary referred to in paragraph 1 should be interpreted broadly and includes any function that may occur in the context of maintaining securities accounts for the account holder in the course of a business or other regular activity (see the definitions of "intermediary" and "relevant intermediary" in Articles 1(d) and 1(g)). For example, the phrase includes sending account statements, opening an account between the relevant intermediary and its account holder, receiving instructions, providing for IT services, paying out dividends or interest with respect to the securities, transferring communications from the issuer, etc.

6-14. However, the circle of persons contributing to the work of the relevant intermediary is supposed to be relatively large in many cases. It is clear that not all persons contributing to maintaining the securities account one way or the other can be considered "other persons" in the sense of Article 6(1), to which certain provisions of the Convention would apply instead of to the relevant intermediary. In particular, there are two groups of ancillary contributors which are not covered:

- Persons to whom part of the activity is "outsourced": every intermediary would probably leave a considerable part of its activity belonging to the maintenance of securities accounts to service providers, e.g., the provision of IT infrastructure or the handling of client mail. The assistance of persons belonging to this category would

normally not be apparent to the account holder and it is not relevant to this Convention.

- Persons who act as legal representatives for the relevant intermediary in the sense that any of their actions take immediate legal effect between the relevant intermediary and the account holder. Such persons are often visible but it is clear that they would not have a legal role in the bilateral relationship between the account holder and its relevant intermediary. They are not relevant to this Convention.

6-15. The relevant intermediary cannot outsource all of its functions to other person or persons. If the purported relevant intermediary outsources all of its functions to A and B, either A or B is the relevant intermediary for the purposes of the Convention and the other is the other person within the meaning of Article 6 (if a declaration is made properly).

6-16. Outsourcing of certain functions or the use of legal representatives are not relevant to this Convention and do not modify the responsibilities of intermediaries to their account holders. Article 6 is only concerned with function-sharing, where one (or more) other person is “responsible” vis-à-vis the account holder for the performance of a function or functions. Responsible means legally responsible, i.e., the person must have its own, independent role regarding the fulfilment of the function, including an element of legal accountability towards the account holder.

EXAMPLE 6-2: In a Contracting State, ABC Inc., the local CSD, is the relevant intermediary. The provision and maintenance of the entire IT infrastructure, including the settlement platform, is entrusted to ABC-IT Ltd., a 100% subsidiary of ABC Inc., on the basis of a service contract. ABC-IT Ltd. does not have any direct relationship with account holders. The relationship with the account holders is entrusted to a category of specialised private financial institutions (“account operators”), which under the law of the Contracting State cannot maintain securities accounts for clients themselves. They enter into service contracts with account holders and can open and manage their accounts directly in the systems of ABC Inc., via a special technical interface. The Contracting State is considering the content of its declaration under Article 6.

In this example, ABC-IT Ltd. is not legally responsible vis-à-vis the account holders of ABC Inc. for the performance of a function and, therefore, cannot be specified as an other person in the declaration. The account operators, however, can be specified as other persons in the declaration, because these operators enter into an independent legal relationship with, and are legally responsible to, the account holders.

“under its non-Convention law”

6-17. The sharing of functions must be prescribed by the rules of the non-Convention law. The purpose of this criterion is to exclude sharing of functions on a purely contractual basis between the intermediary and the “other person”, or sharing on a pure *de facto* basis. Such sharing is outsourcing and not dealt with in Article 6. In addition, only where the sharing of functions has its basis in the non-Convention law can foreign market participants rely on the content of the declaration reflecting properly the actual domestic legal situation.

(iii) Reference to declaration

6-18. A declaration under Article 6 has a constitutive effect, i.e., unless a declaration is made, the provisions of the Convention apply exclusively to the relevant intermediary. Where a declaration is

made, the application of the rules of the Convention follows the specifications of that declaration (see the comments on paragraph 2 for further details).

6-19. A declaration which does not conform with the conditions set out in paragraph 1 (see Example 6-2 above) cannot be made, and thus, if made, would be ineffective. Such declaration would have a disruptive effect and increase legal uncertainty about the application of a number of provisions of the Convention in respect of the relevant intermediary.

III-2. Paragraph 2: specifications contained in the declaration

6-20. Article 6(2) provides details about the content of the declaration mentioned at the end of paragraph 1: the declaration can be either general or in respect of intermediated securities, or securities accounts, of any category or description.

6-21. Sub-paragraph 6(2)(a) makes it clear that, where applicable, the declaration shall specify the categories (e.g., shares, bonds, etc.) or description (e.g., registered or bearer shares, dematerialised or certificated, etc.) of the intermediated securities. The sub-paragraph refers also to the categories of securities accounts that may be specified, which could, for example, either relate to the tier on which the accounts are located in the holding system, in particular those at a CSD, or accounts maintained for foreign account holders, or any other description.

6-22. According to sub-paragraph 6(2)(b), the declaration shall identify the relevant intermediary in respect of the accounts as specified under sub-paragraph 6(2)(a), the parties to the account agreement on which the account is based and the third person performing functions as described in paragraph 6(1). A declaration has a constitutive effect in this regard, i.e., the roles of intermediary and other person as attributed by the declaration cannot be contested.

6-23. Sub-paragraph 6(2)(c) is the core part of Article 6(2). It determines the application of the provisions of the Convention to the relevant intermediary and the other person performing intermediary functions.

6-24. According to Article 6(2)(c)(i), the declaration shall specify function or functions for which the other person shall be responsible. It is understood that “function” is used here only as shorthand for the term used in paragraph 1, “function or functions [...] of the relevant intermediary under this Convention”. The declaration must set out exclusively the functions of that other person. It is not necessary for any or all of the functions of the relevant intermediary itself to be spelled out in the declaration. Under this mechanism uncertainties are avoided: if one or more functions are performed by the other person, it means that all other possible functions under the Convention are within the responsibility of the relevant intermediary.

6-25. According to Article 6(2)(c)(ii), the declaration shall also specify the provisions of the Convention that apply to the other person instead of the relevant intermediary. This element of the declaration must be perfectly congruent with the specification of the function under letter (i). Otherwise, the declaration would be inconsistent and impossible to apply.

EXAMPLE 6-3: Contracting State X declares that the country's CSD is the relevant intermediary and that brokerage firms act as “account agents” and perform certain functions of the relevant intermediary. Among these functions described in the declaration figures the receiving of instructions from the account holders. However, the declaration does not specify that Article 23 of the Convention applies to brokerage firms acting as account agents. The declaration is inconsistent and cannot be applied properly.

6-26. Under the second part of paragraph 2(c)(ii), the declaration shall specify the provisions of the Convention that apply to the other person, “including whether Article 9, Article 10, Article 15 or Article 23 applies to such person”. The declaration may specify articles other than the ones explicitly cited. The word “including” makes this clear.

6-27. The text under Article 6(2)(c)(iii) prescribes that, if the declaration does not apply in a general manner (see also paragraph 6(1)), it must specify, with respect to each person, the relevant category or description of securities or securities accounts.

III-3. Paragraph 3: consequences for the application of the Convention

6-28. Article 6(3) sets out the consequences for the application of the Convention where the responsibility for the performance of functions is shared between the relevant intermediary and an other person. According to this paragraph, references in any provision of the Convention to an intermediary or the relevant intermediary are to the person or persons responsible for performing the function to which that provision applies. Consequently, the rights and obligations set out in some provisions will apply to the other person, while those set out in the remaining provisions apply to the relevant intermediary.

6-29. In particular, where applicable under the relevant declaration:

- Article 9(1)(b) and 9(1)(c): the account holder has the right to instruct the other person instead of the relevant intermediary.
- Article 9(2)(b) and 9(3)(c): the account holder can exercise rights flowing from securities against the other person, or, under certain conditions, against the issuer.
- Article 10: the other person must take appropriate measures to enable the account holder to receive and exercise the rights flowing from the securities.
- Article 15: the requirement of authorisation applies to the other person.
- Article 23(1): the other person is the addressee of the rules on receiving and honouring instructions.

Article 7 ***Effects of insolvency***

Unless otherwise provided in this Convention, nothing in this Convention affects any substantive or procedural rules of law applicable in an insolvency proceeding.

Commentary

I. Introduction

7-1. Article 7 sets forth a baseline rule for the relationship between the Convention and the rules applicable in insolvency proceedings. The Convention does not affect such rules unless it provides otherwise. In some respects, addressed below, the Convention does otherwise provide.

II. History

7-2. Article 7 was added to the Convention text at the first session of the diplomatic Conference. It follows closely a proposal made by the informal Working Group on Insolvency formed during the Conference.

III. Analysis

III-1. General precedence of rules of insolvency law

7-3. Article 7 sets forth a baseline rule for the relationship between the Convention and law applicable in insolvency proceedings: “Unless otherwise provided in this Convention, nothing in this Convention affects any substantive or procedural rules of law applicable in an insolvency proceeding.” In some respects, addressed below, the Convention does otherwise provide. However, it follows from Article 7 that every provision of the Convention must be read while keeping in mind all rules applicable in insolvency proceedings.²

7-4. Part of the language of Article 7 is ambiguous. What are the “substantive [...] rules of law applicable in an insolvency proceeding” which prevail over the provisions of this Convention which do not “otherwise provide”?

EXAMPLE 7-1: AH has obtained an unsecured loan from L but failed to meet the last two interest payments. L is concerned that AH be declared insolvent and obtains from AH a security interest over some intermediated securities credited to AH’s securities account with IM. The security interest has been made effective against third parties by a control agreement. Two months later, L is declared bankrupt. Under the law governing the insolvency, the insolvency administrator can set aside the security interest as a fraudulent preference. The provisions on fraudulent preferences are “substantive [...] rules of law applicable in an insolvency proceeding”. No provision of this Convention prevents their application.

EXAMPLE 7-2: AH has a securities account with IM. On Day 1, IM credited AH’s account with 100 shares of ABC Corp., which AH had instructed IM (acting as broker) to buy for AH’s account. On Day 10, IM becomes subject to an insolvency proceeding. A provision of the law applicable in the insolvency proceedings provides, however, that a further step in addition to the credit was necessary for the acquisition by AH to be effective against third parties. However, Article 21 applies because the insolvency proceeding is in respect of IM. AH’s rights and interests are protected by Article 21(1) and the “further step” required by the non-Convention law does not affect this result.

EXAMPLE 7-3. AH-1 and AH-2 have securities accounts with IM. AH-1 transferred 100 shares of ABC Corp. to AH-2 in order to secure a loan made by AH-2 to AH-1, and IM debited to AH-1’s account and credited to AH-2’s account (in accordance with Article 11). In an insolvency proceeding of AH-1, the insolvency administrator asserts that AH-2’s acquisition is invalid in the insolvency proceeding because the law applicable in the

² *Note of the Editors:* Article 7 may address a useful goal only if there exists some basis for believing that in the absence of Article 7 the provisions of the Convention that do not mention rules applicable in insolvency proceedings are in conflict with such rules. But the basis for that belief is not obvious. However, Examples 7-3 and 7-4 below suggest how such conflicts may arise. The Editors have noted this and several other problematic issues with the Convention’s insolvency-related provisions. Consequently, they have suggested several revisions to the Convention text. See CONF. 11/2 – Doc. 6, section 2.

insolvency proceeding requires a further step and such step was not taken for AH-2. Article 7 is not intended to mean that the rights and interests acquired by AH-2 under Article 11 are denied by the applicable insolvency law. However, Article 11 does not expressly derogate from insolvency law (“otherwise provide”) so that there is a strong doubt as to the proper outcome of this example.

EXAMPLE 7-4: Wife (W) informs IM-1 that (i) the securities credited to the securities account of her Husband (H) with IM-1 are jointly owned by W and H (although the account is in the name of H alone), (ii) that they are parties to a divorce proceeding, and (iii) that her husband moved the securities into his sole account with IM-1 from their joint account with another IM-2. In the meantime, however, H granted a security interest in the intermediated securities to a lender (L) to secure a new loan and the securities have been credited to L’s account with another intermediary. L was aware (from a credit application) that H is married but was unaware of the pending divorce proceeding. (These are the facts of Example 17-1.) Subsequently, W becomes subject to an insolvency proceeding and her administrator sues L to recover the securities. L defends on the basis that it is an innocent acquirer protected by Article 18(1). However, a rule applicable in the insolvency proceeding permits the administrator to recover property to which the debtor has a claim unless the acquirer met a more stringent test of innocence under the non-Convention law applicable in the insolvency proceeding. Because L failed to exercise sufficient diligence in its failure to make proper inquiry, the administrator seeks to recover the securities from L. Article 7 is not intended to preclude L from being protected under Article 18(1). However, Article 18 does not expressly derogate from insolvency law (“otherwise provide”) so that there is a strong doubt as to the proper outcome.

III-2. Need for clarification

7-5. As should be obvious from the above examples, except for specific cases such as the avoidance of a transaction as a preference or a transfer in fraud of creditors (see, for example, Article 21(3)(a)), Article 7 is not intended to deny the rights or interests that have been acquired by an account holder and have been made effective against third parties under Article 11 or Article 12, even if it is not explicitly “otherwise provided” in Article 11 or Article 12. Nor is Article 7 intended to generally interfere with the application of Article 18, which provides a minimal but uniform protection of an innocent acquirer, subject to more protective provisions of the non-Convention law. However, the language of Article 7 is ambiguous because it reserves any “substantive [...] rules of law applicable in an insolvency proceeding”, which may be taken as including insolvency and non-insolvency provisions regulating the creation and perfection of interests in securities or intermediated securities.

7-6. Furthermore, after adopting Article 7, the diplomatic Conference did not revisit provisions such as Articles 11, 12, 18, 19 and the like to explicitly “otherwise provide” where such provisions must override the rules applicable in an insolvency proceedings. This results in a situation where

Article 7, when read literally, may potentially disrupt most of the core provisions of the Convention.³

Article 8
Relationship with issuers

- 1. Subject to Article 29(2), this Convention does not affect any right of the account holder against the issuer of the securities.**
- 2. This Convention does not determine whom the issuer is required to recognise as the holder of the securities or as the person entitled to receive and exercise the rights attached to the securities or to recognise for any other purpose.**

Commentary

I. Introduction

8-1. Article 8 delineates the scope of the subject matter covered by this Convention. Its general idea is that this Convention does not cover the area of what is regulated by the body of law usually (but not necessarily) called “corporate law”. That area is about the rights of the account holder against the issuer of the securities.

8-2. It is not easy to draw a line in precise language between what is covered and what is not covered by this Convention. In particular, it is obvious that using the notion “corporate law” would not work, because the coverage of corporate law varies from jurisdiction to jurisdiction. This Convention follows the functional approach, and delineates the coverage of the subject matter not by using the notion “corporate law” but by directly spelling out (in functional terms) what is not covered by the Convention.

II. History

8-3. The basic idea of excluding so-called corporate law matters from this Convention was supported by the Study Group and has not been problematic at any time thereafter. However, the question of how to incorporate it in the text was much debated and subject to significant discussion during the negotiation process.

³ *Note of the Editors:* Article 7 is novel, extraordinary, and even pathbreaking in at least two respects. First, no other analogous international instrument that addresses property interests, third-party rights, and effectiveness in insolvency proceedings contains a provision similar to Article 7. Consider in this respect, for example, the UNIDROIT Convention on International Interests in Mobile Equipment (Cape Town, 2001; hereinafter: Cape Town Convention) and the Protocols thereto on Matters specific to Aircraft Equipment (Cape Town, 2001) and Railway Rolling Stock (Luxembourg, 2007); the UNIDROIT Model Law on Leasing (2008); the United Nations Convention on Assignments of Receivables in International Trade (New York, 2004); the UNIDROIT Convention on International Financial Leasing (Ottawa, 1988); and the UNIDROIT Convention on International Factoring (Ottawa, 1988). Second, not only is such a hierarchical provision unprecedented in international instruments, but analogous domestic laws relating to the effectiveness of property interests and related matters normally also do not contain such a provision on the hierarchy of insolvency law. For example, the UNCITRAL Legislative Guide on Secured Transactions (2007) makes no recommendation or mention of any similar provision.

8-4. During the first session of the diplomatic Conference, upon various observations and proposals, Article 8(2) and Article 26(3) in the version of UNIDROIT 2008 – CONF. 11 – Doc. 3 were combined into one article, to current Article 8. The history of current Article 8(1) and Article 8(2) should therefore be seen in light of the different provisions of which they originally formed part (respectively Article 10 and Article 29 in the current numbering).

8-5. The first version of Article 8(1) was written during the first session of the CGE (see UNIDROIT 2006 – Study LXVIII – Doc. 24, Appendix 1, Article 4(5) (Version A), second sentence). During the second session of the CGE, it became part of a separate provision on measures to enable account holders to receive and exercise rights (see UNIDROIT 2006 – Study LXVIII – Doc. 42, Appendix 1, Article 10(2)), which subject matter is covered by Article 10 of the current text. During the third session of the CGE, Article 10(2) was renumbered to Article 6(2), but no substantive change was made (see UNIDROIT 2006 – Study LXVIII – Doc. 57, Appendix 1, Article 6(2)). During the fourth session of the CGE, the provision was renumbered to Article 8(2) (see UNIDROIT 2007 – Study LXVIII – Doc. 94, Appendix 1, Article 8(2)). As noted above, during the first session of the diplomatic Conference, current paragraph 8(1) was taken out of the provision relating to measures to enable account holders to receive and exercise rights, and moved to a separate provision relating to the relationship with issuers.

8-6. The history of Article 8(2) should be seen in light of the history of Article 29. A preliminary version of Article 8(2) appeared in the text of the preliminary draft Convention by the Study Group (see UNIDROIT 2004 – Study LXVIII – Doc. 18, Article 17(3)) and in the text resulting from the first session of the CGE (see UNIDROIT 2005 – Study LXVIII – Doc. 24, Appendix 1, Article 19(3)), but was deleted during the second session of the CGE (see UNIDROIT 2006 – Study LXVIII – Doc. 42, Appendix 1, Article 13). A first version of the provision that ultimately became Article 8(2) was drafted during the third session of the CGE (see UNIDROIT 2006 – Study LXVIII – Doc. 57, Appendix 1, Article 24(3)) and remained unchanged during the fourth session of the CGE (see UNIDROIT 2007 – Study LXVIII – Doc. 94, Appendix 1, Article 26(3)). During the first session of the diplomatic Conference, the provision was refined and inserted into a new provision relating to the relationship with issuers as Article 8(2).

III. Analysis

III-1. Exclusion of so-called corporate law issues from this Convention

8-7. Article 8(1) provides that this Convention does not affect any right of the account holder against the issuer of the securities. This rule is subject to an exception located in Article 29(2), which requires Contracting States to recognise a so-called nominee holding structures and the splitting of voting and other rights related to the securities held in the intermediated holding system (see the commentary on Article 29(2)).

8-8. Article 8(2) puts another limitation on the scope of the subject matter covered by this Convention by providing that the Convention does not determine whom the issuer of the securities is required to recognise: (i) as the holder of the securities; or (ii) as the person entitled to the rights attached to the securities, which are often referred to as shareholder rights or bondholder rights and specifically spelled out in Article 9(1)(a); or (iii) for any other purposes.

8-9. The word “account holder” is defined in Article 1(e).

8-10. The word “issuer” of the securities is not defined anywhere in this Convention. For traditional investment securities such as shares and bonds, defining the issuer is usually not difficult, but for structured financial products such as asset-backed securities, it is not always easy to determine who the issuer is.

8-11. Similarly, “holder” of the securities (see Article 8(2)) is not defined in this Convention. It includes shareholders, bondholders and any other holders of securities (“securities” is defined in Article 1(a)). From the standpoint of this Convention, it is not helpful to define the term generally, and it depends on the issue at stake who the holder is.

8-12. In some jurisdictions, the status of shareholder (known as *Mitgliedschaft*) can be the subject matter of a transfer or collateralisation. For such jurisdictions, Article 8 does not preclude such status from being disposed of or acquired under Article 11, nor does it prevent an interest in such status from being granted under Article 12.

III-2. Relationship between Article 8 and Article 9(1)

8-13. Where the securities are credited to the securities account, the account holder is given the rights enumerated in Article 9(1)(a). While Article 8(1) uses the phrase “does not affect any right”, it is not an exception to Article 9(1)(a). In other words, Article 8(1) is not intended to deny or otherwise limit the right resulting from the credit under Article 9(1)(a). Article 8(1) applies to the matters with respect to the relationship between the account holder and the issuer which are beyond what is spelled out in Article 9(1)(a).

8-14. The relationship between Article 8(2) and Article 9(1)(a) is similar. Article 8(2) is not an exception to Article 9(1)(a). It does not address what the account holder is entitled to receive but only whom the issuer is required to recognise.

8-15. Typically, corporate law in most jurisdictions provides various procedural requirements for shareholders to exercise voting rights or receive dividends. For instance, corporate law may state that dividends are payable only upon a valid decision of the board of directors or the shareholders meeting. In such cases, unless the declaration is made, shareholders cannot request the issuer to pay dividends. Similarly, corporate law may state that where the shareholder exercises its voting right by proxy, a valid proxy card must be prepared, signed and submitted to the issuer within a certain number of days before the shareholders meeting. In these situations, corporate law rules apply.

8-16. Also, corporate law in most jurisdictions provides substantive rules for dividends and voting. For instance, corporate law typically provides that dividends can be paid out of retained profits, but that if such profits do not exist, dividends cannot be paid. Similarly, under corporate law, the issuer does not have to permit shareholders of non-voting shares to vote. In these situations, corporate law rules apply.

EXAMPLE 8-1: Shares of IS (issuer) were credited to the securities account of AH (account holder) maintained by its intermediary. Under this Convention, IS cannot assert that AH does not have the rights attached to the securities (see Article 9(1)(a)). However, if under the applicable law, the issuer is obliged to recognise as shareholders only persons whose names appear on the shareholder register, then such law applies. Unless and until the name of AH appears on the shareholder register, IS is not obliged to treat AH as a shareholder, which means that AH cannot exercise the Article 9(1)(a) rights against IS. This result is obtained by Article 8(2).

EXAMPLE 8-2: In the setting of Example 8-1, what if a dispute arises as to whether the Article 9(1)(a) rights (“the shareholder rights”) belong to AH or another person (AN)? As far as the dispute between AH and AN is concerned, this Convention (and not the applicable or non-Convention law) determines who owns the shareholder rights. Thus, if the acquisition of the intermediated securities by AH is “effective” and otherwise not affected under the rules of this Convention, AH has the shareholder rights. IS (or anyone) cannot deny this. However, this does not mean that AH can exercise the shareholder rights against IS. For instance, suppose that AN is a registered holder on the register of IS but the shares are not credited to the securities account of AN. IS does not have to send dividends or permit voting at a shareholder meeting to AH, if the applicable law provides that only persons whose names appear on the shareholder register of the issuer are entitled to receive dividends or to vote.

EXAMPLE 8-3: BH (bondholder) owes debts to IS, but BH is not a registered bondholder on the register of IS. BH attempts to assert set-off against IS of its obligations against its bondholder rights. Whether this is possible would depend on whether BH could assert its bondholder rights against IS, and whether other conditions for set-off were satisfied. These questions are not answered by this Convention, and would be answered by the applicable law (see also Article 30).

III-3. Relationship between Article 8(1) and Article 10(1)

8-17. Article 10(1) provides for an intermediary’s obligation to take appropriate measures so as to enable its account holders to receive and exercise their rights specified under Article 9(1). In this context, Article 8(1) means that the obligations of an intermediary under Article 10(1) do not affect any right of the account holder against the issuer. For instance, the account holder itself can initiate legal proceedings against the issuer if the issuer fails to make dividend payments, but this is so only if it is permitted under the applicable law.

8-18. Note also that Article 8(1) does not delineate an intermediary’s obligations. For instance, whether an intermediary is obliged to take measures in order for the names of its account holders to be recorded on the register of the issuer is determined under Article 28(1).

CHAPTER II – RIGHTS OF THE ACCOUNT HOLDER

Contents and outline

II-1. *Chapter II* contains two provisions that address the rights of an account holder (Article 9) and the corresponding duties of an intermediary (Article 10).

II-2. “[I]ntermediated securities” are defined in Article 1(b). *Article 9* describes and characterises the rights conferred on the account holder by the credit of securities to a securities account.

III-3. *Article 10(1)* provides for the most basic obligations that an intermediary owes to its account holders – it must take the appropriate measures so that its account holders enjoy the rights provided in Article 9(1). However, Article 10(2) sets some limits on these and other obligations of an intermediary.

Article 9
Intermediated securities

1. The credit of securities to a securities account confers on the account holder:

(a) the right to receive and exercise any rights attached to the securities, including in particular dividends, other distributions and voting rights:

(i) where the account holder is not an intermediary or is an intermediary acting for its own account; and

(ii) in any other case, if so provided by the non-Convention law;

(b) the right, by instructions to the relevant intermediary, to effect a disposition under Article 11 or grant an interest under Article 12;

(c) the right, by instructions to the relevant intermediary, to cause the securities to be held otherwise than through a securities account, to the extent permitted by the applicable law, the terms of the securities and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system;

(d) unless otherwise provided in this Convention, such other rights, including rights and interests in securities, as may be conferred by the non-Convention law.

2. Unless otherwise provided in this Convention:

(a) the rights referred to in paragraph 1 are effective against third parties;

(b) the rights referred to in paragraph 1(a) may be exercised against the relevant intermediary or the issuer of the securities, or both, in accordance with this Convention, the terms of the securities and the applicable law;

(c) the rights referred to in paragraph 1(b) and 1(c) may be exercised only against the relevant intermediary.

3. Where an account holder has acquired a security interest, or a limited interest other than a security interest, by credit of securities to its securities account under Article 11(4), the non-Convention law determines any limits on the rights described in paragraph 1 of this Article.

Commentary

I. Introduction

9-1. While intermediated securities are defined in Article 1(b), they are described and characterised by Article 9 as the rights conferred on the account holder by the credit of securities to a securities account. Article 9 (“Intermediated securities”) is the first of the two provisions in Chapter II (“Rights of the account holder”).

9-2. Consistent with the functional approach of this Convention, Article 9 does not attempt to characterise the legal nature of the rights and interests arising from the credit of securities to a securities account. To be capable of broad international acceptance, an instrument setting out substantive provisions in respect of intermediated securities must not try to impose any particular legal or doctrinal characterisation of the rights and interests of account holders. For example, a number of jurisdictions take the position that investors and holders of limited interests enjoy some form of property right in securities and are considered as shareholders or bondholders by the issuer. In those jurisdictions, intermediaries obtain no property interest in the securities, unless they are granted a limited interest such as a security interest. Other jurisdictions maintain the position that every intermediary owns the securities or an interest in the securities it holds for its account holders. In these jurisdictions, the issuer recognises the upper tier intermediary, or its nominee, as the shareholder or bondholder and relies on the chain of intermediaries to convey to investors the economic benefits and voting rights attached to the securities.

9-3. Recognising the wide diversity in the legal and doctrinal characterisation of the position of account holders around the world, this Convention's functional approach treats intermediated securities as a set of rights accruing to account holders. Some of these rights arise from the terms of the securities and the law applicable to the securities and/or to the issuer. Other rights are conferred by the Convention itself. Still other rights are conferred by the non-Convention law. Accordingly, paragraph 1 distinguishes between the rights attached to the securities, the rights to dispose of the intermediated securities and to hold the securities otherwise than through intermediaries, and any additional rights conferred by the non-Convention law. Paragraph 2 specifies against whom these rights are effective and can be exercised. Paragraph 3 considers the extent of these rights when the account holder has acquired a limited or partial interest in the securities credited to its securities account.

9-4. The Convention focuses on account holders, not on investors, a word which is entirely absent. Article 9(1)(a)(i) is the only Convention provision close to addressing specifically the situation of the investor who, for the purpose of the intermediated holding system, is an account holder who "is not an intermediary or is an intermediary acting for its own account". However, it must be noted that this "ultimate account holder" may hold intermediated securities on behalf of other persons under arrangements such as a trust or a fiduciary relationship.

9-5. Regulating the legal position of account holders, not of investors, is the only choice compatible with the functional approach described above and avoids any unnecessary interference with company law and the law of financial markets. Making the operation of the provisions of the Convention depend on the distinction between investors and other account holders would have raised insurmountable difficulties in accommodating the wide diversity of legal systems with which the Convention is intended to interact.

9-6. Article 9 does not address the duties of an account holder acting as an intermediary in respect of the intermediated securities it holds on behalf of its account holders. Such duties are governed by Article 10 (Measures to enable account holders to receive and exercise rights), Article 23 (Instructions to the intermediary), and Article 28 (Obligations and liability of intermediaries), by the non-Convention law and by account agreements between the intermediary and its account holders.

9-7. Article 9 sometimes refers to the "non-Convention law" and sometimes to the "applicable law". The "applicable law" is used whenever the law referred to is not necessarily the "non-Convention law". This usage is consistent with the definition of non-Convention law in Article 1(m); see also the note in section 1-53.

II. History

9-8. The policy choice explained in the introduction was made by the Study Group and was not disputed by the CGE or during the first session of the diplomatic Conference.

9-9. The structure and substance of the first two paragraphs of current Article 9 was present in the original draft developed by the Study Group and submitted to the first session of the CGE (UNIDROIT 2004 – Study LXXVIII – Doc. 18, Article 2). Because of the difficulty in maintaining the functional approach, the language of these two paragraphs was amended at every session of the CGE and during the diplomatic Conference. See UNIDROIT 2005 – Study LXXVIII – Doc. 24, Article 4 (first session of the CGE); UNIDROIT 2006 – Study LXXVIII – Doc. 42, Article 9 (second session of the CGE); UNIDROIT 2006 – Study LXXVIII – Doc. 57, Article 5 (third session of the CGE); and UNIDROIT 2007 – Study LXXVIII – Doc. 94, Article 7 (fourth session of the CGE).

9-10. The substance of paragraph 3 was tentatively added in respect of security interests during the first session of the CGE (UNIDROIT 2005 – Study LXXVIII – Doc. 24, Article 4(7)). It was later expanded to all limited interests (UNIDROIT 2006 – Study LXXVIII – Doc. 57, Article 5).

III. Analysis

III-1. Rights attached to securities

9-11. In the language of Article 9(1)(a), “intermediated securities” includes “rights attached to the securities” such as the rights to receive dividends and vote. These rights do not arise under this Convention. They are typically created and determined by the terms of the securities or the by-laws of the issuer (i.e., the organisational documents governing the issuer), as well as the laws governing the securities or the issuer. This Convention, and the rules generally governing the holding of securities through intermediaries, is only concerned with how the rights attached to the securities are passed through the chain of intermediaries. Article 9(1)(a) does not take any position as to the existence, content, or limitations of the rights attached to securities.

9-12. Not all account holders may be entitled to receive and exercise the rights attached to securities. At a minimum, the “ultimate account holder” at the lowest tier of the intermediary chain is entitled under the Convention to receive and exercise the rights attached to securities (Article 9(1)(a)(i)). Whether that ultimate account holder is itself the investor, or whether it holds intermediated securities on behalf and for the benefit of other persons, is irrelevant to this subparagraph and not addressed by this Convention.

9-13. The Convention does not take any position as to whether an intermediary not acting for its own account is entitled to receive and exercise the rights attached to securities. Under Article 9(1)(a)(ii), this question is entirely governed by the non-Convention law. If under the non-Convention law such an intermediary is entitled to receive and exercise the rights attached to the securities, then Article 10 requires that intermediary to take appropriate measures to pass down the economic benefits of these rights.

EXAMPLE 9-1: In some jurisdictions, the legal system considers that the “ultimate account holder” (and possibly persons to whom it has granted a limited interest) is directly and solely entitled to payments made by the issuer of securities or to exercise voting rights in respect of the issuer. The intermediaries through whom it holds its securities (whether certificated or not) are mostly account keepers and auxiliaries in its exercising the rights attached to the securities. Such “ultimate account holder”, who is not an intermediary (unless possibly an intermediary which is acting for its own account), is entitled to receive

and exercise the rights attached to the securities under Article 9(1)(a)(i). The non-Convention law of these jurisdictions does not provide for any other person to be entitled to exercise the same rights (Article 9(1)(a)(ii)), except possibly for the beneficiaries of a security interest or of a usufruct in the intermediated securities of the account holder.

EXAMPLE 9-2: In some jurisdictions, an intermediary acting in that capacity holds securities or an entitlement in respect of securities for its account holder. Such intermediary is entitled to receive dividends and exercise voting rights in respect of the securities credited to its account holders, but it must do so on their behalf. In accordance with Article 9(1)(a)(ii), the non-Convention law of these jurisdictions provides the right of intermediaries to receive and exercise the rights attached to the securities and their duty to pass the benefit of such rights to their account holders.

9-14. Under Article 9(2)(a), the rights attached to the securities are effective against third parties: persons entitled to such rights must be allowed to protect them against infringement by third parties. Whether these persons may exercise and enforce such rights against the issuer of the securities, or against the relevant intermediary, or against both, will depend on this Convention, the terms of the securities and the applicable law. The applicable law here includes the law governing the issue of securities or the issuer and the non-Convention law applicable to the intermediated securities.

EXAMPLE 9-3: In the setting of Example 9-1 above, if the securities have been issued under the laws of the relevant jurisdiction, the ultimate account holder is recognised by law as the person who can claim against the issuer for the payment of dividends or challenge decisions made at the issuer's shareholders' meeting. The account holder may need to rely on intermediaries to produce evidence of its holding. The direct entitlement of the account holder against the issuer may be disrupted, however, in cross-border holdings of securities, for example, if securities issued by a company in another jurisdiction are held at the upper tier by the CSD in that jurisdiction.

EXAMPLE 9-4: In the setting of Example 9-2 above, any account holder is directed to the relevant intermediary to exercise the right to dividends and other payments or the right to vote at the shareholders' meeting of the issuer.

III-2. Right to dispose of intermediated securities in accordance with the Convention

9-15. Account holders should be able to transfer to other persons their entitlement or a limited interest in securities. As defined in Article 1(a), "securities" must be capable of being disposed of in accordance with the provisions of this Convention. Article 9(1)(b) thus confers on account holders the right to dispose of intermediated securities in accordance with Article 11 or Article 12. This right is effective against third parties, but it may only be exercised against the relevant intermediary, as specified in sub-paragraphs 2(a) and 2(c).

9-16. Article 9(1)(b) does not address the manner of disposing of intermediated securities in accordance with any method provided by the non-Convention law (Article 13) because it is that law, not this Convention, which determines if and how an account holder may make such dispositions.

III-3. Scope of Article 9(1)(b)

9-17. The words "by instructions to the relevant intermediary" apply properly to credits and debits made under Article 11, which must generally rely on the authorised instructions of the

account holder (see Articles 15 and 23). They also apply to designating entries provided under Article 12(3)(b). However, they do not apply to agreements granting an interest to the relevant intermediary (Article 12(1) and (3)(a)) or to control agreements in favour of other persons (Articles 1(k), 12(1) and 12(3)(a)). Such agreements are not “instructions to the relevant intermediary” in the strict sense.⁴

III-4. Right to hold securities otherwise than through a securities account

9-18. Article 9(1)(c) addresses the right of the account holder to hold the securities credited to its securities account otherwise than through a securities account. However, unlike the right to dispose of intermediated securities within the intermediated holding system, the right to withdraw the securities from that system is subject to numerous limitations.

9-19. By stipulating the issuance of a global certificate or of uncertificated securities, the terms of the securities or the by-laws of the issuer may suppress or restrict the right of account holders to obtain certificates capable of being held outside of the intermediated system. The law under which the securities are constituted, or the law governing the issuer (which may be different), may contain the same restriction. Such restrictions may also be imposed by the non-Convention law in respect of some or all types of securities credited to securities accounts to which that law applies, prohibiting account holders from withdrawing securities from the intermediated system.

9-20. For example, some jurisdictions require full dematerialisation and require that issuers issue uncertificated securities only. Such legal restriction is compatible with Article 29(1), which requires Contracting States to allow securities traded on an exchange or regulated market to be held through intermediaries, but does not prohibit them from imposing it.

9-21. Furthermore, subject to the non-Convention law, the account agreement or the uniform rules of a securities settlement system may restrict or waive the right of account holders to hold securities otherwise than through a securities account.

9-22. It is not possible for the Convention to enumerate the various laws that may restrict account holders from holding securities otherwise than through a securities account. To avoid any interference with the rules of conflict governing this issue, Article 9(1)(c) simply refers to “the applicable law”.

9-23. The right stated in Article 9(1)(c) is effective against third parties but may only be exercised against the relevant intermediary (Articles 9(2)(a) and 9(2)(c)).

III-5. Other rights conferred by non-Convention law

9-24. As discussed in the introduction, national laws governing securities held through intermediaries differ widely in the structure and characterisation of account holders’ rights and interests in respect of securities credited to their securities accounts. For example, certain account holders may enjoy some form of ownership or joint ownership over the securities themselves. See Examples 9-1 and 9-2.

9-25. Article 9(1)(d) fully recognises the existence of rights conferred by the non-Convention law on account holders. Such rights are an integral part of the rights comprised in intermediated securities and, to the extent permitted by the non-Convention law, enjoy the same treatment as all

⁴ *Note of the Editors:* for this reason, the reference to instructions by the account holder in Article 9(1)(b) is not sufficient. Therefore, the Editors have suggested a revision of the Convention text that would address this problem. See CONF. 11/2 – Doc. 6, section 3.

other Article 9(1) rights throughout the Convention. In particular, they may be acquired and disposed of in accordance with Articles 11 and 12. In jurisdictions where the notion of “Mitgliedschaft” (the status of shareholder) is not limited to the rights described in Article 9(1)(a), Article 9(1)(d) fully recognises the existence of rights conferred by the non-Convention law on account holders.

9-26. The phrase “unless otherwise provided in this Convention” seeks to avoid any possible inconsistency between the rights conferred by the non-Convention law and the provisions of the Convention. It must be acknowledged that, so far, no such inconsistency has been identified in the preparatory work and negotiations.

9-27. The rights conferred by the non-Convention law are effective against third parties (Article 9(2)(a)), but the Convention does not determine against whom they can be exercised.

III-6. Rights in respect of a limited interest, including a security interest

9-28. A credit of securities to a securities account does not always represent the fullest possible interest in intermediated securities. Article 11(4) states that a security interest, or a limited interest other than a security interest, may be acquired by a credit. Under Article 12, intermediated securities may be charged with one (or more) security or other interest in favour of the intermediary or a third party. This may also occur by a disposition made under the non-Convention law in accordance with Article 13.

9-29. The types of interests that can be credited to a securities account or that can be charged over intermediated securities are not determined by the Convention, but exclusively by the non-Convention law.

9-30. For example, the non-Convention law will determine what type of security interest can be granted to a secured lender by having securities transferred to its account, and which rights accrue to him in respect of these intermediated securities.

9-31. Therefore, Article 9(3) acknowledges that the non-Convention law determines the limits on the rights of an account holder who has obtained a limited interest by a credit to its securities account.

9-32. Article 9(3) does not refer to Article 12 because it only addresses the effects of a credit of securities where such credit only conveys a limited interest in intermediated securities. Article 12 may also be used to convey a limited interest, but it does not do so by a credit to a securities account so that it needs not be mentioned in Article 9(3).

Article 10

Measures to enable account holders to receive and exercise rights

1. An intermediary must take appropriate measures to enable its account holders to receive and exercise the rights specified in Article 9(1).

2. This Convention does not require the relevant intermediary to establish a securities account with another intermediary or to take any action that is not within its power.

Commentary

I. Introduction

10-1. Article 10(1) provides for the most basic obligation that an intermediary owes to its account holders. It must take the appropriate measures so that its account holders enjoy the rights provided in Article 9(1). However, Article 10(2) sets some limits on this obligation as well as other Convention obligations of an intermediary. An intermediary is not required to open an account with another intermediary or to take actions that are not within its power. Note that an intermediary's obligations under this article as well as other obligations of an intermediary under the Convention may be limited as well by the operation of Article 28.

II. History

10-2. Article 10 has its roots in Article 2(3) which was drafted by the Study Group (see UNIDROIT 2004 – Study LXXVIII – Doc. 18, p. 3-4).

10-3. The provision was further developed in Versions A and B of paragraph 5 of Article 4 (the predecessor of Article 9) of the draft Convention that emerged from the first session of the CGE. See UNIDROIT 2005 – Study LXXVIII – Doc. 24 (Appendix 1), p. 4 - 5.

10-4. Article 10(1) of the draft Convention adopted at the second session of the CGE was similar in substance and text to the current version of Article 10. See UNIDROIT 2006 – Study LXXVIII – Doc. 42 (Appendix 1), p. 10.

10-5. The provision remained essentially the same during the third session of the CGE (see UNIDROIT 2006 – Study LXXVIII – Doc. 57 (Appendix 1), Article 6) and the fourth session of the CGE (see UNIDROIT 2007 – Study LXXVIII – Doc. 94 (Appendix 1), Article 8).

10-6. During the first session of the diplomatic Conference the first paragraph of the provision was divided into two paragraphs 1 and 2, and the substance of former paragraph 2 was moved to a new Article 8.

III. Analysis

10-7. As explained in the commentary on Article 9, Article 9(1) specifies the rights that an account holder acquires upon a credit to its securities account. Article 10(1) is the mirror image of Article 9(1). It obliges the intermediary to take appropriate measures so that its account holders enjoy the rights provided in Article 9(1). Consistent with the Convention's functional approach, Article 10(1) describes the results that the intermediary must achieve – providing the rights conferred in Article 9(1) – but does not specify the precise measures that the intermediary must take.

10-8. The measures that an intermediary must take pursuant to Article 10(1) may vary substantially from jurisdiction to jurisdiction by virtue of differences in the applicable law and in the structure of intermediated securities systems. The rights specified in Article 9(1)(a) provide an illustration. In some systems, for example, dividends and voting rights are passed down through tiers of intermediaries. In others, an account holder may enjoy a more direct relationship with the issuer in the context of receiving distributions and exercising voting rights. Articles 9(1)(b) and 9(1)(c) expressly refer to "instructions to the relevant intermediary" as the method by which an account holder may exercise its right to dispose of or grant an interest in intermediated

securities or to hold securities to be held other than through a securities account, when that option is available under the applicable law, account agreement, or the uniform rules of a securities settlement system. Once again, the measures that an intermediary must take in order to comply with those instructions is not harmonised under the Convention's functional approach and will depend on the applicable law.

10-9. The obligations of an intermediary under Article 10(1) are not absolute. They are relaxed in two specific ways by Article 10(2). In addition, the obligations must be interpreted and applied by taking into account the provisions of Article 28. Example 28-1 illustrates the operation of Article 10(1).

10-10. Article 10(2) is straightforward. It specifies two types of actions that the Convention does not require an intermediary to take. Note that it addresses what the *Convention* does not require and in that respect it has a broader reach than an intermediary's Article 10(1) duties. First, the Convention does not require an intermediary "to establish a securities account with another intermediary". Second, it does not require an intermediary "to take any action that is not within its power".

EXAMPLE 10-1: IM is located in State X and the law of State X is the non-Convention law. IM's account holder, AH, instructs IM to dispose of shares of Company A that are credited to AH's securities account. However, AH specifies that the shares should be sold on a stock exchange located in State Y. IM is not a member of the exchange in State Y and has no relationship with a member of that exchange. The only way that IM could follow AH's instructions would be to establish an account in IM's name with another intermediary that is a member of the exchange in State Y. Under Article 10(2), the Convention does not require IM to establish such an account.

EXAMPLE 10-2: IM-1, located in State X, is an account holder of its relevant intermediary, IM-2, located in State Y. AH-1 and AH-2 are account holders of IM-1 and there are 100 shares of A Company shares credited to each of their accounts. There are 200 shares of A Company credited to the account of IM-1 on the books of IM-2. A Company is organised under the law of State Z. In accordance with the law of State X, AH-1 instructs IM-1 to vote AH-1's shares "Yes" on a proposed merger involving A Company. AH-2 instructs IM-2 to vote AH-2's shares "No" on the merger. IM-1 instructs IM-2 to vote 100 shares "Yes" and 100 shares "No" on the merger. IM-2 refuses to follow IM-1's instruction because under the law of State Z, which is not a Contracting State, IM-2 must vote all 200 shares that it holds in A company in the same way; it is not permitted to split its vote. Under Article 10(2), the Convention does not require IM-1 to follow the voting instructions of AH-1 and AH-2 because it lacks the power to do so. It has the power to follow the instructions of AH-1 or AH-2, but lacks the power to follow the conflicting instructions of both.

CHAPTER III – TRANSFER OF INTERMEDIATED SECURITIES

Contents and outline

III-1. *Chapter III* deals with the methods by which account holders acquire and dispose of intermediated securities or may grant any type of interest in intermediated securities to third parties.

III-2. Under *Article 11*, all Contracting States recognise that credits (and debits) can be used for transferring intermediated securities or any limited interest therein. Article 12 provides for three additional methods, each of which may be elected by any Contracting State for the purpose of granting any interest in intermediated securities, including a full (unlimited) interest. Article 13 reserves the right of any Contracting State to provide for other methods. In sum, the Convention provides four internationally recognised methods, one mandatory and the other three at the option of each Contracting State, without precluding additional methods under non-Convention law.

III-3. *Article 14* states the effectiveness of the rights and interests created in accordance with *Article 11* or *Article 12*.

III-4. Under *Article 15*, debits and designating entries may only be made to a securities account if authorised. The non-Convention law determines the effects of an unauthorised credit or designating entry. Article 16 specifies that the non-Convention law also determines when debits, credits and designating entries are invalid, may be reversed or are subject to a condition, and the consequences thereof.

III-5. *Articles 17 and 18* protect the acquisition of intermediated securities or of interests therein made by an innocent person. Article 19 determines the priority among competing interests in the same intermediated securities, while Article 20 partially determines the priority among an intermediary's collateral lender and its account holders.

Article 11

Acquisition and disposition by debit and credit

- 1. Subject to Article 16, intermediated securities are acquired by an account holder by the credit of securities to that account holder's securities account.**
- 2. No further step is necessary, or may be required by the non-Convention law, to render the acquisition of intermediated securities effective against third parties.**
- 3. Subject to Articles 15 and 16, intermediated securities are disposed of by an account holder by the debit of securities to that account holder's securities account.**
- 4. A security interest, or a limited interest other than a security interest, in intermediated securities may be acquired and disposed of by debit and credit of securities to securities accounts under this Article.**
- 5. Nothing in this Convention limits the effectiveness of debits and credits to securities accounts which are effected on a net basis in respect of securities of the same description.**

Commentary

I. Introduction

11-1. Credits and debits to securities accounts are universally recognised methods for the acquisition and disposition of intermediated securities. Article 11 recognises these methods for the acquisition and disposition of intermediated securities or of any interest in intermediated securities. Contracting States may specify what constitutes a credit to a securities account but they may not require any further step for the acquisition to be effective against third parties.

11-2. There is a close relationship between Articles 9 and 11. Intermediated securities are, or include, the rights conferred on the account holder by the credit of securities to a securities account (see Article 9(1)). They are acquired by the credit of securities to the account holder's securities account (see Article 11(1)). Likewise, they are disposed of by the debit of securities to the account holder's securities account. What rights are conferred upon the account holder by a credit is partly determined by the Convention itself and partly by the non-Convention law (see Article 9(1)). In particular, the non-Convention law may confer different rights on account holders who hold intermediated securities for themselves (investors) as opposed to account holders who hold them in the capacity of intermediary (see paragraphs (1)(a)(i) and (1)(d) of Article 9).

11-3. While it could be said that paragraphs 1 and 3 of Article 11 merely state obvious consequences of Article 9, Article 11 contains three important additional rules:

- Without defining what constitutes a credit (a matter implicitly left to non-Convention law), paragraph 2 declares that no further step is necessary to render the acquisition effective against third parties.
- Paragraph 4 provides that a credit to a securities account does not necessarily convey a full interest in the securities so credited, i.e., all the rights under Article 9. It implies that, subject to the non-Convention law, what interest is conferred by a credit is determined by the transaction between the transferor and the transferee. See also Article 9(3).
- Paragraph 5 makes clear that the Convention does not in any way interfere with the effectiveness of debits and credits to securities accounts effected on a net basis.

11-4. The question arises whether the debit and credit entries in one transaction are to be regarded as effecting a single transfer of property from A to B, or whether the debit must be analysed as extinguishing an interest of A, and the credit as creating an interest of B, in a manner such that the two interests need not be regarded as identical. This question was raised in the Study Group's Position Paper of August 2003 (UNIDROIT 2003 – Study LXV VIII – Doc. 8, section 19, footnote 28), which noted that the answer depends mainly on the analysis of the nature of the rights constituted by a credit of securities to a securities account. Consistent with the functional approach, this Convention does not take any view as to the legal nature or doctrine of the interest created or represented by book-entries in securities accounts, and therefore does not answer that question. Depending on the analysis adopted, non-Convention law may link the debit(s) and credit(s) involved in a particular transfer of securities so as to make sure that, for instance, none is reversed without all others being reversed as well ("no credit without debit rule"), or the non-Convention law may consider the credit and the debit as dealing with different interests.

II. History

11-5. The negotiations by the CGE and during the first session of the diplomatic Conference have essentially retained the original substance and language of paragraphs 1 to 3. "No further step or event" was simplified to "no further step" during the first session of the CGE. A reference to

“evidential requirements” to be determined by non-Convention law was introduced by the third session of the CGE in a separate provision and then removed as implicit and unnecessary during the first session of the diplomatic Conference (see below section 12-10). “Subject to” at the beginning of paragraphs 1 and 3 was introduced by the third session of the CGE to clarify the relationship between the relevant provisions of the Convention.

11-6. During the third session of the CGE, paragraph 4 was extended, so as to include limited interests other than security interests.

11-7. Netting is the main policy issue that was modified in this provision by the CGE. A number of delegations were concerned that the Convention might displace or disrupt national provisions and regulations requiring seamless matching and reconciliation of debits and credits. The initial draft Convention (UNIDROIT 2004 – Study LXVVIII – Doc. 18, Article 3(5)) stated that “[d]ebits and credits to securities accounts in respect of securities of the same description may be effected on a net basis” and that 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 has been made” (Article 3(4)). The first provision was changed into the current paragraph 5 during the fourth session of the CGE. During the third session of the CGE, the second provision was deleted entirely.

III. Analysis

III-1. Paragraphs 1 and 2: acquisition by credit and no further step rule

11-8. An account holder acquires intermediated securities by a credit to its securities account maintained by an intermediary. The Convention does not define “credit” and it implies that a credit is an entry in a securities account (Article 1(c)) maintained by an intermediary (Article 1(d)). It does not specify the requirements for a valid credit. However, paragraph 2 declares that “[n]o further step [than a credit] is necessary, or may be required by the non-Convention law, to render the acquisition of intermediated securities effective against third parties”.

11-9. Paragraph 1 says nothing as to what constitutes a credit to a securities account. It is for the non-Convention law to determine what constitutes entries such as credits, debits and designating entries. The relevant provisions may be found in some legal or regulatory provisions of the non-Convention law or, possibly, in the uniform rules of a securities settlement system. What is credited to a securities account may be intermediated securities, but throughout the Convention text the phrase “securities are credited to a securities account” is used for convenience and to reflect common usage in the securities industry.

11-10. Paragraph 1 is subject to Article 16, so that the non-Convention law determines the validity of a credit, but Article 16 is subject to Article 18 (see the commentaries on Articles 16 and 18). For example, the non-Convention law may recognise conditional credits under an account agreement, which are liable to be reversed when some event later occurs or does not occur. Conditional credits are typically used in contractual settlements where securities are credited to the securities account of the transferee before the transferee’s intermediary has received credit of the same with its own (upper-tier) intermediary. Subjecting paragraph 1 to Article 16 implies that the non-Convention law may, as is the case in various jurisdictions, connect debits and credits which are part of the same transfer of intermediated securities in such a manner that a credit is invalid or liable to be reversed if and when it cannot be traced back to a matching debit or when the matching debit is invalid or liable to be reversed (see also 11-4 above). The non-Convention law may also, as is the case in some jurisdictions, make the validity of a credit depend on the validity of the contract or transaction which the credit purports to fulfil. Such validity requirements determined by the non-

Convention law in accordance with Article 16 are not “further steps” within the meaning of Article 11(2) (see 11-11 below). However, it is important to note that all such provisions of the non-Convention law preserved by Article 16 are themselves subject to the overriding protection of an innocent acquirer under Article 18: namely, an innocent acquirer is protected even if the credit is invalid, reversible or conditional pursuant to the non-Convention law under Article 16 (see the commentary on Article 18).

11-11. Paragraph 2 specifies that “[n]o further step is necessary, or may be required by the non-Convention law, to render the acquisition of intermediated securities effective against third parties.” This means that non-Convention law may not require that, in addition to the credit itself, the interest acquired by the account holder must be registered in a public registry, filed with a governmental agency, notarised by a public notary, or published in an official gazette or on the Internet. “Further step” must be understood as an additional, subsequent formality that might otherwise be required to make the acquisition effective against third parties.

11-12. In summary, the Convention sets out the principle that a credit to a securities account is sufficient to make the acquisition of intermediated securities or of an interest therein effective against third parties, and that no further step is necessary. The non-Convention law may define what constitutes a credit. It may also define the requirement for its validity, what makes it ineffective or liable to be reversed, and whether it can be made conditional, subject however to the protection of innocent acquirers under Article 18.

EXAMPLE 11-1: A sells bonds of € 100,000 in nominal value to B. A instructs its intermediary IM-1 to transfer such bonds to the securities account of B with IM-2. After the bonds have been credited to B’s securities account, B further sells to C and has them credited to the securities account of C with IM-2. It later turns out that the CSD could not settle the transaction between IM-1 and IM-2 so that the securities account of IM-2 with CSD has not been credited with the bonds. Alternately, a credit to IM-2’s account with CSD has been made and then reversed in accordance with the uniform rules of the system.

Under Article 11(1) and (2), the credit to B’s account with IM-2 is effective against third parties. In particular, B has validly disposed of the relevant intermediated securities to C. It may be that, under the non-Convention law applicable to the account, or under the account agreement with B, IM-2 can reverse the credit to B’s account (see Article 16). The consequences of such reversal are governed by the non-Convention law. However, if innocent, C stands to be protected in accordance with Article 18.

11-13. One might ask how an intermediary acquires intermediated securities from one of its account holders where such intermediary has one omnibus account with its upper-tier intermediary covering both its own and its account holders’ intermediated securities and where matching of debit and credit is (conceptually) required under the non-Convention law and intermediaries acting for its account holders do not have any property interests under the non-Convention law. In such a situation, when the account holder transfers its intermediated securities to its intermediary, a debit is made to the account holder’s account but no corresponding credit is made to the intermediary’s account (if it is one omnibus account at the upper level for all intermediated securities held for the intermediary). Article 11 is not intended to deny such omnibus account structure or preclude acquisition by the intermediary of the intermediated securities in such situation. Note that this issue does not arise in a jurisdiction where disposition and acquisition are separate and intermediaries hold intermediated securities, because in such a jurisdiction, when an intermediary first obtains credits, the intermediary acquires intermediated securities against the entire world except for account holder claims.

III-2. Paragraph 3: disposition by debit

11-14. An account holder may dispose of intermediated securities credited to its securities account by a debit to that securities account. What constitutes a debit is not determined by the Convention, but by the non-Convention law. The comments made above at 11-9 apply here *mutatis mutandis*.

11-15. Debits are generally made by an intermediary upon instructions by the account holder or by some other authorised person (see Article 23). Article 11(3) is subject to Article 15 to make clear that a debit may only be made if authorised by the account holder and, where applicable, by the persons in whose favour a designating entry has been made or a control agreement entered into. Article 11(3) is also subject to Article 16, so that the non-Convention law (and, to the extent it allows, the account agreement or the uniform rules of a securities settlement system) may allow provisional debits and may make the debit liable to be reversed in other circumstances. The comments made above at 11-10 and 11-12 apply here *mutatis mutandis*.

EXAMPLE 11-2: Same facts as in Example 11-1. Whether A may request the reversal of the debit made to its account because the securities have not been credited to B's account is a matter for the non-Convention law and possibly for its account agreement with IM-1.

11-16. The "no further step necessary" rule is not provided for debits. This is consistent with the philosophy of minimum harmonisation underlying the Convention: the rule must apply to credits, but does not have to apply to debits.

III-3. Paragraph 4: acquisition and disposition of limited interest

11-17. A limited interest, including a security interest, can be acquired and disposed of by debit and credit of securities to securities accounts under Article 11(4). Where a limited interest is disposed of by debit, the interest remaining with the account holder whose account has been debited is no longer evidenced by a book-entry. The exact contents of the interest so transferred, as well as of the interest remaining with the account holder whose account has been debited, is determined by the agreement between the transferor and the transferee and by the non-Convention law.

EXAMPLE 11-3: D has granted a security interest in 20,000 shares in X Inc. ("X-shares") to E in consideration of a loan. The securities account of E has been credited with 20,000 X-shares. Soon after, D has been declared insolvent before repaying the loan. E has acquired a security interest in the securities credited to its account (see Article 11(4)), and is entitled to enforce its security interest in D's insolvency proceeding. Even though the shares have been debited to the securities account of D, the administrator of D's insolvency can claim D's residual interest in the same against E. Where applicable, it may choose to have the shares re-credited to D's account against full repayment of the loan, or it may claim any residual money after E has realised the collateral.

11-18. The rule in paragraph 4 was part of the initial draft Convention, though it was at the time limited to security interests. Its scope was extended to other limited interests by the CGE during its third meeting, at the same time as the scope of the current Article 12 was extended to all interests, including a full interest. This policy decision is consistent with the functional approach upon which the Convention is based. The provisions of the Convention are designed to apply irrespective of how the non-Convention law characterises the legal position of account holders in respect of intermediated securities and, where applicable, of the underlying securities. Therefore, the non-Convention law determines which limited interests are recognised, but if so recognised, then those interests may be transferred under Article 11 or granted under Article 12.

11-19. Where a limited interest is transferred by a credit to a securities account, Article 9(3) specifically states that the non-Convention law determines any limits on the rights described in Article 9(1) conferred on the account holder by that credit.

11-20. Even though credits are likely to be preferred for full-title transactions while the methods in Article 12 are more often used to grant limited interests, full and partial interests are not the dividing line between Article 11 and Article 12. Nor can it be said that only Article 11 relies on book-entries since designating entries contemplated by Article 12(3)(c) are book-entries as well, as underlined by Article 1(l) (“an entry in a securities account”).

11-21. Two aspects distinguish Article 11 from Article 12: (i) all Contracting States are bound to recognise credits and debits, while the methods set out in Article 12 are optional at the discretion of each Contracting State; and (ii) an innocent acquirer of intermediated securities or other interests acquired by a credit is protected against third-party claims under Article 18. Conversely, competing interests in the same intermediated securities credited to the same securities account – the typical result of the grant of successive interests under Article 12 – are governed by the priority rule in Article 19. However, the protection of an innocent acquisition does not modify the priorities determined by Article 19 (see Article 18(6)).

EXAMPLE 11-4: Same facts as in Example 11-3. Whether E has acquired full title to X-shares or a limited interest such as a pledge to secure the loan is not determined by the Convention. The issue must be considered on the basis of the legal relationship between D and E. Their agreement and the non-Convention law determine which interest is represented by the credit to E’s securities account and what residual interest remains with D notwithstanding the debit to D’s securities account. Under Article 9(3), the non-Convention law also determines any limits on the rights A has acquired by credit to its securities account.

EXAMPLE 11-5: F wishes to transfer a usufruct (or life interest) in a particular portfolio of securities to her spouse G. F may choose to have the relevant securities credited to G’s general securities account. If the non-Convention law permits, F may also choose to have them credited to a specifically designed type of securities account or sub-account opened in the name of G. Alternately, F may also chose to grant the life interest by one of the methods in Article 12 that may have been elected by the relevant Contracting State. The choice will be decided based on the methods available to F and on the flexibility and limits each method imposes on the enjoyment of G’s interest.

III-4. Paragraph 5: debits and credits on a net basis

11-22. As mentioned above in section 11-7, the Study Group proposed a strong policy choice in favour of the net settlement of intermediated securities transactions (see UNIDROIT 2003 – Study LXVIII – Doc. 8, section 3.6) and against the requirement that credits must be traced back to the corresponding debits (see UNIDROIT 2004 – Study LXVIII – Doc. 19, section 27).

11-23. The predecessor to Article 11(5) was a positive rule that debits and credits in respect of securities of the same description may be effected on a net basis. However, there was no consensus that the Convention should mandate the recognition of netting arrangements. As it now stands, paragraph 5 merely states that the Convention does not interfere with the non-Convention law provisions requiring, allowing or disallowing the netting of transfers in respect of securities of the same description.

Article 12
Acquisition and disposition by other methods

1. Subject to Article 16, an account holder grants an interest in intermediated securities, including a security interest or a limited interest other than a security interest, to another person if:

(a) the account holder enters into an agreement with or in favour of that person; and

(b) one of the conditions specified in paragraph 3 applies and the relevant Contracting State has made a declaration in respect of that condition under paragraph 5.

2. No further step is necessary, or may be required by the non-Convention law, to render the interest effective against third parties.

3. The conditions referred to in paragraph 1(b) are as follows:

(a) the person to whom the interest is granted is the relevant intermediary;

(b) a designating entry in favour of that person has been made;

(c) a control agreement in favour of that person applies.

4. An interest in intermediated securities may be granted under this Article so as to be effective against third parties:

(a) in respect of a securities account (and such an interest extends to all intermediated securities from time to time standing to the credit of the relevant securities account);

(b) in respect of a specified category, quantity, proportion or value of the intermediated securities from time to time standing to the credit of a securities account.

5. A Contracting State may declare that under its law:

(a) the condition specified in any one or more of the sub-paragraphs of paragraph 3 is sufficient to render an interest effective against third parties;

(b) this Article shall not apply in relation to interests in intermediated securities granted by or to parties falling within such categories as may be specified in the declaration;

(c) paragraph 4, or either sub-paragraph of paragraph 4, does not apply;

(d) paragraph 4(b) applies with such modifications as may be specified in the declaration.

6. A declaration in respect of paragraph 3(b) shall specify whether a designating entry has the effect described in Article 1(I)(i) or Article 1(I)(ii) or both.

7. A declaration in respect of paragraph 3(c) shall specify whether a control agreement must include the provision described in Article 1(k)(i) or Article 1(k)(ii) or both.

8. The applicable law determines in what circumstances a non-consensual security interest in intermediated securities may arise and become effective against third parties.

Commentary

I. Introduction

12-1. Besides acquisitions and dispositions of intermediated securities by credits and debits, a Contracting State may declare that one or more of the three methods specified below are sufficient to create an interest in intermediated securities under its law. “[I]ts law” referred to in the chapeau of paragraph 5 encompasses the non-Convention law and Convention law. The three methods are:

(a) an account holder may grant an interest in intermediated securities to the relevant intermediary by entering into an agreement with that intermediary, and no further step is necessary to make that interest effective against third parties;

(b) an account holder may grant an interest in intermediated securities to another person by entering into an agreement with that person and by having a designating entry apply to those intermediated securities in its securities account, and no further step is necessary to make that interest effective against third parties;

(c) an account holder may grant an interest in intermediated securities to another person by entering into an agreement with that person and by entering into a control agreement in respect of these intermediated securities, and no further step is necessary to make that interest effective against third parties.

12-2. Method (a) applies only to interests granted to the relevant intermediary; the other two apply for any person acquiring an interest from the account holder. Method (b), designating entries, relies on an entry made in the account (see Article 1(l)); the other two methods do not involve any book-entries.

12-3. Each of these three methods – referred to as “conditions” in paragraphs 1(b), 3 and 5(a) – is currently widely (though not universally) used in a number of jurisdictions and in a number of intermediated holding systems. Each method is capable of rendering an interest effective against third parties because it gives to the person to whom the interest is granted a certain degree of control over the intermediated securities subject to that interest. When that person is not the relevant intermediary itself, it exercises this control through or with the help of the relevant intermediary.

12-4. None of these methods is compulsory and Contracting States are entirely at liberty to provide for one, two, all or none of these methods in their non-Convention law. For the sake of international transparency and legal predictability, paragraph 5 requires a Contracting State to make a declaration in respect of each such method that it wishes to make available to account holders under its law.

12-5. The methods proposed in Article 12 apply to the voluntary, express grant of any interest in intermediated securities (“including a security interest or a limited interest other than a security interest”) to one or more persons. Non-consensual interests such as statutory liens, purchase-money liens, etc., are not regulated by the provisions of this Convention. The circumstances in which they arise and become effective against third parties and their priority against other interests must be determined according to the applicable law (see Articles 12(8) and 19(5)).

II. History

12-6. This article underwent constant change during the negotiations. It would not be helpful to trace all of the changes. The following notes focus on the most significant policy issues.

12-7. In the initial draft and throughout the first two sessions of the CGE, this article only dealt with the creation of security interests. During the third session of the CGE, it was extended to any interest in intermediated securities, “including a security interest or a limited interest other than security interest” (UNIDROIT 2006 – Study LXVIII – Doc. 57, Article 8(1)). This extension was not subsequently questioned.

12-8. Article 3 of the initial draft submitted to the CGE only included methods (a) and (b) which all Contracting States would have needed to adopt (UNIDROIT 2004 – Study LXVIII – Doc. 18). At its first session, the CGE added method (c) (control agreement) and allowed Contracting States to choose among these three methods by way of a declaration; it also provided a definition for “designating entry” and “control agreement” in Article 1 (UNIDROIT 2005 – Study LXVIII – Doc. 24). The principle of a free choice by Contracting States and the need for a declaration was not subsequently questioned.

12-9. The initial draft spoke of the “creation” of a security interest and did not require an agreement between the grantor and the grantee. At its first session, the CGE shifted the emphasis to the “grant” of interests “so as to be effective against third parties” and introduced the “no further step is necessary” which has since remained in this article.

12-10. The second session of the CGE specified that the non-Convention law would determine the evidential requirements in respect of what is now in Article 12(1) and (3) (UNIDROIT 2006 – Study LXVIII – Doc. 42, Article 5(6)). The third session moved it to a separate article referring to current Articles 11 and 12 generally (UNIDROIT 2003 – Study LXVIII – Doc. 57, Article 10). The first session of the diplomatic Conference considered that the rule was either obvious or confusing and deleted it entirely on the understanding, however, that formal requirements may be imposed by the non-Convention law.

12-11. The first session of the diplomatic Conference made paragraph 1 subject to Article 16.

12-12. Many other modifications were made, mostly for the purpose of better clarifying the contents of the provision and extending the scope of options which Contracting States may make by way of a declaration.

III. Analysis

III-1. Interest in intermediated securities

12-13. The functional approach adopted in designing and drafting this Convention means, *inter alia*, that the Convention does not characterise the types of interests that an account holder may grant to another party. While this article was originally meant for consensual security interests,

whatever they may be under the non-Convention law, it was soon recognised that its scope should not be so limited. Delegations mentioned that some of the methods covered by this article were currently being used to confer a usufruct or life interest in intermediated securities. Other delegations mentioned that some of these methods could also be used in repurchase operations (repos). The Convention's "blindness" as to what would qualify as a security interest, a life interest, or other types of interests, lead to the common understanding that the scope of this article should not, and could not, be so limited. Like credits and debits under Article 11 (see above 11-20), the methods provided in Article 12 are capable of granting any type of interest in intermediated securities under the non-Convention law, including a full interest. It is generally understood that purchasers of intermediated securities will typically want to have them credited to their account, but there is no policy reason to prohibit the use of one of the Article 12 methods.

12-14. As made clear in paragraph 1(a), Article 12 only deals with interests granted by an agreement made by the account holder with or in favour of the beneficiary of that interest (i.e., consensual interests).

12-15. In accordance with commercial practices in many jurisdictions, paragraph 4 allows for the granting of an interest:

- in respect of a securities account, in which case the interest attaches to any and all intermediated securities from time to time credited to that securities account;
- in respect of a specified category of intermediated securities, in which case the parties need to specify the class or classes of securities subject to the interest or any other method making it possible to determine at any given time which intermediated securities are subject to the interest, and which are not;
- in respect of a specified quantity or value of intermediated securities, terms that are meant to make the granting of floating charges and similar interests possible.

12-16. Not all jurisdictions are familiar with or may want to include such determinations of the subject-matter of an interest. Under paragraph 5(c) and (d), Contracting States may therefore disapply paragraph 4(a) and/or paragraph 4(b), or modify paragraph 4(b) as specified in the declaration.

III-2. Agreement between grantor and grantee

12-17. Article 12(1)(a) requires that the account holder enters into an agreement with or in favour of the person to whom an interest is granted. Within the limits set out by the non-Convention law, that agreement determines the nature, scope and extent of the interest so granted.

12-18. Article 12 is silent about formal requirements applying to that agreement. The issue was not explicitly discussed by the Committee of Governmental Experts nor during the first session of the diplomatic Conference. It was nonetheless covered by the article, introduced by the third session of the CGE, which referred evidential requirements to the non-Convention law, and then deleted by the first session of the diplomatic Conference, which considered that the proposed rule would potentially be confusing, and was in any event unnecessary (see above section 12-10). Consistently with the methodology of the Convention and its relationship with non-Convention law, the non-Convention law may set formal requirements for the agreement referred to in Article 12(1)(a) and, where necessary, may distinguish among classes of account holders. The non-Convention law determines the consequences for an agreement that is invalid or ineffective for lack of formality, lack of capacity, mistake, illegality, etc.

12-19. Neither Article 12 nor the Convention generally regulate non-consensual interests, i.e., interests arising by operation of the law. This is why Article 12(8) defers to the applicable law as to the circumstances in which a non-consensual interest may arise and become effective against third parties, while Article 19(5) defers to the applicable law as regards priority rules. The term “non-consensual interest” itself derives from the 2001 Cape Town Convention on International Interests in Mobile Equipment, where a “non-consensual right or interest” is defined as a “right or interest conferred under the law of a Contracting State which has made a declaration under Article 39 of that Convention to secure the performance of an obligation, including an obligation to a State, State entity or an intergovernmental or private organisation.”

12-20. Neither Article 12 nor the Convention deal with successions where the assets and liabilities of an account holder vest in another person or other persons because of death, liquidation, merger, etc.

III-3. Grant of an interest to the relevant intermediary

12-21. The first method set out by Article 12(3) to make an interest effective against third parties applies when the beneficiary of that interest is the relevant intermediary. In such case, the agreement between the account holder and the relevant intermediary under Article 12(1)(a) is the necessary and sufficient condition for the effectiveness against third parties (“automatic perfection”). This is because the relevant intermediary maintains the securities account and is the only person who can give effect (or refuse to give effect) to instructions from the account holder (Article 23). Therefore, the relevant intermediary controls the intermediated securities in the account and is positioned to decline to act upon instructions from the account holder which would contravene the account holder’s agreement with the relevant intermediary and the interest granted to the relevant intermediary. Requiring a control agreement or a designating entry would add nothing to the control the relevant intermediary can exercise over the securities account.

III-4. Grant of an interest through a designating entry

12-22. The second method in Article 12(3) is a designating entry in favour of the person to whom the interest is granted (hereafter: the grantee). (See Article 1(l) for the definition of “designating entry”). A designating entry is an entry in a securities account whereby specific intermediated securities (or the securities account as a whole) are “earmarked” for the purpose of signalling the existence of an interest in favour of someone other than the account holder. It gives the grantee some type of control over the intermediated securities subject to the interest. The definition in Article 1(l) distinguishes between what can be called positive control (the grantee can give instructions to the relevant intermediary without any further consent of the account holder) and negative control (the relevant intermediary may not comply with instructions from the account holder without the consent of the grantee).

12-23. Under paragraphs 5(a) and 6, a Contracting State which declares that a designating entry is sufficient to render an interest effective against third parties must also declare whether a designating entry provides positive control, negative control, or both.

12-24. A designating entry is entered in a securities account by the relevant intermediary upon an instruction from the account holder (Article 23), and may not be made if not authorised (Article 15). The non-Convention law determines what constitutes a designating entry.

III-5. Grant of an interest by a control agreement

12-25. The third method in Article 12(3) is the execution of a control agreement which gives the grantee either positive control, or negative control, or both, over intermediated securities. (For the definition of “control agreement”, see Article 1(k)). Under Article 12(5)(a) and (7), a Contracting State which declares that a control agreement is sufficient to render an interest effective against third parties must also declare whether it must include positive control, negative control, or both.

12-26. A control agreement is typically entered into by the account holder, the relevant intermediary and the person to whom the interest is granted. However, if allowed by the non-Convention law, it may be made between the account holder and the relevant intermediary only, or between the account holder and the grantee only provided it is notified to the relevant intermediary.

12-27. The non-Convention law determines the formal requirements applicable to control agreements and the effects of a control agreement that is ineffective or invalid because of lack of formality, lack of capacity, mistake, illegality, etc.

III-6. Designating entry and control agreement compared

12-28. Designating entries and control agreements share the following common elements:

- They apply to intermediated securities in a securities account of the grantor of the interest. Unless Article 12(4) is modified by a declaration under Article 12(5)(c) and (d), they may also apply to a securities account, or to a specified category, quantity, proportion or value of the intermediated securities credited to that account.
- They are made in favour of the person to whom an interest is granted and provide that person with some degree of control over the intermediated securities subject to its interest. The non-Convention law determines the type of control that a control agreement must provide or that must result from a designating entry, and which must be disclosed in a declaration by the relevant Contracting State.
- The control is given effect by the relevant intermediary for the benefit of the person to whom the interest is granted. In order for the person to whom the interest is granted to enjoy its benefits, the intermediary must only allow dispositions in respect of the relevant intermediated securities which conform to the authorities granted by the control agreement or by the designating entry.
- The relevant intermediary must comply with instructions from the person to whom the interest is granted in respect of the intermediated securities subject to that interest to the extent provided by the control agreement or in respect of a designating entry, or by the account agreement or the uniform rules of a securities settlement system, to the extent permitted by the non-Convention law.
- An innocent acquirer of an interest under either method enjoys the protection accorded by Article 18 (see the commentary to Article 17 and Article 18, especially at 17-5 and the examples at 18-16).

12-29. Designating entries and control agreements differ in one significant respect, however. A designating entry is a “book-entry”, or most often an electronic entry into an electronically maintained securities account. The notion of “an entry in a securities account” (see Article 1(l)) suggests that the entry is visible to whoever has access to the account or to a statement of account. Several delegations consider that designating entries are superior to control agreements because they provide this element of transparency, even though it is restricted to the persons who get access to

the account and only provides a snapshot of existing interests at the time of the access (or of the account statement).

12-30. This publicity element of designating entries is the reason why Article 19(7) allows Contracting States to change the first-in-time priority among interests granted under Article 12 (see Article 19(3)) by making a declaration that, under its non-Convention law, any interest granted by a designating entry has priority over any interest granted by another Article 12 method.

12-31. Within the limits set out by the relevant declaration and the non-Convention law (see Articles 12(7) and 1(k)), a control agreement can be designed in a more flexible way and be better suited to the particular needs of the transaction giving rise to the interest.

III-7. Declaration by Contracting State

12-32. Because Article 12 sets out a number of options for Contracting States, an increased degree of international transparency appeared to be necessary and a robust declaration mechanism was developed by the CGE along with the extension of the available options.

12-33. A declaration under Article 12 is applicable only if the law in force in the Contracting State making the declaration is the non-Convention law (see Article 46). A declaration under Article 12 is thus meant to provide international publicity to specific features of the method(s) mentioned in Article 12 selected by the relevant Contracting State. In accordance with Article 12(5) to (7), a declaration must be made:

- (a) listing the Article 12 method or methods for making an interest effective against third parties;
- (b) in the case of a designating entry, whether it provides positive control, negative control, or both;
- (c) in the case of a control agreement, whether it must provide positive control, or negative control, or both;
- (d) categories of persons who are not permitted to grant an interest under Article 12 or to whom an interest is not permitted to be granted under Article 12;
- (e) limitations to, or exclusion of, alternative ways of determining to which intermediated securities an interest applies in accordance with Article 12(4).

12-34. The non-Convention law may provide for methods other than Article 11 and 12 to make an interest effective against third parties (see Article 13). Such methods cannot be part of an Article 12 declaration.

Article 13

Acquisition and disposition under non-Convention law

This Convention does not preclude any method provided by the non-Convention law for:

- (a) the acquisition or disposition of intermediated securities or of an interest in intermediated securities; or**
- (b) the creation of an interest in intermediated securities and for making such an interest effective against third parties, other than the methods provided by Articles 11 and 12.**

Commentary

I. Introduction

13-1. In addition to the treaty methods set out in Articles 11 and 12, Article 13 allows methods provided by the non-Convention law in order to transfer intermediated securities or to create a security or other limited interest therein.

II. History

13-2. The Study Group already envisaged the possibility of applying non-Convention law (then: “applicable law”) methods to transfer intermediated securities or to vest a security interest therein. See UNIDROIT 2004 – Study LXXVIII – Doc. 18, Article 3(7) and Article 4(5). The policy set out in the initial draft was never varied. For the documents of the first and second sessions of the CGE on this provision, see UNIDROIT 2005 – Study LXXVIII – Doc. 24, Article 5(6) and Article 6(7) and UNIDROIT 2006 – Study LXXVIII – Doc. 42, Article 4(6) and Article 5(8).

13-3. The only significant drafting change occurred at the third session of the CGE, where it was decided to move the provisions relating to methods available under the non-Convention law to a separate provision. See UNIDROIT 2006 – Study LXXVIII – Doc. 57, Article 9; UNIDROIT 2007 – Study LXXVIII – Doc. 58, section 137.

13-4. During the fourth session of the CGE, no changes were made to the provision. See UNIDROIT 2007 – Study LXXVIII – Doc. 94, Article 11. The substance of the provision also remained unchanged during the first session of the diplomatic Conference.

III. Analysis

13-5. Because the Convention aims at minimal harmonisation rather than full harmonisation, the methods provided by Articles 11 and 12 for the transfer of intermediated securities or for the grant of an interest in the same are not exclusive of other methods available under the non-Convention law. Acquisitions made and interests granted according to such other methods are not eligible for the protection of an innocent acquirer under Article 18, though they may be protected by a similar provision of the non-Convention law. Their priorities are determined by the non-Convention law, except that they are subordinated to all interests that become effective against third parties under Article 12 (see Article 19(5)).

13-6. Article 13 does not apply to non-consensual interests. Non-consensual interests arise, become effective against third parties and enjoy the priority determined by the applicable law (see Articles 12(8) and 19(5)).

Article 14 ***Effectiveness in insolvency***

1. Rights and interests that have become effective against third parties under Article 11 or Article 12 are effective against the insolvency administrator and creditors in any insolvency proceeding, to the same extent as comparable interests in that insolvency proceeding.

2. This Article does not apply to the circumstances referred to in Article 21.

3. Nothing in this Convention impairs the effectiveness of an interest in intermediated securities against the insolvency administrator and creditors in any insolvency proceeding where that interest has become effective by any method referred to in Article 13.

Commentary

I. Introduction

14-1. Article 14(1) generally addresses the treatment of interests that have become effective under Article 11 or Article 12 in an insolvency proceeding. However, by excluding the circumstances addressed by Article 21, Article 14(2) makes it clear that Article 14 does not apply in an insolvency proceeding of the relevant intermediary. Article 14(3) provides that the Convention does not impair the effectiveness of interests made effective under the non-Convention law, which are permitted under Article 13.

II. History

14-2. Article 14(1) and (2) were added to the Convention text at the first session of the diplomatic Conference. They follow closely a proposal made by the informal Working Group on Insolvency formed during the Conference. Article 14(3) is substantially similar to Article 18(2) of the draft Convention text that was submitted to the diplomatic Conference.

III. Analysis

III-1. Effectiveness of Convention interests in insolvency proceedings: in general

14-3. Article 14(1) provides that rights and interests that are effective under Articles 11 (credit to securities account) and 12 (other methods of granting interests) are effective in an insolvency proceeding “to the same extent as comparable interests in that insolvency proceeding”. This rule applies only as to the effectiveness of rights and interests itself. Where they are effective in an insolvency proceeding, one might ask whether they are subject to the rules on priorities under the law applicable in an insolvency proceeding. Article 19 ought to apply as among competing interests in the insolvency proceeding, but if there is an additional rule of insolvency law, Article 7 would allow that to control. Also, even where they are effective in an insolvency proceeding, under Article 7, they are subject to (i) the rules of the applicable insolvency law and (ii) the rules of procedure in the applicable insolvency law.

III-2. Comparable interests

14-4. The application of Article 14(1) requires consideration of the meaning of “comparable interests”. “[C]omparable interests” means interests created and made effective under the applicable law *other than the Convention*. Interests effective against third parties under the applicable law that are the closest analogues or effective counterparts to Convention interests are “comparable”. A comparable interest need not have characteristics that are in all respects identical to a Convention interest. It is intended that “comparable interest” refers to the substance of the interest granted under the Convention, not to the manner in which it has been granted (e.g., control agreement) or to the subject-matter (e.g., securities). Essentially, Article 14 requires the applicable insolvency rules not to discriminate a pledge (or usufruct, outright ownership, or beneficial interest under a trust, etc.) of intermediated securities from a pledge (or usufruct, outright ownership, or beneficial interest under a trust) of any other asset. If insolvency law treats

differently pledges of different types of assets (not in the manner they are granted, but in their effectiveness in an insolvency proceeding), then there is a doubt as to whether Article 14 requires a pledge of intermediated securities to be treated no worse than the worst case or the best case under the applicable insolvency law.⁵

EXAMPLE 14-1: On Day 1, Account Holder (AH) agreed to grant an interest in intermediated securities to Collateral Taker (CT) and on that date AH, CT and AH's intermediary (IM) entered into a control agreement covering the intermediated securities. CT thereby acquired an interest effective against third parties under Article 12. On Day 10, AH commenced an insolvency proceeding. The law applicable in the insolvency proceeding does not address intermediated securities, but it is possible for a person to grant a security interest in such intangible movables under the applicable civil code. Such an interest is effective against third parties and also is effective in the grantor's insolvency proceedings (subject to certain avoidance rules). Consequently, the interest is a comparable interest to CT's Article 12 interest within the meaning and scope of Article 14(1). It follows that CT's interest is effective in AH's insolvency proceeding to the same extent as the comparable interest.

EXAMPLE 14-2: On Day 1, Account Holder (AH) agreed to grant an interest in intermediated securities to Collateral Taker (CT) and on that date AH, CT and AH's intermediary (IM) entered into a control agreement covering the intermediated securities. CT thereby acquired an interest effective against third parties under Article 12. On Day 10, AH commenced an insolvency proceeding. The law applicable in the insolvency proceeding does not address intermediated securities, but it is possible for a person to grant a security interest in such intangible movables through compliance with a law requiring registration of interests in a public register. Such a registered interest is effective against third parties and also is effective in the grantor's insolvency proceedings (subject to certain avoidance rules). Consequently, the interest is a comparable interest to CT's Article 12 interest within the meaning and scope of Article 14(1). It follows that CT's interest is effective in AH's insolvency proceeding to the same extent as the comparable interest.

III-3. Insolvency of relevant intermediary

14-5. Article 21 addresses the interests of account holders whose relevant intermediary is subject to an insolvency proceeding. Article 14(2) provides that Article 14 does not apply in circumstances in which Article 21 applies.

III-4. Article 13 interests made effective under the non-Convention law

14-6. Article 14(3) addresses interests made effective under methods provided by the non-Convention law and recognised pursuant to Article 13. It provides that nothing in the Convention impairs the effectiveness of such Article 13 interests in an insolvency proceeding. Stated otherwise, the Convention does not render ineffective in an insolvency proceeding Article 13 interests that otherwise would be effective in the proceeding.

⁵ *Note of the Editors:* because of the difficulty to apply the "comparable interest" test and because of more significant concerns regarding Article 7, the Editors have suggested a revision of the Convention text that would address these problems. See CONF. 11/2 - Doc. 6, section 2.

Article 15
Unauthorised debits or designating entries

1. An intermediary may make a debit of securities to a securities account or a designating entry or remove a designating entry only if it is authorised to do so:

(a) in respect of a debit, by the account holder and, if applicable, the person in whose favour a designating entry has been made;

(b) in respect of a designating entry, by the account holder;

(c) in respect of the removal of a designating entry, by the person in whose favour the designating entry has been made; or

(d) by the non-Convention law.

2. The non-Convention law and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system determine the consequences of an unauthorised debit, an unauthorised removal of a designating entry or, subject to Article 18(2), an unauthorised designating entry.

Commentary

I. Introduction

15-1. The purpose of Article 15 is to protect: (i) the rights of an account holder who has acquired intermediated securities (Article 11(1)) or a security interest, or a limited interest other than a security interest (Article 11(4)) by the credit of securities to its securities account against an unauthorised debit or an unauthorised designating entry made by the relevant intermediary; and, (ii) the rights of a person in whose favour a designating entry has been made against an unauthorised removal of this designating entry by the relevant intermediary. Article 15(1) states the basic rule that an intermediary may make a debit to a securities account or a designating entry or remove a designating entry only if it is authorised to do so. Article 15(1)(a) to (d) specify whom the intermediary must be authorised by. In Article 15(1)(a) to (c), this is the person whose rights are affected by the debit, the designating entry or its removal. Under Article 15(1)(d), the authorisation may also derive from the non-Convention law.

15-2. Under Article 15(2), the consequences of an unauthorised debit, an unauthorised removal of a designating entry or an unauthorised designating entry are, with the exception of Article 18(2) in respect of an unauthorised designating entry, left to the non-Convention law and, to the extent permitted by that non-Convention law, the account agreement or the uniform rules of a securities settlement system.

15-3. Article 15 should be read and analysed in close conjunction with Article 11(3) and (4) and Article 12(1)(b) and (3)(b), to which Article 15 implicitly refers. Only Article 11(3) is explicitly subject to Article 15.

II. History

15-4. Throughout the negotiations this provision experienced various modifications, although the basic rule that a debit or a designating entry must not be made without the account holder having

authorised the intermediary accordingly was contained in Article 5(1) of the first draft of the Convention (UNIDROIT 2004 – Study LXXVIII – Doc. 18) presented to the first session of the CGE in May 2005. However, the following two issues should be noted when looking at the history of Article 15.

15-5. Firstly, until the first session of the diplomatic Conference, the authorisation rule was always the first paragraph of a much wider article which also contained provisions on reversal of debits or credits and on conditional book entries which now form the content of Article 16.

15-6. Secondly, the consequences of unauthorised debits (and, until the second session in March 2006, unauthorised credits) and of unauthorised designating entries were part of the authorisation rule. Thus, Article 5(1) in UNIDROIT 2004 – Study LXXVIII – Doc. 18, stated that a debit, etc., is not effective unless it is made with the authority of the account holder. During the first session of the CGE, this wording was only slightly modified by stating that the relevant intermediary must be authorised. The consequence that “unauthorised” means “not effective” remained unchanged. The heading of Article 5 (renumbered as Article 7) was changed from “Effectiveness of debits, credits etc.” to “Authorisation, timing, conditionality and reversal of debits, credits etc.” (see Article 7 in UNIDROIT 2005 – Study LXXVIII – Doc. 24).

15-7. At its second session in March 2006, the CGE again changed the heading of renumbered Article 8 into “Lack of authorisation, ineffectiveness and reversal” (see Article 8 in UNIDROIT 2006 – Study LXXVIII – Doc. 42). The “credit of securities” was deleted in Article 8(1). The CGE felt that it was irrelevant in the context of authorisation (see UNIDROIT 2006 – Study LXXVIII – Doc. 43, section 179). Article 8(1) read: “A debit of securities to a securities account or a designating entry is not effective unless the relevant intermediary is authorised to make that debit or designating entry: (a) by the account holder and, in the case of a debit or designating entry that relates to intermediated securities which are subject to a security interest arising under Article 5(3) by the collateral taker; or (b) by the domestic non-Convention law.

15-8. The determination that “unauthorised” means “not effective” remained unchanged in paragraph 1. However, the newly added paragraph 3(a) in Article 8 (after deletion of former paragraphs 2 and 3) provided for an interesting amendment: Where a debit or designating entry is not authorised (or a debit, credit or designating entry is otherwise ineffective), the non-Convention law shall determine the consequences of such ineffectiveness (UNIDROIT 2006 – Study LXXVIII – Doc. 42).

15-9. At the third session in November 2006, the CGE replaced the notion of “ineffectiveness” with “invalidity” in the English title so that the renumbered Article 11(1) read: “A debit of securities to a securities account or a designating entry is invalid if the relevant intermediary is not authorised to make that debit or designating entry: (a) by the account holder and, in case of a debit or designating entry that relates to intermediated securities which are subject to an interest granted under Article 8, by the person to whom an interest is granted; or (b) by the non-Convention law.” (See UNIDROIT 2006 – Study LXXVIII – Doc. 57.) The former Article 8(3) was deleted and partly replaced by the new paragraph 2(a) of the renumbered Article 11 stating that “the non-Convention law and, to the extent permitted by the non-Convention law, an account agreement or the uniform rules of a securities settlement system determine (a) the validity of a debit, credit or designating entry [...]”. In connection with Article 11(1) this could only mean that an unauthorised debit, etc., would always be invalid. However, what invalidity meant would be determined by the non-Convention law.

15-10. This text was maintained at the fourth session of the CGE in May 2007 with the only change – besides the renumbering of Article 11 as Article 13 (UNIDROIT 2007 – Study LXXVIII – Doc. 94) – that the “validity rule” of paragraph 2(a) was expressly made subject to paragraph 1(a), i.e., the non-Convention law could not determine that an unauthorised debit, designating entry or removal of a designating entry was valid. This was therefore the text submitted to the first session of the diplomatic Conference, still followed in Article 13(2) by the rules on validity, reversal and conditions (UNIDROIT 2008 - CONF. 11 – Doc. 3).

15-11. At the first session of the diplomatic Conference, an extensive discussion of Article 13 took place with the following results: The “authorisation rule” of paragraph 1 and the rules on validity, reversal and conditionality of paragraph 2 were placed into two separate articles. The newly renumbered Article 15(1) as adopted by the Conference is now formulated in a positive way and contains the authorisation requirement for debits, designating entries and – newly added – removal of designating entries. In substance there is no policy change in Article 15(1)(a) to (d) as to who may authorise the intermediary to make the debit, etc. However, the subdivision into the alternatives (a) to (d) facilitates the understanding of the rule which also now covers the unauthorised removal of a designating entry. Moreover, the language of what is now paragraph 1(a) has been changed from “the person to whom that interest is granted” into “the person in whose favour a designating entry has been made”. No change of policy was intended by this change.

15-12. Paragraph 2 of the new Article 15 deals with the consequences of an unauthorised debit, an unauthorised removal of a designating entry and, subject to Article 18(2), an unauthorised designating entry. The terms “validity” or “invalidity” respectively were removed and – after extensive discussions – fully neutralised in paragraph 2 by the concept of “consequences”, which are determined by the non-Convention law and, to the extent permitted by such law, the account agreement or the uniform rules of a securities settlement system. Invalidity, reversal and conditions are dealt with separately by the new Article 16. The diplomatic Conference acknowledged that harmonisation of the consequences of unauthorised debits, etc., has not been possible, although it agreed on the overriding protection of the innocent acquirer (Article 18).

III. Analysis

15-13. Article 15 complements Article 11(3) (disposal of intermediated securities by debit) as well as Article 12(3) (creating an interest in intermediated securities including a security interest or other limited interest by a designating entry in favour of a person other than the account holder). Article 15(1) establishes the core rule that such debit, designating entry or removal of a designating entry may be made by the intermediary only if it is authorised to do so, irrespective of whether and which legal effect the unauthorised debit, designating entry or removal of a designating entry may have. Article 15(2) declares that the non-Convention law is the law determining the consequences of any unauthorised debit, etc.

15-14. Note that Article 15 does not require authorisation for the relevant intermediary to make a credit entry in favour of an account holder. In the vast majority of circumstances an account holder receiving a credit will be entitled to the credit and will be expecting it as a result of a consensual transaction. Moreover, even if a credit is entered by mistake the credit entry, unlike a debit entry, is unlikely to impose any harm or damage on the account holder. Finally, requiring affirmative proof or an authorisation likely would require material modifications of market practices in many intermediated systems.

III-1. Authorisation of the intermediary

15-15. The core rule of Article 15(1) is formulated in a positive way: the intermediary may make debits, etc., only if it is authorised to do so. Paragraph 1 outlines who may authorise the intermediary, and this will depend upon the nature of the action. In general terms, it is the person or persons whose rights are negatively affected by the action of the intermediary. The term “authorisation” is not defined in the Convention. In the context of Article 15, this term has to be understood in a broad sense and includes any consent, instruction, direction, request or ratification given regardless of the wording or the form.

15-16. In most cases, the authorisation of the account holder to make a debit to its securities account will be implied in the instruction of the account holder to sell its securities or to transfer them to a securities account of another person or to another securities account which is maintained for the account holder by the intermediary or another intermediary. It is neither common practice nor is it required by the Convention to explicitly declare “I herewith authorise you to debit my securities account” or to use a similar explicit wording. The term “debit” is not defined in the Convention. Article 11(3) provides the debit method to dispose of intermediated securities. What constitutes a debit is determined by the non-Convention law (see the commentary on Article 11, at section 11-14).

15-17. If the account holder has granted an interest in intermediated securities by a designating entry in favour of a third person, then the intermediary needs also the authorisation by that person before making the debit.

15-18. If the account holder has granted an interest in intermediated securities in favour of a third person (“the grantee”), then the intermediary needs also the authorisation of that person before making the debit. This principle was recognised by the CGE at its first session (see UNIDROIT 2005 – Study LXXVIII – Doc. 24, Article 7(1)(a)) and was never disputed. During the re-drafting of what is now Article 15(1) during the first session of the diplomatic Conference, “the person to whom [an] interest is granted” was replaced by “the person in whose favour a designating entry has been made”, but no reference to a control agreement or automatic perfection was included.⁶

15-19. Where the account holder authorises the intermediary to make a designating entry to its securities account (Article 15(1)(b)), the instruction has to be more explicit. The term “designating entry” is defined in Article 1(e) and is one of the methods for the acquisition of an interest in intermediated securities, including in particular a security interest or other limited interest under Article 12(1) and (3)(b). According to this definition, one of the effects of a designating entry may be that the account holder cannot dispose of the intermediated securities to which the designating entry relates without the consent of the person in whose favour the designating entry has been made (assuming the relevant Contracting State opted for a negative control system in its declaration under Article 12(6)). Another effect of a designating entry may be that the beneficiary of the entry is entitled to give instructions to the relevant intermediary with respect to the intermediated securities concerned (assuming the relevant Contracting State opted for a positive control system in its declaration under Article 12(6)).

15-20. Consequently, in order to protect the account holder, a designating entry requires the authorisation of the account holder. However, the risk that the account holder’s rights would be

⁶ *Note of the Editors:* this unwanted change in respect of an undisputed policy was remarked upon, but no action was taken. On the merits, a debit of intermediated securities is certainly detrimental to the grantee of an interest in the same intermediated securities. Whether that interest was perfected by a designating entry, by a control agreement or by automatic perfection changes nothing to the requirement that the debit must be authorised by the grantee in addition to the account holder. The Editors have suggested a revision of the Convention text that would address this problem. See CONF. 11/2 – Doc. 6, section 4.

impaired by an unauthorised designating entry alone is rather remote, since under Article 12(1)(a), besides the designating entry, granting an interest in intermediated securities by this method requires an agreement between the account holder and the person to whom the interest is granted. Article 15(1)(b) does not require the intermediary to be given a copy of the agreement. Depending on the content of the right granted by the agreement, it may be necessary, however, to instruct the intermediary precisely as to which instructions and from whom the intermediary would have to comply with once the designating entry has been made (see Article 1(e)(i) and (ii)). This might be advisable also in cases where the declaration of the relevant Contracting State under Article 12(1)(b) and 12(6) limits the effect of a designating entry to one of the two alternatives of Article 1(e)(i) and (ii) (i.e., either positive or negative control, but not both).

15-21. With respect to the removal of a designating entry, Article 15(1)(c) requires the authorisation by the person in whose favour the designating entry has been made. The term “removal of a designating entry” was inserted in the Convention during the first session of the diplomatic Conference for the first time and only appears in Articles 15 and 16. Article 12, which contains the rule on granting an interest by designating entry, is silent as to how the interest is removed. Article 15(2) makes it clear that the non-Convention law and, where applicable, the account agreement or settlement system rules, determine the effect of an unauthorised removal.

EXAMPLE 15-1: Account holder A grants to B a security interest in the shares of company X which are credited to its securities account with IM I. The agreement between A and B provides that the security interest shall secure the repayment of a loan granted by B to A and that the security interest shall be created by instructing IM I to make a designating entry regarding the X-shares on A’s securities account in favour of B. B undertakes in the agreement to instruct IM I to remove the designating entry as soon as A has repaid the loan. After repayment of the loan, B must instruct IM I to remove the designating entry. IM I may not remove it if not authorised by B. The same applies if the agreement does not explicitly require B to instruct IM I to remove the designating entry upon discharge of the loan.

15-22. The authorisation of the intermediary to make the debit or the designating entry, or to remove a designating entry, may be contained in the non-Convention law. This reference to the non-Convention law in Article 15(1)(d) may be applicable, for example, in cases where a designating entry has to be removed because the repayment obligation of B in Example 15-1 has been fulfilled, with the result that both the security interest created by agreement and the designating entry cease to exist. To be on the safe side, an intermediary would be well advised to always request a confirmation from the holder of the security interest that its security interest has been extinguished, which would mean that the designating entry would be able to be removed by the intermediary. No confirmation or consent is necessary where a credit or designating entry or removal of a designating entry is reversed by the intermediary because it is invalid, or liable to be reversed (“reversible”), or, if made conditional, the condition is not fulfilled. In such cases, the authorisation may be derived from the provisions of the non-Convention law determining that the respective book entry is invalid or reversible (see sections III.1 and III.2 of the commentary on Article 16).

III-2. Consequences of unauthorised debits, etc.

15-23. Article 15(2) provides that the non-Convention law determines the consequences of unauthorised debits, unauthorised designating entries or unauthorised removals of such entries, but with respect to unauthorised designating entries, this is subject to the overriding principle that an innocent acquirer should be protected, so the fact that a designating entry is unauthorised would not prevent an innocent acquirer from enjoying the protection of Article 18(2).

15-24. Where applicable and to the extent permitted by the non-Convention law, account agreements and the uniform rules of a securities settlement system may also be determinative. The definitions of “account agreement” and “uniform rules of a securities settlement system” are laid down in Article 1(f) and 1(p), respectively.

15-25. The proviso “subject to Article 18(2)” regarding an (unauthorised) designating entry will protect the acquirer of an interest under Article 12 in cases where the earlier credit of the securities, which is the prerequisite and basis for making subsequently the designating entry, was a “defective entry” as defined in Article 17(d), i.e., invalid or reversible. Unless the acquirer of the subsequent designating entry actually knows, or ought to know as determined by Article 17(b), at the relevant time as defined in Article 17(e), that the earlier credit was a defective entry, the designating entry may not be treated as an “unauthorised” entry under Article 15.

EXAMPLE 15-2: Account holder A’s securities account with IM I is credited with 1,000 X-shares. This credit is the result of an embezzlement committed by an employee of IM I in collusion with A who bribed this employee. One month later, A grants B a security interest in those 1,000 X-shares as collateral for a loan and instructs IM I to make a corresponding designating entry to A’s securities account. The designating entry was made by another employee of IM I who had no knowledge of the earlier fraudulent action. B has no knowledge thereof either.

By virtue of Article 18(2), B’s security interest is protected; B is not liable to anyone. The applicable non-Convention law determining the consequences of an unauthorised designating entry may not impair this protection of B.

15-26. An innocent acquirer to whose securities account securities are credited is protected under Article 18, even if, for instance, the non-Convention law requires matching of debits and credits and the corresponding debit may be treated as invalid under that non-Convention law. In such a situation, the legal consequences of the credit are determined by the non-Convention law (generally see the commentary on Article 16, especially at 16-10).

Article 16

Invalidity, reversal and conditions

Subject to Article 18, the non-Convention law and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system determine whether and in what circumstances a debit, credit, designating entry or removal of a designating entry is invalid, is liable to be reversed or may be subject to a condition, and the consequences thereof.

Commentary

I. Introduction

16-1. Article 16 addresses three topics relating to debit, credit, designating entry and removals of a designating entry: invalidity, reversibility and conditionality of such book entries. Subject to the innocent acquisition rules of Article 18, all three topics are governed by the non-Convention law and, to the extent permitted by the non-Convention law, by the account agreement or the uniform rules of a securities settlement system. Such non-Convention law rules also determine the

consequences of book entries which are invalid, or reversible and, if an entry is conditional, the consequences of the fulfilment or non-fulfilment of the condition. Any rule under the non-Convention law is subject to the innocent acquisition rules of Article 18.

II. History

16-2. Until the first session of the diplomatic Conference, the content of Article 16 was part of a broader article, the first paragraph of which concerned the authorisation rule which is now contained in Article 15. Throughout the negotiations, effectiveness, validity, reversal and conditionality and their consequences were some of the most controversial topics.

16-3. The Study Group's first draft of the Convention (UNIDROIT 2004 – Study LXXVIII – Doc. 18) provided in paragraphs 2 to 5 of Article 5 for rules on:

- conditional debits, credits and designating entries with mandatory retroactive effect upon fulfilment of the condition (paragraph 2);
- debits or credits which, under the applicable law, are liable to be reversed on the ground of fraud or misrepresentation or any other ground; the applicable law would have to determine whether such debit or credit had any effect against third parties and, if so, what that effect was (paragraph 3);
- subsequent innocent acquisitions despite the fact that an earlier credit or designating entry was not effective or was liable to be reversed (paragraphs 4 and 5).

16-4. During its first session, the CGE approved some fine-tuning on these provisions and inserted two new paragraphs (2 and 3) which were deleted at the second session and which are not relevant to this discussion. (Paragraph 2 had provided that except when made conditionally, a debit, credit or designating entry would take effect when it was made. Paragraph 3 had related to the time at which intermediated securities would be treated as having been delivered into the possession or control of a collateral taker. See Articles 7(2) and 7(3) in UNIDROIT 2005 – Study LXXVIII – Doc. 24.)

16-5. At its second session, the CGE deleted the paragraph on conditional book entries on the understanding that conditional book entries could be subject to the rules on effectiveness of the non-Convention law (Article 8(2) and (3) in UNIDROIT 2006 – Study LXXVIII – Doc. 42). Under the new Article 8(2), the non-Convention law and, to the extent permitted by the non-Convention law, an account agreement or the rules and agreements governing the operation of a settlement system may provide that a debit or credit or designating entry is not effective or is liable to be reversed. According to Article 8(3) the consequences of such ineffectiveness, reversibility and reversal shall also be determined by the non-Convention law, subject, however, to the protection of an innocent acquirer.

16-6. At the third session, the provision on conditional book entries was re-introduced as paragraph 2(d) and (e) of the renumbered Article 11 (UNIDROIT 2006 – Study LXXVIII – Doc. 57). The CGE felt in particular that the possibility to make credits subject to a condition would be of great importance to the market and that there should be no doubt that the Convention permits conditional book entries (see UNIDROIT 2007 – Study LXXVIII – Doc. 58, section 61). The CGE also affirmed the conclusion of the second session that there should be full flexibility for the non-Convention law to determine whether, and in what circumstances, a debit, credit or designating entry may be made subject to a condition (Article 11(2)(d)) and, where such a book entry is made subject to a condition, its effect (if any) against third parties before the condition is fulfilled and the consequences of the fulfilment, or non-fulfilment, of the condition (Article 11(2)(e)).

16-7. Regarding the rules on effectiveness and reversibility the term “effectiveness” was replaced by “validity”. The determining role of the non-Convention law was not affected by this change in terminology. The overriding importance of protecting an innocent acquirer was reemphasised, and the article was provisionally amended through making the non-Convention law subject to priority rules of the Convention regarding competing interests.

16-8. At its fourth session, the CGE left Article 11 (which was renumbered as Article 13) substantially unchanged with the only amendment being the addition of the phrase “subject to paragraph 1(a)” in paragraph 2(a) to clarify and underline the overriding principle that, whatever the non-Convention law would otherwise determine, the protection of the account holder against unauthorised debits or designating entries would prevail due to the Convention declaring such unauthorised book entries to be invalid (cf. section 15-10 of the commentary on Article 15). The reference at the beginning of paragraph 2 “subject to Article 15” was left in square brackets. See UNIDROIT 2006 – Study LXXVIII – Doc. 94.

16-9. At the first session of the diplomatic Conference, an extensive discussion on Article 13 took place and resulted in the following changes: The authorisation rule in paragraph 1 and the rules on validity, reversal and conditionality in paragraph 2 were placed into two separate articles. Article 15(1) now contains the authorisation rule, while Article 15(2) leaves the consequences of unauthorised book entries to the non-Convention law. Invalidity, reversal and conditions now form the subject of Article 16. The text was streamlined but not changed in substance. The reference in square brackets to former Article 15 on priority (now renumbered as Article 19) was deleted.

III. Analysis

16-10. Article 16 is a prominent example of the difficulty of harmonising the substantive rules on debits and credits of intermediated securities to securities accounts. Like Article 15, Article 16 is an important complementary provision to Article 11 (acquisition and disposition by credit and debit) and Article 12 (acquisition and disposition by other methods). The rules under Article 11(1) and (3) as well as Article 12 are expressly made “subject to Article 16”. Regarding Article 12, however, Article 16 refers only to the “designating entry” or the removal of a designating entry (Article 12(3)(b)). The scope of Article 16 does not cover the other two methods of granting an interest pursuant to Article 12, namely, (i) by agreement between account holder and relevant intermediary in favour of the intermediary (“self perfection” – Article 12(3)(a)), or (ii) by a control agreement in favour of a third party (Article 12(3)(c)). This is because the validity of control agreements and the validity of automatic perfection agreements are governed by the applicable law. This would not preclude the interests that have become effective against third parties pursuant to control agreements or automatic perfection agreements from being subject to innocent acquirer protection under Article 18 (see the commentary on Article 18, especially at 18-16).

16-11. Invalidity, reversal and conditionality relate to the legal effects of book entries, i.e., even where a credit, debit, designating entry or removal of a designating entry has been made, the effect intended by Article 11 or 12 may not occur (invalidity), may have to be undone (reversal) or may depend on the fulfilment of a condition (conditionality). The Convention does not define any of these effects. Article 17(d) only defines credits or designating entries which are invalid or reversible as “defective entries”. This approach applies also to conditional credits or designating entries which become invalid or are reversible by reason of the operation or the non-fulfilment of the condition.

III-1. Invalid entries

16-12. If a book entry covered by Article 16 is invalid according to the non-Convention law, then it is likely that it does not produce some or all legal effects described by Article 11 or 12. Some legal

systems may consider that no acquisition or disposition has taken place and that this must be reflected by rectifying the securities account. Other may require the rectification of the securities account to undo the effects of the book entry. Such rectification would be made:

- in case of an invalid credit, by deleting the credit or by debiting the account;
- in case of an invalid debit, by deleting the debit or by crediting the account;
- in case of an invalid designating entry, by deleting the designating entry; or
- in case of an invalid removal of a designating entry, by re-establishing the original designating entry.

16-13. Such “rectifying” actions are generally called “reversals” as the invalid book entry is undone or reversed. In legal terms, those actions may be one category of reversal, and the intermediary does not need the consent of the account holder, or of the beneficiary of the designating entry, for the rectification.

16-14. Since the consequences of the invalidity may be different in different States and since the general issues of when a book entry, or its removal, is invalid or when it is reversible are to be determined by the non-Convention law, Article 15 merely states that the intermediary must be authorised in order to make a debit, etc. Pursuant to Article 15(2) the consequences of lack of authorisation are left to the non-Convention law.

16-15. It is assumed that in most jurisdictions an invalid book entry would be ineffective, which would usually mean that it would not change the legal situation of the account holder or beneficiary of a designating entry. However, it is also possible that an invalid book entry would have legal effects until it had been reversed by a counter-action. In such cases “invalid” would be synonymous with “liable to be reversed”.

16-16. The non-Convention law determines the prerequisites and consequences of invalid entries or invalid removal of entries, but this remains subject to the overriding principle of protecting an innocent acquirer in a subsequent transaction, so that an invalid entry or removal would not prevent an innocent person from enjoying the protection described in Article 18.

EXAMPLE 16-1: Account holder A has recently divorced and is a good friend of employee E of IM I. A’s ex wife W maintains a securities account with IM I for which A had a power of attorney which, however, was revoked by W upon the divorce. A urges his friend to transfer from W’s account 100 X-shares to the securities account of A which he maintains with IM I. Although A has no power of attorney anymore for the account of his ex wife, E fulfils the wish of A. E is not in charge of A’s or W’s account, but has the possibility within IM I’s organisation to cause the debit of W’s account and the credit of A’s account. W returns from her vacation three weeks later. She discovers the debit of her account when reading the respective account statement. She requests to re-credit 100 X-shares to her securities account.

Alternative 1: A sells the 100 X-shares to Z in a private sale transaction, instructs IM I to transfer the shares to Z’s securities account, withdraws the sale proceeds from his cash account and disappears.

Alternative 2: A grants a security interest on the 100 X-shares to C as collateral for a loan and instructs IM I to make a designating entry in this respect on his securities account. C has no knowledge of the previous fraudulent transfer.

If the non-Convention law determines that a debit without proper authorisation is invalid and that the consequence of invalidity is that the debit does not have any legal effect, W has not lost her rights with respect to 100 X-shares. IM I must either delete the debit or make a credit. Note that the non-Convention law may provide that invalidity has other effects such as W losing her proprietary interest and having a claim for compensation against IM I.

Result for alternative 1: In order to avoid a shortfall of 100 X-shares in its holding with upper-tier IM U, IM I has to buy in 100 X-shares. IM I has a claim against A to recover the purchase price, the successful realisation of which, however, is doubtful. If it cannot be recovered IM I would have to bear the loss. Assuming that the non-Convention law determines that an account holder in a fraudulent transaction like this does not acquire anything and that the credit is invalid, A has not acquired the 100 X-shares when his securities account was credited. Upon the execution of A's transfer order, Z, however, acquired 100 X-shares when his securities account was credited since he did not know or ought to know of the defective entry of the 100 X-shares on A's securities account (Article 18(2)).

Result for alternative 2: Although the credit of the 100 X-shares to A's securities account is invalid, C has acquired a security interest by agreement with A and the designating entry made by IM I (Article 18(2)). IM I has to re-credit 100 X-shares to the account of W. IM I furthermore has a claim against A to buy in 100 X-shares to be credited to A's securities account in order to cover the designating entry in favour of C. If A fails to make such buy-in, IM I would have to do it at its expense. Normally, IM I would, in turn, have a security interest ("banker's lien") on the 100 X-shares credited to A's account for the purchase price (Article 12(3)(a)). However, the security interest granted to C would rank prior to IM I's security interest (Article 19(3)). Alternatively, if C's interest is a non-consensual one, then C's priority would be determined by the non-Convention law (Article 19(5)).

III-2. Reversible entries

16-17. Whether a debit, credit, designating entry or removal of a designating entry is reversible, and the consequences that would follow from such reversibility, is determined by the non-Convention law. As in the case of invalidity, reversal will not affect the rights of an innocent acquirer under Article 18. As long as the innocent acquirer is protected, reversal is meaningless from the acquirer's point of view.

16-18. In general terms, reversibility means that a book entry has been effective, but that its legal effect has to be "undone". This can be achieved by:

- debiting the securities account in case of a credit which is liable to be reversed;
- re-crediting the securities account in case of a debit which is liable to be reversed;
- deleting the designating entry which is liable to be reversed; or
- making the designating entry again in case it had been removed and such removal is liable to be reversed.

16-19. In contrast to the mere effect of rectification of an account in case of an invalid book entry, reversal may have additional legal effects, and these effects are determined by the non-Convention law.

16-20. If a book entry is liable to be reversed, the non-Convention law determines whether the reversal can be done without the consent of the account holder or beneficiary of a designating entry (or whether such consent is necessary). Such consent is not required and that the intermediary is entitled to unilaterally reverse the relevant book entry. The Convention provides for unilateral reversal pursuant to Article 15. Although Article 15 establishes the fundamental principle that an intermediary may make a debit or remove a designating entry only if it is authorised to do so, the non-Convention law may provide such authorisation, e.g., in case of a credit or a designating entry which is liable to be reversed. Again, in establishing whether a credit or designating entry may be reversed, the rights of an innocent acquirer under Article 18 must be respected.

16-21. The non-Convention law determines whether the reversal has a retroactive effect, i.e., whether its effect is “ex tunc” or “ex nunc”. Normally a reversal has an “ex nunc” effect, at least in jurisdictions which clearly distinguish between invalid transactions and transactions which are liable to be reversed.

EXAMPLE 16-2: IM I erroneously credits A’s securities account with 1,000 X-shares which had been transferred to IM I via the national CSD to be credited to the securities account of B. When the mistake is found three weeks later, IM I wants to debit the account of A without seeking the prior consent of A.

Result: IM I is entitled to debit the securities account of A without being required to ask A for his consent. Thereafter, IM I makes a credit of the 1,000 X-shares to the securities account of B.

Alternative 1: A participated in a shareholders meeting of X and exercised the voting rights of the 1,000 shares before the error was detected.

Result: Since the credit of the 1,000 shares conferred upon A the right to exercise the voting rights (Article 9(1)(a)), such exercise was not in violation of corporate law, at least if the subsequent reversal of the credit has no retroactive effect.

Alternative 2: A receives a dividend on the 1,000 X-shares before the error is detected.

Result: A has to repay the dividend to IM I. Legally, A is not entitled to benefit economically from the erroneously credit of the shares. IM I has to compensate B for the dividend.

Alternative 3: A sells the 1,000 X-shares in a private sale to Z before the erroneous credit has been detected. He instructs IM I to transfer the shares to Z’s securities account. IM I acts accordingly. Z has no reason to believe that A might not be entitled to dispose of the 1,000 shares.

Result: Z is protected by Article 18(2). IM I has to buy-in 1,000 X-shares in order to be able to credit them to B’s account. The expenses of this have to be borne by A.

III-3. Conditional entries

16-22. A credit, debit, designating entry or removal of a designating entry may be made subject to a condition. It is again the non-Convention law (and, if so allowed by the non-Convention law, the account agreement or the uniform rules of a SSS), and not the Convention, which determines whether, and if so with what consequences, such book entries may be made conditional.

EXAMPLE 16-3: Under the non-Convention law of country A, the settlement period for stock exchange trades is T+2. This rule is also applied to OTC trades unless agreed otherwise. Under A’s law a bank executing a sale or purchase order for a customer has to inform the customer without delay that its order has been executed and at which price. Such

information statement has to be sent out to the customer at T+1 at the latest. Furthermore, banks acting as intermediaries as defined in Article 1(d) are obliged to inform their customers without delay of any credit or debit to their securities accounts. In order to be able to combine both statements in a cost efficient way the banking industry in country A (where the broker and the intermediary function is, as a rule, fulfilled by one and the same bank) has developed – with the consent of the supervisory authorities – the practice of making the credits and debits to the securities accounts of their customers on, or immediately after the trading day, as soon as they know that the order has been executed. Since the settlement of any trade takes place only on the second stock exchange trading day after the trade day (T+2), any such credit or debit is made under the condition that the respective trade is duly settled on T+2. The legal purpose of this condition is to postpone the legal effect of any credit or debit until the moment when either (i) in case of a credit, the securities account of IM I with the national CSD has been credited accordingly; or (ii) in case of a debit, this securities account has been debited. Since the settlement system in country A is based on the DvP-system (“delivery versus payment”), each participating intermediary can also rely on the due settlement of the payment side. If those credits and debits were not made subject to the condition precedent that corresponding credits and debits on the upper-tier CSD level would be made, the DvP-principle would not work since the payments would be made only on the settlement date. Furthermore, temporary shortfalls would occur since the CSD only credits and debits the securities accounts of its participants on the settlement date (T+2).

When the condition is fulfilled the credit or debit becomes effective. The book entry may have retroactive effect depending on the non-Convention law and/or the account agreement if so permitted by the non-Convention law. The more practical solution, however, may be not to provide for a retroactive effect but to couple the moment of the effectiveness of the credit or debit with the moment of the fulfilment of the condition (“ex nunc”). This also makes it easier to determine the moment of the effectiveness in a general way applicable to all trades in country A.

If the condition is not fulfilled, the provisional debit or credit does not have its intended effect and has to be “undone” by a respective counter-action (credit or debit). This counter-action has only a rectifying effect in the sense that the book entry situation which existed before the conditional credit or debit was made is reinstated. However, this result is subject to Article 18 (protection of an innocent acquirer).

EXAMPLE 16-4: Account holder A instructs its bank (IM I) to purchase 1,000 X-shares. After the execution of the trade, IM I makes a respective credit to A’s securities account. As stipulated in IM I’s general business terms, which form part of the account agreement with A, such credit is conditional upon delivery of the securities through the national CSD on the settlement date. The delivery fails.

On T+1, A grants a security interest on those 1,000 X-shares to B as collateral for a loan. A instructs IM I to make a designating entry on its securities account regarding those 1,000 shares. IM I acts accordingly on the same day T+1. Since the settlement fails, IM I wants to debit A’s securities account in order to “undo” the provisional credit. What happens to B’s security interest? B did not know that A bought the X-shares just one day before it granted the security interest thereon and that the credit was only conditional.

Result: B’s securities interest is protected by Article 18(2) although the credit of the 1,000 X-shares to A’s account was a “defective entry” within the meaning of Article 17(d). IM I should not have made the designating entry in respect of the 1,000 X-shares before the

settlement occurred. IM I has to buy-in 1,000 X-shares for the account of A and to credit A's securities account accordingly so that B's security interest is duly funded. Note that IM I may protect itself by making a note in the designating entry or, as the case may be, the control agreement that the credit of securities is or may be conditional or otherwise liable to be reversed. However, in a system in which IM I merely receives a notice of a control agreement (see Article 1(k)), it would not be in a position to protect its ability to reverse the credit.

Article 17
Terms used in Chapter III

In this Chapter:

(a) "acquirer" means

(i) an account holder to whose securities account securities are credited; or

(ii) a person to whom an interest in intermediated securities is granted under Article 12;

(b) in determining whether a person ought to know of an interest or fact:

(i) the determination must take into account the characteristics and requirements of securities markets, including the intermediated holding system; and

(ii) the person is under no general duty of inquiry or investigation;

(c) where a person is an organisation, such person actually knows or ought to know of an interest or fact from the time when the interest or fact is or ought reasonably to have been brought to the attention of the individual responsible for the matter to which the interest or fact is relevant;

(d) "defective entry" means a credit of securities or designating entry which is invalid or liable to be reversed, including a conditional credit or designating entry which becomes invalid or liable to be reversed by reason of the operation or non-fulfilment of the condition;

(e) "relevant time" means the time that a credit is made or the time referred to in Article 19(3).

Commentary

I. Introduction

17-1. Article 17 contains three definitions and two rules of construction. The definitions are provided here, not in Article 1, because they are used only in Chapter III.

II. History

17-2. Article 17 was added during the first session of the diplomatic Conference. The definition of “acquirer” was included in order to shorten and simplify the drafting of Article 18, which deals with the innocent acquisition of intermediated securities. Similarly, the rule of construction for determining the circumstances in which a person ought to know of an interest or fact and the definition of “relevant time” simplify the drafting of Articles 18 and 20, where the phrase “ought to know” and the term “relevant time” are used. The rule of construction for when an organisation ought to know of an interest or fact and the definition of “defective entry” were formerly included in the predecessor of Article 18.

17-3. The principal change in substance made by Article 17 at the first session of the diplomatic Conference was the addition of the rule of construction on “ought to know”, reflected in paragraph (b). All earlier drafts contained a version of the so-called “willful blindness” test for when a person has knowledge of an interest or fact. That test is met when a person “deliberately” (i.e., intentionally) avoids actual knowledge. For example, Article 14(4)(b) of the draft submitted to the first session of the diplomatic Conference provided that a person has knowledge of a fact or interest if the person has “actual knowledge” or “has knowledge of facts sufficient to indicate that there is a significant probability that the interest or fact exists and deliberately avoids information that would establish that this is the case”. See UNIDROIT 2008 – CONF. 11 – Doc. 3, Article 14(b). However, at the fourth session of the CGE, the text providing for the willful blindness test was placed in square brackets in order to indicate the absence of a consensus as to the appropriate test for knowledge. As was eventually made obvious, the disagreement among delegations on the test of knowledge was not one of actual substance or result but instead a disagreement over the appropriate Convention text. For example, there was no substantial support for a standard that generally would require an acquirer to undertake investigation or other due diligence. Moreover, as the analysis of paragraph (b) below indicates, proper application of the “ought to know” standard essentially captures the substance of the “willful blindness” test.

17-4. A second change of substance was incorporated in the definition of acquirer. Earlier drafts of Article 18(1) protected only persons who acquired interests in intermediated securities by way of credit or designating entry. Article 18(1) now extends its protection to those who acquire interests under a method provided in Article 12, but only when the priority rules in Article 19 do not provide a different result.

III. Analysis

III-1. “acquirer”

17-5. The term “acquirer” is defined broadly to mean any person who acquires an interest in intermediated securities by a method provided in the Convention. These methods are the credit of securities to a securities account of an acquirer, addressed by Article 11, and the granting of an interest by a method provided in Article 12 (by a grant to the relevant intermediary, by a designating entry or by a control agreement). The term is used only in Article 18 in order to specify persons who are eligible for innocent acquisition protection under the article.

17-6. While invalidity mentioned under Article 16 does not preclude protection under Article 18 (Article 16 is subject to Article 18), Article 18 protection for an acquirer to whose securities account a credit or designating entry is made requires the existence of a credit or designating entry. What is or constitutes a credit or designating entry to a securities account is determined by the non-Convention law.

III-2. “determining whether a person ought to know of an interest or fact”

17-7. Articles 18(1) and 18(2) protect an acquirer of an interest in intermediated securities, unless the acquirer at the “relevant time” (see below) either actually knows or ought to know of a conflicting interest or a defective entry. The rule of construction provided by paragraph (b) explains the determination of “whether a person ought to know of an interest or fact”.

17-8. Sub-paragraph (b)(i) makes clear that the “ought to know” element is to be applied in light of the unique circumstances applicable to intermediated securities. Traditional notions of “good faith” or “innocence” are inappropriate in the *sui generis* context of intermediated securities systems. Courts should not seek guidance from the applicable law with respect to the good faith purchase of movables more generally.

17-9. Transactions in intermediated securities are very often entered into and executed on a rapid basis; acquisitions are very often effectuated through impersonal markets; and acquisitions are very often relied on as the basis for further onward transfers or other actions by the acquirer. These circumstances, among others, impose a distinctly heightened necessity for innocent acquirers to have *ex ante* confidence in the rights that they are acquiring. The distinctions between these systems of acquiring and holding securities and traditional markets for movables generally are obvious. Moreover, as explained next in connection with sub-paragraph (b)(ii), the attributes of intermediated holding systems reflect the futility and inappropriateness of imposing any general duty of inquiry or investigation on an acquirer.

17-10. Sub-paragraph (b)(ii) further makes it clear that the “ought to know” standard imposes on an acquirer no general duty of inquiry or investigation. In most acquisitions by way of a credit or designating entry, it would be impossible for the acquirer to discover any conflicting claims or defective entries, because the acquirer must rely entirely on the intermediary. Similarly, in most acquisitions by way of a control agreement, or by an intermediary by agreement with its account holder, the acquirer will ordinarily have no practicable and conclusive way of discovering the interests or facts with which Articles 18(1) and 18(2) are concerned. It follows that requiring an acquirer to somehow undertake due diligence by way of inquiry or investigation would undermine the very efficiencies that intermediated systems are intended to capture. Accordingly, innocent acquisition protection is generally available under this article even to an acquirer who is concededly oblivious, ignorant, and uncurious – subject to the standards of honest behaviour and wrongful knowledge discussed below.

17-11. By no means does the “ought to know” standard protect a person who fails to observe appropriate standards of honest behaviour. Indeed, the “ought to know” standard is expressly designed to hold a dishonest person responsible for any interest or fact of which an honest person would have actually known. For example, if a person actually knows of very suspicious circumstances, and consciously decides not to make any inquiry, and that decision is made so that the person will avoid actual knowledge of a fact, then the person “ought to know” of that fact. However, the nature of transactions in intermediated securities is such that this standard will rarely apply outside of an acquirer’s actual collusion with a wrongdoer, or in highly suspicious circumstances when the acquirer’s knowledge falls just short of “actual knowledge”.

EXAMPLE 17-1: Wife (W) informs the relevant intermediary that (i) the securities credited to the securities account of her Husband (H) are jointly owned by W and H (although the account is in the name of H alone), (ii) that they are parties to a divorce proceeding, and (iii) that her husband moved the securities into his sole account from their joint account with another intermediary. In the meantime, however, H granted a security interest in the intermediated securities to a lender (L) to secure a new loan and the securities have been

credited to L's account with another intermediary. L was aware (from a credit application) that H is married but was unaware of the pending divorce proceeding.

L is an innocent acquirer, as he had no wrongful knowledge and was not aware of any suspicious circumstances. L's knowledge that H is married is not a highly suspicious circumstance that would be a sufficient basis to conclude that L purposefully failed to make inquiry in order to avoid wrongful knowledge. (Note that the facts of Example 17-1 would not occur under a system in which W, not being an account holder, would not have a property interest in the securities credited to H's account or in a system in which joint accounts are not permitted.)

EXAMPLE 17-2: The facts of Example 17-1 apply except that L's loan officer handling the transaction knew (i) of the divorce proceeding, (ii) that it is typical in such proceedings that the transfer of an interest in assets other than in routine transactions is prohibited, and (iii) from documentation provided to L's loan officer, that prior to the security interest being granted the securities were transferred from a joint account in the name of H and W to the account in the sole name of H.

L's failure (i.e., the loan officer's failure) to make any inquiry that might have revealed W's proprietary claim and the wrongfulness of the grant of a security interest to L make it plausible that L ought to have known about the claim and the violation of W's rights. If that is so, then L would not be protected under Article 18(1). (Of course, no simple example that does not assume actual knowledge can be sufficiently rich in factual detail to support a definite conclusion on the "ought to know" issue.)

EXAMPLE 17-3: Public Company (PC) owned dematerialised shares of M Co., also a public company, registered in PC's name on the books of M Co. PC instructed M Co. (or its transfer agent) to transfer the shares to Closely Held Co. (CHC). M Co. (or its transfer agent) registered the shares in the name of CHC. The correct, authorised person gave the instructions on behalf of PC to M Co., but that person was acting wrongfully and without actual authority. CHC then granted a security interest to lender (L) to secure a new loan and the securities were credited to L's account with its intermediary. Under the applicable law, PC is entitled to rescind the transfer to CHC and to recover the securities. L's loan officer handling the transaction knew that (i) PC had made public filings in the past stating that PC owned a large block of M Co. shares, (ii) Maxwell Roberts (MR) owns a controlling interest in PC and in CHC (making the two companies affiliates), and (iii) MR and the companies he controlled were rumoured in the financial press to be experiencing some financial distress.

As in Example 17-2, L's failure (i.e., the loan officer's failure) to make any inquiry that might have revealed PC's proprietary claim and the wrongfulness of the grant of a security interest to L make it plausible that L ought to have known about the claim and the violation of PC's rights. If that is so, then L would not be protected under Article 18(1). (To reiterate, no simple example that does not assume actual knowledge can be sufficiently rich in factual detail to support a definite conclusion on the "ought to know" issue. Note as well that the facts of Example 17-3 could not occur in a dematerialised system in which investors must hold through intermediaries and may not hold directly on the books of an issuer.)

17-12. Paragraph (b)'s rule of construction does not deny Article 18 protection to an acquirer merely because a third party has made or given a public filing, registration, recordation or other notice with respect to the third party's interest in the intermediated securities. In some

jurisdictions, such a public notice is a means by which the third party may protect its interest against certain claims. However, to require an acquirer, in advance of a transaction, to undertake a search for such notices would impose substantial delays and costs that have no place in modern securities markets. Accordingly, under sub-paragraph (b)(ii), an acquirer “is under no general duty of inquiry or investigation” with respect to such notices, and similarly under sub-paragraph (b)(i), “the characteristics and requirements of securities markets, including the intermediated holding system” make clear that an interest or fact is not among those of which an acquirer “ought to know” merely because the interest or fact is reflected by such a notice.

17-13. This analysis does not differ merely because the acquirer has read or is otherwise aware of the third party’s public notice (unless the acquirer actually knows or ought to know, not only that the third party has an interest in the intermediated securities, but also that the acquirer’s acquisition violates the rights of the third party). An acquirer’s awareness that another person has an interest in the intermediated securities does not, by itself, constitute awareness that the acquisition “violates the rights of that other person” (Article 18(1)). On the contrary, it is common for a third party who has filed a public notice nonetheless to permit and desire the account holder to sell or otherwise transfer the intermediated securities, e.g., in order to generate funds with which to pay the third party. An acquirer is entitled to presume, without inquiry or investigation, that such is the arrangement in any particular transaction (unless the additional circumstances mentioned above are present).

EXAMPLE 17-4: As collateral for its obligations to lender L, account holder A has granted L a security interest in intermediated securities credited to A’s account maintained by IM. Under applicable law, L’s interest in the securities has been made effective against third parties by means of a publicly filed notice describing such interest (see Article 13). Later, A sells an interest in the same securities to B, and IM duly debits A’s account and credits B’s account. If B at the time of the acquisition is not aware of the contents of L’s notice, or if B is aware thereof but the notice merely specifies L’s interest without also making clear that the transfer by A would violate L’s rights, then under paragraph (b)’s rule of construction, B is not deprived of protection under Article 18(1). (By contrast, if in addition to being aware of the contents of L’s notice B has also been told by L that A has promised not to sell the intermediated securities, then the circumstances taken together make it plausible that B ought to know about the violation of L’s rights. Here again, no simple example that does not assume actual knowledge can be sufficiently rich in factual detail to support a definite conclusion on the “ought to know” issue.)

III-3. Circumstances in which “an organisation [...] ought to know of an interest or fact”

17-14. The standards of actual knowledge or “ought to know” of Articles 18(1) and 18(2) apply to organisations just as they apply to other acquirers. The only additional consideration is that organisations generally involve multiple individuals, and consequently present threshold questions concerning the individuals to whom the “ought to know” standard applies, and when. These threshold questions are addressed by the rule of construction provided in paragraph 1(c). It does not alter the more substantive point that organisations are governed by the standards of Articles 18(1) and 18(2).

17-15. Paragraph 1(c) is important for two reasons. First, an organisation cannot have knowledge except through particular individuals. Second, most acquisitions of intermediated securities are by organisations, composed by or otherwise linked to numerous individuals having widely varying levels of knowledge and widely varying roles.

17-16. This rule of construction provides guidance for whose knowledge counts, while preventing abuses and not imposing undue burdens. It focuses not only on “the individual responsible for the matter” but also on the time at which a relevant interest or fact is “or ought reasonably to have been brought to [the responsible individual’s] attention”. The rule’s reference to reasonableness is important in at least two ways. First, if reasonable action would bring the interest or fact to the attention of the individual responsible for the matter, then the organisation acquiring the intermediated securities is charged with that knowledge, whether the organisation did in fact act reasonably or not. (This is clear from the “or ought reasonably” clause.) Second, the concept of reasonableness enables the rule to apply flexibly in a wide variety of circumstances.

17-17. As one important example of this flexibility, whenever the circumstances are such that an organisation acquiring intermediated securities should reasonably acquire information from a source *outside* the organisation, then the test requires the organisation to do so. In other words, *nothing limits the reasonableness requirement to sources within the organisation itself*. This point directly forecloses abusive manoeuvres, such as a commercial actor with relevant knowledge attempting to insulate itself from that knowledge by artificially arranging for intermediated securities to be acquired through a nominee, affiliate or outsourcing partner. The organisational knowledge test should prevent this abuse by being flexible enough, under proper circumstances, to charge an acquiring organisation with the knowledge even of individuals who are outside the organisation.

17-18. The flexibility of the test’s reasonableness concept is important in other circumstances as well. For example, reasonableness should not require that every single one of an organisation’s employees, even those that have no role in a particular acquisition of intermediated securities, report his or her relevant knowledge to the individual responsible for the acquisition. An organisation should not be discouraged from enjoying the benefits of a division of labour within the organisation. But a duty to report would exist under certain circumstances, such as where the reporting of the knowledge is part of the employee’s prescribed duties (as, for example, with a bank employee responsible for monitoring financial newspapers for stories about the bank’s prospective transactions), or where the employee otherwise has reason to know that his or her knowledge, if shared, would have an important effect on the acquisition.

17-19. Finally, the term “organisation” is not defined in the Convention, and it should be interpreted broadly. It includes any person other than an individual natural person, including a corporation, partnership, government, governmental subdivision or any other legal or commercial entity that has the power and capability to acquire an interest in intermediated securities and to incur legal and contractual obligations, powers and capabilities that an account holder must possess.

EXAMPLE 17-5: The facts of Example 17-3 apply except that it was not L’s loan officer who had the knowledge but instead L’s trust officer who had the knowledge. The trust officer handled MR’s family trusts, worked at another branch of L in another city, and had no knowledge of the loan transaction.

Under the special rule for when an organisation has knowledge or ought to know of an interest or fact, Article 17(c), the above circumstances raise the question whether the facts known to the trust officer “ought reasonably to have been brought to the attention of” the loan officer by the time that the credit was made to L’s account (the “relevant time” under Article 17(e)).

III-4. “defective entry”

17-20. Article 18(2) protects acquirers against risks relating to an “earlier defective entry”. The definition of “defective entry” is straightforward: A defective entry is a credit or designating entry that is “invalid or liable to be reversed”. It also includes a conditional entry that is rendered invalid or liable to be reversed as a result of a condition that is not fulfilled. Article 16 addresses the circumstances that give rise to invalidity or reversibility for this purpose. Those matters are determined by the non-Convention law and, in some cases, by the account agreement or the uniform rules of a securities settlement system.

III-5. “relevant time”

17-21. The operation of the innocent acquisition protection in Articles 18(1) and 18(2) and the operation of the priority rule in Article 20(2) require a determination of whether an acquirer knows or ought to know of a fact or interest at the “relevant time”. Depending on the method of acquisition, that time is the time when a credit is made or the time specified in Article 19(3) for the application of the Article 19 temporal priority rules for interests acquired by a method provided in Article 12.

Article 18***Acquisition by an innocent person***

1. Unless an acquirer actually knows or ought to know, at the relevant time, that another person has an interest in securities or intermediated securities and that the credit to the securities account of the acquirer or the interest granted to the acquirer violates the rights of that other person with respect to the interest of that other person:

(a) the right or interest acquired by the acquirer is not subject to the interest of that other person;

(b) the acquirer is not liable to that other person; and

(c) the credit, designating entry or the interest granted is not rendered invalid against third parties or liable to be reversed on the ground that the right or interest of that other person invalidate any previous debit or credit made to another securities account.

2. Unless an acquirer actually knows or ought to know, at the relevant time, of an earlier defective entry:

(a) the credit or interest is not rendered invalid, ineffective against third parties or liable to be reversed as a result of that defective entry; and

(b) the acquirer is not liable to anyone who would benefit from the invalidity or reversal of that defective entry.

3. Paragraphs 1 and 2 do not apply in respect of an acquisition of securities, other than the grant of a security interest, made by way of gift or otherwise gratuitously.

4. Where an acquirer is not protected by paragraph 1 or paragraph 2, the applicable law determines the rights and liabilities, if any, of the acquirer.

5. To the extent permitted by the non-Convention law, paragraph 2 is subject to any provision of the uniform rules of a securities settlement system or of the account agreement.

6. This Article does not modify the priorities determined by Article 19.

Commentary

I. Introduction

18-1. Article 18 provides protection to innocent acquirers of intermediated securities. It reflects the general idea that once a person has acquired a right or interest over intermediated securities for value and unless the person has actual knowledge or ought to know of the relevant interest or fact, no adverse claim can be asserted against that person. In effect, Article 18 sets out a “last-in-time” priority rule. It is primarily associated with acquisition by credit, but also applies to acquisition by a method provided in Article 12 in cases in which the priority rules of Article 19 or Article 20(2) do not apply.

II. History

18-2. Rules protecting innocent acquirers of interests in intermediated securities have been included in all earlier drafts of the Convention. A consensus has prevailed throughout the drafting and deliberation process that these rules are vitally important to the Convention’s regime. This has been so even though it has been recognised that actual conflicting claims are rare in the intermediated securities systems.

18-3. The most significant substantive changes to the Convention text made during the first session of the diplomatic Conference are described in the History section of the Official Commentary to Article 17. They are the rule of construction on “ought to know” and the expansive definition of “acquirer”. Related to that definition, a new paragraph 6 makes it clear that Article 18 does not modify the Article 19 priorities. In addition, a new paragraph 4 provides that if an acquirer is not protected by Article 18 it is the applicable law that determine an acquirer’s rights and liabilities.

III. Analysis

III-1. Basic operative rules

Paragraph 1

18-4. The text contemplates two different but analogous scenarios. Paragraph 1 ensures the protection of an acquirer against any competing claim from another person. In this case, the provision protects the acquirer unless it actually knows or ought to know that (i) another person has an interest in the securities or intermediated securities and (ii) the acquisition violates the rights of that other person. If those conditions are met, the acquirer is “immunised”, i.e., (i) the acquirer’s right or interest is not subject to the interest of the other person; (ii) the acquirer is not liable to the other person; and (iii) the acquisition is not invalid or liable to be reversed “on the ground that the right or interest of that other person invalidate [sic] any previous debit or credit made to another securities account”.

18-5. Note the narrowness of the third protection in paragraph 1(c), which identifies only one specific ground for invalidity, ineffectiveness, or reversal. However, there is a variety of grounds on which the acquisition might be held invalid or liable to be reversed as a result of the violation of the rights of another person. Paragraph 1(c) provides no protection against invalidation or reversal on such other grounds arising out of the violation of rights.⁷

EXAMPLE 18-1: A agreed in an off-exchange trade to sell intermediated securities to B. (If A had sold the securities on an exchange or organised market it normally would not have had any direct dealings with B and it normally would be difficult, impracticable or impossible to trace the securities to B or C or anyone else.) A's intermediary debited A's securities account for the securities and B's intermediary credited B's securities account. (The debit and the credit are the relevant steps for present purposes. There are a variety of intermediate steps and intermediaries that might have been involved in the process.) B sent funds representing the price to A by electronic funds transfer. B defrauded A by making false statements about the issuer of the securities, leading A to sell them for below market value. Under the applicable law, A was entitled to rescind the sale and recover the securities. Before such remedy had been obtained, in another off-exchange trade B sold the securities to C and C's intermediary credited the securities to C's account.

A asserts its adverse claim against C and C invokes the innocent acquisition rule of Article 18(1).

EXAMPLE 18-2: The facts of Example 18-1 apply except that instead of misrepresenting facts to A, B failed to send funds representing the price to A contrary to B's agreement to do so.

EXAMPLE 18-3: The facts of Example 18-1 apply except that instead of misrepresenting facts to A, the agreement between A and B was void under the applicable law.

In none of these examples is there any suggestion that C was aware of any suspicious circumstances or even of the transaction in which B acquired intermediated securities pursuant to its agreement with A. It follows that Article 18(1) protects C's interest in the intermediated securities and protects C from any liability to A.

EXAMPLE 18-4: An employee (B) stole certificated securities that were duly indorsed by his employer (A), the registered owner of the securities. B then submitted the security certificates to the issuer and requested that the securities be transferred to C (B's friend and accomplice), with new certificates to be issued in the name of C. C then indorsed and deposited the new certificates with its intermediary, which credited the securities to C's securities account. C then granted a security interest to lender (L) to secure a new loan and C, L, and C's intermediary entered into a control agreement effective under Article 12. Under the applicable law, A is entitled to an order rescinding the grant of the interest to C and for the recovery of the securities.

As in Examples 18-1 to 18-3, L is an innocent acquirer, as it had no actual wrongful knowledge, and was not aware of any suspicious circumstances. Article 18(1) applies because A's conflicting claims did not become effective under Article 12 or 13. See Article 18(6); Article 19(1). (Note that the facts of Example 18-4 could not occur in a system in which all relevant securities are dematerialised.)

⁷ *Note of the Editors:* the Editors have suggested a revision of the Convention text that would address this problem. See CONF. 11/2 – Doc. 6, section 5.

18-6. Note that Article 18(1) is intended to address “three party” situations, where, as in Examples 18-1 to 18-3, A has transferred securities to B and B has transferred intermediated securities to innocent C. Article 18(1) governs the question whether C is protected even though under the non-Convention law A could recover from B because B does not qualify for the protection of Article 18(2). Depending on the facts, B may be protected from the claims of A by virtue of Article 18(2), which applies in situations where there are two or more parties.

Paragraph 2 and paragraph 5

18-7. Paragraph 2 protects acquirers against risks relating to an “earlier defective entry” (see the definition of “defective entry” in Article 17). In this setting, the innocent acquirer’s rights or interests over the intermediated securities are also immunised: (i) the credit or interest “is not rendered invalid, ineffective against third parties or liable to be reversed as a result of that defective entry”, and (ii) the acquirer is not liable to anyone who would benefit from the invalidity or reversal of the defective entry. (Note that “third parties” as used in paragraphs 1 and 2 does not include an issuer of securities, as Article 18 does not address the relationship (if any) between an innocent acquirer and an issuer.) As in paragraph 1, the protections are available unless the acquirer knows or ought to know of the earlier defective entry. Note the breadth of the first protection (“as a result of the defective entry”) when compared to the narrowness of the third protection in paragraph 1, discussed above. This paragraph is not aimed primarily at protection of the acquirer against a particular claimant (as is paragraph 1), but against removal or reversal by its intermediary based on some earlier defective entry. In some legal systems there may be no reason for concern that an earlier defective entry would hinder the acquisition of intermediated securities by a subsequent entry. But in others such concerns exist inasmuch as an entry may be invalid or liable to be reversed because the entry is linked or traced to an earlier defective entry.

18-8. Paragraph 5 provides that paragraph 2 is subject to provisions of the rules of a securities settlement system or an account agreement. Because paragraph 1 is not made subject to system rules or an account agreement, it is necessary to consider the relationship among these three paragraphs. In any context where both paragraphs 1(c) and 2(a) may apply, if an innocent acquirer is protected by paragraph 1(c), the acquisition is not invalid or liable to be reversed on the ground that the acquisition violates the rights of the third person. If the acquisition is also invalid or reversible based on a defective entry, then paragraph 2(a) also applies. If the innocent acquirer is protected only by paragraph 2(a), by virtue of paragraph 5 the acquisition may nonetheless be invalid or reversible under settlement system rules or the account agreement. However, an acquirer that is not a participant in a securities settlement system and has not consented to be bound by the rules of the system is not bound by the relevant rule, is entitled to protection under paragraph 2(a), and is not subject to paragraph 5.

EXAMPLE 18-5: A series of transfers (for simplicity, of the same number of units of the same securities) were made from A to B and B to C on the same day and on the books of the same intermediary (a CSD). The debit entry to A’s account and the credit entries to B and C were invalid and liable to be reversed on the ground that the entries violated the rights of A because B defrauded A in the underlying transaction (See Example 18-1). However, C is protected by paragraph 1(c) if it meets the test of innocence. Consequently, C’s entry would not be invalid or liable to be reversed. C’s protected entry is also a defective entry under Article 17(d), and C (if innocent) also is protected by paragraph 2(a). The relevant rule of the securities settlement system (in which A, B and C are participants) provides that if one or more of the credits is defective (in this case, A’s debit and B’s credit) a related series of book-entries does not take place. Thus, under paragraph 5, C would be deprived of protection under paragraph 2(a). However, so long as the *reason* that C’s entry is a defective entry is the *ground specified in paragraph 1(c)* – violation of the rights of A –

C will retain its paragraph 1(c) protection and the entry will not be invalid or liable to be reversed. If C's entry is defective for *another reason* (in addition to or in lieu of the paragraph 1(c) ground), then its entry would be invalid and liable to be reversed by operation of paragraph 5 and the securities settlement system rule.

18-9. The policy underlying paragraph 5 recognises the importance of securities settlement system rules in maintaining stability and reducing risks in the settlement process. It also recognises that those participating in a settlement system or who participate in a market connected to such a system generally consent and are on notice of the securities settlement system rules. The same is true, of course, as to the terms relating to invalidity or reversal in an account holder's account agreement. Paragraph 5 also recognises that invalidating entries or rendering entries liable to be reversed may in specific cases provide benefits to participants in and those affected by a securities settlement system which may outweigh the risks of invalidity or reversal imposed on those persons. However, paragraph 1 represents the Convention's most fundamental and baseline innocent acquisition protection for acquirers of interests in intermediated securities. Consequently, a qualifying acquirer is protected under paragraph 1(c) from invalidity or reversal even if the acquirer is not protected under paragraph 2(a) by virtue of the operation of paragraph 5.

III-2. Proprietary claims

18-10. Paragraphs 1 and 2 each provide an immunity, or limitation of liability, of an innocent acquirer. Traditional good faith purchase doctrine generally addresses only competing property-based claims, although a limitation of liability may be implicit in the rights of a good faith purchaser. Paragraph 1, more conventionally, affords protection only against claims made by a person with a conflicting property interest ("another person has an interest in securities or intermediated securities"), not against claims made by a person who does not have a property interest and whose claims are based on the wrongfulness of the relevant acquisition. However, where paragraph 1 applies, it does not matter on what theory the conflicting claimant may rely (tort, unjust enrichment, etc.).

III-3. Shelter principle

18-11. It follows from the protections afforded an innocent acquirer under paragraphs 1 and 2 that the acquirer must be empowered to pass on its protected rights and interest to another person. And these rights and interest must be unimpaired by the claims of any person whose rights were eliminated by the innocent acquisition and unimpaired by any earlier defective entry. This is the "shelter principle". For example, the innocent acquirer might grant an interest under Article 12 to another person by way of control agreement or designating entry. Even if a third party's adverse claim became generally known, the knowledge by the person to whom the Article 12 interest is granted would not impair that person's rights and interest in the intermediated securities. Otherwise, the rights and interest of the innocent acquirer in free transferability would be seriously damaged.

III-4. Exclusion of gratuitous acquisitions

18-12. Only innocent acquirers for value are eligible for protection. Under paragraph 3 the protection offered by paragraphs 1 and 2 does not apply in respect of acquisitions of securities made by way of gift or otherwise gratuitously. However, paragraph 3 provides expressly that a grant of a security interest is not disqualified from protection, even if it were to be gratuitous. For example, a security interest granted by one person to secure the obligations of another person would be eligible for protection and would not be vulnerable to the claim that it should be considered as gratuitous.

18-13. The Convention text does not specify generally what is or is not to be considered as gratuitous. However, if an intermediary acquires securities for credit to its account holder's account, and credits the account accordingly, the intermediary's acquisition is not gratuitous and the intermediary is eligible for innocent acquisition protection. Such an intermediary gives value *inter alia* by incurring obligations to its account holder under, e.g., Article 24. On the other hand, an account holder that receives a credit to its account by mistake or otherwise unexpectedly and who is otherwise not entitled to the credit, does acquire the credit gratuitously and is not eligible for innocent acquisition protection.

III-5. Relationship to the applicable law

18-14. Paragraph 4 reflects what would be a truism even in its absence. Failure to qualify for innocent acquisition protection under Article 18(1) does not necessarily mean that an acquirer takes its rights and interest subject to another person's claim or that it is liable to the other person. Similarly, failure to qualify under Article 18(2) does not mean that the acquisition is invalid or that it will be reversed. In each case, failure to qualify means simply that the Convention does not provide protection. Whether another person has a valid claim to securities or intermediated securities is a matter for the applicable law, as is whether the acquisition is invalid or reversible. Defences that the acquirer might have under the applicable law are not eliminated by the failure to qualify for Article 18 protection. For example, the applicable law might provide a more generous protection than does Article 18.

18-15. If an acquirer does qualify for protection under Article 18, however, then the failure of the acquirer to qualify for protection under the applicable law does not impair protection under Article 18. In this sense, Article 18 provides a "safe harbour". A qualifying acquirer is protected notwithstanding the applicable law.

III-6. Article 12 interests and Article 19 priority rules

18-16. The definition of "acquirer" includes persons who acquire rights or interests in intermediated securities by credit under Article 11 or by a method provided in Article 12. However, competing interests in the same intermediated securities (i.e., securities credited to the same securities account) are governed by the temporal (e.g., first-in-time) priority rules of Article 19, not by the last-in-time rule of Article 18. Paragraph 6 makes this clear. This should apply to the situation where priority is determined under Article 20(2) (see the commentary on Article 20).

EXAMPLE 18-6: Account Holder (AH) agreed to grant an interest in intermediated securities to Collateral Taker 1 (CT-1) and AH, CT-1 and AH's intermediary (IM) entered into a control agreement covering the intermediated securities. Later, AH agreed to grant an interest in the same intermediated securities to CT-2 and on that date AH, CT-2 and IM entered into a control agreement covering the intermediated securities in favour of CT-2. Under the priority rule promulgated by Article 19, CT-1's interest has priority over CT-2's. There is no room for CT-2 to be protected by Article 18(1) or 18(2), namely, CT-1 does not lose priority over CT-2 by virtue of Article 18(1) or 18(2). Article 18 simply does not apply (Article 18(6)). For details, see the commentary on Article 19, section 19-11.

EXAMPLE 18-7: Account holder (AH) granted a security interest to Collateral Taker (CT-1) and AH, CT-1 and AH's intermediary (IM) entered into a control agreement. Later, AH obtained a second secured loan from CT-2 and instructed IM to transfer the relevant intermediated securities to CT-2's account with IM. IM credited the intermediated securities to CT-2's account and debited them to AH's account. Assuming that the control agreement provides for negative control (see Article (1)(k)(i)), the debit is unauthorised under Article

15 and thus ineffective. However, CT-2 is protected if the conditions of Article 18(1) are satisfied.

EXAMPLE 18-8: Intermediary (IM) granted to Collateral Taker (CT-1) a security interest effective under Article 12 in intermediated securities held in a segregated account for the benefit of IM's account holders (AHs). The security interest secures a loan from CT-1 to IM. CT-1 knew about IM's purpose for the borrowing, but both the loan and the security interest are permitted by the applicable law and regulatory regimes. Later, one of AHs granted a security interest to its collateral taker (CT-2) to cover a loan made by CT-2 to that AH. IM is now in insolvency, and the AH also is in insolvency. There is a shortfall in the intermediated securities subject to the security interests – there are insufficient securities to satisfy both IM's debt to CT-1 and the AHs' debt to CT-2. CT-2 asserts that its interest is protected under Article 18(1). CT-2's claim for innocent acquisition is without merit. The priority conflict between CT-1 and CT-2 is addressed in Article 20(2). For details, see the commentary on Article 20, in particular, Example 20-2 and Example 20-3 and the explanations of them.

Article 19

Priority among competing interests

- 1. This Article determines priority between interests in the same intermediated securities which become effective against third parties under Article 12 or Article 13.**
- 2. Subject to paragraph 5 and Article 20, interests that become effective against third parties under Article 12 have priority over any interest that becomes effective against third parties by any other method provided by the non-Convention law.**
- 3. Interests that become effective against third parties under Article 12 rank among themselves according to the time of occurrence of the following events:**
 - (a) if the relevant intermediary is itself the holder of the interest and the interest is effective against third parties under Article 12(3)(a), when the agreement granting the interest is entered into;**
 - (b) when a designating entry is made;**
 - (c) when a control agreement is entered into or, if applicable, a notice is given to the relevant intermediary.**
- 4. Where an intermediary has an interest that has become effective against third parties under Article 12 and makes a designating entry or enters into a control agreement with the consequence that an interest of another person becomes effective against third parties, the interest of that other person has priority over the interest of the intermediary unless that other person and the intermediary expressly agree otherwise.**
- 5. A non-consensual security interest in intermediated securities arising under the applicable law has such priority as is afforded to it by that law.**

6. As between persons entitled to any interests referred to in paragraphs 2, 3 and 4 and, to the extent permitted by the applicable law, paragraph 5, the priorities provided by this Article may be varied by agreement between those persons, but any such agreement does not affect third parties.

7. A Contracting State may declare that under its non-Convention law, subject to paragraph 4, an interest granted by a designating entry has priority over any interest granted by any other method provided by Article 12.

Commentary

I. Introduction

19-1. Article 19 determines the priorities among interests in the same intermediated securities (i.e., securities of the same description, credited to the same securities account, and as to which there are conflicting claims). It covers only interests that become effective against third parties under Article 12 or Article 13. Article 19 provides (with some exceptions) a first-in-time priority rule for interests granted under Article 12. It does not apply to interests acquired by credit pursuant to Article 11. Article 20, not Article 19, addresses priority conflicts between account holders and the persons to whom the relevant intermediary has granted an interest under Article 12 or Article 13.

II. History

19-2. The draft Convention considered by the first session of the Committee of Governmental Experts contained a last-in-time innocent acquisition rule for interests acquired by credit and also for security interests acquired by another method under the Convention. The draft also contained a first-in-time priority rule that applied to the same types of acquisitions. See UNIDROIT 2004 – Study LXXVIII – Doc. 18, Articles 9 (priority) and 10 (innocent acquisition). Consequently, every such acquisition would have been both senior to earlier interests (assuming qualification for innocent acquisition protection) and junior to earlier interests. This anomaly persisted in the draft produced at the conclusion of the first session. See UNIDROIT 2005 – Study LXXVIII – Doc. 24, Articles 10 (priority) and 11 (innocent acquisition).

19-3. Between the first and second sessions, one delegation observed:

The Convention should adopt those principles of priority among competing claims which are reflected by the majority view of the September 2005 Berne Working Group on Effectiveness of Book-Entries, Priority And Loss Sharing, Study LXXVIII - SEM. 1, Appendix 9. In particular, the first-in-time priority rule of Article 10 [now 19] would apply only to priority contests among collateral takers who have security interests in intermediated securities credited to the securities account of a collateral provider. Priority among these collateral takers would not be covered by the innocent acquisition (last-in-time) rules. Article 10 [now 19] would not apply to security interests when the collateral taker itself receives a credit to a securities account under Article 5 [now 11].

See UNIDROIT 2006 – Study LXXVIII – Doc. 35, Comments by the Government of the United States of America, p. 2.

19-4. This problematic situation was rectified in the draft produced at the conclusion of the second session. The priority rule was limited to “priority between security interests in the same intermediated securities” and the innocent acquisition rule was limited to acquisitions by credit. UNIDROIT 2006 – Study LXXVIII – Doc. 42, Articles 6 (priority) and 7 (innocent acquisition).

19-5. The draft that emerged from the third session expanded the scope of the priority rule beyond the priority of security interests. The article providing for the grant of security interests was expanded to cover “an interest in intermediated securities, including a security interest or a limited interest other than a security interest.” See UNIDROIT 2006 – Study LXXVIII – Doc. 57, Article 8 [now 12]. This resulted in the corresponding expansion of the priority rule. *Id.*, Article 13 [now 19]. In addition, at the third session, a new article was added which provided that the Convention would not determine the relative priorities between an intermediary’s account holders and a person to which an interest was granted by that intermediary under the expanded article providing for the grant of interests other than by way of a credit. *Id.*, Article 14 [now 20(1)].

19-6. At the fourth session, this new article with an exclusion from the priority regime was narrowed. A rule was added that would award priority to the grantee of an interest from the intermediary over the intermediary’s account holders if the grantee acquired its interest without wrongful knowledge under the test for innocent acquisition. UNIDROIT 2007 – Study LXXVIII – Doc. 94, Article 16(2) [now 20(2)]. No other material changes to the priority rules were made at the fourth session. *Id.*, Article 15.

19-7. One material change to the priority rules was made during the first session of the diplomatic Conference. A declaration mechanism was added under which a Contracting State could declare that interests granted by a designating entry have priority over interests granted by another method under Article 12. See Article 19(7).

III. Analysis

III-1. Scope

19-8. Paragraph 1 specifies the scope of Article 19. Article 19 determines the priorities only among interests in the same intermediated securities (i.e., securities of the same description, credited to the same securities account, and as to which there are conflicting claims) and it covers only interests that become effective against third parties under Article 12 or Article 13. It does not apply to conflicting interests acquired by way of credits, because that situation necessarily means that the conflicting claims arose out of credits to different securities accounts.

19-9. Several of the complexities raised by the following examples arise from the possibility that a Contracting State could make a declaration under Article 12(5)(a) to the effect that all three of the conditions to effectiveness specified in Article 12(3) may be utilised where that State’s law is the non-Convention law. Moreover, such a Contracting State also could make a declaration under Paragraph 7 that would afford special priority to interests granted by designated entry, making possible still additional complex priority contests.

III-2. First-in-time priority rule

19-10. Paragraph 3 provides the basic, traditional first-in-time priority rule for interests granted by a method provided by Article 12. Such competing interests rank according to the time when they have been made effective against third parties. This time depends on the method by which the interests were granted. Where the relevant intermediary is the grantee of an interest granted pursuant to Article 12(3)(a), the “relevant time” (see Article 17(e)) for priority purposes is the time

at which “the agreement granting the interest is entered into”. For a designating entry, the relevant time is the time at which the entry is made (see Article 12(3)(b)), and for a control agreement it is the time at which the agreement is entered into, or, where applicable, the time at which notice is given to the relevant intermediary (see Article 12(3)(c)). As a general matter, grantees of interests under Article 12 will have no means to discover earlier-in-time interests except for reliance on representations of the account holder, the relevant intermediary or both.

EXAMPLE 19-1: On 15 January, Account Holder (AH) agreed to grant an interest in intermediated securities to Collateral Taker 1 (CT-1) and on that date AH, CT-1 and AH’s intermediary (IM) entered into a control agreement covering the intermediated securities. On 1 March, AH agreed to grant an interest in the same intermediated securities to CT-2 and on that date IM made a designating entry covering the intermediated securities in favour of CT-2. On 15 April, AH agreed to grant an interest in the same intermediated securities to CT-3 and on that date IM made a designating entry covering the intermediated securities in favour of CT-3.

Under the first-in-time priority rule of paragraph 3, CT-1 is first priority, CT-2 is second, and CT-3 is third.

19-11. In some circumstances the first-in-time rule, while never achieving an improper result, may not actually operate as a “priority” rule. This is because an interest granted under Article 12 may be an outright, ownership interest in intermediated securities. If such an interest is made effective by a control agreement, for example, then under the applicable law the account holder would have no remaining rights or interest whatsoever that it could grant to a second-in-time grantee, even though it remained the account holder on the books of the relevant intermediary. In that case, if the account holder purported to grant a second interest to a putative grantee, the grantee would not receive a “second priority” interest as it would not receive any rights or interest at all. This is simply a case where an outright ownership interest is made effective under Article 12. Note also that there is no room for the second grantee to be protected as an innocent acquirer under Articles 18(1) or 18(2) (see Article 18(6)). The important point is that one should not read into Article 19 any implication, from its structure as a priority rule or because interests granted under Article 12 can be full ownership interests, that it empowers an account holder to transfer full ownership. Of course, if an account holder first granted an effective security interest and subsequently granted an effective full ownership interest to another person, then the second grantee would hold its interest subject to the first priority security interest.

EXAMPLE 19-2: On 15 January AH agreed to grant a full ownership interest in intermediated securities to Buyer and on that date AH, Buyer and AH’s intermediary (IM) entered into a control agreement covering the intermediated securities. (Although a buyer conventionally would take its interest by way of a credit, this sale may be the first leg of a short-term “repurchase” or “repo” transaction, for example, and taking by control agreement may be a more efficient structure for the parties.) On 1 March AH agreed to grant an interest in the same intermediated securities to CT-1 and on that date IM made a designating entry covering the intermediated securities in favour of CT-1.

The full ownership interest of Buyer became effective against third parties on 15 January. Consequently, if under the applicable law on 1 March AH had no rights or interests that it could grant to CT-1, CT-1 received no interest whatsoever. If the grant of an interest to Buyer was the first leg of a repo transaction, then upon payment of the repurchase price and termination of the control agreement the intermediated securities will revert in Seller, Buyer’s interest will cease to exist, and at that point CT-1’s interest will become effective, if such after-acquired collateral is recognised by the applicable law.

III-3. Interests effective under non-Convention law

19-12. Paragraph 2 is an exception to the basic first-in-time priority rule of paragraph 3. It addresses the priorities when one competing interest is an interest granted under Article 12 and the other has been created under the non-Convention law, as contemplated by Article 13. In such a case, the interest granted under Article 12 has priority irrespective of the time at which it was created or the relevant time as specified in paragraph 3.

EXAMPLE 19-3: The facts of Example 19-1 apply except that CT-1 did not enter into a control agreement or make a designating entry but instead relied on a method of obtaining an effective interest under another method available under the non-Convention law.

Under paragraph 2 the interests granted under Article 12 have priority over CT-1's interest made effective under the non-Convention law. CT-2 is first priority, CT-3 is second, and CT-1 is third.

III-4. Article 12 interest held by intermediary

19-13. Paragraph 4 is another exception to the first-in-time priority rule. It relates to the special situation of a conflict between an interest granted to an intermediary under Article 12 and the interest of another person that has subsequently become effective against third parties on the basis of a designating entry made or a control agreement entered into by that same intermediary. In that case, the interest of the other person prevails over that of the intermediary, unless the other person and the intermediary otherwise agree pursuant to paragraph 6, discussed below. This rule recognises that the other person would have no means of discovering the intermediary's interest unless the account holder or the intermediary were to disclose its existence to the other person. The underlying policy is the unfairness of allowing an intermediary's undisclosed interest to prevail under the first-in-time priority rule of paragraph 3. As noted above, it is true that in all cases a grantee of an interest under Article 12 generally must rely on representations of the account holder, the relevant intermediary or both to discover earlier-in-time interests. But the prevailing view is that where the relevant intermediary itself holds the earlier interest, the burden of moving forward to negotiate concerning priorities should be placed on the intermediary. The relevant intermediary's interest can be subordinate to an earlier interest under the first-in-time rule of paragraph 3, but paragraph 4 prohibits the intermediary from achieving priority under that rule.

EXAMPLE 19-4: On 15 January AH agreed to grant an interest in intermediated securities to its relevant Intermediary (IM) and the interest became effective against third parties under Article 12. On 1 March AH agreed to grant an interest in the same intermediated securities to CT-1 and on that date IM made a designating entry covering the intermediated securities in favour of CT-1.

Pursuant to paragraph 4 IM's interest is subordinate to the interest of CT-1. CT-1 is first priority and IM is second. In order to ensure first priority IM should have refused to make the designating entry unless CT-1 subordinated its interest to that of IM.

III-5. Non-consensual security interests

19-14. Paragraph 5 is another exception to the first-in-time priority principle. It provides a special rule for "non-consensual security interest[s]" (a term not defined in the Convention). Although the term is not defined, Article 12(8) provides that it is the applicable law that determines the circumstances under which such a security interest arises and becomes effective against third

parties. Paragraph 5 provides that the priority of non-consensual security interests will be determined by the applicable law.

EXAMPLE 19-5: On 15 January, AH agreed to grant an interest in AH's securities account (i.e., in all intermediated securities from time to time credited to the account) to CT-1 and on that date AH, CT-1 and AH's intermediary (IM) entered into a control agreement covering the account. On 1 March, AH instructed IM (also AH's broker) to purchase 100 shares of ABC common stock on a stock exchange. On the settlement date (T + 3, or March 4) IM credited the 100 shares to AH's account but AH failed to provide to IM the necessary funds to cover the purchase price. Under the applicable law: (a) IM has a non-consensual lien in the intermediated securities consisting of the 100 shares which secures the unpaid price; and (b) that lien has priority over any other interest in those intermediated securities.

Example 19-5 illustrates the operation of paragraph 5. Under that provision, the applicable law determines the priority of a non-consensual security interest. Consequently, under the applicable law as described in this example, IM's lien in the intermediated securities consisting of the 100 shares has priority over CT-1's interest. Note that paragraph 4, which subordinates the relevant intermediary's interest to other interests effective under Article 12, applies only to an intermediary's interest under Article 12. In Example 19-5, IM's interest is effective pursuant to the applicable law, not Article 12. Note as well that paragraph 2 is made subject to paragraph 5.

III-6. Variation of priorities by agreement

19-15. Paragraph 6 provides for the holders of interests subject to the Article 19 priority rules to vary their priorities by agreement. However, such an agreement may vary the priority of a non-consensual security interest mentioned in paragraph 5 only if permitted by the applicable law. Moreover, an agreement to vary priorities between the holders of interests does not affect the rights of third parties.

EXAMPLE 19-6: The facts of Example 19-1 apply except that CT-1 and CT-3 entered into a subordination agreement, pursuant to which CT-1 agreed that CT-3's interest would have priority over CT-1's interest.

The subordination agreement between CT-1 and CT-3 is effective under paragraph 6. However, because under that paragraph the agreement does not affect third parties, the priority of CT-2's interest over that of CT-3 is not affected.

The subordination arguably creates a circular priority. CT-1 has priority over CT-2, CT-2 has priority over CT-3, and CT-3 (by virtue of CT-1's subordination) has priority over CT-1. The Convention implicitly leaves the resolution of this circular priority contest to the applicable law. One plausible resolution would be for CT-1 to obtain its first priority share from the collateral, with CT-2 then taking its share. CT-1 would then be obliged to turn over its share to CT-3. After CT-3 is satisfied, CT-1 would receive the residual value, if any.

III-7. Declarations regarding priority of interests granted by designating entry

19-16. Paragraph 7 provides a declaration mechanism that permits a Contracting State to make a declaration concerning the priority of an interest granted under Article 12 made by designating entry. A Contracting State may declare that such an interest has priority over interests granted by other methods under Article 12. If such a declaration is made, it is implicit in this priority scheme

that the priorities as among competing designating entry interests *inter se* would be governed by the first-in-time priority rule of paragraph 3.

EXAMPLE 19-7: The facts of Example 19-1 apply except that the Contracting State whose law is the non-Convention law has made an effective declaration under paragraph 7.

As a result of the declaration under paragraph 7, the interests of both CT-2 and CT-3 have priority over the interest of CT-1. The priority as between CT-2 and CT-3 is governed by paragraph 3. CT-2 has first priority, CT-3 is second, and CT-1 is third.

EXAMPLE 19-8: The facts of Example 19-2 apply except that the Contracting State whose law is the non-Convention law has made an effective declaration under paragraph 7.

This variation produces a result different from the result in Example 19-2. It remains true that on 1 March AH had retained no interest in the intermediated securities that had been sold to Buyer. However, policy considerations dictate that the purpose of the declaration should be honoured and CT-1 should be entitled to rely on its priority based on the designating entry. For this reason, *implicit* in the priority rule emanating from the declaration is the *power* of AH (if not the right) to grant an effective interest to CT-1. Buyer should have insisted on a designating entry instead of relying on a control agreement.

Article 20

Priority of interests granted by an intermediary

1. Except as provided by paragraph 2, this Convention does not determine the priority or the relative rights and interests between the rights of account holders of an intermediary and interests granted by that intermediary so as to be effective against third parties under Article 12 or Article 13.

2. An interest in intermediated securities granted by an intermediary so as to become effective against third parties under Article 12 has priority over the rights of account holders of that intermediary unless, at the relevant time, the person to whom the interest is granted actually knows or ought to know that the interest granted violates the rights of one or more account holders.

Commentary

I. Introduction

20-1. Normally competing claims between an intermediary's account holders and the holders of Article 12 or 13 interests granted by the intermediary will not arise. But such a conflict may occur in the case of an insolvent intermediary and the occurrence of a shortfall in securities which would have been needed to cover account holder claims. Article 20 provides special rules to address the priority of rights of account holders of an intermediary and the holders of effective Article 12 or 13 interests granted by the intermediary.

20-2. There are many settings in which an intermediary may grant an interest under Articles 12 or 13. Intermediaries sometimes have a "right of use" or "right to rehypothecate" with respect to

securities credited to the accounts of their account holders. Also, in some legal regimes, securities credited to an intermediary's proprietary account are allocated to account holders to the extent necessary to cover a shortfall, but in the meantime the intermediary may have granted interests in some of the securities under Article 12 or 13.

20-3. The policy underlying Article 20(2) is that a person to whom an interest is granted under Article 12 by an intermediary must be protected against a claim of the account holders of the intermediary if that person is innocent (namely, if the person meets the test under Article 20(2)). Otherwise, an acquisition under Article 11 would become the only practical way of taking intermediated securities as collateral from an intermediary.

II. History

20-4. The drafting history of Article 20 is explained along with the drafting history of Article 19, above.

III. Analysis

III-1. General rule

20-5. Paragraph 1 establishes the baseline rule. The Convention does not determine the result of a priority contest between the interests of account holders and an effective interest granted by the intermediary under Article 12 or 13. It is implicit that this priority contest is determined by the applicable law.

III-2. Innocent acquisition under Article 12

20-6. Paragraph 2 provides an exception to the general rule of paragraph 1. The holder of an effective interest granted by an intermediary under Article 12 has priority over the rights of the intermediary's account holders, "unless, at the relevant time, the person to whom the interest is granted actually knows or ought to know that the interest granted violates the rights of one or more account holders". This standard essentially is identical to the innocent acquisition test under Article 18. Given the protection that Article 18 affords to interests effective under Article 12, paragraph 2 may be redundant, at least in part. But taking into account the special treatment given account holders in the insolvency proceeding of an intermediary under the Convention (see Article 21) and under the non-Convention law of many jurisdictions, a specific rule is useful and provides certainty.

III-3. Intermediary insolvency

20-7. Article 14(1) provides that interests that are effective under Articles 11 or 12 are effective in any insolvency proceeding of the relevant intermediary "against the insolvency administrator and creditors". The priority rule of paragraph 2 supplements and complements Article 14(1) by awarding the qualifying holder of an interest made effective under Article 12 priority over the intermediary's account holders. This priority rule is controlling notwithstanding any contrary rule under the law applicable in the insolvency proceeding. Article 26, on loss sharing in the intermediary's insolvency proceeding and any such contrary rule under the applicable law apply only after first giving effect to the priority established by paragraph 2.

EXAMPLE 20-1: On 1 March, intermediary (IM) granted to collateral taker (CT) a security interest effective under Article 12 in intermediated securities held in a segregated account for the benefit of IM's account holders (AHs). The security interest secures a loan from CT

to IM for the purpose of funding IM's "margin" loans to its AHs. CT knew about IM's purpose for the borrowing, but both the loan and the security interest are permitted by the applicable law and regulatory regimes. IM defaulted on the loan, is now subject to insolvency proceedings, and there is a shortfall in the intermediated securities subject to the security interest – there are insufficient securities to satisfy both IM's debt to CT and the AHs' claims to those securities.

CT's security interest has priority over the rights and interest of IM's AHs under paragraph 2. There is no suggestion that CT had knowledge that its interest violated the rights of the AHs (and, moreover, it did not violate their rights). Nor was CT aware of any suspicious circumstances.

EXAMPLE 20-2: The facts of Example 20-1 apply except that the AHs who acquired their intermediated securities by credits to their accounts made after March 1 assert that their interests are free of CT's security interest under Article 18(1) by virtue of their innocent acquisition.

EXAMPLE 20-3: The facts of Example 20-1 apply except that after March 1 one of the AHs granted a security interest to CT-2 and CT-2 asserts that its interest is protected under Article 18(1).

In both Example 20-2 and Example 20-3, the assertion for innocent acquisition is without merit. The more specific rule under paragraph 2 is controlling over the general rule under Article 18(1). CT's interest has priority for the same reasons as in Example 20-1.⁸

EXAMPLE 20-4: The facts of Example 20-1 apply except that on 1 March IM granted a full ownership interest to Buyer (which may be a repo buyer, as explained in Example 19-2 in the Article 19 commentary) that was effective under Article 12.

Buyer's interest has priority for the same reasons as in Example 20-1. As explained above in connection with Article 19, inasmuch as Buyer received a full ownership interest, there is not in the strict sense a "priority" contest. The AHs have no rights or interest in the intermediated securities acquired by Buyer, and the discussion in connection with Article 19 is applicable here.

EXAMPLE 20-5: The facts of Example 20-1 apply except that the intermediated securities acquired by CT were credited to a segregated proprietary account for the benefit of IM and not to a segregated account for the benefit of IM's AHs.

CT's interest has priority for the same reasons as in Example 20-1. In addition, under the law of some jurisdictions the AHs had no rights or interest in securities credited to the proprietary account.

EXAMPLE 20-6: The facts of Example 20-1 apply except that communications from IM to CT's loan officer prior to the transaction strongly suggested that the security interest to be acquired by CT would violate the rights of at least some of IM's AHs. In addition, granting the interest did violate the rights of the AHs under the applicable law.

⁸ *Note of the Editors:* however, this conclusion may not be sufficiently clear from the current text. The Editors have therefore suggested a revision of the Convention text that would address this problem. See CONF. 11/2 – Doc. 6, section 6.

The loan officer's failure to make any further inquiry that might have revealed the violation makes it plausible that CT ought to have known about the violation of the rights of the AHs. If that is so, then CT would not qualify for the priority under paragraph 2 and the issue would be resolved under the applicable law pursuant to paragraph 1. As noted in connection with the examples discussing Article 18, no simple example that does not assume actual knowledge can be sufficiently rich in factual detail to support a definite conclusion on the "ought to know" issue.

CHAPTER IV – INTEGRITY OF THE INTERMEDIATED HOLDING SYSTEM

Contents and outline

IV-1. *Chapter IV* contains several articles that are essential to the Convention's functional, substantive approach to intermediated holding systems. Chapter IV addresses a broad range of issues that arise in all intermediated systems.

IV-2. *Article 21* ensures the effectiveness of the rights of account holders, and those to whom interests have been granted by account holders under Article 12, in any insolvency proceeding in respect of the relevant intermediary. Article 21 makes certain exceptions to this effectiveness, including the case in which an account holder has granted an interest to the intermediary under Article 12.

IV-3. *Article 22* prohibits "upper-tier attachment", a term that is commonly used where a creditor of an account holder attempts to freeze or attach securities credited to a securities account maintained by an intermediary which is not the account holder's relevant intermediary. In an upper-tier attachment a creditor seeks to attach at an inappropriate tier of the holding chain, which if successful could spawn several negative consequences.

IV-4. *Article 23* protects the rights of an account holder as the only person who is entitled to give instructions to the intermediary with respect to rights in intermediated securities, with certain specified exceptions. Article 23 also ensures the integrity of the intermediated system inasmuch as it provides that an account holder is entitled to give instructions to its relevant intermediary but only to that intermediary.

IV-5. *Article 24* provides an important rule to ensure the adequate protection of the rights of account holders. It imposes an obligation on an intermediary to hold or have available sufficient securities and intermediated securities so that the total amount thus held or available is equal to the total amount of the securities credited to the securities accounts of its account holders.

IV-6. *Article 25* provides another core protection for account holders. It requires an intermediary to allocate sufficient securities or intermediated securities to its account holders' rights.

IV-7. *Article 26* provides a loss-sharing rule applicable in the insolvency proceeding of an intermediary. It addresses the situation in which there is a discrepancy between the aggregate number or amount of securities allocated under Article 25 and a greater aggregate number or amount of securities actually credited to securities accounts of an account holder, a group of account holders or the intermediary's account holders generally. Article 26 is subject to any conflicting rule applicable in the insolvency proceeding.

IV-8. *Article 27* shields the legal effects of certain provisions in uniform rules of securities settlement systems and securities clearing systems against adverse consequences of an insolvency of the system operator or a system participant.

IV-9. *Article 28* addresses the obligations of an intermediary under the Convention as well as the liability of an intermediary for its failure to comply with those obligations. As to obligations, it provides that the non-Convention law may specify the content of and the manner of an intermediary's compliance with its Convention obligations and that compliance with a corresponding provision of the non-Convention law constitutes compliance with the Convention obligation. As to liabilities for non-compliance, it also defers to the non-Convention law. As to both obligations and liabilities, it also defers to the account agreement or the uniform rules of a securities settlement system, to the extent that the non-Convention law so permits.

IV-10. *Article 29* addresses the position of the issuer of securities held in the intermediated holding system. It provides an important minimum standard for the effective functioning of the market for publicly traded securities: A Contracting state must ensure that such securities may be held in the intermediated holding system and must permit the effective exercise of the rights attached to such securities. It also ensures the recognition of a so-called nominee holding structure in a cross-border context and, as such, ensures the interoperability of different systems of holding and trading securities.

IV-11. *Article 30* provides that an account holder who holds securities for its own account has a right of set-off against the issuer of those securities in the event of the issuer's insolvency to the same extent as such a right of set-off would have existed and would have been exercisable in a non-intermediated context. There must be no discrimination between non-intermediated and intermediated securities in this context.

Article 21

Effectiveness in the insolvency of the relevant intermediary

- 1. Rights and interests that have become effective against third parties under Article 11 or Article 12 are effective against the insolvency administrator and creditors in any insolvency proceeding in respect of the relevant intermediary or in respect of any other person responsible for the performance of a function of the relevant intermediary under Article 6.**
- 2. This Article does not apply to interests granted under Article 12 by an account holder to the relevant intermediary or any other person responsible for the performance of a function of the relevant intermediary under Article 6.**
- 3. Paragraph 1 does not affect:**
 - (a) any rules of law applicable in the insolvency proceeding relating to the avoidance of a transaction as a preference or a transfer in fraud of creditors; or**
 - (b) any rules of procedure relating to the enforcement of rights to property which is under the control or supervision of the insolvency administrator.**

4. Nothing in this Article impairs the effectiveness of an interest in intermediated securities against the insolvency administrator and creditors in any insolvency proceeding referred to in paragraph 1, where that interest has become effective by any method referred to in Article 13.

Commentary

I. Introduction

21-1. The purpose of Article 21 is to ensure the effectiveness of the rights of account holders, and the rights of those to whom interests have been granted by account holders under Article 12, in any insolvency proceeding in respect of the relevant intermediary. In line with the definition of “insolvency proceeding” in Article 1(h), the proceeding may be one with the purpose of reorganisation or liquidation. There are certain exceptions to this effectiveness, including the case in which an account holder has granted an interest to the intermediary under Article 12.⁹

II. History

21-2. Article 21(1) is substantially the same as Article 11 of the draft Convention text submitted to the first meeting of the CGE (see UNIDROIT 2004 – Study LXXVIII – Doc. 18) and to the text of Article 12 of the draft Convention that emerged from the first meeting (see UNIDROIT 2005 – Study LXXVIII – Doc. 24) (with the exception, in each case, of the reference in Article 21(1) to “any other person responsible”). At the first meeting, a new Article 14 was added which was substantially the same as Article 21(3), except that Article 14 provided that “nothing in this Convention affects” the specified avoidance powers or rules of procedure.

21-3. The drafts that emerged from the second (see UNIDROIT 2006 – Study LXXVIII – Doc. 42) and third (see UNIDROIT 2006 – Study LXXVIII – Doc. 57) meetings of the CGE made no material changes to these provisions.

21-4. At the fourth meeting of the CGE, two changes were made. The reference to “any other person responsible” was added to the predecessor of Article 21(1), to conform to the addition of Article 5 to the draft Convention. In addition, text similar to Article 21(4) and Article 14(3) was added.

III. Analysis

III-1. Effectiveness of Article 11 and 12 interests in relevant intermediary’s insolvency proceeding: in general

21-5. Article 21 deals with Article 11 and 12 interests in intermediated securities in the relevant intermediary’s insolvency proceeding. Paragraph 1 provides that these rights and interests are effective against the insolvency administrator and the creditors of the relevant intermediary, as well as, in the case of a transparent system, against any other person responsible for the performance of a function of the relevant intermediary under Article 6 (see also the commentary on Article 6). The holders of these interests are the intermediary’s account holders, who have taken under Article 11 by way of a credit, and the holders of Article 12 interests granted by the intermediary’s account holders. This rule embraces the principle that an intermediary performs a

⁹ *Note of the Editors:* while Article 21 is clear, the Editors have identified significant difficulties in interpreting Articles 7 and 14. They have suggested merging Articles 14 and 21, and adding a new article. See CONF. 11/2 – Doc. 6, section 2.

role analogous to “holding” property that belongs to others and that this property should not be reached by the intermediary’s creditors. Article 25(2) complements Article 21(1); it provides that securities allocated to an intermediary’s account holders are not the intermediary’s property and are not available for distribution or realisation for the benefit of the intermediary’s creditors.

21-6. Article 21(1) provides useful clarity by providing explicitly that holders of Article 12 interests are covered. However, Article 21(1) would protect the effectiveness of these interests in any event inasmuch as the interests are derivative of the interests of the account holders granting the interests under Article 12.

EXAMPLE 21-1: Intermediary (IM-1) granted an interest to X under Article 12 in intermediated securities credited to IM-1’s account with another intermediary (IM-2). Subsequently, IM-1 became subject to an insolvency proceeding. Article 21(1) does not apply to the interest granted to X because IM-1 would not be the “relevant intermediary” with respect to those intermediated securities credited to IM-1’s account with IM-2. See Article 1(g). Consequently, X’s Article 12 interest would be effective in the IM-1’s insolvency proceeding only to the extent provided by Article 14(1).

EXAMPLE 21-2: IM-1 credited the securities account of an account holder (AH) as a result of a security interest granted by IM-1 to AH and made effective by way of a credit. Article 21 applies to and protects the AH’s interest (subject to any applicable exceptions provided in Article 21). However, because AH holds a security interest granted by IM-1, AH normally would not be entitled to retain value in excess of the obligation secured by the intermediated securities.

III-2. Exception: Article 12 interest granted to relevant intermediary

21-7. Article 21(2) provides that Article 21 does not apply in the case of an account holder that has granted an interest under Article 12 to its own intermediary (such as a secured “margin loan”) or to a “person responsible” under Article 6. In this situation, the account holder has voluntarily granted an interest that should be effective against the account holder and in favour of the intermediary (or “person responsible”). Accordingly, the account holder’s rights under Article 21(1) *would* be subject to the intermediary’s interest under Article 12, but *only* to the extent of that interest.

III-3. Exception: avoidance powers and procedural rules

21-8. Article 21(3) provides that the effectiveness of Convention interests in insolvency proceedings of the intermediary is subject to procedural rules and certain avoidance powers. Article 21(3) was inspired by Article 30(3) of the Cape Town Convention. Sub-paragraph (a) exempts from the protection of Article 21(1) rules of law relating to the avoidance of a transaction as a preference or a transfer in fraud of creditors. Sub-paragraph (b) excludes procedural rules relating to the enforcement of rights to property, such as a security interest, when that property is under the control or supervision of an insolvency administrator. It follows that these issues are governed by non-Convention law or other law applicable in the insolvency proceedings.

III-4. Article 13 interests made effective under the non-Convention law

21-9. Article 21(4) provides another important protection for interests made effective under methods provided by the non-Convention law and recognised pursuant to Article 13. It supplements Article 14(3) by providing that nothing in Article 21 impairs the effectiveness of Article 13 interests in an insolvency proceeding. Stated otherwise, the Article 21 does not render

ineffective in an insolvency proceeding Article 13 interests that are otherwise effective in the proceeding. Article 21(4) was inspired by Article 30(2) of the Cape Town Convention.

Article 22
Prohibition of upper-tier attachment

1. Subject to paragraph 3, no attachment of intermediated securities of an account holder shall be made against, or so as to affect:

(a) a securities account of any person other than that account holder;

(b) the issuer of any securities credited to a securities account of that account holder; or

(c) a person other than the account holder and the relevant intermediary.

2. In this Article "*attachment of intermediated securities of an account holder*" means any judicial, administrative or other act or process to freeze, restrict or impound intermediated securities of that account holder in order to enforce or satisfy a judgment, award or other judicial, arbitral, administrative or other decision or in order to ensure the availability of such intermediated securities to enforce or satisfy any future judgment, award or decision.

3. A Contracting State may declare that under its non-Convention law an attachment of intermediated securities of an account holder made against or so as to affect a person other than the relevant intermediary has effect also against the relevant intermediary. Any such declaration shall identify that other person by name or description and shall specify the time at which such an attachment becomes effective against the relevant intermediary.

Commentary

I. Introduction

22-1. Article 22 prohibits upper-tier attachment. The phrase "upper-tier attachment" is commonly used where a creditor of an account holder attempts to freeze or attach securities credited to a securities account maintained by an intermediary which is not the account holder's relevant intermediary. In other words, upper-tier attachment indicates that the creditor tries to attach at an inappropriate tier of the holding chain. The negative consequences of such an attachment are illustrated by the following example.

EXAMPLE 22-1: Account holder A holds ABC-Securities with Intermediary X. The latter pools all its clients' securities into one single account which is held with the CSD. Upon failure by A to pay back a loan, its creditor tries to attach A's ABC-Securities. The ABC-Securities are issued as physical certificates and are in custody with the CSD. The creditor obtains an attachment order against the CSD, ordering that the securities have to be delivered to him. The CSD claims that it is unable to comply with the order as it does not know how many, if any, ABC-Securities belong to A, because A is not an account holder of

the CSD and therefore completely unknown to the CSD. However, in order to avoid going against a court order, the CSD blocks all settlement operations of ABC-Securities in its system until the situation is sorted out.

22-2. The prohibition of upper-tier attachment is based on two important policy considerations. The first reason for a general rule prohibiting upper-tier attachment is that an attachment should not be permitted in circumstances where it undermines the ability of an intermediary to perform its functions. In particular, an attachment order should not block securities accounts of other account holders who have nothing to do with the subject-matter of the attachment. The second reason is that upper-tier attachment is not compatible with the ability of an account holder or someone dealing with an account holder at a lower level in the holding chain to rely on the position as it is apparently stated on the account. If an account at a lower level appears to show the ability of the account holder to transfer or collateralise securities credited to that account, then, if in fact these securities are encumbered by an attachment order at a higher tier, the account holder or persons dealing with the account holder at the lower level may, in the absence of information about the attachment order, be misled. This, in turn, would have a negative impact on the overall integrity of the intermediated securities holding system.

22-3. The general rule is set out in Article 22(1). Article 22(3) allows an exception under certain circumstances, reflecting the specific mechanism of the so-called transparent systems. Article 22(2) contains the definition of attachment in this article.

II. History

22-4. The prohibition of upper-tier attachment (and a definition of “attachment”) already figured in the preliminary draft Convention produced by the Study Group as Article 8 (see UNIDROIT 2004 – Study LXXVIII – Docs. 18 and 19).

22-5. During the first session of the CGE, the provision was modified and clarified on some points, but no substantive change took place (see UNIDROIT 2005 – Study LXXVIII – Doc. 24, Article 9).

22-6. The text of the provision remained unchanged during the second session of the CGE (see UNIDROIT 2006 – Study LXXVIII – Doc. 42, Article 15) and the third session of the CGE (UNIDROIT 2006 – Study LXXVIII – Doc. 57, Article 17).

22-7. During the fourth session of the CGE, Article 19(1) and the definition in Article 19(2) were clarified. In addition, the exception in paragraph 3 was included in the draft, aiming at accommodating the mechanism of transparent holding systems. See UNIDROIT 2007 – Study LXXVIII – Doc. 94, Article 19 and UNIDROIT 2007 – Study LXXVIII – Doc. 95, sections 53-65, 128, 131-133, 177 and 228.

III. Analysis

III-1. Paragraph 1: general rule

22-8. Paragraph 1 contains the general prohibition of upper-tier attachment. It is designed to make sure that an attachment of intermediated securities happens “at the right place” in the holding chain. It is built on the understanding that there are three parties involved in an attachment situation: (a) the debtor, who has securities credited to an account maintained by an intermediary and whose intermediated securities are the subject matter of the attachment; (b) the creditor, who tries to attach the debtor's intermediated securities with a view to satisfying its claim

against the debtor; (c) the addressee of the attachment order (here the relevant intermediary) who is compelled to make the intermediated securities of the debtor available to the creditor.

22-9. Paragraph 1 reflects the logic that only assets of the debtor can only be attached at the level of the person who is actually able to identify assets of the debtor so as to have them blocked and made available to the debtor's creditors. Paragraph 1 also reflects the concern that an attachment which is not made at the right level may hinder the ability of an intermediary to perform its functions, creating inefficiencies and possible inconsistencies in cross-border situations. Consequently, the rule ensures that the attachment affects the right account (the one of the debtor) and addresses the right person (the debtor's relevant intermediary, who is alone capable of making the debtor's intermediated securities available to the creditor). Therefore, the role of paragraph 1 is to exactly define the object and the addressee of an attachment order. To this end, this paragraph sets the following cumulative conditions for an attachment:

- an attachment must not affect the securities account of a person who is not the debtor (see sub-paragraph 1(a)); and,
- an attachment must be made against the appropriate person (see sub-paragraphs 1(b) and 1(c)).

(i) Sub-paragraph 1(a)

22-10. The chapeau of paragraph 1 and sub-paragraph 1(a) together read: "Subject to paragraph 3, no attachment of intermediated securities of an account holder shall be made so as to affect a securities account of any person other than that account holder". This element aims at avoiding a situation where an attachment is formally made against the right person (notably the account holder or the relevant intermediary; see sub-paragraph 1(c)), but affects the securities account of a different account holder who is not the debtor.

EXAMPLE 22-2: X has a securities account with B-Bank. B-Bank has a securities account with C-Bank which it uses as global custodian. Therefore, B-Bank pools all securities which it holds for clients in its account with C-Bank. A creditor of X tries to obtain an attachment order against C-Bank in order to seize securities belonging to X.

In Example 22-2, the competent judge or authority of a Contracting State should not issue an attachment order against C-Bank. Even if it is clear that all securities of B-Bank's clients are part of the pool in the account with C-Bank, there is no account maintained by C-Bank for X. C-Bank does not have any means of knowing whether, and if any, how many securities belong to X.

EXAMPLE 22-3: X has a securities account with B-Bank. Y, also an account holder of B-Bank, extended credit to X and received in turn a security interest in 100 of X's shares. B-Bank moves the shares to a separate pledge account which is opened in the name of Y. Z is another creditor of X, however, no security interest was created in its favour. Upon default of X to repay its debt to Z, the latter tries to obtain an attachment order against B-Bank to freeze all securities belonging to X. B-Bank blocks X's own securities account as well as the pledge account which was set up in the name of Y.

In Example 22-3, it might well be that the securities booked to the special pledge account are, under the applicable law, still attributed to X, while Y has only a limited interest. However, B-Bank should not have blocked the account which was opened in Y's name.

(ii) Sub-paragraph 1(b)

22-11. Sub-paragraph 1(b) prohibits attachment against the issuer. This is particularly important in jurisdictions where there is a direct legal relationship between the issuer and the holder of intermediated securities.

EXAMPLE 22-4: X holds bonds of ABC-Issuer. Both are located in the same country. The bonds are credited to X's securities account with B-Bank, which is located in a second country. X has debts with creditor Y who, upon X's default, wants to attach the bonds in the account maintained by B-Bank. However, it gives up the plan rather soon because of a too cumbersome cross-border procedure. Then, Y seeks to obtain an attachment order against ABC-Issuer, following which the latter, when paying the bond at maturity date, shall pay to Y.

22-12. Under sub-paragraph 1(b), an attachment order against the issuer should not be issued. This is, again, against the background that the addressee of the order (the issuer in the present case) cannot know whether or not the debtor actually has securities of the relevant description.

(iii) Sub-paragraph 1(c)

22-13. Sub-paragraph 1(c) limits the range of possible addressees of an attachment to the account holder and the relevant intermediary. These two persons alone have control over the securities account. The applicable procedures and laws determine whether the account holder or its relevant intermediary are formally addressees of the attachment.

22-14. The function of sub-paragraph 1(c) is to exclude the possibility that other intermediaries than the relevant intermediary could find themselves addressees of the attachment. This rule reflects the fact that other intermediaries regularly have no access to the debtor's securities account and in most cases would even be unable to identify him. This is even true where they actually take part in the holding chain of intermediaries through which securities credited to the debtor's account are actually held.

22-15. In particular, CSDs need to be protected against upper-tier attachment. They are particularly vulnerable to such attempts because they may hold all or a substantial portion of a securities issue. Therefore, a creditor could easily argue that the debtor's securities of a specific issue are held through the CSD which administers exactly that issue.

III-2. Paragraph 2: definition

22-16. Paragraph 2 contains a very broad definition of "attachment of intermediated securities of an account holder". This is achieved by attributing the widest possible sense to the various components of an attachment.

22-17. From a procedural angle, an attachment must be a "judicial, administrative or other act or process". This indicates that making an attachment requires the issuing authority to have jurisdiction and power over the addressee. However, which judicial or administrative entities or persons are competent to issue an attachment is determined by the applicable law.

22-18. The content of an attachment is an order to "freeze, restrict or impound" intermediated securities of an account holder. The first two alternatives mean the total or partial impeding of dealings with the securities, aiming at securing them for the purpose of a later realisation. The

third alternative goes further because it implies that in addition to a freezing or a restriction of the securities a right in or over them is created in favour of the creditor.

22-19. An attachment in the sense of Article 22(2) can be made “to enforce or satisfy” the decision which is at its basis.

22-20. Regularly, an attachment is an act enforcing a legal claim that has been established in a separate previous act which serves as a basis for the attachment. Under Article 22, that basis can be “a judgement, award or other judicial, arbitral, administrative or other decision”. Article 22(2) intends to cover the broadest possible range of acts at the basis of an attachment. Whereas the attachment itself must be made by a judicial or administrative entity or person (relationship of subordination mentioned above), this is not necessary for the decision serving as its basis and which is to be enforced or satisfied through the attachment. This derives from the fact that besides acts which rely on the jurisdiction and power of the issuing authority, there is also the possibility that the attachment aims at enforcing or satisfying an *arbitral* decision, which is of a private nature. Again, it is the applicable law which specifies which acts can serve as a basis for an attachment.

III-3. Paragraph 3: exception

22-21. Paragraph 3 is intended to accommodate holding patterns allowing an attachment to be made against a person other than the relevant intermediary. This is often the case in the context of holding patterns (the so-called “transparent systems”) where the relevant intermediary shares its functions with a third person (see Article 6 and Example 22-5). However, the exception of paragraph 3 can also apply where there is no holding pattern built on such shared functions in the sense of Article 6 (see Example 22-6).

EXAMPLE 22-5: In a given country, the CSD is the relevant intermediary and broker firms act as “account operators” vis-à-vis the investors (who are account holders). The sharing of functions between the CSD and the “account operators” is acknowledged by way of a declaration under Article 6. The national law prescribes that an attachment order aiming at impounding intermediated securities of an account holder has to be addressed to the account operator.

EXAMPLE 22-6: In another country, the holding patterns in place do not involve the sharing of functions and the CSD is not the relevant intermediary. However, the law prescribes that an attachment has to be made against the CSD and identify the debtor and the debtor’s relevant intermediary. It also prescribes that the CSD has to communicate to and check with the debtor’s relevant intermediary what the debtor’s holdings are before freezing the intermediated securities in both the relevant intermediary’s and the CSD’s securities accounts simultaneously.

Both countries would have to make a declaration under Article 22(3) in order to be able to maintain the practice described in the above examples. Without such declaration, their law would not properly reflect the substance of Article 22.

22-22. The reasoning of this exception lies in the general purpose of the prohibition of upper-tier attachment, i.e., upper-tier attachment bears the risk of disrupting the holding chain. However, this detrimental effect can be avoided where the applicable law provides for special safeguards avoiding such disruption, in particular reconciliation mechanisms which allow the relevant intermediary and the other person to communicate with each other and have procedures in place

which guarantee that an attachment made at the level of one entity is correctly reflected in the accounts maintained by the other entity.

22-23. In many (probably most) cases, a Contracting State making a declaration under Article 22(3) also will have made a declaration under Article 6 with respect to the sharing of intermediary functions, as contemplated by Example 22-5. However, Article 22(3) does not limit its applicability to such Contracting States. It is based on the plausible assumption that a Contracting State that elects to become a party to the Convention and that also elects to make a declaration under paragraph 3 will do so rationally. A Contracting State should make such a declaration only if a system is in place (through the use of information technology or otherwise) which ensures that the problems and risks that Article 22(1) is intended to prevent are adequately addressed (see Example 22-6 above).

22-24. Where a declaration under Article 22(3) is made, it must identify the other person by name or description. Furthermore, it must specify the time at which such an attachment becomes effective against the relevant intermediary. This last requirement shows that the decisive account to look at remains under all circumstances the one held for the debtor by the relevant intermediary. Only if and when the attachment of intermediated securities standing to the credit of that account takes legal effect, the intermediated securities are validly frozen, restricted or impounded. Until that point in time, the intermediated securities can be disposed of.

Article 23

Instructions to the intermediary

1. An intermediary is neither bound nor entitled to give effect to any instructions with respect to intermediated securities of an account holder given by any person other than that account holder.

2. Paragraph 1 is subject to:

(a) the provisions of the account agreement, any other agreement between the intermediary and the account holder or any other agreement entered into by the intermediary with the consent of the account holder;

(b) the rights of any person (including the intermediary) who holds an interest that has become effective against third parties under Article 12;

(c) subject to Article 22, any judgment, award, order or decision of a court, tribunal or other judicial or administrative authority of competent jurisdiction;

(d) any applicable provision of the non-Convention law; and

(e) where the intermediary is the operator of a securities settlement system, the uniform rules of that system.

Commentary

I. Introduction

23-1. The purpose of Article 23 is to protect the rights of an account holder and the integrity of the system of intermediated securities. In general, the protection of the rights of an account holder

has positive and negative aspects. Article 9 focuses on the positive aspect, and sets out the rights conferred on the account holder. It follows naturally from Article 9 that only the account holder (and no one else) is entitled to give instructions to the intermediary with respect to its rights. Article 23 focuses on the negative aspect and prevents interference of third parties on the rights of the account holder. Specifically, Article 23 makes it clear that no one other than the account holder can give instructions to the intermediary. Article 23 is therefore a corollary of Article 9. But Article 23 provides further. Article 23 also ensures the integrity throughout the chain of intermediaries since it provides that each account holder is entitled to give instructions to its relevant intermediary, but only to that intermediary.

23-2. The general rule, set out in Article 23(1), states this idea. It is formulated in a negative way: an intermediary is neither bound nor entitled to carry out instructions with respect to intermediated securities of an account holder where these instructions have been given by any person other than that account holder. Paragraph 2 contains a number of exceptions to this general rule in order to accommodate, in particular, (i) arrangements between the intermediary and the account holder or a person who has received an interest over the securities, (ii) decisions of courts and other competent authorities, (iii) and the needs of securities settlement systems.

II. History

23-3. Throughout the negotiations, the content of this provision has experienced very few modifications. In the first version of the preliminary draft Convention (UNIDROIT 2004 – Study LXXVIII – Doc. 18), Article 13, under the title of “Duties of intermediary”, already contained a similar rule. The only significant difference was that the list of exceptions in paragraph 2 did not include a reference to a securities settlement system.

23-4. In the first session of the CGE, two modifications were agreed on: (a) to change the title of the provision, “Duties of intermediary”, which was considered to be too broad, to “Instructions”, (ii) and to include an explicit reference to securities settlement systems in paragraph 2 (UNIDROIT 2005 – Study LXXVIII – Doc. 24). Under the new numbering of the text, old Article 13 was moved to Article 15.

23-5. In the second, third and fourth sessions of the CGE, the provision remained practically unchanged. Apart from minor drafting points, the title was modified to “Instructions to the intermediary” and the text was moved to Article 16 (UNIDROIT 2006 – Study LXXVIII – Doc. 42), afterwards to Article 18 (UNIDROIT 2006 – Study LXXVIII – Doc. 57), and to Article 20 (UNIDROIT 2007 – Study LXXVIII – Doc. 94).

23-6. Finally, during the diplomatic Conference, the provision was adopted without introducing any modifications (UNIDROIT 2008 – CONF. 11 – Doc. 48 Rev.). In the final text, it became Article 23.

III. Analysis

III-1. General rule: paragraph 1

23-7. Article 23(1) provides a general rule and Article 23(2) provides exceptions. The general rule, set out in Article 23(1), is straightforward: An intermediary is obliged to deal only with the instructions given by its account holder and it is not obliged to deal with the instructions given by anyone else.

23-8. Article 23(1) is formulated in negative terms and provides that an intermediary is neither bound by, nor entitled to carry out any instructions given by a third party (any person other than the account holder). This formula protects the rights of the account holder, since it ensures that only the account holder can give instructions with regard to its intermediated securities, i.e., only that account holder (and no one else) can exercise the rights recognised under Article 9. But it also protects the intermediary since it is not exposed to liability *vis à vis* third parties for not following the instructions given by them.

23-9. Article 23 should not be read as precluding any agency or other valid arrangements or legal provisions between the account holder and its agent or other person (collectively called “agent”), where such agent is given power to act on behalf of the account holder. As far as such delegation of power is valid and enforceable under the applicable law, the agent is entitled to give instructions on behalf of the account holder to its intermediary. For instance, where the account holder is a company, the company’s officer who has valid power to act on behalf of the company is entitled to give instructions on behalf of the company to its intermediary.

23-10. Article 23 employs the expression “with respect to intermediated securities of an account holder”. The concepts of “intermediated securities” and “account holder” are defined in Article 1(b) and Article 1(e) respectively. “Intermediated securities” means “securities credited to a securities account or rights or interests in securities resulting from the credit of securities to a securities account”. An account holder is “a person in whose name an intermediary maintains a securities account [...]”. Accordingly, “intermediated securities of an account holder” means the securities credited to the securities account, or the resulting rights or interest, of a particular account holder. Article 23(1) provides that with respect to those securities, rights or interest no one can give instructions to that intermediary apart from the account holder.

23-11. Although the Convention employs the term “instructions” in various places, it does not contain any definition of this term. In the context of Article 23, this term must be understood in a broad sense and include any order, direction or request given to the intermediary regardless of its content or form.

23-12. The implications of this provision can be analysed (i) horizontally, i.e., *vis à vis* other account holders of the same intermediary or creditors or claimants of the account holder, and (ii) vertically, i.e., *vis à vis* account holders of the intermediaries in the different tiers.

EXAMPLE 23-1: IM 1 has three account holders X, Y and Z. With regard to X’s intermediated securities, Article 23(1) means that IM 1 is only bound to follow the instructions given by X. Accordingly, IM 1 is neither bound to follow, with regard to X’s securities account, any instructions given by Y or Z, nor by any other third party that alleged to have any claim against X, for example, X’s creditors. If X’s creditors want to address any instructions to IM 1, they would have to obtain a court order (see Article 23(2)(c)).

EXAMPLE 23-2: In a multi-tier system, IM 1 maintains a securities account for and in the name of IM 2, which in turn has three account holders X, Y and Z. In this scenario, Article 23(1) means that, even if IM 2 is acting on behalf of its account holders, IM 1 must disregard any instruction received from X, Y or Z. IM 1 is only bound to follow the instructions given by IM 2.

23-13. In jurisdictions having the so-called transparent system, if IM 1 in Example 23-2 is the CSD and IM 2 is a broker and the functions of the relevant intermediary are shared between IM 1 and IM 2, the account holders can only give instructions to the CSD or the broker who performs the

function of receiving instructions from account holders specified by the declaration that is made by the Contracting State pursuant to Article 6 (see commentary on Article 6).

23-14. Article 23(1) does not mention the consequences of its violation. The liability of the intermediary when it violated Article 23(1) is governed by the non-Convention Law (see Article 28).

EXAMPLE 23-3: IM 1 has an account holder, X. IM 1 receives a notification from Y which states that specified securities were stolen by X and then deposited with IM 1 for credit to X's account. Y demands that IM 1 prohibit X from disposing of those intermediated securities. IM 1 must disregard Y's notification and demand and must obey X's instruction to sell those securities, subject to Article 23(2).

23-15. In Example 23-3, IM 1 is acting appropriately in accordance with Article 23(1). It follows that IM 1 has incurred no liability to Y even though IM 1 acted on X's instructions after being informed of Y's adverse claim. This result necessarily is implicit in Article 23(1).

III-2. Exceptions: paragraph 2

23-16. Paragraph 1 of Article 23 is subject to paragraph 2. This second paragraph contains a list of exceptions to the general rule, i.e., situations where the intermediary may be bound or entitled to follow the instructions given by a person other than the account holder. With regard to these exceptions, even though the list is exhaustive, they are intended to be fairly wide-ranging and in certain cases apply cumulatively.

23-17. Article 23(2) contains five categories. The first two exceptions are based on the consent of the account holder (sub-paragraphs (a) and (b)), the third on the intervention of a public authority (sub-paragraph (c)); the fourth on the operation of the non-Convention law (sub-paragraph (d)); and the fifth on the need to respect the particularities of securities settlement systems (sub-paragraph (e)).

23-18. Sub-paragraph 2(a) is based on the consent of the account holder and foresees the case where the intermediary and the account holder have agreed that a third party is allowed to give instructions to the intermediary.

EXAMPLE 23-4: X has an investment adviser, Y, who provides X with financial advice but who does not have the legal capacity to act as an intermediary. A securities account is, accordingly, opened in the name of X with IM 1. However, under an agreement between X and IM 1, Y is authorised to give instructions to IM 1 directly with regard to the securities credited to X's securities account. In this case, IM 1 is bound to follow the instructions of Y even though Y is not the account holder.

23-19. Article 23(2)(a) is an open rule with regard to the way the parties may agree on this issue and it expressly clarifies that the agreement to follow the instructions of a third party can derive from the provisions of (i) the account agreement, (ii) any other agreement between the intermediary and the account holder, or (iii) any other agreement entered into by the intermediary with the consent of the account holder. In each case, the corresponding provisions must be looked at to see if and under what conditions the intermediary is allowed, and obliged, to depart from the general rule stated in Article 23(1).

23-20. The second category, Article 23(2)(b), is also based on the consent of the account holder and foresees the case where the account holder has granted an interest effective under Article 12. Normally, the granting of an interest in favour of any person (including the intermediary) in

accordance with Article 12 implies (i) a limit to the rights of the account holder (i.e., the capacity of the account holder to give instructions to the intermediary is restricted), and/or (ii) concession of rights to the beneficiary of that interest to give certain instructions to the intermediary. In the latter case, the general rule laid down by Article 23(1) is subject to these rights of the beneficiary of the interest.

EXAMPLE 23-5: Account holder X grants a security interest to Y under a “positive” control agreement (see Article 1(k)(ii)). In this case, the intermediary is obliged to comply with the instructions given by Y under the conditions in the agreement without any further consent of the account holder.

23-21. With regard to this exception, one additional point is worth noting. Article 23(2)(b) refers to interests that have become effective under Article 12. This has two consequences. On the one hand, it does not cover security interests created under the non-Convention law according to Article 13. In relation to Article 13 interests, the non-Convention law applies by virtue of subparagraph (d). On the other hand, since Article 12 is formulated as an open rule allowing Contracting States different options (see Article 12(5)), the position of each Contracting State must be consulted to see if the interest has become effective according to the conditions declared by that State.

23-22. Thirdly, the general rule in paragraph 1 is subject to any judgment, award, order or decision of a court, tribunal or other judicial or administrative authority of competent jurisdiction (Article 23(2)(c)).

EXAMPLE 23-6: X is an account holder with IM 1. According to Article 23(1), IM 1 is neither bound by nor entitled to follow, with regard to X’s securities account, any instructions given by X’s creditors. However, X’s creditors can ask a court for an attachment over X’s securities account. If the court grants the attachment, IM 1 will be obliged to follow the instructions of the court.

23-23. Even though the Convention refers to “competent jurisdiction”, it does not establish any rule on this matter. The determination of the competent authority or court is outside the scope of this Convention and, therefore, shall be governed by the rules on jurisdiction of each State. Each *lex fori* determines if, to what extent and under what conditions the orders can be addressed directly to the intermediary.

23-24. The exception contained in sub-paragraph (c) of Article 23(2) is subject to Article 22. This latter provision prohibits upper-tier attachment. This cross-reference means that the rule prohibiting upper-tier attachment under Article 22 is not pre-empted and remains unaffected by Article 23(2)(c). Even though public authorities may give instructions to intermediaries directly under their law, they can only do so to the corresponding relevant intermediary, i.e., public authorities cannot invoke Article 23(2)(c) to address an attachment to the upper-tier intermediary.

EXAMPLE 23-7: In a multi-tier system, IM 1 has opened a securities account in the name of IM 2, which in turn has opened a securities account for X. Article 23(1) means that X cannot directly give instructions to IM 1. This intermediary is only bound to follow the instructions given by IM 2. For the same reason, if a creditor of X asks for an attachment to a court, this court can only order the attachment *vis à vis* IM 2. According to Article 22, the court is not allowed to order the attachment *vis à vis* IM 1. The cross-reference to Article 22 in Article 23(2)(c) leads to this result.

23-25. Note that the cross-reference to Article 22 includes paragraph 3 of that Article, and therefore the possibility for Contracting States to allow an attachment at an upper-tier level under certain conditions.

23-26. Fourthly, Article 23(1) is subject to any applicable provision of the non-Convention law (Article 23(2)(d)). This referral presupposes that there are circumstances in which the non-Convention law may allow a third party, other than the account holder, to give instructions to the intermediary. Typical examples are where the account holder has deceased or where the account holder lacks the legal capacity to administer the securities account (e.g., minors). As noted above, sub-paragraph (d) also includes the cases of interests that have become effective against third parties under the non-Convention law pursuant to Article 13.

23-27. However, sub-paragraph (d) would not apply so as to require an intermediary to act on a stranger's assertion of an adverse claim or permit the intermediary to refuse to act on its account holder's instructions in the setting of Example 23-3. This is so even if the non-Convention law would give a different result. Sub-paragraph (d) contemplates that any third party empowered by the non-Convention law to give instructions would be a person whose power is derived from the account holder or who acts on the account holder's behalf and whose power is consistent with the account holder's rights.

23-28. Finally, Article 23(1) is subject to the uniform rules of a securities settlement system where the intermediary is the operator of that system (Article 23(2)(e)). A "securities settlement system" and the "uniform rules" are defined in Article 1(o) and Article 1(p) respectively. This exception attempts to safeguard the needs of maintaining the integrity of securities settlement systems (as many other provisions in the Convention) and thus recognises the possibility that the intermediary which is the operator of such system may be obliged to comply with the uniform rules of the system without the account holder's instructions.

Article 24

Holding or availability of sufficient securities

- 1. An intermediary must, for each description of securities, hold or have available for the benefit of its account holders, other than itself, securities and intermediated securities of an aggregate number or amount equal to the aggregate number or amount of securities of that description credited to securities accounts which it maintains for such account holders.**
- 2. An intermediary may comply with paragraph 1 by:**
 - (a) procuring that securities are held on the register of the issuer in the name, or for the account, of its account holders;**
 - (b) holding securities as the registered holder on the register of the issuer;**
 - (c) possession of certificates or other documents of title;**
 - (d) holding intermediated securities with another intermediary; or**
 - (e) any other appropriate method.**

3. If at any time the requirements of paragraph 1 are not complied with, the intermediary must within the time permitted by the non-Convention law take such action as is necessary to ensure compliance with those requirements.

4. This Article does not affect any provision of the non-Convention law, or, to the extent permitted by the non-Convention law, any provision of the uniform rules of a securities settlement system or of the account agreement, relating to the method of complying with the requirements of this Article or the allocation of the cost of ensuring compliance with those requirements or otherwise relating to the consequences of failure to comply with those requirements.

Commentary

I. Introduction

24-1. Article 24 constitutes a core rule for the protection of account holders. Paragraph 1 states a general rule by providing that an intermediary must hold or have available securities or intermediated securities corresponding to the credits it has made to the securities accounts of its account holders, so that the total amount thus held or available is at least equal to the total amount of the securities credited to the securities accounts of its account holders.

24-2. This general rule is supplemented by three provisions. Paragraph 2 contains a list of ways in which the intermediary may comply with the rule. Paragraph 3 refers to the non-Convention law for the determination of the time frame within which the intermediary must take action to comply with the rule. Finally, paragraph 4 introduces a safeguard: The obligations imposed by this article do not prejudice any provisions of the non-Convention law or, to the extent permitted by the non-Convention law, any provisions of a securities settlement system or of an account agreement with regard to two issues: (a) the method of compliance with the requirements set forth in this article and (b) the allocation of the costs with respect to the compliance with those requirements.

II. History

24-3. Throughout the negotiations, this provision has experienced important changes. In the first version of the preliminary draft Convention (UNIDROIT 2004 – Study LXXVIII – Doc. 18), Article 14, under the title of “Duties of the intermediary with respect to holding or credit of securities”, already contained an implicit general obligation of the intermediary to hold sufficient securities. However, the rule was formulated in negative terms: the intermediary may not make a credit to its account holders or dispose of the securities held with another intermediary if this would lead to non-fulfilment of the requirement to hold sufficient securities. In addition, Article 14 was a more detailed rule. In particular, it paid special attention to (a) the determination of the moment of the failure to comply with the requirement, (b) the time framework to comply with the requirement, or (c) the distribution of the costs incurred by the intermediary for this reason.

24-4. During the first session of the CGE, many delegations agreed on the substance but expressed their view that the article was excessively detailed and that it should provide only for the core duties of intermediaries. As a result, the provision was notably simplified and reduced to three main issues: (a) the general rule on the requirement to hold sufficient securities but maintaining the negative formulation; (b) when this requirement is not met, the obligation of the intermediary to correct it immediately or promptly; (c) and a broad reference to the non-Convention law on the

distribution of the costs of ensuring compliance with that requirement. In the text resulting from the first session, old Article 14 was renumbered as Article 16. See UNIDROIT 2005 – Study LXXVIII – Doc. 23 rev., sections 138-144 and 193, and UNIDROIT 2005 – Study LXXVIII – Doc. 24, Appendix 1, p. 12-13.

24-5. During the second session of the CGE, the formula of the general rule was changed into a positive one: the Committee reached consensus on the need to retain the rule but in a less restrictive form that placed a positive duty on an intermediary to maintain sufficient securities. The title of the Article was modified accordingly. Moreover, the words “for account holders” were added in square brackets to paragraph 1 in order to flag the question whether the article should relate to account holders’ securities only. In the text resulting from the second session, the provision corresponded to Article 17. See UNIDROIT 2006 – Study LXXVIII – Doc. 42, Appendix 1, p. 13-14 and UNIDROIT 2006 – Study LXXVIII – Doc. 43, sections 117-118 and 183.

24-6. During the third session of the CGE, apart from some drafting points, three issues were agreed: (a) to delete the text “for account holders” in square brackets in paragraph 1; (b) to refer to the non-Convention law for the timeframe for the intermediary to comply with the requirement; and (c) to expand the reference to the non-Convention law not only to the cost but also the methods of maintaining the balance. In the text resulting from the third session, the provision corresponded to Article 19. See UNIDROIT 2006 – Study LXXVIII – Doc. 57, Appendix 1, p. 12-13 and UNIDROIT 2007 – Study LXXVIII – Doc. 58, sections 83-87 and 153.

24-7. During the fourth session of the CGE, three modifications were introduced: (a) in paragraph 1, the idea of “availability” was incorporated into the text, i.e., the word “hold” was replaced by the expression “hold or have available”; (b) in paragraph 1, the formula “other than itself” was added in order to express that Article 24 applies to securities that an intermediary holds or has available for its account holders, but not to its own securities; and (c), in paragraph 2 the list of methods to comply with the obligation to maintain sufficient securities was reformulated in a more neutral and open manner. In the text resulting from the fourth session, the provision corresponded to Article 21. See UNIDROIT 2007 – Study LXXVIII – Doc. 94, Appendix 1, p. 11 and UNIDROIT 2007 – Study LXXVIII – Doc. 95, sections 179 and 229.

24-8. Finally, during the first session of the diplomatic Conference, the provision was adopted without introducing any modifications (UNIDROIT 2008 – CONF. 11 – Doc. 48 Rev.). In the final text, it corresponds to Article 24.

III. Analysis

III-1. General rule: paragraph 1

24-9. Paragraph 1 states the main rule, i.e., the obligation of an intermediary to hold or have available for the benefit of its account holders securities or intermediated securities that correspond to the credits it has made to the securities accounts of its account holders, so that the total amount thus held or available is at least equal to the total amount of the securities credited to the securities accounts of its account holders. The meaning of “hold or have available” is discussed later in section 24-13, and the word “hold” is used in most of the following examples and commentary.

EXAMPLE 24-1: IM 1 has three account holders, X, Y and Z. Each of them has 100 ABC shares. According to Article 24(1), IM 1 has the obligation to hold 300 ABC shares, for example, in physical certificates and/or in a securities account opened with an upper-tier intermediary.

24-10. The purpose of this rule is to provide a minimum duty of an intermediary to its account holders. The rule applies at any level of the chain of intermediation, and thus applies to a CSD where it acts as an intermediary. In that situation, the CSD must hold or have available securities registered on the register of the issuer which correspond to the credits it has made to the securities accounts of its account holders.

EXAMPLE 24-2: ABC has issued 1,000,000 shares represented by a global note that is immobilised in a CSD. With regard to the accounts of the participants in the CSD, Article 24(1) applies. Therefore, the CSD must not credit to the securities accounts of its participants an amount of ABC shares greater than 1,000,000.

24-11. The class of the securities credited to the securities accounts of the account holders must correspond to the class of the securities or intermediated securities held by the intermediary; i.e., for each description of securities credited to the securities accounts of its account holders, the intermediary must hold sufficient securities or intermediated securities of that description.

EXAMPLE 24-3: If IM 1 has credited 100 ABC shares to the securities account of its account holder X, it must hold an equivalent amount of ABC shares of the same class. It does not meet the obligation imposed by Article 24(1) if it holds, for example, bonds issued by the same issuer or DEF shares, even though the economic value of the securities held is the same.

24-12. The term "*securities of that description*" is equivalent to the term "*securities of the same description*" which is defined in Article 1(j). Securities are "of the same description" as other securities if they are issued by the same issuer and (i) they are of the same class of shares or stock; or (ii), in the case of securities other than shares or stock, they are of the same currency and denomination and are treated as forming part of the same issue. The underlying idea is legal fungibility between the securities or intermediated securities held by the intermediary and the securities credited to the securities accounts of its account holders. The qualification is determined by the applicable law: i.e., the question of whether the shares or the stock are of the same class or whether the securities form part of the same issue is determined by the law applicable to the corresponding securities.

EXAMPLE 24-4: In the setting of EXAMPLE 24-3, the question of whether the ABC shares credited to the securities accounts of the account holders of IM 1 are of the same class as other ABC shares held by IM 1 is determined by the law applicable to the shares. This is not a question dealt with in the Convention.

24-13. The obligation imposed on the intermediary is "to hold or have available" sufficient securities. This is intended to cover different jurisdictions with respect to what intermediaries have in their intermediated securities system. In some jurisdictions, intermediaries hold securities (or intermediated securities). In other jurisdictions, intermediaries have nothing but power to make book entries (i.e., credits and debits). For simplicity, the word "hold" is used in most places in this commentary.

24-14. If the securities are credited to the securities accounts of its account holders, the intermediary must have the securities available by a method contemplated by paragraph 2, discussed below. For example, the intermediary may physically possess them or have them credited to its securities account with an upper-tier intermediary. However, an arrangement to borrow securities in the future or a mere pledge in favour of the intermediary at the upper-tier level is not enough to meet the obligation set forth in Article 24(1).

24-15. Article 24(1) only deals with the securities of the account holders of an intermediary. This provision only requires that the intermediary hold sufficient securities or intermediated securities to satisfy the amount of securities credited to the securities accounts it maintains for its account holders. The phrase “other than itself” means that where an intermediary maintains a securities account for itself, Article 24(1) does not impose such obligation on the intermediary with respect to the securities credited to that securities account.

III-2. Methods: paragraph 2

24-16. Paragraph 1 states the general obligation to hold or have available sufficient securities. Paragraph 2 sets out the ways to do so. It contains an open-ended list of methods which are considered appropriate to meet the condition that the intermediary must hold or have available sufficient securities for its account holders. The distinction between “securities and intermediated securities” is due to the fact that the intermediary may have them directly (e.g., physically) or indirectly (through another intermediary).

24-17. Article 24(2) foresees four alternative methods and an open clause for any other appropriate method. (a) Firstly, an intermediary may procure that securities are held on the register of the issuer in the name, or for the account, of its account holders. (b) Secondly, the intermediary may hold securities as the registered holder on the register of the issuer. In these two cases, either the account holders or the intermediaries hold the securities directly on the register of the issuer. Naturally, this rule presupposes that the register of the issuer implies a right over the securities equivalent to holding them through an intermediary or having them physically, not a mere entitlement to exercise certain corporate rights. (c) Thirdly, the intermediary may possess the certificate or other documents of title. (d) Fourthly, the intermediary may hold intermediated securities with another intermediary. (e) Finally, the intermediary may hold or have available securities by any other appropriate method. The list tries to reflect the standard or typical methods of holding securities nowadays, but sub-paragraph (e) opens the door to alternative methods that may develop in the future.

24-18. The methods contemplated in Article 24(2) can be combined, and therefore the intermediary may have different amounts of securities by different methods. The relevant element is that the total amount held by the intermediary under one or more of those methods must be sufficient to satisfy the amount of securities credited to the securities accounts of its account holders.

EXAMPLE 24-5: IM 1 has three account holders, X, Y and Z. Each of them has 100 ABC shares. According to Article 24(1), IM 1 has an obligation to hold 300 ABC shares. According to Article 24(2), IM 1 meets that obligation if, for example, it has 50 ABC shares in the name of IM 1 on the register of the issuer, possesses 200 ABC shares represented by certificates, and holds 50 ABC with an upper-tier intermediary (50+200+50=300).

24-19. The Convention places all the methods listed in Article 24(2) on an equal footing. It leaves it to the parties (intermediaries and account holders) to decide whether to give preference to one of them or to combine two or more (see paragraph 4). The Convention is neutral on this question. However, not all methods set out in Article 24(2) are always available to an intermediary. The question of whether it is possible to hold securities on the register of the issuer or physically, for example, depends on the law under which the securities have been issued, the law of the issuer, or even on the non-Convention law (Article 24(4)), which may limit the methods that are acceptable. This question is outside the scope of the Convention. Article 24(2) presupposes the pertinence of the corresponding method under the applicable law and then gives different options to the parties for compliance with the obligation to maintain sufficient securities.

III-3. Time framework: paragraph 3

24-20. Paragraph 3 of Article 24 provides the timeframe within which an intermediary shall comply with the requirement promulgated by paragraph 1, and refers to the non-Convention law on this issue. A failure to comply with the requirement may arise for different reasons. It may be the result of a deliberate decision (fraud or misconduct) or of an inadvertent breach by the intermediary of its obligation. In addition, such failure may be downstream or upstream: either because the intermediary credits securities to its account holder's securities account in circumstances where a corresponding increase in the underlying securities or intermediated securities held by the intermediary does not take place, or because securities are debited from the intermediary's holdings without a corresponding debit to the account holder's securities account. In both cases, the Convention assumes that the new or remaining credit in the account holder's securities account is valid and effective even though there is no matching book-entry at an upper-level.

24-21. If this circumstance arises, the intermediary must correct it. The operations to rectify the situation can take different forms. The situation can be rectified either by increasing the holdings of the intermediary (e.g., purchasing securities or intermediated securities from the market) or by reducing the holdings of its account holders (e.g., purchasing intermediated securities from the account holders or using a securities lending arrangement to borrow securities from an account holder). The timeframe for carrying out these operations is found in the non-Convention law. The non-Convention law also governs the liability of the intermediary for the violations of these obligations under Article 24 (see Article 28).

III-4. Paragraph 4

24-22. Finally, paragraph 4 contains an additional referral to the non-Convention law. The non-Convention law or, to the extent permitted by the non-Convention law, any provision of the uniform rules of a securities settlement system or of an account agreement may set out rules in respect of two aspects. Firstly, they may specify the method of compliance with the obligation to hold or have available sufficient securities under this article. That is, the standard for the intermediary's compliance with its obligations under this provision can be set by agreement or by the rules of a securities settlement system; for example, the rules of a securities settlement system may permit temporary, intra-day shortages or may permit provisional credits. Secondly, they may determine the allocation of the costs of ensuring compliance and other consequences of failure to comply with the obligation to hold or have available sufficient securities.

EXAMPLE 24-6: IM 1 has credited 100 ABC shares to the securities account of one of its account holders, X. IM 1 holds those 100 ABC shares with an upper-tier intermediary, IM 2. If IM 2 goes bankrupt and there is a shortfall, an imbalance may arise. If IM 1 acquires additional shares to correct the imbalance, the non-Convention law determines whether this cost is borne by IM 1 or by X.

Article 25***Allocation of securities to account holders' rights***

1. Securities and intermediated securities of each description held by an intermediary as described in Article 24(2) shall be allocated to the rights of the account holders of that intermediary to the extent necessary to ensure compliance with Article 24(1).

2. Subject to Article 20, securities and intermediated securities allocated under paragraph 1 shall not form part of the property of the intermediary available for distribution among or realisation for the benefit of creditors of the intermediary.

3. The allocation required by paragraph 1 shall be effected by the non-Convention law and, to the extent required or permitted by the non-Convention law, by arrangements made by the relevant intermediary.

4. The arrangements referred to in paragraph 3 may include arrangements under which an intermediary holds securities and intermediated securities in segregated form for the benefit of:

(a) its account holders generally; or

(b) particular account holders or groups of account holders,

in such manner as to ensure that such securities and intermediated securities are allocated in accordance with paragraph 1.

5. A Contracting State may declare that, where all securities and intermediated securities held by an intermediary for its account holders are in segregated form under arrangements such as are referred to in paragraph 4, under its non-Convention law the allocation required by paragraph 1 applies only to those securities and intermediated securities and does not apply to securities and intermediated securities held by an intermediary for its own account.

6. This Article applies notwithstanding the commencement or continuation of an insolvency proceeding in respect of the intermediary.

Commentary

I. Introduction

25-1. Article 25 provides another core rule for investor protection. The principal purpose is to protect account holders by ensuring that enough of an intermediary's securities or intermediated securities are allocated so as to cover its account holders' rights. Paragraphs 1 and 2 of Article 25 state the main idea and its consequence. The securities or intermediated securities held by an intermediary under any of the methods listed in Article 24(2) must be allocated to the account holders to the extent necessary to ensure compliance with Article 24(1). Paragraph 2, in turn, states that the securities or intermediated securities that are allocated to account holders do not form part of the intermediary's property and are not available to the creditors of the intermediary. This provision is, however, subject to Article 20, which means that the priority given in that provision to the intermediary's secured creditors over account holders must be respected.

25-2. Paragraphs 3 and 4 relate to the methods of allocation. Paragraph 3 refers to the non-Convention law with respect to this issue and, to the extent required or permitted by that law, to arrangements made by the relevant intermediary. This latter method is elaborated upon in paragraph 4, which specifies two kinds of segregation arrangements: either for the benefit of account holders generally or for the benefit of particular account holders or groups of account holders.

25-3. Paragraph 5 foresees a declaration mechanism. A Contracting State may declare that, where the securities held by the intermediary are in segregated form, the allocation set out in paragraph 1 does not apply to the securities held by the intermediary for its own account.

25-4. Finally, paragraph 6 clarifies that this provision applies notwithstanding the commencement or continuation of an insolvency proceeding in respect of the intermediary.

II. History

25-5. The principle underlying this provision was already contained in the first version of the preliminary draft Convention (UNIDROIT 2004 – Study LXXVIII – Doc. 18). Article 15 of this text established that the securities held by the intermediary were appropriated to the rights of its account holders to the extent necessary to satisfy their credits. It also contained the main consequence of this principle, i.e., in case of insolvency of the intermediary, the securities belonged to the account holders and were not available for the other creditors. Finally, it also recognised that the non-Convention law would determine the precise technique by which the appropriation should be effected and the procedure by which the account holders' rights should be enforced.

25-6. In the first session of the CGE (UNIDROIT 2005 – Study LXXVIII – Doc. 24), the provision was redrafted basically to make clear that it could be applied to both jurisdictions where intermediaries segregate accounts (i.e., differentiate between its own securities and its account holders' securities) and those where they do not. In addition, a declaration mechanism was introduced for allowing Contracting State to impose segregation. Finally, the concept of "appropriation" was replaced by a more neutral term: "allocation". Under the new numeration of the text, former Article 15 was moved to Article 17.

25-7. During the second session of the CGE (UNIDROIT 2006 – Study LXXVIII – Doc. 42), the provision was not practically modified. Only the paragraph allowing for a declaration was changed to clarify its meaning, i.e., the possibility of Contracting States to give proprietary-law consequences to regulatory rules on segregation. After that session, the provision corresponded to Article 19.

25-8. During the third session of the CGE (UNIDROIT 2006 – Study LXXVIII – Doc. 57), apart from slight drafting changes, two elements were added: (a) a cross-reference to the provision dealing with the priority of particular creditors of the intermediary, and (b) a specification of the arrangements that an intermediary may have to effect the allocation required by paragraph 1. In the text adopted after this session, the provision corresponded to Article 21.

25-9. During the fourth session of the CGE (UNIDROIT 2007 – Study LXXVIII – Doc. 94), the only relevant modification introduced was a clarification in the sense that the allocation applies to all securities held by the intermediary irrespective of the method (i.e., directly or through another intermediary). The provision corresponded to Article 22.

25-10. Finally, during the first session of the diplomatic Conference, the provision was adopted without any substantial modifications (UNIDROIT 2008 – CONF. 11 – Doc. 48 Rev.).

III. Analysis

III-1. Paragraphs 1 and 2

25-11. Article 25 is a fundamental rule for investor protection, closely related to Article 24. Article 24 imposes an obligation on the intermediary to hold sufficient securities or intermediated securities of each description for its account holders. Article 25 provides that the securities or intermediated securities held by the intermediary must be first allocated to its account holders. That is, the financial assets held by an intermediary are held for its account holders to the extent necessary to satisfy Article 24(1). This allocation principle applies to the securities or intermediated securities of *each description* held by the intermediary for the benefits of the corresponding account holders, i.e., those in whose accounts the securities of that description have been credited, and not to other securities or intermediated securities that the intermediary may hold.

EXAMPLE 25-1: IM 1 has two account holders X and Y. X has a securities account with 50 ABC shares and Y with 100 ABC shares. If IM 1 holds 150 ABC shares, they are allocated to X and Y. If IM 1 holds 200 ABC shares, 150 are allocated to X and Y and 50 to itself. This result applies irrespective of the way the intermediary holds the securities, either physically, with an upper-tier intermediary or by any other of the methods listed in Article 24(2). That is why the provision distinguishes between securities and intermediated securities (see *supra* Commentary to Article 24). Note that if IM 1 does not hold sufficient securities to satisfy the rights of X and Y, for instance it only holds 100 ABC shares, then Article 26 will determine how the 100 ABC shares will be distributed between X and Y. Note also that if IM 1 does not hold any ABC shares, but DEF shares, these shares are not allocated to the account holders since they are not of the same description as the ones credited to them (see Commentary to Article 24).

25-12. Paragraph 2 establishes the natural consequence of the allocation rule. If the securities or intermediated securities held by the intermediary belong to the account holders, they do not form part of the intermediary's estate available for creditors; i.e., creditors cannot realise their claims over the securities held by the intermediary on account of its account holders. This rule applies in all cases, but it is particularly relevant in the case of insolvency of the intermediary. If the intermediary goes bankrupt, these securities do not form part of the property of the intermediary available for distribution among or realisation for the benefit of its creditors.

EXAMPLE 25-2: In the former example, if IM 1 holds only 150 ABC shares, they are allocated to X (50) and Y (100). Accordingly, if IM 1 goes bankrupt, those shares do not form part of the insolvency estate. The 150 ABC shares cannot be distributed among the creditors of IM 1, nor can they be sold to pay their claims.

25-13. In principle, the term "creditors" includes any secured and unsecured creditors and even account holders acting in that capacity (as creditors), i.e., account holders whose claim is not based on a credit of securities to their securities account but on another title (a loan to the intermediary, for example). However, the rule stated in paragraph 2 is subject to the priority rule stipulated in Article 20. This cross-reference means that the interests granted by an intermediary to its creditors have the priority recognised in Article 20. This safeguard applies to both paragraphs of Article 20: paragraph 1, which contains a reference to the non-Convention law, and paragraph 2, which establishes a uniform rule in favour of the creditors *vis-à-vis* the rights of the account holders. Also, it applies irrespective of the arrangements made by the intermediary at the upper-level, i.e., it applies, for example, even if the securities are segregated at the upper-level and the intermediary grants an interest over the securities credited to the securities account of its account

holders insofar as the creditor satisfies the test laid down in Article 20 (see the commentary on Article 20).

EXAMPLE 25-3: IM 1 has two account holders, X and Y. Each of them has 100 ABC shares credited to its securities account. IM 1 holds 200 shares with an upper-tier intermediary, IM 2. A third party, Z, gives a loan to IM 1 and IM 1 grants a security interest under Article 12 over the 200 ABC shares that IM 1 is holding through IM 2, for example by a control agreement in favour of Z. Even if IM 1 acted fraudulently, since the 200 ABC shares belonged to its account holders and it was not authorised to use them, Z has priority over the rights of X and Y under Article 20(2) (provided that Z was innocent according to this provision). Hence, the 200 ABC shares held by IM 1 at the upper-tier are not allocated to X or Y insofar as this allocation contravenes the priority rule contained in Article 20. The cross-reference included in Article 25(2) to Article 20 seeks to protect the application of this priority rule.

III-2. Paragraphs 3 and 4

25-14. Different legal systems use different techniques for ensuring that the securities held for account holders are allocated to them and protected from the insolvency of the intermediary. The Convention respects this diversity and remains neutral on this issue. It refers to the non-Convention law for the determination of the precise technique and the procedure to enforce the rights of the account holders. Paragraph 3 sets forth this principle and clarifies that the allocation can be effected *ex lege* or by arrangements made by the relevant intermediary but to the extent required or permitted by the non-Convention law.

25-15. Paragraph 4 contemplates one of the typical methods to ensure the allocation rule: segregation. This method implies that the pool of securities belonging to the account holders are kept distinct from the securities belonging to the intermediary in such a manner as to ensure that the allocation rule laid down by paragraph 1 is fulfilled. The text of the provision distinguishes between securities and intermediated securities held by the intermediary. In the first case, i.e., if the intermediary holds certificates, segregation usually implies a physical separation between the pool of certificates representing the intermediated securities credited to the securities accounts of its account holders and its own securities. In the second case, i.e., if the intermediary holds intermediated securities in a securities account with another intermediary, segregation usually means that there is some kind of identification at the upper level so as to permit us to distinguish between the two groups: the intermediated securities allocated to its account holders and the intermediated securities belonging to the intermediary itself.

25-16. Paragraph 4 also clarifies that the segregation mechanism can take three forms. The segregation mechanism can identify the securities or intermediated securities allocated to (a) all account holders of the intermediary generally; (b) particular account holders; or (c) groups of account holders. An intermediary may combine these mechanisms.

EXAMPLE 25-4: IM 1 has three account holders X, Y, and Z. X is a resident in the jurisdiction of IM 1 and Y and Z abroad. Each of them has 100 ABC shares. IM 1 has the 300 ABC shares through another intermediary, IM 2. According to Article 25(1) these 300 ABC shares are allocated to X, Y and Z. If IM 1 buys 100 additional ABC shares for itself, the segregation mechanism implies a method that permits to separate at the level of IM 2 between the 100 ABC shares belonging to IM 1 itself and the 300 ABC shares belonging to its account holders. This can be carried out by opening two accounts with IM 2: one account in the name and on behalf of IM 1 and the other account in the name of IM 1 but on behalf of its account holders. This second account can be an omnibus account, where

the beneficiaries are the account holders of IM 1 generally; or, for example, it can also be an account where X is identified as beneficiary of 100 ABC shares, and the group of foreign investors (Y and Z) as beneficiaries of 200 ABC shares.

25-17. Segregation is one of the possible methods of complying with the allocation rule stated in Article 25(1). But segregation is not imposed by the Convention. Contracting States remain free to provide for it, either as a regulatory requirement or as a legal mechanism by which the allocation rule is satisfied, or may design other methods.

III-3. Paragraph 5: declaration

25-18. The Convention presupposes that the segregation mechanism is a method of complying with the allocation rule of paragraph 1. But segregation itself cannot be invoked to frustrate that rule. Hence, if an intermediary has not segregated sufficient securities or intermediated securities to satisfy its account holders' rights, the allocation rule extends its application – *ex Conventione* – to the securities or intermediated securities of the same description that the intermediary may hold for itself.

EXAMPLE 25-5: IM 1 has three account holders X, Y, and Z. Each of them has 100 ABC shares. IM 1 has ABC shares through another intermediary, IM 2. At the level of IM 2, IM 1 has two accounts, one for its own benefit and another for the benefit of its account holders. However, by mistake or fraud, in the first account there are 100 ABC shares, and in the second account, there are only 200 ABC shares. In spite of this fact, according to the rule stated in Article 25(1), the 100 ABC shares credited in the first account are allocated to X, Y, and Z: the 100 ABC shares that IM 1 intends to allocate to itself should be deemed to be allocated to its account holders. The segregation mechanism is only a method to ensure the fulfilment of the allocation rule, but it does not have proprietary law effects, i.e., the segregation mechanism cannot contravene the allocation rule.

25-19. Paragraph 5 allows Contracting States to make an exception to this solution by a declaration. Under this provision, a Contracting State can declare that, where all securities and intermediated securities held by an intermediary for its account holders are in segregated form under arrangements such as are referred to in paragraph 4, under its non-Convention law the allocation required by paragraph 1 applies only to those securities and intermediated securities and does not apply to securities and intermediated securities held by an intermediary for itself. This option is conceived for those jurisdictions that draw proprietary-law consequences from the segregation mechanism.

EXAMPLE 25-6: In the former example, if IM 1 has two accounts at the upper-tier level, one for itself with 100 ABC shares and the other for its account holders with only 200 ABC shares, and a Contracting State has made a declaration under paragraph 5, the 100 ABC shares of the former account are not allocated to the account holders. Accordingly, in case of insolvency of IM 1, those shares belong to the insolvency estate and may be realised for the benefit of the unsecured creditors of IM 1. The idea behind this solution is that the segregation of accounts has proprietary-law consequences, and since the 100 ABC shares were not credited to the account opened on behalf of the account holders of IM 1, they never acquired a proprietary right over those shares.

III-4. Paragraph 6: insolvency

25-20. The allocation rule has general application. That is, the securities and intermediated securities held by the intermediary are allocated to its account holders and, therefore, are not

available for the benefit of the creditors of the intermediary, irrespective of whether the issue arises in a pre-insolvency situation (e.g., when a creditor seeks to enforce a judgement against the intermediary) or in an insolvency situation (e.g., when an insolvency trustee seeks to include the securities into the insolvency estate). Paragraph 6 expressly clarifies this latter point. Article 25 applies notwithstanding the commencement or continuation of an insolvency proceeding in respect of the intermediary.

Article 26

Loss sharing in case of insolvency of the intermediary

1. This Article applies in any insolvency proceeding in respect of an intermediary unless otherwise provided by any conflicting rule applicable in that proceeding.

2. If the aggregate number or amount of securities and intermediated securities of any description allocated under Article 25 to an account holder, a group of account holders or the intermediary's account holders generally (as the case may be) is less than the aggregate number or amount of securities of that description credited to the securities accounts of that account holder, that group of account holders or the intermediary's account holders generally, the shortfall shall be borne:

(a) where securities and intermediated securities have been allocated to a single account holder, by that account holder; and

(b) in any other case, by the account holders to whom the relevant securities have been allocated, in proportion to the respective number or amount of securities of that description credited to their securities accounts.

3. To the extent permitted by the non-Convention law, where the intermediary is the operator of a securities settlement system and the uniform rules of the system make provision in case of a shortfall, the shortfall shall be borne in the manner so provided.

Commentary

I. Introduction

26-1. Article 26 provides a loss-sharing rule applicable in the insolvency proceeding of an intermediary. In particular, Article 26 addresses the situation in which there is a discrepancy between the aggregate number or amount of securities allocated under Article 25 and a greater aggregate number or amount of securities actually credited to securities accounts of an account holder, a group of account holders or the intermediary's account holders generally. Article 26 provides a general rule to address this situation, but the rule is subject to any conflicting rule applicable in the insolvency proceeding.

II. History

26-2. A first version of the current provision on loss sharing was set out in the preliminary draft Convention developed by the Study Group. See UNIDROIT 2004 – Study LXXVIII – Doc. 18, Article 16; UNIDROIT 2004 – Study LXXVIII – Doc. 19, p. 33-34.

26-3. During the first session of the CGE, no substantive changes were made to the provision. See UNIDROIT 2005 – Study LXXVIII – Doc. 24, Article 18.

26-4. During the second session of the CGE, the provision was changed so as to reflect that it applies in relation to the insolvency of the intermediary and is subject to conflicting rules in insolvency proceedings. See UNIDROIT 2006 – Study LXXVIII – Doc. 42, Article 20; UNIDROIT 2006 – Study LXXVIII – Doc. 43, sections 122, 186.

26-5. During the third session of the CGE, the provision was restructured, which resulted in the basis of the current text. See UNIDROIT 2006 – Study LXXVIII – Doc. 57, Article 22; UNIDROIT 2007 – Study LXXVIII – Doc. 58, sections 105-109, 157.

26-6. During the fourth session of the CGE (UNIDROIT 2007 – Study LXXVIII – Doc. 94, Article 23) and the first session of the diplomatic Conference (UNIDROIT 2008 – CONF. 11 – Doc. 48 Rev., Article 26), no substantive changes were made.

III. Analysis

(i) Loss sharing: in general

26-7. The interests of account holders that are effective under Article 21 may not be fully protected if the relevant intermediary subject to insolvency proceedings does not have available sufficient securities to satisfy their interests. Article 26(2) addresses that situation. It provides a pro-rata sharing regime for allocating losses to account holders in the relevant intermediary's insolvency proceeding in case of such a shortfall. The sharing rule applies on an issue-by-issue basis to a deficiency of "securities and intermediated securities of any description allocated under Article 25". Where securities of an issue are allocated to only one account holder, however, under paragraph 2(a) that account holder bears the entire risk of the shortfall. In all other cases, paragraph 2(b) provides that the loss is shared among the account holders to whom the securities concerned have been allocated in proportion to the respective number or amount of such securities credited to their respective securities accounts.

26-8. Article 26(1) provides that the Article 26(2) loss sharing rule applies only in an intermediary's insolvency proceeding. It follows that it is not a generally applicable rule that determines the property rights of account holders on a continuous basis, namely, outside the insolvency proceeding of an intermediary. This is consistent with the Convention's functional approach, which generally leaves to the non-Convention law the characteristics and nature of an account holder's property interest.

(ii) Relationship with Article 20(2)

26-9. Article 20(2) awards priority to the qualifying holder of an Article 12 interest granted by an intermediary over the intermediary's account holders. This priority rule is controlling notwithstanding any contrary rule under the law applicable in the insolvency proceeding. Article 26(2) on loss sharing in the intermediary's insolvency proceeding and any such contrary rule under the applicable law apply only after first giving effect to the priority established by Article 20(2).

(iii) Conflicting rules applicable in insolvency proceedings

26-10. In addition to limiting the paragraph 2 loss sharing rule to insolvency proceedings, paragraph 1 also provides that the Convention's loss sharing rule applies "unless otherwise provided by any conflicting rule applicable in that [intermediary's insolvency] proceeding". This carve-out from the loss sharing rule is carefully crafted: "conflicting rule *applicable in* that proceeding" [emphasis added]. This approach is intended to capture the idea that the conflicting rule need not be a part of any insolvency law *per se*. For example, in some States a similar pro rata sharing rule is a principle that is imposed by property law but which is applicable in an insolvency proceeding. In other States a distributional scheme that is quite different from the issue-by-issue pro rata sharing rule applies in insolvency proceedings. Under paragraph 1, the paragraph 2 sharing rule would defer to the conflicting distributional rules.

(iv) Loss sharing: operator of a securities settlement system

26-11. Paragraph 3 applies in the case of an intermediary subject to an insolvency proceeding if the intermediary is the operator of a securities settlement system. If the uniform rules of the securities settlement system determine the results in the event of a shortfall, then, to the extent that the non-Convention law so permits, the solution provided by the rules applies instead of the sharing scheme of paragraph 2.

Article 27***Insolvency of system operator or participant***

To the extent permitted by the law governing the relevant system, the following provisions shall have effect notwithstanding the commencement of an insolvency proceeding in respect of the operator of that system or any participant in that system and notwithstanding any invalidation, reversal or revocation that would otherwise occur under any rule applicable in an insolvency proceeding:

(a) any provision of the uniform rules of a securities settlement system or of a securities clearing system in so far as that provision precludes the revocation of any instruction given by a participant in the system for making a disposition of intermediated securities, or for making a payment relating to an acquisition or disposition of intermediated securities, after the time at which that instruction is treated under the rules of the system as having been entered irrevocably into the system;

(b) any provision of the uniform rules of a securities settlement system in so far as that provision precludes the invalidation or reversal of a debit or credit of securities to, or a designating entry or removal of a designating entry in, a securities account which forms part of the system after the time at which that debit, credit, designating entry or removal of a designating entry is treated under the rules of the system as not liable to be reversed.

Commentary

I. Introduction

27-1. The purpose of Article 27 is to shield the legal effects of certain provisions in uniform rules applied in respect of the operation of securities settlement systems (“SSSs”) and securities clearing systems (“SCSs”) against adverse consequences of an insolvency of the system operator or a system participant. For the definitions of SSSs and SCSs, see the commentary on Articles 1(n) and 1(o).

27-2. More specifically, Article 27 addresses those provisions in the uniform rules of a SSS or SCS concerning the irrevocability of instructions for dispositions of intermediated securities or payments related to dispositions or acquisitions of intermediated securities. It also addresses those provisions in the uniform rules of a SSS concerning the preclusion of invalidation or reversal of debits, credits, designating entries, or removals of designated entries. For more information on the definition of “uniform rules”, see the commentary on Article 1(p).

27-3. Article 27 provides that, to the extent permitted by the law governing the relevant systems, these provisions in uniform rules are effective notwithstanding (i) the commencement of an insolvency proceeding in respect of the operator of the system or a participant in the system or (ii) that an invalidation, reversal or revocation otherwise would have occurred under a rule applicable in the insolvency proceeding. This protection is necessary because the application of the principles of general insolvency law and of certain principles contained in the present Convention inside an SSS or SCS might lead to inappropriate results.

27-4. Generally, under most insolvency laws, any dealings involving an insolvent person or entity are halted as from the moment of the opening of the insolvency proceeding. Unsettled instructions may be voided or book-entries or designating entries may face the risk to be undone, for purposes of safeguarding assets for the insolvency estate.

27-5. The clearing and settlement of securities within an SSS or SCS are particularly vulnerable to such unwinding. This is because the participants enter instructions into the system which are, however, often processed at a time later in the business day of the system. Consequently, there is frequently a gap between entering instructions into a system and the finalisation of the clearing and settlement process. However, the revocation of instructions once entered may cause huge practical problems, in particular where instructions will be netted, processed in batches or subject to settlement cycles/algorithms. In such instances, the revocation of a single instruction may cause the unwinding of already netted obligations or settled positions of a multitude of participants, with potential systemic consequences. In order to avoid systemic risk, it needs to be ensured that transfer orders entered into a system can be settled and book-entries remain effective regardless of whether a participant or the system operator have become insolvent. This concept is often referred to as “finality”. Note that the term finality is used for a wide variety of meanings, most often denominating a transfer order which is legally binding and enforceable. A transfer of funds, of securities, or of other assets can be final; settlement or netting can be final as well. Finality may also be referred to in a non-legal, purely technical sense as referring to an irreversible entry in an account.

27-6. Against this background, many national laws provide for specific rules or regulations or allow systems to establish internal rules (“uniform rules of the system”) which regulate this case. In particular, these uniform rules make sure that a clearing and/or settlement cycle can be accomplished and the settlement of instructions can take place without the risk of being unwound on the basis of the general insolvency law.

27-7. Article 27 does not provide any rule on the issues in respect of the liability of an intermediary, restitution or other consequences that might result from the operation of the Article. The liability of an intermediary is governed by Article 28(2). Other issues are determined by the non-Convention law.

II. History

27-8. The general substance of what is now Article 27 appeared already in slightly different form in the first draft of the preliminary draft Convention, as developed by the Study Group (see UNIDROIT 2004 – Study LXXVIII – Doc. 18, Article 12). The first session of the CGE brought only minor changes to the provision in order to enhance drafting (see UNIDROIT 2005 – Study LXXVIII – Doc. 24, Article 13). At the second session of the CGE, square brackets indicated that the CGE was unsure whether SSS and SCS needed a different treatment (see UNIDROIT 2006 – Study LXXVIII – Doc. 42, Article 22). At the occasion of the third session of the CGE, the provision was redrafted with a view to better capturing the differing roles of SSS on the one hand and SCS on the other (see UNIDROIT 2006 – Study LXXVIII – Doc. 57, Article 23). The provision remained unchanged at the occasion of the fourth session of the CGE (see UNIDROIT 2005 – Study LXXVIII – Doc. 94, Article 24). The provision was amended in the sense of a clarification at the first session of the diplomatic Conference (see UNIDROIT 2008 – CONF. 11 – Doc. 48 Rev., Article 27).

III. Analysis

27-9. Article 27 prescribes that two different types of provisions contained in the uniform rules of systems shall apply notwithstanding the commencement of an insolvency proceeding in respect of the operator of that system or any participant in that system. The chapeau of the provision sets out the general conditions for upholding such provisions in uniform rules, whereas paragraphs (a) and (b) describe the two types of provisions. Article 27 does not prescribe a specific wording or content of such provisions.

III-1. Chapeau

"to the extent permitted by the law governing the relevant system"

27-10. The "law governing the relevant system" is not necessarily the non-Convention law of the forum. This is because there are cases where the law governing the system internally is not identical to the law under which the system or its operator is established. These laws may coincide, but not necessarily.

EXAMPLE 27-1: The two systems operated by Euroclear UK & Ireland Limited (formerly CRESTCo – a single legal entity established in the UK and incorporated under English law), namely the system for UK securities (the CREST UK system) and the one for Irish securities (the CREST Irish system), provide the best such example.

In the UK and Ireland, it is a legislative instrument (and not a contractual instrument) that primarily supports the "execution" of securities transfer orders in relation to securities constituted under UK law and Irish law respectively. The law that is applicable to those legislative instruments is properly considered to be the law governing the respective systems, rather than the law governing the contractual rules to which the members of the system are subject in their relationship with the operator.

27-11. The term “to the extent” indicates that the law governing the system determines both the question whether provisions in terms of paragraphs (a) and (b) can be established at all, and, in the affirmative case, how far these provisions can reach.

EXAMPLE 27-2: The law governing the system may permit a provision according to which instructions entered into the system and deemed to be irrevocable following the uniform rules of the system shall apply notwithstanding the commencement of an insolvency proceeding in respect of the operator of that system or any participant in that system. However, the law governing the system may stipulate that a revocation is possible nevertheless in case of criminal offences or fraud.

27-12. The term “relevant” is used in the chapeau of Article 27 in its natural meaning, not pointing to a defined term like “relevant intermediary” (see Article 1(g)). The word “system” is not defined in Article 1; it intends to cover both SSSs and SCSs in the meaning of the present Convention (see the commentary on Articles 1(n) and 1(o)).

“the following provisions shall have effect”

27-13. This phrase relates to the rules in paragraph (a) and (b). The wording appears to be somewhat ambiguous, because it is not the provisions of (a) and (b) that shall have effect *themselves* but provisions contained in the uniform rules of a system the content of which reflect what is described in (a) and (b).

“notwithstanding the commencement of an insolvency proceeding”

27-14. The term “insolvency proceeding” is defined in Article 1(g).

“in respect of the operator of that system or any participant in that system”

27-15. The terms “operator” and “participant” in a system are explained in the commentary on Articles 1(n) and 1(o). Article 27 provides for insolvency protection of instructions and resulting dispositions both against the insolvency of a system participant or the system operator.

“and notwithstanding any invalidation, reversal or revocation that would otherwise occur under any rule applicable in an insolvency proceeding”

27-16. The provisions described in Articles 27(a) and 27(b) apply in the cases of insolvency of a system participant or the system operator, even if rules applicable in such insolvency proceedings would otherwise result in a revocation of an instruction or an invalidation or reversal of book entries in the system.

III-2. Paragraph (a)

27-17. Paragraph (a) defines the first category of provisions in the uniform rules of both SSSs and SCSs protected by Article 27. These provisions have to be designed to prevent the revocation, by the insolvency law, of instructions entered into the system by a participant and considered to be irrevocable at a moment in time determined by the uniform rules of the system. However, the provisions are only upheld to the extent (“in so far as”) they are within the described scope of paragraph (a).

27-18. Paragraph (a) relates to provisions in uniform rules which protect two types of instructions: first, instructions for the making of a disposition of intermediated securities; and second, instructions for making a payment relating to an acquisition or disposition of intermediated securities. It is only exceptionally that the text of the Convention addresses issues of payments. In the present context, this reference is necessary, as both the “securities leg” and the “cash leg” of a transaction may be dependent on each other during clearing and settlement in most SSSs and SCSs. If only the securities leg was protected but not the cash leg and the latter could actually be revoked, the provider of the securities and receiver of the cash payment would be exposed to the insolvency risk of its counterpart, thus undermining the overall soundness of the transaction.

27-19. Note that typically, where a securities transfer is linked to a simultaneous payment, the underlying mechanism is called “delivery versus payment” or DvP. In such scenario, one party (usually the seller) transfers securities to another party (usually the buyer) and the latter transfers cash (i.e., the purchase price) to the first, whereby the exchange of securities and cash occurs simultaneously. In this case, the cash accounts, on which the cash leg of the securities transaction is being executed, may be maintained by the national central bank in the country of the respective system (settlement in central bank money), by the entity operating the SSS or by a settlement bank.

27-20. The reference in paragraph (a) to “instruction” should be given a wide interpretation. It is intended to embrace any agreed form of communication to or with an SSS or SCS pursuant to which a disposition of intermediated securities is to be made or pursuant to which a payment relating to the acquisition or disposition of intermediated securities is to be made.

EXAMPLE 27-3: Data relating to a disposition or payment entered into a system directly by means of a remote computer terminal or transmitted in bundled form in a data file contained on an electronic storage device can constitute an instruction.

27-21. Similarly, the references in paragraph (a) to “revocation” and “entered irrevocably” should be given wide interpretations. Revocation refers to the unilateral revocation of an instruction properly given to a system so that it would not be followed or would be removed from the system. The present Convention does not differentiate between revocations by the instructing participant and those made by any third party. The purpose of paragraph (a) would, however, not be achieved if an instruction that has been entered in a system in accordance with its uniform rules could still be challenged by a third party after the moment in time of irrevocable entry. An instruction entered irrevocably shall result in the instruction being followed within the system at the appropriate time. It is noted that paragraph (a) does not contain any limitation in time of the protection of a instruction once considered irrevocable, e.g., does not require that an instruction is actually executed on the same business day that it has been entered in the system.

27-22. However, the unilateral revocation needs to be distinguished from situations in which an instruction can be cancelled by express agreement by all relevant parties or in circumstances where the system rules as agreed by a participant when joining the system permit the system or its operator to do so. This possibility is needed to preserve a system to function in accordance with its clearing and settlement processes, e.g., by cancelling instructions for which no sufficient securities or cash is available on the participant’s account(s) at the end of a business day.

27-23. Paragraph (a) provides for protection of an instruction following purely objective parameters, i.e., protection is granted if the moment in time of irrevocable entry as defined by the uniform rules of the system precedes the moment of opening of insolvency proceedings. Whether or not instructions entered into a system after opening of insolvency proceedings against a participant but prior to the system or its operator obtaining actual knowledge about such insolvency is a matter not addressed by the present Convention which thus remains subject to the applicable law.

EXAMPLE 27-4: A securities settlement system participant (P-1) entered into the system an instruction for a disposition of intermediated securities by way of a debit to P-1's account and a credit to the account of another system participant (P-2). Under the uniform rules of the system the instruction became irrevocable. Later on the same day, an insolvency proceeding is commenced against P-1. Under the rule applicable in the insolvency proceeding the instruction would not be followed and the disposition would be stayed or enjoined. Under Article 27(a), however, the system rule under which the instruction became irrevocable is effective. Consequently, the instruction will be followed and the disposition will take place notwithstanding commencement of the insolvency proceeding or the revocation that would have taken place as a result of the rule otherwise applicable in the insolvency proceeding.

EXAMPLE 27-5: The facts of Example 27-4 apply except that the relevant system is a securities clearing system. The result in Example 27-4 would not change.

III-3. Paragraph (b)

27-24. Paragraph (b) defines the second type of provisions in the uniform rules of an SSS which are protected under Article 27. Such provisions have to be designed to prevent the invalidation or the reversal of debits and credits in a securities account which forms part of the SSS, equally covering the designating entry or the removal of a designating entry.

27-25. Whereas the uniform system rules which form the object of paragraph (a) deal with instructions aiming at clearing or settlement of a transaction, the provisions addressed under paragraph (b) deal with the acts completing the transaction itself, i.e., the settlement.

27-26. Paragraph (b) is limited to the rules of SSSs because once a debit, credit, designating entry or removal of a designating entry has been effectuated, i.e., when settlement has been completed, rules relating to securities clearing are no longer relevant.

27-27. The protection is granted starting from the moment the uniform rules of the system treat these acts as not liable to be reversed. It will be effective even though subsequently, an insolvency proceeding has been commenced in respect of the system operator or a system participant and even though an invalidation or reversal would have occurred otherwise under a rule applicable in the insolvency proceeding, e.g., as the result of retroactive effects of the opening of insolvency proceedings ("zero hour rules").

27-28. Paragraph (b) provides for protection of book-entries following purely objective parameters, i.e., protection is granted if the moment in time of treating book-entries as not liable to be reversed under the rules of the system precedes the moment of opening of insolvency proceedings. Whether or not book-entries made by a system after opening of insolvency proceedings against a participant but prior to the system or its operator obtaining actual knowledge about such insolvency are protected, is a matter not addressed by the present Convention which thus remains subject to the applicable law.

EXAMPLE 27-6: Various debits and credits were made to the accounts of participants in a securities settlement system between 22:00 and 24:00 on Day 1 and between 00:00 and 03:00 on Day 2, at which time the book entries were not liable to be reversed pursuant to a uniform rule of the system. At noon on Day 2, a system participant (P) commenced an insolvency proceeding. Under the rule applicable in the insolvency proceeding, the debits made to P's system account on the day of commencement of insolvency proceedings may be reversed. Under Article 27(b), however, the system rule that precludes the invalidation

or reversal of the book entries is effective. Consequently, the book entries will not be invalidated or reversed in the insolvency proceeding, notwithstanding commencement of the insolvency proceeding or the reversal that would have taken place as a result of the rule otherwise applicable in the insolvency proceeding.

27-29. The references in that paragraph to “invalidation” and “reversal” should be given wide interpretations. Invalidation and reversal refers to any form of avoidance, cancellation or unwinding of debits, credits, designating entries or removals of designating entries under any rule applicable in an insolvency proceeding.

27-30. The purpose of paragraph (b) would not be achieved if a book-entry could still be challenged in an insolvency situation after having been made in accordance with the uniform rules of an SSS. However, the invalidation and reversal under any rule applicable in an insolvency proceeding needs to be distinguished from situations in which a reversal may be made by a system or its operator in circumstances where the system rules as agreed by a participant when joining the system permit the system or its operator to do so. This possibility is needed to preserve a system to function in accordance with its settlement processes, e.g., by reversing book-entries made by technical mistake or subject to a condition.

27-31. Finally, the protection of Article 27(b) only extends to preventing the invalidation or the reversal of debits and credits, designating entries or the removal of designating entries made in the context of the settlement processes of an SSS. It does not insulate participants from claims for recovery of assets asserted outside of the systems and not interfering with the orderly operation of the systems, e.g., resulting in an unwinding of settlement procedures. Such claims for recovery may still be enforced, e.g., by courts ordering the receiving participant to retransfer such assets.

EXAMPLE 27-7: The facts of Example 27-4 apply. Several months after commencement of the insolvency proceeding P-1’s insolvency administrator brings a lawsuit against P-2 seeking to recover the intermediated securities credited to P-2’s account or the value of the securities under a theory of voidable preference. P-2 defends on the ground that the system rule made the instruction irrevocable and the credit resulting from the instructions is effective. If the insolvency administrator is otherwise entitled to a recovery, then the system rule will not protect P-2 from the administrator’s claim. Article 27 provides finality and certainty for systems for clearing and settlement. But it does not insulate participants from such claims asserted outside of the systems and that would not interfere with the orderly operation of the systems.

Article 28

Obligations and liability of intermediaries

1. The obligations of an intermediary under this Convention, including the manner in which an intermediary complies with its obligations, may be specified by the non-Convention law and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system. If the substance of any such obligation is addressed by any provision of the non-Convention law or, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system, compliance with that provision satisfies that obligation.

2. The liability of an intermediary in respect of its obligations is governed by the non-Convention law and, to the extent permitted by the non-Convention law, the account agreement or the uniform rules of a securities settlement system.

Commentary

I. Introduction

28-1. Article 28 addresses the obligations of an intermediary under the Convention as well as the liability of an intermediary for its failure to comply with those obligations.

28-2. Article 28(1) deals with Convention *obligations*. The first sentence provides that the non-Convention law may specify the content of and the manner in which an intermediary is to comply with its obligations under the Convention. The second sentence provides that an intermediary's compliance with a provision of the non-Convention law that addresses the substance of an obligation under the Convention satisfies the Convention obligation. Both sentences also defer to the account agreement or the uniform rules of a securities settlement system, to the extent that the non-Convention law so permits.

28-3. Article 28(2) deals with the *liability* of an intermediary with respect to its obligations under the Convention. It defers to the non-Convention law as to the intermediary's liability and, to the extent permitted by the non-Convention law, to the account agreement or the uniform rules of a securities settlement system.

II. History

28-4. The draft Convention placed before the first session of the CGE addressed the obligations of an intermediary in Article 2(3) (Article 2 was a predecessor of current Article 9), which addressed only the obligations under that article (i.e., to provide the specified rights to an account holder receiving a credit). The draft that emerged from the first session of the CGE replaced Article 2(3) with Versions A and B of Articles 4(5) and 4(6), again addressing only the obligations under that article. See UNIDROIT 2004 – Study LXXVIII – Doc. 18, p. 3-4 and UNIDROIT 2005 – Study LXXVIII – Doc. 24, Appendix 1, p. 3-5.

28-5. The draft Convention that emerged from the second session of the CGE is the true predecessor of Article 28. Article 18 of that draft provided:

The obligations and duties of an intermediary under this Convention and the extent of the liability of an intermediary are subject to any applicable provision of the domestic non-Convention law and, to the extent permitted by that law, the account agreement.

See UNIDROIT 2006 – Study LXXVIII – Doc. 42, Appendix 1, p. 14.

28-6. Article 20(1) of the draft Convention produced at the third session of the CGE was similar. In addition to stylistic changes that article added a reference to the uniform rules of a securities settlement system. See UNIDROIT 2006 – Study LXXVIII – Doc. 57, Appendix 1, p. 13.

28-7. Article 25 of the draft Convention produced at the fourth session, and that was considered at the first session of the diplomatic Conference, made no changes to the former Article 20(1). However, it added a second sentence that in substance was quite similar to the second sentence of Article 28(1). See UNIDROIT 2007 – Study LXXVIII – Doc. 94, Appendix 1, p. 13.

28-8. At the first session of the diplomatic Conference, various additional stylistic changes were made. In addition, the article was divided into paragraphs 1 and 2, the former addressing intermediary obligations and the latter addressing intermediary liabilities.

III. Analysis

III-1. Paragraph 1: obligations

28-9. Article 28(1) deals with Convention obligations. The Convention imposes express obligations on intermediaries in the following articles: Article 10 (measures to enable account holders to receive and exercise rights), Article 23 (instructions to the intermediary), Article 24 (holding or availability of sufficient securities), and Article 25 (allocation of securities to account holders' rights). In general, Article 28(1) defers to the non-Convention law with respect to the manner of an intermediary's compliance with its Convention obligations.

28-10. The first sentence of Article 28(1) provides that the non-Convention law may specify the content of and manner in which an intermediary is to comply with its Convention obligations. This is consistent with the Convention's functional approach which identifies the results that an intermediary is to achieve but does not specify the details of how an intermediary is to accomplish those results.

EXAMPLE 28-1: CSD (an intermediary) is located in State X and is the registered owner, on the books of issuers or their transfer agents, of all securities that it holds for its participants (account holders). CSD, consistent with the law of State X, from time to time receives proxy and other voting materials and distributes these materials to its participants. Its participants, in their capacities as intermediaries, pass on these materials to their account holders. CSD and its participants have afforded their respective account holders the opportunity to exercise their voting rights in the manner specified by the non-Convention law of State X and, accordingly, have complied with their obligations in that respect under Article 10(1).

28-11. The second sentence of Article 28(1) provides that an intermediary's compliance with a provision of the non-Convention law that addresses the substance of an obligation under the Convention also satisfies the intermediary's Convention obligation. This provision recognises that the Convention lays down very general obligations and duties that are likely to be the subject of more detailed laws and regulations under the non-Convention law. Moreover, it relieves intermediaries from the prospect of being subjected to a double standard: a treaty standard and the standard provided or permitted under the non-Convention law.

EXAMPLE 28-2: IM is located in State X. The non-Convention law and applicable regulations of State X generally require IM to hold and have available sufficient securities to match the outstanding credit balances of its account holders. However, that law also permits temporary shortfalls in the securities that IM must hold and have available and provides protections for account holders by way of capital and collateral requirements, mark-to-market rules, reporting requirements, etc. Notwithstanding the existence of these shortfalls, IM's compliance with the law of State X constitutes compliance with its obligations under Article 24.

EXAMPLE 28-3: IM is located in State Y. The non-Convention law and applicable regulations of State Y strictly require IM to hold and have available sufficient securities to match the outstanding credit balances of its account holders. IM is not permitted, under penalty of fines and other sanctions, to credit any securities account of an AH unless it holds or has available sufficient securities. If for any reason a shortfall exists, IM is required to enter debits to the securities accounts of its account holders or to acquire additional securities so as to bring the credits into balance within one business day. IM's compliance with the law of State Y constitutes compliance with its obligations under Article 24.

EXAMPLE 28-4: IM is located in State Z. The non-Convention law and applicable regulations of State Z generally require IM to hold and have available sufficient securities to match the outstanding credit balances of its account holders. However, that law also provides that IM may maintain an omnibus account in its name with the CSD in which both IM's proprietary securities and securities allocated to its accounts are maintained. That law also provides that in the event of a shortfall in securities allocated to IM's account holders then IM's proprietary securities will be allocated first to account holder claims as a matter of law. At all times IM maintains securities allocated to account holders and proprietary securities sufficient in the aggregate to match all account holder claims. IM's compliance with the law of State Z constitutes compliance with its obligations under Article 24 (holding sufficient securities) and Article 25 (allocation of securities to account holders).

28-12. Both sentences of Article 28(1) defer to the account agreement and the uniform rules of a securities settlement system to the extent that the applicable law so permits. The agreement or rules would determine the manner of compliance and compliance with the terms of the agreement or rules would constitute compliance with the intermediary's Convention obligations.

EXAMPLE 28-5: IM is located in State X. The non-Convention law and applicable regulations of State X generally require IM to hold and have available sufficient securities to match the outstanding credit balances of its account holders. In the account agreement between IM and AH, AH agrees that IM will have a "right of use" with respect to securities credited to AH's securities account with IM. IM lends securities to a third party thereby creating a shortfall in securities of the description that are loaned. Both AH's agreement and IM's loan of securities are consistent with the law of State X. Because IM is in compliance with the account agreement it is in compliance with Article 24.

EXAMPLE 28-6: IM is located in State X. In the account agreement between IM and AH, IM and AH agree that IM may rely on telephone and email instructions from AH with respect to AH's securities account with IM but also requires IM to provide a written confirmation of its receipt of instructions within three days after receipt. IM's acceptance of and action on such instructions in accordance with the account agreement comply with IM's obligation to act only on AH's instructions under Article 23 (and IM's implicit corresponding obligations under Article 10(1)).

28-13. Note that if a provision of the non-Convention law, account agreement, or uniform rule relating to the subject of a Convention obligation is so contradictory of the Convention obligation, or is so minimal that it amounts to no obligation in substance, then such a provision would not be one that addresses "the substance of any such [Convention] obligation" within the meaning of the second sentence of Article 28(1).

III-2. Paragraph 2: liability

28-14. Article 28(2) deals with the liability of an intermediary with respect to its obligations under the Convention. Like Article 28(1), it defers to the non-Convention law as to the intermediary's liability and, to the extent permitted by the non-Convention law, to the account agreement or the uniform rules of a securities settlement system. Liabilities for non-compliance with a Convention obligation may take a variety of forms under the non-Convention law. These may include such liabilities as civil or criminal fines, civil liability to a government or regulatory authority, or civil liability to an account holder that has suffered damages resulting from the non-compliance.

28-15. As noted above concerning a contradictory or minimalist provision of the non-Convention law for purposes of the second sentence of Article 28(1), if the substance of the non-Convention law, account agreement, or uniform rules is such that there is virtually no material liability at all for non-compliance with a Convention obligation, that result would be incompatible with the Convention.

Article 29***Position of issuers of securities***

1. The law of a Contracting State shall permit the holding through one or more intermediaries of securities that are permitted to be traded on an exchange or regulated market, and the effective exercise in accordance with Article 9 of the rights attached to such securities which are so held, but need not require that all such securities be issued on terms that permit them to be held through intermediaries.

2. In particular, the law of a Contracting State shall recognise the holding of such securities by a person acting in its own name on behalf of another person or other persons and shall permit such a person to exercise voting or other rights in different ways in respect of different parts of a holding of securities of the same description; but this Convention does not determine the conditions under which such a person is authorised to exercise such rights.

Commentary**I. Introduction**

29-1. Article 29 addresses a few issues relating to the position of the issuer of securities held in the intermediated holding system.

29-2. Article 29(1) sets out a minimum standard that is crucial for the effective functioning of the market for publicly traded securities, namely, securities traded on an exchange or regulated market. It must be possible for such securities to be held through intermediaries, i.e., held in the intermediated holding system. Also, a Contracting State must permit the effective exercise of the rights attached to such securities as enumerated in Article 9(1)(a). However, a Contracting State may allow that a certain category or categories of publicly traded securities may be issued on terms that do not require them to be held in the intermediated holding system.

29-3. Article 29(2) addresses a mechanism in which securities may be held by a person who acts in its own name but on behalf of another person or other persons. The purpose of this provision is to ensure the recognition of a so-called nominee holding structure in a cross-border context and, as such, to ensure the interoperability of different systems of holding and trading securities. Recognising nominee holding mechanism includes so-called split-voting arrangements, in which a person acting in its own name on behalf of another person or other persons exercises voting rights in different ways in respect of different parts of its holding of securities of the same description. The same rule applies to other rights, for instance, the rights to receive payments such as interests or dividends. Article 29(2) leaves to the non-Convention law whether certain conditions may be imposed for the rights to be exercised by a person acting in its own name but on behalf of another person or other persons.

II. History

29-4. There was a consensus throughout the negotiation process that the relationship between the account holder and the issuer of the securities should generally be outside the scope of this Convention. It was ultimately agreed that supplying rules with respect to the issuer of securities must be kept to a minimum, even though it is vital to maintain the integrity of the intermediated holding of securities and avoid obstacles for cross-border investment.

29-5. The first version of the provision relating to the position of issuers of securities was drafted by the Study Group. See UNIDROIT 2004 – Study LXVIII – Doc. 18, Article 17, and the explanations set out in UNIDROIT 2004 – Study LXVIII – Doc. 19, p. 34.

29-6. During the first session of the CGE, the provision remained largely the same. See UNIDROIT 2005 – Study LXVIII – Doc. 24, Appendix 1, Article 19; UNIDROIT 2005 – Study LXVIII – Doc. 23 rev., sections 158-161 and 194.

29-7. During the second session of the CGE, the provision was redrafted considerably. The resulting text is the basis of current Articles 29(1) and 29(2). See UNIDROIT 2006 – Study LXVIII – Doc. 42, Appendix 1, Article 13; UNIDROIT 2006 – Study LXVIII – Doc. 43, sections 127-129 and 187.

29-8. During the third session of the CGE, paragraphs (1) and (2) of the provision were refined, and a third paragraph (the basis of current Article 8(1)) was added. See UNIDROIT 2006 – Study LXVIII – Doc. 57, Appendix 1, Article 24; UNIDROIT 2007 – Study LXVIII – Doc. 58, sections 70-77, 159 and 161.

29-9. During the fourth session of the CGE, the interpretation of the provision on the position of issuers of securities was debated, but its text remained unchanged. See UNIDROIT 2007 – Study LXVIII – Doc. 94, Appendix 1, Article 26; UNIDROIT 2007 – Study LXVIII – Doc. 95, sections 199-205.

29-10. In the version submitted to the first session of the diplomatic Conference (UNIDROIT 2008 – CONF. 11 – Doc. 3), Article 29 (then Article 26) and Article 30 (then Article 27) were located in a separate chapter entitled “Relationship with issuers of securities”. During the first session, this separation was removed and these two articles were moved to the end of Chapter IV (see UNIDROIT 2008 – CONF. 11 – Doc. 48 Rev.). But this move was not intended to mean any substantive change with respect to the character and purposes of these two provisions. In addition, during the first session of the diplomatic Conference, Article 26(3) (as it was numbered in UNIDROIT 2008 – CONF. 11 – Doc. 3) was moved to a separate article on the relationship with issuers (see UNIDROIT 2008 – CONF. 11 – Doc. 48 Rev., Article 8(1)). See also the commentary on Article 8.

III. Analysis

29-11. Article 29 and Article 30 apply to matters relating to the issuer. While this Convention generally does not cover the relationship between the issuer and the account holders and those matters are relegated to corporate law or other law (see Article 8), it was felt that Article 29 and Article 30 are necessary minimum provisions in order to ensure the integrity and obtain compatibility of the securities holding systems around the world.

29-12. Article 29 requires every Contracting State to permit publicly traded securities (see below) to be held in the intermediated holding system. Paragraph 1 is the general rule, and paragraph 2 is a supplemental rule, which applies to the intermediated securities held or traded in a cross-border context.

III-1. Recognition of the intermediated holding system: paragraph 1

29-13. It is assumed that every State adopting this Convention has some form of intermediated holding system (i.e., a system of holding securities through intermediaries) for securities that are traded on an exchange or regulated market ("publicly traded securities"). The notion of "exchange or regulated market" is broad and includes traditional exchanges, over-the counter trading systems, multilateral trading facilities, alternative trading systems, and other electronic communication networks. Article 29(1) does not apply to non-publicly traded securities.

29-14. Article 29(1) requires a Contracting State to provide that publicly traded securities in that State may be held in an intermediated holding system in that State.

29-15. However, a Contracting State is not required to force all publicly traded securities to be held in the intermediated holding system, and the terms of the issue of the relevant securities or the articles of incorporation or bylaws of the issuer may provide that they are not held in the intermediated holding system.

EXAMPLE 29-1: X Ltd is incorporated in Contracting State A ("CS A"). Ordinary shares issued by X Ltd are admitted to trading on a regional exchange; preference shares issued by X are not admitted to trading on any exchange or regulated market.

Article 29(1) requires CS A to permit that A's ordinary shares may be held in the intermediated holding system in CS A and may be credited to securities accounts maintained by intermediaries in CS A. CS A may also allow preference shares to be so held and credited, but Article 29(1) does not require this.

Under the Convention, issuer X Ltd may or may not provide in its articles of incorporation or by-laws that its shares (ordinary or preference) are not allowed to be held in an intermediated holding system. Neither Article 29(1) nor the Convention as a whole set any obligation on issuers in this respect. Article 29(1) requires Contracting States to permit all such shares or other securities to be held in the intermediated holding system, but does not require them to mandate that issuers permit them to be so held.

EXAMPLE 29-2: Y SA is not incorporated in CS A, but in another jurisdiction. Y SA has issued bonds whose terms of issue are governed by the law of CS A and such bonds are publicly traded in CS A. Article 29(1) requires CS A to permit that the bonds may be held in the intermediated holding system in CS A and may be credited to securities accounts maintained by intermediaries in CS A. CS A may also decide that such bonds must be held in the intermediated holding system, a policy decision that is neither mandated nor prohibited by the Convention.

29-16. Does Article 29(1) only apply to so-called domestic securities (securities issued by an issuer whose law is the law of the Contracting State referred to in Article 29 or securities of which the terms of issue are governed by the law of that Contracting State) or does it apply to all securities? Paragraph 1 contains no restriction as to the law governing the issue or the issuer and only refers to the fact that the securities are permitted to be traded on an exchange or regulated market ("publicly traded"). Thus, a Contracting State must allow the holding in an intermediated holding system of all securities, domestic or foreign, which are publicly traded in that Contracting State.

29-17. The thinking behind the rule in Article 29(1) is that compatibility of the intermediated system can be achieved around the world by this minimum requirement. Namely, if for instance shares of certain public companies incorporated in one State are held in the intermediated holding system in that State but they (or depository receipts representing them) are traded in another Contracting State without being admitted into the intermediated holding system, this would not be desirable from the standpoint of compatibility among securities holding systems and might become an obstacle for promoting cross-border investment.

EXAMPLE 29-3: Z Ltd. is incorporated in CS C, where its shares are publicly traded and admitted into the intermediated holding system. Its shares are also admitted to trading in a multilateral trading facility (MTF) in CS D.

Article 29(1) requires CS D to permit that Z's shares may be held through intermediaries in CS D. It is important to note that the obligation imposed by Article 29(1) on CS D arises from the admission to trading on an exchange or regulated market in CS D. Absent such an admission, CS D is free to decide whether Z's shares may be admitted in its intermediated holding system or systems.

29-18. For those securities that can be held in the intermediated holding system, a Contracting State must recognise the effective exercise of the rights attached to such securities enumerated in Article 9(1). However, Article 29(1) does not go beyond the matters provided for in Article 9, Article 10 and other provisions in the Convention, and a Contracting State may impose conditions for the exercise of the Article 9(1)(a) rights by the account holder against the issuer by its corporate law or otherwise, since Article 8 is not subject to Article 29(1), while it is subject to Article 29(2) (see the commentary on Article 8).

III-2. Recognition of nominee holding structure and split voting: paragraph 2

29-19. This Convention could stop with paragraph 1, but it further provides a supplemental rule in paragraph 2, which is of particular importance in cross-border situations. The thought is that as a corollary of the recognition of the intermediated holding system, the recognition of so-called nominee holding and split voting (or split exercise of rights) is desirable for promoting cross-border holding and trading of securities.

29-20. The first part of Article 29(2) requires a Contracting State to recognise the so-called nominee holding mechanism. Under such system, a person (nominee) acts in its own name and on behalf of another or other persons (beneficiaries). Article 29(2) does not use the notion "nominee" or "beneficiaries", and rather uses more generic terminology to maintain the Convention's functional and neutral approach. In any case, a Contracting State must recognise a mechanism by which such nominee holds intermediated securities in its own name and on behalf of the beneficiaries.

29-21. In that situation, the second part of Article 29(2) applies, and the Contracting State must permit so-called split voting and a similar mechanism for the exercise of the rights against the issuer. However, the Convention stops here, and does not prevent the Contracting State from providing conditions for such exercise of the rights. For instance, law in a Contracting State may require the beneficiaries names to be disclosed as a condition for permitting split voting by the nominee.

29-22. There may be different systems of recognising the functionally same result of nominee holding and split voting around the world, and a Contracting State is free to name and prepare its mechanism as far as what is described in Article 29(2) in generic terms is obtained.

29-23. Nominee holding and split voting or split exercise of rights in functional terms typically operate in the following way. For instance, A as a shareholder acts for B, C and D in respect of shares of issuer Z. A may vote differently for B, C and D in Z's annual shareholders meeting, according to the instructions it receives from the three investors. Other rights relating to, for example, payments such as interests or dividends may also be carried out in different ways in respect of the different parts of a holding of securities of the same description.

29-24. To the extent that Article 29(2) guarantees the nominee holding structure and split voting or split exercise of rights, it is an exception to the general rule declared in Article 8 that this Convention does not affect any right of the account holder against the issuer of the securities (see the commentary on Article 8).

EXAMPLE 29-4: X Inc. is incorporated in Contracting State A. X's shares are admitted to trading on the national exchange in CS A. The laws of CS A do not allow investors in domestic issuers to hold shares or bonds through nominees. However, a bank incorporated in another country holds shares for several of its customers as nominee, as permitted by the laws and regulations applicable to the bank.

Article 29(2) requires CS A and X Inc. to permit the bank to hold shares as a nominee for investors or beneficiaries. Moreover, the bank must be permitted to exercise split voting in the general assembly of X Inc. For instance, if the bank has 1,000 beneficiaries and 700 want to vote "yes" and 300 "no", then the bank must be permitted to vote "yes" for 700 shares and "no" for 300 shares. Whether the bank is required to exercise this split voting is another issue; it is dealt with by the applicable law, not Article 29.

EXAMPLE 29-5. In the setting of Example 29-4, the Contracting State may impose conditions where the bank exercises the voting right. Note also that the State may require the name of the bank to be recorded on the shareholder register of the issuer (i.e., the bank must be a registered shareholder) for the bank to exercise the voting right. This point is dealt with under Article 8, not Article 29. The "Subject to" wording in Article 8(1) does not prevent such treatment.

29-25. A few questions may arise. For instance, as noted above, a Contracting State (having an intermediated system) is not required to treat securities issued and held in an intermediated holding system in another State to be held in the intermediated system in that Contracting State (unless they are publicly traded in that Contracting State). In this case, if that State does not permit such foreign securities to be held in the intermediated system, is that State required to recognise nominee holding and split voting for such foreign securities? Is it permitted that a Contracting State does not recognise nominee holding or split voting for its domestic securities at all? The answers depend on how to interpret the words "such securities" in Article 29(2). The answer to the first question should be yes. In other words, if certain securities are held in the

intermediated holding system in a State other than a Contracting State, the Contracting State must recognise nominee holding and split voting for those securities even where it does not permit such foreign securities to be held in the intermediated holding system in that Contracting State. The underlying policy is to ensure the compatibility of systems among different States and facilitate cross-border investment. The answer to the second question would be no. A Contracting State must recognise nominee holding or split voting for its domestic securities if they are held by foreign investors in another State.

Article 30 **Set-off**

As between an account holder who holds intermediated securities for its own account and the issuer of those securities, the fact that the account holder holds the securities through an intermediary or intermediaries shall not of itself, in any insolvency proceeding in respect of the issuer, preclude the existence or prevent the exercise of any rights of set-off which would have existed and been exercisable if the account holder had held the securities otherwise than through an intermediary.

Commentary

I. Introduction

30-1. Article 30 deals with one specific question of whether an account holder which holds certain securities for its own account has a right of set-off against the issuer of those securities in the event of the issuer's insolvency. On this question, the Convention takes the approach that there must be no discrimination between non-intermediated and intermediated securities. If a right of set-off would have existed and would have been exercisable in a non-intermediated context, it must exist and must be exercisable where the securities are held in the intermediated holding system.

II. History

30-2. The substance of this provision has not given rise to much debate in the negotiation process.

30-3. The first version of this provision was drafted by the Study Group. See UNIDROIT 2004 – Study LXVIII – Doc. 18, Article 18, and the explanations thereto in UNIDROIT 2004 – Study LXVIII – Doc. 19, p. 34.

30-4. During the first session of the CGE, only small changes were made to the provision. See UNIDROIT 2005 – Study LXVIII – Doc. 24, Appendix 1, Article 20; UNIDROIT 2005 – Study LXVIII – Doc. 23 rev., sections 162-164 and 194.

30-5. Hardly any changes were made to the provision during the second session of the CGE (see UNIDROIT 2006 – Study LXVIII – Doc. 42, Appendix 1, Article 14; UNIDROIT 2005 – Study LXVIII – Doc. 43 rev., sections 130-131), the third session of the CGE (see UNIDROIT 2006 – Study LXVIII – Doc. 57, Appendix 1, Article 25; UNIDROIT 2007 – Study LXVIII – Doc. 58, sections 78-80 and 159) and the fourth session of the CGE (see UNIDROIT 2007 – Study LXVIII – Doc. 94, Appendix 1, Article 27).

30-6. During the first session of the diplomatic Conference, the second paragraph of (then) Article 27, stating that this Convention does not affect any express provision of the terms of issue of the securities, was deleted because it was felt to be unnecessary. See UNIDROIT 2008 – CONF. 11 – Doc. 3, Article 27 and UNIDROIT 2008 – CONF. 11 – Doc. 48 Rev., Article 30.

III. Analysis

30-7. Article 30 provides an equal footing rule between intermediated and non-intermediated holding systems with respect to set-off, but only in the insolvency proceeding with respect to the issuer. This provision shows the minimalist approach and is silent about set-off in other contexts. Thus, this article provides that if the right of set-off were to exist or be exercisable by the account holder against the issuer in the insolvency proceeding with respect to the issuer in case of the non-intermediated holding system in a Contracting State, then such set-off right must exist or be exercisable in case of the intermediated holding system. Article 30 does not cover the right of set-off asserted by the issuer or any situations other than the above.

30-8. For instance, under the non-intermediated system, AH (account holder), who holds a certificate of shares and has rights as a shareholder, may happen to owe obligations to IS (issuer). In this setting, in most jurisdictions, AH may exercise the right of set-off in insolvency proceedings regarding IS if mutuality of the obligations and other conditions are met. If so, such right of set-off would have to be recognised in the jurisdiction if it is a Contracting State, even where the shares are held in the intermediated holding system.

EXAMPLE 30-1. In a Contracting State's intermediated holding system, AH holds bonds through its IM (intermediary) and its bondholder rights against IS are only exercisable through the CSD or the nominee for the CSD (like in many common law jurisdictions). One might say that mutuality of the obligations as a condition for set-off is lost here, because IS owes the obligations against CSD or the nominee for the CSD and AH owes the obligations against IS. In this setting, in insolvency proceedings with respect to IS, AH's right of set-off must be recognised under Article 30.

30-9. The words "of itself" means that Article 30 does not go beyond equal footing between intermediated and non-intermediated holding systems. Thus, Article 30 does not prevent the situation where factors other than the holding pattern itself disallow or limit the right of set-off. For instance, the applicable insolvency law may limit the right of set-off during the suspect period, and if so such law applies. This result is not obtained from Article 7 (general exclusion of insolvency law matters), but from "of itself" under Article 30. In other words, Article 7 provides "unless otherwise provided in this Convention", and Article 30 covers one of the cases on which rules are "otherwise provided in this Convention".

CHAPTER V – SPECIAL PROVISIONS WITH RESPECT TO COLLATERAL TRANSACTIONS

Contents and outline

V-1. *Chapter V* provides a special set of rules with respect to collateral transactions. Most rules in this Chapter are modelled on the European Financial Collateral Directive (European Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements), but they are not identical to the Directive. Contracting States are given the opportunity to make declarations for opting-out of the entire Chapter V or part of it in accordance with Articles 38 and 36(2).

V-2. *Article 31* sets out the scope of Chapter V and provides that the rules in Chapter V set minimum harmonisation standards, in that Contracting States may provide additional rules for protecting the collateral taker. However, Contracting States may not limit the protection of the collateral taker provided by Chapter V. Article 31(3) contains definitions that apply in Chapter V.

V-3. *Article 32* eliminates the risk that an agreement to transfer the full title of collateral will be subsequently characterised as a security collateral agreement. Such a re-characterisation is not allowed and a title transfer collateral agreement takes effect in accordance with its terms.

V-4. *Article 33* provides methods by which a collateral taker may realise or otherwise enforce its interest in collateral securities. It also provides that, upon the occurrence of an enforcement event the relevant obligations of the collateral provider and the collateral taker's obligation to transfer equivalent collateral may be subject to a close-out netting provision. Moreover, it contains provisions intended to ensure that enforcement takes place in an efficient and timely manner.

V-5. *Article 34* deals with a "right of use" of collateral intended to enhance market liquidity and promote secured finance. Such a general right of disposal for the collateral taker under a security collateral agreement must, however, be authorised in the collateral agreement. Article 34 also provides for the collateral taker's obligation to transfer equivalent collateral to the collateral provider.

V-6. In the event of enforcement under Article 33 or calculation of obligations under Article 34, *Article 35* upholds any standard of commercial reasonableness imposed by the non-Convention law.

V-7. *Article 36* protects "top-up" and "substitution of collateral" provisions that are provided in many collateral arrangements against the "timing claw back rule" in insolvency law that is found in some jurisdictions. The delivery of top-up or substitution collateral is not treated as invalid, reversed or declared void solely under certain insolvency provisions, such as the so-called "zero hour rule" by which a declaration of insolvency has retroactive effect to the beginning of the day on which such a declaration is issued, or because collateral was given after the relevant secured obligations were incurred.

V-8. *Article 37* provides protections similar to those provided by Article 36, except that Article 36 relates only to the particular cases of top-up and substitution of collateral. Article 37 applies where Article 36 does not apply.

V-9. *Article 38* sets out a number of possible declarations that a Contracting State may make in respect of Chapter V. A Contracting State may declare that it will not apply Chapter V at all. Where a Contracting State wishes to apply Chapter V, it may nonetheless limit its scope in respect of three specific issues (but only these three issues) mentioned in Article 38(2).

Article 31

Scope of application and definitions in Chapter V

1. This Chapter applies to collateral agreements under which a collateral provider grants an interest in intermediated securities to a collateral taker in order to secure the performance of any existing, future or contingent obligations of the collateral provider or a third person.

2. Nothing in this Chapter impairs any provision of the non-Convention law which provides for additional rights or powers of a collateral taker or additional obligations of a collateral provider.

3. In this Chapter:

(a) “*collateral agreement*” means a security collateral agreement or a title transfer collateral agreement;

(b) “*security collateral agreement*” means an agreement between a collateral provider and a collateral taker providing (in whatever terms) for the grant of an interest other than full ownership in intermediated securities for the purpose of securing the performance of relevant obligations;

(c) “*title transfer collateral agreement*” means an agreement, including an agreement providing for the sale and repurchase of securities, between a collateral provider and a collateral taker providing (in whatever terms) for the transfer of full ownership of intermediated securities by the collateral provider to the collateral taker for the purpose of securing or otherwise covering the performance of relevant obligations;

(d) “*relevant obligations*” means any existing, future or contingent obligations of a collateral provider or a third person;

(e) “*collateral securities*” means intermediated securities delivered under a collateral agreement;

(f) “*collateral taker*” means a person to whom an interest in intermediated securities is granted under a collateral agreement;

(g) “*collateral provider*” means an account holder by whom an interest in intermediated securities is granted under a collateral agreement;

(h) “*enforcement event*” means, in relation to a collateral agreement, an event of default or other event on the occurrence of which, under the terms of that collateral agreement or by the operation of law, the collateral taker is entitled to realise the collateral securities or a close-out netting provision may be operated;

(i) “*equivalent collateral*” means securities of the same description as collateral securities;

(j) “*close-out netting provision*” means a provision of a collateral agreement, or of a set of connected agreements of which a collateral agreement forms part, under which, on the occurrence of an enforcement event, 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:

(i) 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;

(ii) 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.

Commentary

I. Introduction

31-1. Chapter V provides a special set of rules with respect to collateral transactions. Most rules in this Chapter are modelled on the European Financial Collateral Directive (European Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements), but they are not identical to the Directive. Article 31(1) sets out the scope of Chapter V. Article 31(2) shows the position that rules in Chapter V set minimum harmonisation standards, in the sense that Contracting States may provide additional rules of protecting the collateral taker. Article 31(2) does not permit Contracting States to limit the protection of the collateral taker provided by Chapter V. Article 31(3) contains a number of definitions that are relevant in Chapter V. Finally, Contracting States are given the opportunity to make declarations for opting-out of entire Chapter V or part of it in accordance with Articles 38 and 36(2).

II. History

Article 31(1)

31-2. An initial version of Article 31(1) was originally part of the provision on enforcement. See Study LXXVIII – Doc. 13, p. 12; Study LXXVIII – Doc. 18, p. 11; Study LXXVIII – Doc. 24, Appendix 1, p. 16.

31-3. During the second meeting of the CGE, it was put at the beginning of the provision that also contains the definitions. See Study LXXVIII – Doc. 42, Appendix 1, p. 16. It was explicitly intended to apply to both title transfer and security collateral agreements. See Study LXXVIII – Doc. 43, section 189.

31-4. Nonetheless, during the third session of the CGE, the collateral chapter was stated to apply in the case of collateral agreements under which a collateral provider “grants a security interest” in intermediated securities [...]. See Study LXXVIII – Doc. 57, Appendix 1, p. 17.

31-5. The text of the provision was not changed during the fourth session of CGE. It was, however, remarked that the text of the provision should put beyond doubt that it also relates to title transfer collateral agreements (see Study LXXVIII – Doc. 95, section 210).

31-6. As a consequence, the reference to a “security interest” added during the third meeting of the CGE was replaced during the first session of the diplomatic Conference by a reference to an “interest”, so as to clearly reflect the intention to cover both security and title transfer collateral agreements.

Article 31(2)

31-7. Article 31(2) was introduced during the first session of the diplomatic Conference.

Article 31(3)

31-8. Definitions of “relevant collateral agreement” (now: “collateral agreement”), “collateral provider”, “collateral taker”, “collateral securities” and “secured obligations” (now: “relevant obligations”) were already present in the very first draft of the chapter on collateral transactions presented by the Study Group. Originally, they formed part of the provision on enforcement. See Study LXXVIII – Doc. 13, p. 12.

31-9. In a later draft, the Study Group added a special definitional provision mentioning these terms, the content of which was, nonetheless, still explained in the provision on enforcement. Moreover, the Study Group added a definition of “enforcement event”. See Study LXXVIII – Doc. 18, p. 11 and the explanatory note in Study LXXVIII – Doc. 19, p. 34. This approach was maintained during the first session of the CGE (see Study LXXVIII – Doc. 24, Appendix 1, p. 16).

31-10. During the second session of the CGE, however, the definitions were concentrated in one single provision. Whereas the definitions of “enforcement event”, “collateral securities” and “secured obligation” were maintained, those of “collateral agreement”, “collateral provider” and “collateral taker” were temporarily suppressed, only to appear again at the CGE’s third session. For the changes made during the second session of the CGE, see Study LXXVIII – Doc. 42, Appendix 1, p. 16.

31-11. The text emerging from the third session of the CGE shows the list of definitions as it is present in the current text of the Convention. The definitions of “collateral agreement”, “collateral provider” and “collateral taker” reappeared, and new definitions of “security collateral agreement”, “title transfer collateral agreement”, “equivalent collateral” and “close-out netting provision” were introduced. See Study LXXVIII – Doc. 57, Appendix 1, p. 17-18. See also Study LXXVIII – Doc. 58, sections 113, 114 and 184.

31-12. At the fourth session of the CGE, the only change to the definitions was the addition of contingent obligations to the definition of “relevant obligations”, besides existing and future obligations. See Study LXXVIII – Doc. 94, Appendix 1, p. 15 and Study LXXVIII – Doc. 95, section 207.

31-13. During the first session of the diplomatic Conference a minor substantive change was made only to the definition of “enforcement event”, reflecting that such an event could take place not only under the terms of a collateral agreement, but also by the operation of law.

III. Analysis

Article 31(1)

31-14. Article 31(1) sets out the scope of Chapter V on collateral transactions. Chapter V applies to “collateral agreements”, and “collateral agreement” includes both security and title transfer collateral agreements (Article 31(3)(a)-(c)).

31-15. Article 31(1) makes it clear that Chapter V only applies to an interest granted in respect of intermediated securities (defined in Article 1(b)), and not any other assets (unless specified explicitly, as in Articles 34 and 36).

31-16. Article 31(1) also makes it clear that the collateral can secure “the performance of any existing, future or contingent obligation”. These obligations are defined as the “relevant obligations” in Article 31(3)(d).

31-17. The relevant obligations may be owed by either the “collateral provider or a third person”. This means that Chapter V not only applies to the bi-lateral situation where collateral is given to secure the debt owed by the collateral provider, but also covers the situation where collateral is given to secure the debt owed by a third person.

Article 31(2)

31-18. Article 31(2) is a second provision concerning the scope of Chapter V. It is intended to express the minimum harmonisation approach in this chapter. This approach means that by adopting Chapter V, a Contracting State accepts to implement the rules set out in the chapter (subject to opt-out possibilities), but may go further and introduce additional mechanisms of protecting the collateral taker.

EXAMPLE 31-1: State X has the so-called “zero hour rule” stating that the court decision to begin an insolvency proceeding has a retroactive effect back to the beginning of the day when the decision is issued. In line with Articles 36 and 37, State X, by implementing the Convention, excludes the applicability of the zero hour rule in respect of the conclusion of a collateral agreement, the delivery of collateral, top-up collateral or substitute collateral. In addition, however, State X may introduce a rule stating that such events are enforceable even if they are carried out on the day of but *after* the court decision concerning the commencement of the insolvency proceeding, provided that the collateral taker was not aware of such decision. Such an additional rule is allowed under the Convention’s minimum harmonisation approach.

31-19. The idea of minimum harmonisation approach is used in many provisions of the Convention. Article 18 concerning acquisition by an innocent person is another example of this approach. It must be noted that under Article 31(2) Contracting States may provide additional rules of protecting the collateral taker, but Article 31(2) does not permit Contracting States to limit the protection of the collateral taker provided by Chapter V.

Article 31(3)

31-20. Article 31(3) contains a number of definitions specific to Chapter V.

“collateral agreement”, “security collateral agreement” and “title transfer collateral agreement”

31-21. The definitions of “collateral agreement”, “security collateral agreement” and “title transfer collateral agreement” make clear that two types of collateral agreements fall within the scope of Chapter V: security collateral agreements which envisage the grant of an interest in collateral other than transfer of full ownership, such as a right of pledge, and title transfer collateral agreements in which full ownership is transferred to the collateral taker.

31-22. An example of a collateral agreement falling within the scope of these definitions is a repurchase (or commonly known as “repo”) agreement, which involves the sale of securities from seller A to buyer B and a later transfer of equivalent securities for value from B to A. Another example is a securities lending agreement under which borrower A borrows securities from lender B, promising to return those (or equivalent) securities at a later date. (The lender typically obtains a fee or other form of return for lending the securities.) To secure borrower A’s obligation to return the borrowed securities, borrower A provides collateral to lender B. Although this collateral would typically be in the form of cash, in which case this Convention would not apply to such collateral, if the collateral were posted in securities, the agreement governing the provision of such collateral would be covered. This would be true whether or not the agreement provided for a transfer of title to such securities collateral.

"relevant obligations"

31-23. The definition of "relevant obligations" indicates that collateral may be given to secure existing, future or contingent obligations of the collateral provider or a third person. As was stated above, mentioning both the collateral provider and a third person means that collateral given to secure the debt of a third party is covered by Chapter V. A broad terminology including "existing", "future" and "contingent" obligations has been chosen in order to cover differences in terminology in different jurisdictions. For instance, in some jurisdictions future obligations comprise contingent obligations, whereas in other jurisdictions they may be in different categories.

31-24. An example of a contingent obligation is the obligation of a party in connection with a standby guarantee or a letter of credit, where, when the agreement is entered into for collateral, no one knows whether in the future the support device will be called upon. In this case, the obligation to reimburse the party under such standby guarantee or letter of credit arrangement is contingent.

31-25. Under Article 38, a Contracting State can declare that Chapter V does not apply to certain types of relevant obligations.

"collateral securities"

31-26. According to the definition of "collateral securities", only intermediated securities as defined in Article 1(b) fall within the scope of Chapter V. Under Article 38, a Contracting State can narrow the scope of Chapter V by a declaration and specify the type of collateral securities to which Chapter V applies.

"collateral taker" and "collateral provider"

31-27. The definitions of "collateral taker" and "collateral provider" describe the parties to a collateral agreement. These terms may include professional entities such as banks, pension funds and insurance undertakings, but also small- and medium-sized enterprises and natural persons. Under Article 38, a Contracting State can declare that Chapter V does not apply to certain parties to a collateral agreement.

EXAMPLE 31-2: State X has legislation relating to collateral agreements, which does not extend to transactions involving natural persons under the policy that they need special protection. In such case, State X can make use of the opt-out mechanism set out in Article 38 and, by making a declaration, limit the scope of the definitions of collateral taker and collateral provider.

"enforcement event" and "close-out netting provision"

31-28. The definitions of "enforcement event" and "close-out netting provision" are important for Article 33. The definition of "enforcement event" reflects that enforcement may be triggered by any event agreed upon between the parties or by the operation of law. The occurrence of an enforcement event enables the collateral taker to realise its collateral and allows the operation of a close-out netting provision.

31-29. Close-out netting is an enforcement technique which is commonly found in standard documentation used by market participants in order to structure, e.g., repurchase, securities lending and other collateral arrangements. Whereas the repurchase or securities lending agreement itself may contain a close out netting provision, the parties may also agree on a

separate agreement which links different financial products in different agreements to one process of close-out netting.

EXAMPLE 31-3: A typical master repurchase agreement and a typical master securities lending agreement, which are standard agreements to structure repurchase and securities lending arrangements, each contains close-out netting provisions. If two banks have concluded both repurchase and securities lending transactions, they can terminate their relationship under the close-out netting provisions of those agreements separately. However, they may wish these transactions to be all subject to one single close-out netting process. They can reach this goal, for example, by separately concluding a cross-product master agreement, a standard agreement which has been designed for that purpose.

EXAMPLE 31-4: Two banks conclude repurchase and securities lending transactions and wish these agreements to be subject to a single close-out netting process. They can reach this goal by concluding a multi-product agreement covering both repurchase and securities lending transactions and including a close out netting mechanism for all of these transactions.

31-30. While the agreement pursuant to which collateral provided in certain securities lending transactions could be covered by this provision, it does not govern the treatment of the securities being loaned under a securities lending transaction. As noted above, a collateral agreement associated with a securities lending transaction would only be covered by this provision if the subject collateral is itself securities.

31-31. The definition of close-out netting has been phrased in a broad manner, so as to cover different national legal approaches, for example, set-off, novation or other doctrines.

"equivalent collateral"

31-32. The definition of "equivalent collateral" is, in particular, relevant to determine the collateral taker's obligations in the case of close-out netting (see Article 33(2)) and where the "right of use" under a security collateral agreement is exercised (see Article 34).

Article 32

Recognition of title transfer collateral agreements

The law of a Contracting State shall permit a title transfer collateral agreement to take effect in accordance with its terms.

Commentary

I. Introduction

32-1. Article 32 eliminates the risk of so-called re-characterisation, i.e., the risk that an agreement to transfer the full title of collateral is subsequently characterised as a security collateral agreement. Article 32 makes it clear that such re-characterisation is not allowed and that a title transfer collateral agreement takes effect in accordance with its terms.

II. History

32-2. The provision regarding the recognition of title transfer agreements was added during the third session of the CGE. Originally, it also contained a second paragraph relating to the enforcement of title transfer collateral agreements by way of close-out netting. See Study LXXVIII – Doc. 57, Appendix 1, p. 18 and Study LXXVIII – Doc. 58, sections 123-127 and 185. The recognition of title transfer collateral arrangements goes back to comments by the International Swaps and Derivatives Association (ISDA). See, notably, Study LXXVIII – Doc. 47, but also earlier submissions by ISDA, such as Study LXXVIII – Doc. 16, section 1 and Study LXXVIII – Doc. 20, p. 8-11.

32-3. No substantive changes were made to the provision at the fourth session of the CGE. See Study LXXVIII – Doc. 94, Appendix 1, p. 16.

32-4. During the first session of the diplomatic Conference, the paragraph relating to the enforcement of title transfer collateral agreements was integrated into current Article 33 on enforcement.

III. Analysis

32-5. The purpose of Article 32 is to eliminate the risk of what is usually referred to as “re-characterisation”, i.e., of a challenge arising from failure to comply with current, generally conservative, legal provisions concerning security interests. This legal risk presents an obstacle to the development of repurchase, or “repo”, transactions (see the description in section 31-22 above) and other forms of collateral transactions based on title transfer.

32-6. Article 32 is intended to eliminate this re-characterisation risk. This means that Article 32 requires a Contracting State to permit the “transfer of full ownership” to be effective under a title transfer collateral agreement. It follows that the Contracting State must give effect to the full ownership of a collateral taker under a title transfer collateral agreement, but nothing more.

32-7. The provision must be read in conjunction with Article 33(2), which confirms that both the secured obligations and the obligation of the collateral taker to return equivalent collateral under the terms of a title transfer collateral agreement may be subject to a close-out netting provision. This aspect is essential because the enforcement of a title transfer collateral agreement usually entails the implementation of a close-out netting provision.

Article 33 Enforcement

1. On the occurrence of an enforcement event:

(a) the collateral taker may realise the collateral securities delivered under a security collateral agreement by:

(i) selling them and applying the net proceeds of sale in or towards the discharge of the relevant obligations; or

(ii) 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 relevant obligations, provided that the collateral agreement provides for realisation in this manner and specifies the basis on which collateral securities are to be valued for this purpose;

or

(b) a close-out netting provision may be operated.

2. If an enforcement event occurs while any obligation of the collateral taker to deliver equivalent collateral under a collateral agreement remains outstanding, that obligation and the relevant obligations may be the subject of a close-out netting provision.

3. Collateral securities may be realised, and a close-out netting provision may be operated, under this Article:

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

(i) prior notice of the intention to realise or operate the close-out netting provision shall have been given;

(ii) the terms of the realisation or the operation of the close-out netting provision be approved by any court, public officer or other person; or

(iii) the realisation be conducted by public auction or in any other prescribed manner or the close-out netting provision be operated in any prescribed manner; and

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

Commentary

I. Introduction

33-1. Article 33(1) sets out three different methods by which a collateral taker realises or otherwise enforces its interest in collateral securities. Where such securities are given under a security collateral agreement, the collateral taker may either sell or appropriate the collateral securities. In the event of a sale, the net proceeds are applied to discharge the relevant obligations, while upon appropriation the value of the collateral securities is applied in or towards the discharge of or set off against the relevant obligations. Appropriation, however, is possible only if it has been agreed upon in the collateral agreement and, in addition, if the agreement sets out the basis on which the collateral securities are to be valued for this purpose. A third method of enforcement that applies to all collateral agreements is the operation of a close-out netting provision (defined in Article 31(3)(j)).

33-2. Article 33(2) elaborates further on Article 33(1)(b) and applies to both title transfer and security collateral agreements. It specifies that, upon the occurrence of an enforcement event, the relevant obligations of the collateral provider and the collateral taker's obligation to transfer equivalent collateral may be subject to a close-out netting provision.

33-3. Article 33(3) guarantees that enforcement takes place in an efficient and timely manner, to the extent specified in that paragraph. The law may not require that prior notice of the intention to enforce be given, that the terms of the enforcement be approved by a court, public officer or other person, or that the enforcement take place in a prescribed manner (e.g., by public auction). Only the parties themselves can agree that such requirements apply to their relationship. Moreover,

according to Article 33(3)(b), the commencement or continuation of an insolvency proceeding relating to the collateral provider or collateral taker is no impediment to enforcement.

II. History

33-4. The issue of enforcement or realisation of interests in securities has been within the scope of the project as of its very start (see Study LXXVII – Doc. 1, section 12), and features in the first preliminary drafts produced by the Study Group (see Study LXXVIII – Doc. 13, p. 12-13 and Study LXXVIII – Doc. 18, p. 11-12). For the Study Group's explanatory notes to the initial enforcement provision, see Study LXXVIII – Doc. 19, p. 35.

33-5. During the first session of CGE hardly any substantive change was made to the enforcement provision. A first attempt was made to simplify paragraph 2 relating to the types of secured obligations. The only new element was that the requirement to realise in a commercially reasonable manner was no longer a Convention standard, but was made optional to Contracting States. See Study LXXVIII – Doc. 24, Appendix 1, p. 16-17 and Study LXXVIII – Doc. 23 rev., sections 170-174 and 194.

33-6. During the second session of the CGE, the first two paragraphs, which had until then formed part of the enforcement provision but did not really fit there, were replaced by the provision on scope and interpretation, and amended or deleted. Moreover, during this session, a provision on enforcement that originally formed part of the right of use provision was integrated into the enforcement provision. See Study LXXVIII – Doc. 42, Appendix 1, p. 17-18 and Study LXXVIII – Doc. 43, sections 145-148 and 190.

33-7. At the CGE's third session explicit references to close-out netting provisions were inserted into the enforcement provision, in particular in light of the extension of the scope of the collateral chapter to title transfer collateral agreements. Moreover, during this session, "close-out netting" was added as a definition. As a result, paragraph 3 of the enforcement provision became superfluous. In addition, the paragraph relating to commercial reasonability was moved to a separate article. See Study LXXVIII – Doc. 57, Appendix 1, p. 18-19 and Study LXXVIII – Doc. 58, sections 115-117, 123-127, 186.

33-8. No substantive changes were made to the provision at the CGE's fourth session.

33-9. During the first session of the diplomatic Conference, current Article 33(2), which originally formed part of current Article 32 on title transfer collateral agreements, was added to the enforcement provision.

III. Analysis

33-10. The purpose of Article 33 is, on the one hand, to specify the rights of the collateral taker on the occurrence of an enforcement event and, on the other, to eliminate obstacles to enforcement that may arise under national legislation, particularly with regard to insolvency proceedings.

33-11. Paragraph 1 specifies the rights of the collateral taker on the occurrence of an enforcement event, which is defined in Article 31(3)(h). For agreements that involve a security interest, subparagraph (a) sets out the rights that the collateral taker may exercise with regard to the collateral securities when an enforcement event occurs.

33-12. Paragraph 1(a) outlines (i) realisation in the strict sense, by selling the collateral securities and (ii) realisation by appropriating the collateral. This provision must be read in conjunction with paragraph 3, which specifies the (very flexible) modalities for exercising these rights.

33-13. As regards realisation in the strict sense, the provision enables the collateral taker to sell the collateral securities and be paid by applying the net proceeds of the sale towards the amounts due. The proceeds of the sale are thus applied in discharge – in some cases partial – of the secured debt. Where the amount of the net proceeds of the sale is higher than the amount of the secured debt, the difference will have to be repaid to the collateral provider.

33-14. Although no prior court approval is required in order to realise the collateral securities (see paragraph 3 below), under Article 35, the non-Convention law may, for example, introduce a *posteriori* control in order to verify whether the collateral taker made an effort to sell the securities at the most advantageous price for the debtor and within the shortest possible time, given the relevant market and the volume of the transactions (see commentary on Article 35 below).

33-15. The second way of realising collateral securities referred to under letter (a) is the *appropriation* of the collateral securities. This manner of realisation is permitted only with the consent of the parties and if the parties have specified the basis on which the collateral securities are to be valued. As in the case of realisation by the sale of the securities, appropriation means applying the estimated value of the collateral securities in or towards the discharge of the secured obligation. Thus, in cases where, in applying the valuation methods agreed by the collateral provider and the collateral taker, the estimated value of the collateral securities exceeds the amount of the secured obligation, the surplus will have to be reimbursed to the collateral provider.

33-16. The purpose of paragraphs 1(b) and 2 of Article 33 is to confirm the availability of close-out netting. Since the definition of a close-out netting provision in Article 31(3)(j) is very broad, encompassing any such provision in a collateral agreement or a set of connected agreements of which a collateral agreement forms part, the scope of paragraphs 1(b) and 2 is likewise very broad. Paragraph 1(b) is a general provision stating that a close-out netting provision – defined in Article 31(3)(j) – may be operated on the occurrence of an enforcement event.

33-17. Paragraph 2 relates to the effectiveness of a close-out netting provision in the specific situation where an enforcement event occurs before the collateral taker has performed its obligation to transfer equivalent collateral under the terms of the collateral agreement. Specifically, this paragraph refers to two scenarios which, in terms of legal drafting, could have been handled under Article 32 on title transfer collateral agreements and under Article 34 on the right to use collateral securities.

33-18. The first scenario is close-out netting that is the intrinsic and popular manner of enforcing a title transfer collateral agreement. The second scenario to which paragraph 2 may apply concerns situations (which are the subject of Article 34) where, in a security collateral agreement, the collateral provider has agreed to allow the collateral taker to use the securities given as collateral, on the condition that it returns equivalent collateral at the latest by the time when the secured obligation is discharged. In this scenario, in order to offset the risk borne by the collateral provider in respect of the collateral taker, paragraph 2 allows for a close-out netting provision to be triggered.

33-19. Paragraph 3 is intended to avoid the obstacles to the realisation of the collateral which traditionally exist in some jurisdictions. It thus complements paragraph 1 as regards the scope of the rights enjoyed by the collateral taker under the terms of a security collateral agreement (paragraph 1(a)) or under a close out netting provision in a security or title transfer collateral agreement (paragraph 1(b)).

33-20. The introductory part of paragraph 3 specifies its scope. Insofar as this paragraph addresses the possibility of realising collateral securities, it applies equally to the securities given under the terms of a title transfer collateral agreement and to those given under the terms of a security collateral agreement. Similarly, this paragraph covers the operation of close-out netting provisions defined in Article 31(3)(j).

33-21. On the substance of the matter, sub-paragraph 3(a) sets out a default rule, which means that the parties to the collateral agreement may provide otherwise and limit the rights of the collateral taker (this is not allowed for under sub-paragraph 3(b)).

33-22. Points (i) to (iii) permit the realisation of collateral securities – according to the methods described in paragraph 1 – without prior notification to the debtor of the secured obligation (or to the collateral provider, if different), without prior approval by a court, a public or ministerial officer or other person, and without the requirement that the realisation be conducted by public auction or in any other prescribed manner.

33-23. The provision thus eliminates the formalism that may traditionally exist in some national laws with respect to the realisation of collateral. The provision applies the same approach to close-out netting provisions.

33-24. Paragraph 3(b), moreover, provides that realisation as well as the implementation of a close-out netting provision takes effect notwithstanding the opening of an insolvency proceeding that affects the collateral provider or the collateral taker. In the event that the collateral provider is not the same person as the debtor of the secured obligation, although this is not explicit in the provision, realisation should also be possible where the insolvency proceeding involves the debtor of the secured obligation. The definition of an insolvency proceeding (Article 1(h)) includes a reorganisation as well as a liquidation.

Article 34

Right to use collateral securities

1. If and to the extent that the terms of a security 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 delivered (the "original collateral securities") by delivering to the collateral provider, not later than the discharge of the relevant obligations, equivalent collateral or, where the security collateral agreement provides for the delivery of other assets following the occurrence of any event relating to or affecting any securities delivered as collateral, those other assets.

3. Securities delivered under paragraph 2 before the relevant obligations have been fully discharged shall:

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

(b) in all other respects be subject to the terms of the relevant security 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 security collateral agreement.

Commentary

I. Introduction

34-1. In order to enhance market liquidity and promote secured finance, Article 34 envisages a general right of disposal for the collateral taker under a security collateral agreement. Such a “right of use” must, however, be authorised in the collateral agreement. This is because the exercise of such right has an impact on the position of the collateral provider in the sense that, under non-Conventional law, it may lose its (proprietary) interest in respect of the collateral securities and be left with a contractual claim until equivalent collateral is given by the collateral taker.

34-2. Article 34(2) sets out the collateral taker’s obligation to transfer equivalent collateral to the collateral provider. The obligation arises at the moment when the right of use is exercised and should be fulfilled no later than the moment when the relevant obligations are discharged. “Equivalent collateral” is defined in Article 31(3)(i) as securities of the same description as the original collateral securities. Under certain circumstances, the collateral agreement may specify an obligation for the collateral taker to transfer other assets, e.g., in the event where, following a merger or take-over concerning the issuing company, securities of the same description are no longer available.

34-3. If the collateral taker fulfils its obligation under paragraph 2 by transferring the collateral securities before the relevant obligations have been fully discharged, its rights in respect of such securities are upheld. More specifically, paragraph 3 states that the collateral securities transferred are subject to the security interest under the relevant security collateral agreement, in the same manner as the original collateral securities and with retroactive force. Moreover, the securities are also in all other respects subject to the terms of the relevant collateral agreement. This means, for example, that the collateral taker may exercise its right of use in respect of the collateral securities transferred under paragraph 2.

34-4. Article 34(4) makes it clear that the rights of the collateral taker under the security collateral arrangement is not rendered invalid or unenforceable as a result of the exercise of the right of use.

II. History

34-5. Like the issue of enforcement, the “right of use” has been within the scope of the project as of its very start (see Study LXXVIII – Doc. 1, sections 10 and 11), and features in the first preliminary drafts produced by the Study Group (see Study LXXVIII – Doc. 13, p. 13 and Study LXXVIII – Doc. 18, p. 12-13). For the Study Group’s explanatory notes to the initial right of use provision, see Study LXXVIII – Doc. 19, p. 35-36.

34-6. At its first session, the CGE specified the kind of securities or other assets that a collateral taker is obliged to transfer to the collateral provider upon exercise of the right of use (see Study LXXVIII – Doc. 24, Appendix 1, p. 17).

34-7. During its second session, the CGE envisaged a right of use which would arise automatically upon credit of securities to the account of a collateral taker. Moreover, the paragraph on the right of use and enforcement was moved to the article on enforcement. See Study LXXVIII – Doc. 42, Appendix 1, p. 18 and Study LXXVIII – Doc. 43, sections 149-154.

34-8. During the third session of the CGE, the automatic right of use inserted during the third session was deleted. Moreover, it was emphasised that the provision relates to security interest collateral agreements only. In addition, a new definition of “equivalent collateral” made it possible to simplify the right of use provision. See Study LXXVIII – Doc. 57, Appendix 1, p. 19 and Study LXXVIII – Doc. 58, sections 118-120 and 187.

34-9. During the fourth session of the CGE no substantive changes were made to the provision. See Study LXXVIII – Doc. 94, Appendix 1, p. 17.

34-10. During the first session of the diplomatic Conference, the only substantive change made was the deletion of the square brackets in paragraph 2.

III. Analysis

34-11. Certain laws already authorise, to a certain extent, the use by a collateral taker of assets given as collateral under the terms of a security collateral agreement. According to these laws, the parties may agree to derogate from the prohibition against the collateral taker disposing of the assets given as collateral, that is, specifically, against disposing of collateralised assets. The purpose of Article 34 is to offer a more precise framework and protection for reusing securities given as collateral, in order to avoid any possible negative impact on market liquidity and thereby promote a sound “rehypothecation” market, where securities given as collateral remain available in the market place. In addition, permitting the use of securities which are subject to a security interest may lead to the reduction of the cost of secured finance for the debtor. Thus, the right of use is recognised in all situations where securities are given as collateral, for instance, in traditional collateral transactions or in prime brokerage arrangements.

34-12. Paragraph 1 of Article 34 confirms that if and to the extent that the parties to a security collateral agreement so agree, the collateral taker has the right to use the collateral securities as if it were the owner of them. In other words, the collateral taker may sell those securities, lend them, use them as collateral or perform other similar legal actions (namely, any act of “disposal”), on the condition explained below. The right of use may be granted in the context of, for example, securities lending, repurchase and derivatives transactions, or prime brokerage arrangements.

34-13. Paragraph 2 imposes on the collateral taker the obligation to return equivalent collateral or other assets if so provided in the agreement, by the time of the discharge of the secured obligation. Specifically, where the collateral taker exercises its right of use, paragraph 2 obliges the collateral taker to replace the collateral securities originally delivered (the “original collateral securities”) by delivering equivalent collateral to the collateral provider, not later than the discharge of the relevant obligations. Alternatively, where the security collateral agreement provides for the delivery of other assets following the occurrence of any event relating to or affecting any securities delivered as collateral, the collateral taker is obliged to deliver those other assets. An example of such an event is the extinguishment of shares as a result of a merger of the issuer company.

34-14. If an enforcement event occurs while any obligation of the collateral taker to deliver equivalent collateral (equivalent securities or “other assets”) under a collateral agreement remains outstanding, Article 33(2) applies. In such situation, the collateral taker's obligation to deliver

equivalent collateral and the relevant obligations may be subject to a close-out netting provision. If the value of the equivalent collateral which should have been delivered is higher than that of the relevant obligations, the collateral provider may suffer a loss.

EXAMPLE 34-1: A credit line was granted by bank X to company Y, and Y received an advance of amount 100, repayment of which is due on D+90. As collateral for the sums advanced in this line of credit, X was granted a pledge of securities credited to Y's securities account maintained by intermediary Z. The portfolio of pledged securities consists of bonds issued by company M and of shares issued by companies P, Q and R in equal proportion and for the total value of 120. The collateral agreement stipulates that the creditor/pledgee may use the pledged securities and lays down the manner in which equivalent securities are to be returned.

On D+25, X uses, of the securities pledged, securities consisting of shares for the value of 90, and lends them out to one of its customers. At the latest on D+90, X must, in accordance with the collateral agreement, return equivalent securities, to Y. Once equivalent securities are back in Y's securities account, they will serve as collateral as if there had been no interruption relating to the pledged securities. Should X fail to return equivalent securities to Y's securities account by D+90, the value of the collateral, calculated according to the close-out netting provision set out in the collateral agreement, will be applied to the advance of 100 (i.e., the amount of credit extended by bank X).

If all the 120 securities have been disposed of by X on D+25 and X fails to return equivalent securities, Y is left with a contractual net claim of 20 (after 100 is netted out).

34-15. Paragraph 3 sets out the principle that collateral securities delivered under paragraph 2 follow the same legal regime as the securities initially given as collateral. By explicitly stipulating this subrogation, the provision prevents, among other things, the possibility of a challenge based on the assertion that this is new collateral and a security interest in it has become effective at the time of the delivery of it, for instance, for determining the priority of such interest.

34-16. Paragraph 4 explicitly provides that the use of collateral securities shall not render invalid any right of the collateral taker. The latter thus retains its rights, even if it temporarily no longer holds the securities that were initially given to him as collateral. The Convention thus neutralises the provisions of national legislation that often require that collateralised assets must remain in the possession of the collateral taker or of a person designated by the parties for this purpose (designated third party).

34-17. Finally, under Article 35, courts may be empowered, under the non-Convention law, to exercise *a posteriori* control of the conditions for valuing the collateral and the secured obligations.

Article 35

Requirements of non-Convention law relating to enforcement

Articles 32, 33 and 34 do not affect any requirement of the non-Convention law to the effect that the realisation or valuation of collateral securities or the calculation of any obligations must be conducted in a commercially reasonable manner.

Commentary

I. Introduction

35-1. The non-Convention law may contain a standard of commercial reasonableness where a right in respect of collateral securities is enforced or where the obligations between the parties are calculated. Such a standard is upheld under Article 35 in the event of enforcement under Article 33 and the calculation of obligations under Article 34.¹⁰

II. History

35-2. The requirement to act in a commercially reasonable manner has been in the Convention since its first preliminary draft was presented by the Study Group (see Study LXXVIII – Doc. 13, p. 13 and Study LXXVIII – Doc. 18, p. 12), but originally it was part of the provision on enforcement.

35-3. At the first session of the CGE, the draft provision was refined. In particular, it was made clear that the requirement to act in a commercially reasonable manner is optional to Contracting States (see Study LXXVIII – Doc. 23 rev., section 174 and Study LXXVIII – Doc. 24, Appendix 1, p. 17).

35-4. During the second session of CGE, no substantive change to the provision were made.

35-5. At its third session, the CGE decided that the provision relating to commercial reasonableness should no longer be part of the enforcement provision, but should be a separate article. As such, the provision could not only be applied to the enforcement provision (then: Article 28), but also to the enforcement section of the new article relating to the recognition of title transfer arrangements (then: Article 27) and to the calculation of obligations in the event of a right of use (then: Article 29). See Study LXXVIII – Doc. 57, Appendix 1, p. 20.

35-6. The CGE made no substantive changes to the provision at its fourth session. During the first session of diplomatic Conference, no substantive changes were made either.

III. Analysis

35-7. Articles 33 and 34 contain rules on enforcement and right of use, and the rights of a collateral taker under these articles apply despite any contrary rule in the non-Convention law. In other words, the non-Convention law cannot change Articles 33 and 34. However, Article 35 contains a restriction to this principle. Article 35 upholds requirements in the non-Convention law that the realisation or valuation of collateral securities or the calculation of any obligations must be conducted in a commercially reasonable manner even if it may result in some limitation of the collateral taker's rights under Articles 33 and 34.

35-8. Article 35 itself does not provide what exactly the requirements are for acting in a "commercially reasonable manner". Such requirements are expected to be provided by the non-Convention law.

¹⁰ *Note of the Editors:* the reference to Article 32 is no longer correct since the reference to close-out netting provisions and their operation has been moved to Article 33 during the first session of the diplomatic Conference. The Editors have therefore suggested a revision of the Convention text. See CONF. 11/2 – Doc. 6, section 7.

35-9. Other requirements in the non-Convention law are not within the scope of Article 35. For instance, a requirement in the non-Convention law that obliges the collateral taker to give notice to the collateral taker prior to enforcement is not covered by Article 35 as such rule is not a requirement to ensure that realisation of collateral is conducted in a commercially reasonable manner. The same is the case with respect to, for instance, a requirement under the non-Convention law that a collateral taker is not permitted to realise collateral by appropriation. On the other hand, a requirement in non-Convention law that in case of appropriation the valuation of the securities may not differ from the current market price of the securities is a requirement covered by Article 35. Consequently, such requirement in the non-Convention law would apply even if the parties to the collateral agreement have explicitly agreed that the collateral taker can value the securities by the lowest market price within two weeks prior to the appropriation.

35-10. Finally, although this does not follow from Article 35, it should be noted that Articles 33 and 34 (and any other part of Chapter V) are subject to the rules of the non-Convention law on the rights with respect to restitutions, errors or lack of capacity. In other words, enforcement under Article 33 or an exercise of right of use under Article 34 does not preclude any claim based on the non-Convention law regarding restitutions, errors or lack of capacity.

Article 36

Top-up or substitution of collateral

1. Where a collateral agreement includes:

(a) an obligation to deliver additional collateral securities:

(i) in order to take account of changes in the value of the collateral delivered under the collateral agreement or in the amount of the relevant obligations;

(ii) in order to take account of any circumstances giving rise to an increase in the credit risk incurred by the collateral taker as determined by reference to objective criteria relating to the creditworthiness, financial performance or financial condition of the collateral provider or other person by whom the relevant obligations are owed; or

(iii) to the extent permitted by the non-Convention law, in any other circumstances specified in the collateral agreement; or

(b) a right to withdraw collateral securities or other assets on delivering collateral securities or other assets of substantially the same value,

the delivery of securities or other assets as described in sub-paragraphs (a) and (b) of this paragraph shall not be treated as invalid, reversed or declared void solely on the basis that they are delivered during a prescribed period before, or on the day of but before, the commencement of an insolvency proceeding in respect of the collateral provider, or after the relevant obligations have been incurred.

2. A Contracting State may declare that paragraph 1(a)(ii) shall not apply.

Commentary

I. Introduction

36-1. Collateral agreements in many instances contain provisions for “top-up” and substitution of collateral. Top-up refers to the situation where one of the parties to a collateral agreement delivers additional collateral or returns excess collateral in order to ensure that the outstanding obligations of the parties are balanced. An imbalance may occur as a result of price fluctuations in the financial market (see Article 36(1)(a)(i)). An obligation to transfer top-up collateral may also arise when credit ratings change (Article 36(1)(a)(ii)) or in other circumstances specified in the collateral agreement (Article 36(1)(a)(iii)).

36-2. Substitution takes place when one of the parties to a collateral agreement exercises its right to withdraw collateral securities or other assets and to replace them by other securities or assets having substantially the same value.

36-3. The purpose of Article 36 is to protect top-up and substitution arrangements against the “timing claw back rule” in insolvency law that is found in some jurisdictions. Specifically, the delivery of top-up or substitution collateral are not treated as invalid, reversed or declared void solely because such collateral is given during a prescribed period before, or on the day of, but before the commencement of an insolvency proceeding in respect of the collateral provider. Among other things, this means that the so-called “zero hour rule”, by which a declaration of insolvency has retroactive effect to the beginning of the day on which such a declaration is issued, has no effect in this context. Moreover, the delivery of securities or other assets as top-up or substitution collateral is not treated as invalid, reversed or declared void on the sole basis that they were given after the relevant obligations were incurred.

36-4. Since top-up is not undisputed in some jurisdictions if it takes place as a result of deteriorated credit ratings, Article 36(2) gives a Contracting State the opt-out option to declare that it will not apply Article 36(1)(a)(ii).

II. History

36-5. The first version of a provision on top-up or substitution of collateral was devised by the Study Group and occurred in Study LXXVIII – Doc. 18, p. 13. The Study Group’s explanatory notes to this provision can be found in Study LXXVIII – Doc. 19, p. 36.

36-6. At its first session, the CGE developed a first draft of the three instances in which top-up collateral may have to be provided, as currently set out in Article 36(1)(a)(i)-(iii) (see Study LXXVIII – Doc. 23 rev., section 177 and Study LXXVIII – Doc. 24, Appendix 1, p. 18).

36-7. During its second session, the CGE refined its approach in this respect. See Study LXXVIII – Doc. 42, Appendix 1, p. 19 and Study LXXVIII – Doc. 43, sections 155-158.

36-8. At its third meeting, the CGE refined the text relating to the provision of top-up collateral upon, in short, a change of credit rating, by adding objective criteria. Moreover, in respect of this instance of the provision of top-up collateral, an opt-out clause was added. See Study LXXVIII – Doc. 57, Appendix 1, p. 20 and Study LXXVIII – Doc. 58, sections 121 and 189.

36-9. During the fourth session of the CGE and the first session of the diplomatic Conference, no substantive changes were made to the provision.

III. Analysis

36-10. Article 36 contains two rules both of which potentially limit the application of the so-called “timing claw back rule” in insolvency law concerning invalidity, reversibility and avoidance. To that extent, Article 36 overrides insolvency law. In other words, rules in Article 36 fall within “unless otherwise provided in this Convention” in Article 7.

III-1. Rule no. 1: top-up

36-11. For this rule to apply, a collateral agreement as defined in Article 31(3)(a) must exist prior to the delivery of top-up collateral, and the additional collateral must be delivered as a performance of the obligation to do so in the collateral agreement. Note that Article 36 only applies to “additional” collateral. Consequently, Article 36 does not apply in a situation where a lender wishes collateral to secure a loan which was originally made unsecured. This is the case even where the original loan agreement stipulates, for example, that if the borrower’s credit rating drops, the borrower must give collateral.

36-12. Furthermore, even if the collateral is additional collateral, in order for Article 36 to apply *one* of the following three conditions must be fulfilled:

i) The additional collateral is delivered in order to take account of changes in the value of the collateral delivered under the collateral agreement or in the amount of the relevant obligations.

36-13. When determining the changes of the value of the original collateral, the value at the time when that collateral was delivered must be compared to the value of that collateral at the time where the top-up obligation is implemented. Article 36 only applies to additional collateral delivered in order to take account of this change.

EXAMPLE 36-1: A lent EUR 500,000 to B and originally received collateral securities in listed shares in Company AG, Germany, worth EUR 800,000. Later, the value of the shares fell down to EUR 600,000. The collateral agreement prescribes that if the value of the collateral falls 20% or more, additional collateral must be delivered. B delivers additional collateral worth EUR 200,000. This delivery of additional collateral is covered by Article 36(1)(a)(i). If instead B gave additional collateral worth EUR 300,000, the entire collateral worth EUR 300,000 may be additional collateral under Article 36(1)(a)(i) if the collateral agreement provides to that effect. In contrast, if instead the drop of value was not EUR 200,000 but only EUR 100,000, Article 36(1)(a)(i) would not apply, because the fall in value is less than 20% and no obligation under the collateral agreement exists to deliver additional collateral.

36-14. Article 36(1)(a)(i) applies also in the situation where the collateral provider is a company and the collateral consists of its shares (in the setting of EXAMPLE 36-1, where B is Company AG). In such situation, the reason for the drop of the value of the collateral (the shares of the collateral provider company) may often be that the general financial situation of the collateral provider has become worse. In other words, this fact pattern may be covered both by Article 36(1)(a)(i) and Article 36(1)(a)(ii). A Contracting State may declare that the rule in Article 36(1)(a)(ii) does not apply, but even if such declaration has been made, Article 36(1)(a)(i) would still apply in the case of a fall in the value of collateral consisting of shares of the collateral provider company itself.

36-15. Further, Article 36(1)(a)(i) applies where a change in the relevant obligations has occurred (even if there is no change of the value of the original collateral). However, in the context of Article 36, the term relevant obligations must be understood to cover such obligations as secured

by the collateral agreement (and not obligations under an unsecured loan agreement). The value of the relevant obligations must be considered in relation to the value of the collateral securing the obligations. For instance, if both the relevant obligations and the collateral are in the same currency, changes in the exchange rate for that currency against other currencies do not affect the value of the obligations in the context of Article 36. Also, failure of the borrower to pay interests will result in an increase of the relevant obligations but that cannot be considered as a change of the value of the obligations (as these include the obligation to pay interest) and is not within the scope of Art 36(1)(i)(a).

EXAMPLE 36-2: If in Example 36-1 the euro raises against, e.g., the US dollar, this results in no change of the value of the underlying obligation compared to the collateral as both the obligations and the collateral are valued in euro. If instead the loan was not in euro, but instead in US dollars, a raise of the US dollar against the euro would increase the value of the loan and thus justify delivery of additional collateral under Article 36(1)(a)(i), provided that the collateral agreement obliges the borrower to give such additional collateral.

36-16. The rules of Art 36(1)(a)(i) on the changes in the value of collateral and relevant obligations can be applied simultaneously. If at the same time the value of the collateral decreases and the value of the relevant obligations increases, additional collateral given under the collateral agreement to cover the sum of these changes of values would be covered by Article 36(1)(a)(i).

36-17. A Contracting State can declare that Chapter V (including Article 36) shall not apply at all (Article 38(1)), or that Chapter V shall not apply to certain market participants, types of securities or relevant obligations (Article 38(2)), but a State cannot declare that only Article 36(1)(a)(i) shall not apply (Article 36(2)).

ii) The additional collateral is delivered in order to take account of any circumstances giving rise to an increase of the credit risk incurred by the collateral taker as determined by objective criteria relating to creditworthiness, financial performance or financial condition of the collateral provider or other person by whom the relevant obligations are owed.

36-18. Article 36(1)(a)(ii) differs from Article 36(1)(a)(i). It focuses on the general financial condition of the collateral provider (or the borrower, if different) rather than the value of the collateral and the secured obligations. Article 36(1)(a)(ii) applies only where the collateral agreement obliges the collateral provider to deliver additional collateral in such situation. In addition, circumstances for the increase of credit risk must be based on objective criteria relating to creditworthiness, financial performance or financial condition of the collateral provider or other person by whom the relevant obligations are owed. For instance, a change in the credit rating of the collateral provider is an objective criterion within the scope of Article 36(1)(a)(ii) if the rating is made by an independent agency. A decrease of the collateral provider's annual income or its equity is also covered as well as non-compliance with certain financial ratios agreed upon between the parties. If the collateral provider is a listed company, a change in the value of the market price of its shares is within the scope of Article 36(1)(a)(ii), as the value of the company reflects the financial situation of the company. In contrast, subjective criteria are outside the scope of Article 36(1)(a)(ii). It does not apply, for instance, if the collateral agreement obliges the collateral provider to deliver additional collateral when the collateral taker itself considers the financial situation of the collateral provider has changed.

36-19. Even if a criterion is objective, Article 36(1)(a)(ii) applies only where circumstances specifically relate to the collateral provider or another person by whom the relevant obligations are owed. For instance, a collateral agreement that obliges the collateral provider to deliver additional

collateral in the case of an increase of the interest rate of a central bank is not within the scope of Article 36(1)(a)(ii).

36-20. A Contracting State can declare that Article 36(a)(1)(i) shall not apply (Article 36(2)).

(iii) The additional collateral is delivered in other circumstances than mentioned in (i)-(ii), provided the obligation to do so is included in the collateral agreement and this is permitted by the non-Convention law.

36-21. Delivery of additional collateral in any circumstances other than those in (i) and (ii) is protected against the timing claw back rule in insolvency law, if such circumstances are specified in the collateral agreement and it is permitted by the non-Convention law. As noted before, the whole of Article 36(1) overrides insolvency law to the extent that the final clause in Article 36(1) overrides the pure timing claw back rule. Thus, Article 36(1)(a)(iii) means that the pure timing claw back rule applicable in an insolvency proceeding should give way to Article 36(1)(a)(iii) if the obligation under Article 36(1)(a) is otherwise permitted under the non-Convention law.

III-2. Rule no. 2: substitution

36-22. Article 36(1)(b) covers situations where the collateral provider in the collateral agreement has the right to substitute collateral. A right of substitution which is agreed sometime after the original collateral agreement is made, is within the scope of Art 36(1)(b) as it can be viewed as an amendment and thus forms part of the collateral agreement.

36-23. Article 36(1)(b) applies to substitution of collateral securities as defined in Article 31(3)(e) *or other assets* with collateral securities *or other assets*. In principle, substitution of a mortgage in real estate with a security interest in a vessel could be within the scope of Article 36(1)(b). However, Article 36 applies only to a collateral agreement which per definition must include securities (see Article 31(3)(a)). Consequently, if prior to the substitution no securities are given as collateral under the agreement, it is not a collateral agreement under this Convention and Article 36 does not apply.

36-24. Substitution takes place by delivering collateral securities or other assets of substantially the same value. This means that if the substituted collateral is worth 100 and the substituting collateral is worth 100, or 120, substitution is possible. If the substituting collateral is worth 80, substitution is not permitted (unless the substituted collateral can be divided into the part worth 80 and the part worth 20). Article 36(1)(b) is silent about the method for valuation of substituted and substituting collateral, and such method should be determined on the basis of the collateral agreement.

36-25. Article 36(1)(b) does not require that the substituting collateral must be delivered to the collateral taker before the collateral provider withdraws the substituted collateral. A later delivery could happen in the cases of system failure or time-zone differences in cross-border flows of securities. Whether such a difference in timing is allowed should be determined in accordance with the collateral agreement.

36-26. A Contracting State can declare that Chapter V (including Article 36) shall not apply at all (Article 38(1)), or that Chapter V shall not apply to certain market participants, types of securities or relevant obligations (Article 38(2)), but a Contracting State cannot declare that only Article 36(1)(b) shall not apply (Article 36(2)).

III-3. The scope of protection

36-27. Additional (top-up) collateral covered by Rule no. 1 (above) or substitute collateral covered by Rule no. 2 (above) is not treated as invalid, reversed or declared void solely on the basis that the collateral is delivered during a prescribed (“suspect”) period prior to the commencement of an insolvency proceeding in respect of the collateral provider and/or on the basis that the collateral is delivered after the relevant obligations were incurred. The delivery of collateral, which in fact took place on the same day but before the actual commencement of the insolvency proceeding, is covered by Article 36 despite any rule that deems the insolvency proceeding to have begun at the beginning of the day (“zero-hour-rule”). See also Article 37, which sets out a similar rule for more general situations. Article 36 does not cover collateral delivered after the commencement of the insolvency proceeding – even where the collateral taker did not know or ought to have known about the insolvency proceeding. Consequently, the applicable insolvency law decides to which extent collateral delivered after the commencement of insolvency proceedings can be invalidated, reversed or declared void.

36-28. Article 36 only protects against invalidity, reversal and avoidance, which are *solely* based on the collateral being delivered in a prescribed period prior to the insolvency proceeding and/or being delivered after the relevant obligations were incurred. Consequently, the applicable insolvency law may provide that a delivery of collateral may be avoided if the collateral taker knew or ought to have known that the collateral provider was insolvent at the time of the delivery, even if the collateral is top up collateral or substitute collateral. It may also provide for avoidance on the basis, for example, that the delivery was not an ordinary business transaction or that the collateral taker and the collateral provider belong to the same group of companies. In other words, Article 36(1) overrides pure timing claw back rules, but not more.

EXAMPLE 36-3: Collateral provider B delivered collateral to collateral taker A. The collateral is additional collateral covered by Article 36(1)(a)(i). Four weeks later, an insolvency proceeding commenced in respect of B. The applicable insolvency law provides that any delivery of collateral that took place later than three months before the commencement of the insolvency proceeding can be avoided, if it secures previously existing obligations. In addition, the applicable insolvency law provides that any delivery of collateral can be avoided, regardless when it was made, if the collateral is made to secure previous existing obligations and the collateral taker knew or ought to have known that the collateral provider was insolvent at time of the delivery.

Additional collateral most often secures previously existing obligations. The delivery of collateral to A is made in the three-month suspect period. As the collateral is additional collateral covered by Article 36(1)(a)(i), the delivery cannot be avoided solely on the basis that it was made in the suspect period or made in respect of antecedent debt. Consequently, the delivery of the collateral to A which took place four weeks prior to the commencement of the insolvency proceeding in respect of B cannot be avoided. However, if B was insolvent at the time of the delivery and A knew or ought to have known that, the delivery may be avoided under the applicable insolvency law, as one of the grounds for avoidance is that A knew or ought to have known that B was insolvent. In other words, the avoidance is not solely based on the collateral being delivered in respect of an antecedent debt.

Article 37
Certain insolvency provisions disapplied

Where Article 36 does not apply, a collateral agreement or the delivery of collateral securities under such agreement shall not be treated as invalid, reversed or declared void solely on the basis that the agreement is entered into or the collateral securities are delivered during a prescribed period before, or on the day of but before, the commencement of an insolvency proceeding in respect of the collateral provider.

Commentary

I. Introduction

37-1. Article 37 provides that a collateral agreement and the delivery of collateral under such an agreement is not treated as invalid, reversed or declared void on the sole basis that the agreement was entered into or that the collateral was delivered on the day of the commencement of the insolvency proceeding but prior to the order making the commencement, or in a prescribed period prior to that commencement. In other words, such “timing claw back rule” in insolvency law should not affect the validity of a collateral agreement or the delivery of collateral. This means, for example, that the so-called zero-hour rule is disapplied. As noted in the commentary on Article 36 above, such rule gives the order initiating the insolvency proceeding retroactive effect back to the beginning of the day it is issued. For instance, the order is issued at 14.00 o’clock, but is effective as of 00.00 o’clock on that day.

37-2. The rule set out in Article 37 is comparable to that in Article 36(1), but this latter rule relates to the particular cases of top-up and substitution of collateral. Thus, Article 37 applies where Article 36 does not apply.

II. History

37-3. This provision was added during the first session of the diplomatic Conference. See CONF. 11 – Doc. 14, section 8; CONF. 11 – Doc. 41.

III. Analysis

37-4. Article 37 protects a collateral taker against rules in insolvency law that set aside agreements and dispositions merely on the basis that they were entered into or made in a prescribed period prior to the commencement of an insolvency proceeding in respect of the collateral provider. Article 37 refers – similar to Article 36 – to events that take place “during a prescribed period before, or on the day of but before, the commencement of the insolvency proceeding in respect of the collateral provider”. This phrase was discussed in the commentary on Article 36.

37-5. Article 37 has a broader scope of application than Article 36. It covers the collateral agreement as such and any delivery of collateral under the collateral agreement, whereas Article 36 only covers the delivery of additional (top-up) and substitute collateral.

37-6. The scope of protection granted by Article 37 is, however, also narrower than that by Article 36. Both Articles provide protection against invalidity, reversal and avoidance, but Article 37 merely protects against such actions if they are made solely on the basis that the agreement or the

delivery of collateral was made within a certain period prior to the commencement of the insolvency proceeding, whereas Article 36 also protects against such actions where they are made on the basis that the delivery of collateral took place after the relevant obligations were incurred. The reason for this difference is that securing an antecedent debt is particularly relevant in the context of top up and substitution arrangements.

EXAMPLE 37-1: The collateral agreement between collateral provider B and collateral taker A gives B the right to substitute the collateral securities. B exercises this right and substitutes the collateral. At the same time, B accepts an offer from A to get an increased loan against the delivery of further collateral securities. The majority of these further securities are delivered in the morning and B instructs its intermediary to deliver the remaining of these further securities later that day. Before B's intermediary is able to carry out this instruction, an insolvency proceeding is commenced in respect of B. However, as B's intermediary is unaware of this, the intermediary on behalf to B delivers the remaining securities to A, who is also unaware of the insolvency proceeding.

According to the applicable insolvency law any delivery of collateral made later than one month before the commencement of the insolvency proceeding is avoidable, if the collateral secures previously existing debt. In addition, according to the applicable insolvency law all transactions made on the day of the commencement of the insolvency proceeding are invalid.

With respect to the substitution of the collateral, Article 36 protects substitution against both types of avoidance claim identified. The same protection would not have been provided under Article 37, if it would have been applicable, because of its more limited scope. Namely, Article 37 does not protect A against avoidance as the avoidance claim is not solely based on the fact that the substitute collateral was delivered later than one month before the insolvency proceeding, but also on the fact that the collateral secures the previously incurred obligation.

With respect to the delivery of the further "new" securities, these are made on the day of the commencement of the insolvency proceeding in respect of B and thus invalid under the applicable insolvency law. However, as the first part of these further securities was delivered in the morning prior to the commencement of the insolvency proceeding, A is protected under Article 37 against invalidity of this delivery. It is noted that this result does not follow from Article 36(1)(a), as the "new" securities are not additional collateral within the meaning of Article 36. The second part of the further "new" securities was delivered after the commencement of the insolvency proceeding. Consequently, this part of the delivery is not covered under Article 37 (or Article 36).

Article 38

Declarations in respect of Chapter V

- 1. A Contracting State may declare that this Chapter shall not apply.**
- 2. A Contracting State may declare that this Chapter shall not apply:**
 - (a) in relation to collateral agreements entered into by natural persons or other persons falling within such categories as may be specified in the declaration;**

(b) in relation to intermediated securities which are not permitted to be traded on an exchange or regulated market;

(c) in relation to collateral agreements which relate to relevant obligations falling within such categories as may be specified in the declaration.

Commentary

I. Introduction

38-1. Article 38 sets out a number of possible declarations that a Contracting State may make in respect of Chapter V, in addition to the declaration option envisaged in Article 36(2). Under Article 38(1), a Contracting State may declare that it will not apply Chapter V at all.

38-2. Where a Contracting State wishes to apply Chapter V, it may nonetheless limit its scope in respect of three specific issues (but only these three issues) mentioned in Article 38(2). First, Article 38(2)(a) makes it possible to exclude natural persons or persons in other specified categories. This provision should be read in connection with the definitions of “collateral taker” and “collateral provider” in Article 31(3)(f)-(g), which place no limitations upon the market participants to which Chapter V applies. Secondly, Article 38(2)(b) makes it possible to exclude intermediated securities which are not permitted to be traded on an exchange or regulated market. This provision should be read together with the definition of “collateral securities” in Article 31(3)(e). Thirdly, Article 38(2)(c) permits a Contracting State to specify the categories of relevant obligations that fall within the scope of Chapter V, for instance, only obligations to deliver cash and/or securities. For the definition of “relevant obligations”, see Article 31(3)(d).

II. History

38-3. The first preliminary drafts of the Convention produced by the Study Group already contained a possibility to opt out of the provisions relating to collateral. See Study LXXVIII – Doc. 13, p. 13 and Study LXXVIII – Doc. 18, p. 13. The relevant provisions in these documents correspond essentially to paragraph 1 of current Article 38, but contain the requirement that a declaration be made at the moment of signature, ratification, acceptance, approval or accession. For the Study Group’s explanatory notes, see Study LXXVIII – Doc. 19, p. 37.

38-4. During the first session of the CGE, the requirement specifying the moment at which a declaration should be made was deleted. Furthermore, the CGE added the declaration mentioned in current Article 38(2)(a), by which certain persons can be excluded from the scope of applicability of the Convention. See Study LXXVIII – Doc. 23 rev., sections 171-172 and 194 and Study LXXVIII, Doc. 24, Appendix 1, p. 18.

38-5. At its second meeting, the CGE also included the opt-out possibilities currently set out in sub-paragraphs (b) and (c) of Article 38(2). See Study LXXVIII – Doc. 42, Appendix 1, p. 19 and Study LXXVIII – Doc. 43, section 159.

38-6. No substantive change was made to the provision at the third and fourth sessions of CGE. See Study LXXVIII – Doc. 57, Appendix 1, p. 20 and Study LXXVIII – Doc. 94, Appendix 1, p. 18. Also during the first session of the diplomatic Conference, no substantive change was made.

III. Analysis

38-7. Even though harmonisation of the rules relating to collateral transactions as set out in Chapter V is highly beneficial to ensuring legal certainty with respect to cross border transactions, the proper and sound functioning of the intermediated securities system envisaged in Chapters I-IV as such does not necessarily require the harmonisation of the rules on collateral transactions. Because Chapter V touches upon important public policy issues, notably regarding consumer protection and insolvency, the opt-out possibility set out in Article 38(1) has been introduced, and Contracting States can opt out of the whole of Chapter V.

38-8. The opt-out possibilities envisaged in Article 38(2) are more limited in scope and should be read in close connection with the definitions set out in Article 31(3). No "partial" opt-outs other than those enumerated in Article 38(2) and Article 36(2) are permitted.

38-9. Article 38(2)(a) opens the possibility to protect natural persons or other categories of persons by excluding them from the applicability of Chapter V. Chapter V has the goal of enhancing liquidity in the securities market and, to that end, conveys a number of rights to collateral takers, e.g., in the form of enforcement without traditional procedural safeguards or the right of use. For some jurisdictions, there may be a policy reason that a natural person or another person is in a weak bargaining position against the collateral taker and a level of protection may thus be warranted. Article 38(2)(a) thus gives Contracting States the possibility to provide for such protection. See also Example 31-4.

38-10. Article 38(2)(b) opens the possibility for Contracting States not to apply Chapter V to intermediated securities which are not permitted to be traded on an exchange or regulated market. This provision should be read together with the definition of "collateral securities" in Article 31(3)(e), which covers both tradable and non-tradable securities. The aim of most provisions of Chapter V is to enhance the liquidity of the securities market. This aim can be reached where rules on tradable securities are harmonised, but some jurisdictions may have a valid policy reason for excluding non-tradable securities from Chapter V.

38-11. Article 38(2)(c) should be read in close connection with the definition of "relevant obligations" in Article 31(3)(d), which specifies that relevant obligations are "any existing, future or contingent obligations of a collateral provider or a third person". Because different national policies can exist about what obligations should be secured, Article 38(2)(c) provides a declaration mechanism for Contracting States to limit the scope of Chapter V by specifying to what kind of relevant obligations it applies.

EXAMPLE 38-1: Special legislation relating to collateral transactions in State X defines "relevant financial obligations" as "obligations which are secured by a financial collateral arrangement and which give a right to cash settlement and/or delivery of securities". The scope of this definition is more limited than that of Article 31(3)(d), as the definition in State X does not relate to *any* obligations, but only to the relevant obligations which give right to cash or securities. State X may, in this light, wish to consider whether it makes use of the opt-out possibility set out in Article 38(2)(c).

CHAPTER VI – TRANSITIONAL PROVISION**Contents and outline**

VI-1. *Article 39* provides a transitional provision that deals with priority conflicts between the interests in intermediated securities created and made effective against third parties before and those after the entry into force of this Convention in respect of a particular Contracting State.

Article 39**Priority**

1. This Convention does not affect the priority of interests granted under the law in force in a Contracting State before the date on which this Convention has entered into force in respect of that Contracting State.

2. A Contracting State may declare that a pre-existing interest shall retain the priority it enjoyed before the relevant date only if, at any time before that date, the interest has become effective against third parties by satisfying a condition specified in the declaration made by that Contracting State in accordance with Article 12(5)(a).

3. In this Article:

(a) “pre-existing interest” means any interest, other than a non-consensual security interest, that has been granted before the relevant date other than by a credit to a securities account;

(b) “the relevant date” means the date stated by a Contracting State in the declaration made under this Article and that date shall not be later than two years after the effective date of that declaration.

4. Article 45(6) does not apply to the declaration provided for in this Article.

Commentary**I. Introduction**

39-1. Article 39 is a transitional provision and deals with priority conflicts between the interests in intermediated securities created and made effective against third parties before and those after the entry into force of this Convention in respect of a particular Contracting State. This type of conflict usually arises in respect of the interests granted under the law of a Contracting State and made effective against third parties in accordance with a method which, under Article 19(2), does not provide priority over the interests granted under Article 12 of the Convention.

39-2. The general provision in paragraph 1 provides full grandfathering to such “pre-Convention” interests for an indefinite period of time. Paragraph 2 allows a Contracting State to make a declaration and limit the extent in time of such grandfathering by setting a date (“the relevant date”) after which Article 19(2) will apply to pre-Convention interests.

II. History

39-3. Inter-temporal priority conflicts between Article 12 and Article 13 are the only transitional issue identified by the CGE and the first session of the diplomatic Conference as requiring a transitional provision. The problem was recognised before, and briefly discussed during, the third session of the CGE (UNIDROIT 2006 – Study LXXVIII – Doc. 49, UNIDROIT 2007 – Study LXXVIII – Doc. 58, at sections 51 and 52). Based on inter-sessional consultations, a Working paper on transitional issues (UNIDROIT 2007 – Study LXXVIII – Doc. 84) was submitted to the fourth session of the CGE, which did not arrive at a policy consensus (UNIDROIT 2007 – Study LXXVIII – Doc. 95, sections 83-97). Article 39 was drafted and agreed upon during the first session of the diplomatic Conference itself. See also Study LXXVIII – Docs. 59, 68, 69, 73, 87 and CONF. 11 – Doc. 5 Add.

III. Analysis

III-1. Policy issues

39-4. Article 39 strikes a balance between secured lenders and other beneficiaries who received an interest in intermediated securities before the Convention's entry into force in a Contracting State and those who received an interest thereafter.

39-5. On the one hand, legal certainty requires that, unless it consents, the beneficiary of a collateral interest or other interest in intermediated securities should not face the risk of losing priority, once recognised before the Convention has entered into force, to interests that were subsequently created by the account holder in the same intermediated securities after the Convention has entered into force.

39-6. On the other hand, the international harmonisation promoted by this Convention for the creation of interests in intermediated securities requires that an acquirer of such interest need not investigate about interests that were created, before the entry into force of the Convention and possibly a long time ago, in accordance with a method then recognised by the law of the relevant Contracting State. Article 13 provides that Contracting States may wish to maintain methods that are different from those listed in Article 11 and 12 of the Convention. However, Article 19(2) generally subordinates the interests created in accordance with such methods to the interests created in accordance with Article 12, irrespective of when the latter interests were granted.

39-7. Protecting the beneficiaries of the interests granted before the Convention's entry into force, irrespective of the method used, would require all collateral takers and acquirers of other interests after such date to research whether prior interests have been granted in the same securities under any method that was then applicable in the relevant State. This may be a quite difficult and costly task, given that the current rules governing security interests in many jurisdictions were promulgated a long time ago for movable assets and do not easily adapt to the operation and market practices of intermediated securities. Thus, protecting the priority of all interests acquired before the Convention's entry into force would produce significant inefficiencies and legal uncertainty for the parties who transact on intermediated securities after the Convention's entry into force.

39-8. Conversely, providing full protection to the beneficiaries of the interests created under Article 12 of the Convention would require all beneficiaries of the interests granted before the entry into force of the Convention to verify that their interests will retain their original priority. Any interest that was not granted in accordance with one of the methods elected by the relevant Contracting State in its Article 12(5) declaration would need to be re-established (or reperfected), so as to be effective against third parties under the new rules of the Convention, for example, by

having the account holder and the beneficiary take the steps required by that Contracting State for the granting of new interests.

39-9. The choice between those two opposite policies was warmly debated. The solution reached in Article 39 was inspired by the “opt-in” mechanism adopted in Article 60 of the 2001 Cape Town Convention on International Interests in Mobile Equipment. The priority with respect to the interests granted before this Convention’s entry into force is not affected by the entry into force of this Convention. However, a Contracting State may make a declaration and state a date (“the relevant date”) after which those interests are subject to the priority rules of this Convention.

III-2. Paragraph 1: full grandfathering

39-10. The general rule is that the Convention does not affect the priority of interests granted under the law in force in a Contracting State before the date on which the Convention has entered into force in respect of that Contracting State. Under that law, priority may be based on the respective times when competing interests have been made effective or on some other criteria. It may also be the case that a Contracting State varies its priority rules over time, including at the time it proposes to ratify the Convention. Under paragraph 1, the Convention does not affect such rules in any respect.

EXAMPLE 39-1: The law in State X provides that security interests may be granted and made effective against third parties either by recording the interest in a public registry or by designating the relevant securities in the securities account of the collateral giver. Upon ratifying the Convention, State X has not changed its law in respect of security interests and it has made a declaration under Article 12(5) in respect of designating entries. One year before the entry into force of the Convention, account holder A has granted to bank B a security interest in its securities credited to its account with IM 1 by having that interest recorded in the relevant public registry. One year after the entry into force of the Convention, A is seeking a loan from bank C and proposes to grant to C a security interest in all its securities credited to its securities account with IM 1. Absent a declaration under Article 39(2), C will need to look at the non-Convention law to ascertain the priority of the proposed interest over interests in the same securities created before the entry into force of the Convention. If the non-Convention law gives priority to earlier interests recorded in the public registry, then C will need to verify if a prior interest has been recorded in respect of the same securities account or intermediated securities.

EXAMPLE 39-2: In the setting of Example 1, assuming that C has made a loan after having satisfied itself that A has been fully repaid and therefore that A’s interest is extinguished, C is now confronted with a claim by F, a friend of A, claiming an interest in securities credited to A’s account with IM 1 which was created and publicly recorded three months after the entry into force of the Convention. C may ignore F’s interest because it has been created after the entry into force of the Convention and does not benefit from the grandfathering clause in Article 39(1).

III-3. Paragraphs 2 and 3: option to limit grandfathering in time

39-11. The second paragraph allows a Contracting State to depart from the general rule under paragraph 1 by making a declaration at any time that a “pre-existing interest” will only retain the priority it enjoyed before the entry into force of the Convention if it has been granted by way of a credit to the securities account of the account holder or if it has been made or repeated before “the relevant date” in accordance with the methods elected by that Contracting State under Article 12.

39-12. A declaration made under paragraph 2 cuts off the grandfathering effect of paragraph 1 and restores the Convention-based priority rule of Article 19(2) as of the relevant date. After the relevant date, interests that were created and made effective against third parties in compliance with the law of the relevant Contracting State but not in accordance with the methods elected by that State in its declaration under Article 12(5) will become subordinated to any interest made effective in accordance with the latter methods, unless steps have been taken for the pre-existing interest to conform with Article 12.

39-13. Under paragraph 2, a Contracting State can freely decide if and when it is appropriate to cut off the grandfathering of pre-existing interests. In accordance with Article 45(3) and (5), a Contracting State may make a declaration either at the time it ratifies, accepts, approves or accedes to the Convention, or at any subsequent time. As defined in paragraph 3(b), “the relevant date” may be freely stated by the Contracting State in its declaration provided that it is not later than 2 years after the moment that the declaration becomes effective under Article 45. This allows considerable flexibility to Contracting States in determining how much time market participants need to review existing interests and confirm in the appropriate manner those interests that need to retain their priority over a longer period of time.

EXAMPLE 39-3: In the circumstances set out in Example 39-1, State X has made a declaration under Article 39(2) stating the relevant date to be 1 January 2012. Before that date, bank C and any other person considering taking a collateral interest in the securities credited to A’s account with IM 1 must look at the priority rules in the non-Convention law to determine whether they need to enquire about interests created before the entry into force of the Convention which do not conform with Article 12. As from 1 January 2012, a potential taker of a collateral (or other) interest in the same intermediated securities need only to look at prior interests made effective against third parties in accordance with Article 12. The taker of an interest under Article 12 need not concern itself with interests that may have been granted according to a method recognised by the non-Convention law (see Article 19(2) and 13).

III-4. Scope of declaration under Article 39(2)

39-14. The definition of “pre-existing interest” excludes non-consensual security interests from the operation of Article 39. In accordance with Article 19(5), a non-consensual security interest retains the priority it is given by the applicable law under which it arises.

39-15. The definition of “pre-existing interest” also excludes interests granted by a credit to a securities account because Article 19, dealing with priority among competing interests, only applies to interests granted under Article 12 or Article 13, and not to interests acquired by credit.¹¹

III-5. Paragraph 4

39-16. Declarations made under this article are subject to the general rules on declarations in Article 45. However, Article 39(4) displaces Article 45(6) because otherwise the latter would prevent the retrospective effect of any declaration made under Article 39(2) in respect of pre-existing interests.

¹¹ *Note of the Editors:* the text reflects a contradiction between paragraphs 1 and 2 on one hand and the definition of pre-existing interest in paragraph 3(a) on the other. The Editors have therefore suggested a revision of the Convention text that would address this problem. See CONF. 11/2 – Doc. 6, section 8.