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soumis par le Bureau Permanent

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submitted by the Permanent Bureau

Document préliminaire No 16 de septembre 2002
à l'intention de la Commission spéciale sur les titres intermédiés

Preliminary Document No 16 of September 2002
for the attention of the Special Commission on indirectly held securities

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OPTIONS A AND B IN ARTICLE 4(1)

A BRIEF SUMMARY OF THE RESULTS OF THE DISCUSSIONS AT THE 9 REGIONAL DISCUSSION WORKSHOPS HELD IN ASIA, EUROPE AND NORTH AMERICA THROUGHOUT JUNE AND JULY 2002

Introduction

The purpose of this Memorandum is to *summarise* in broad terms the *discussions held at the Regional Discussion Workshops* on the two Options of Article 4(1) as contained in Preliminary Document No 15 (*i.e.* Option A and Option B). The Memorandum also contains a *new proposal* for Article 4(1) that is intended to take into account the comments made at the Workshops and to reflect the current status of discussions.

Summary of the discussions

Preliminary Document No 15 contains two Options for Article 4(1). While both these Options are based on PRIMA as the unanimously accepted connecting factor, they take different approaches in substantiating it: Option A is simply based on the *law selected by the relevant intermediary and the account holder*, whereas Option B requires this choice of law to designate the *place of the maintenance of the account*. During the Regional Discussion Workshops, Option A was well received and, in general, clearly preferred over Option B. The general sentiment in nearly all of the meetings in Asia, Europe and North America was that Option A would better provide the certainty and predictability sought in this Convention. Option B was viewed as less desirable and potentially problematic for a number of reasons, including the following.[1]

The issue of "second guessing"

First, by requiring that the parties agree on the law of a State "as the State in which the securities account is maintained", there is a high risk that a court might be tempted to investigate whether this condition is fulfilled and to *second guess* whether the account is *really* maintained in the State agreed. If the court holds that this condition is not satisfied, the fallback rule would apply. This might lead to the application of the fallback rule in conceivably a significant number of cases. This, in turn, would be contrary to the unanimous view that the fallback rule should apply in exceptional

[1] As for the discussions at the European meetings in particular, one might add that while in general, a clear preference for Option A emerged, some of the participants at the Frankfurt meeting said they would need more time to reflect on Option A. A clear majority of the participants at this meeting, however, acknowledged the problems underlying Option B summarised in this Memo.

cases only (this is because the fallback rule is not based on the premise to reflect the "reality" of the disposition but rather to give "ultimate certainty"). Thus, it became evident that under Option B, much of the certainty and predictability sought by the Convention would be lost.

Alternatively, if Option B were interpreted to mean that the *account need not actually be maintained* in the place designated, this provision adds nothing to the substantiation of the PRIMA rule and would be superfluous. In light of this, either reading of Option B is quite problematic.

Possible side effects

Secondly, it is unclear what the *possible side effects* of such a designation of the place of the account may be. In particular, concerns were raised that the designation of the place of the account might have significant tax implications leading to unexpected consequences under domestic tax laws. The same argument was also used from the opposite standpoint: it may well be that for tax purposes in particular, parties want an account to be located in a particular State, but do not want the law of that same State to govern the issues mentioned in Article 2(1).

It was clearly agreed that such tax issues and similar side effects should be left out of the scope of the Convention and should not need to be considered in drafting Article 4. This increased the desire for distance from the approach in Option B.

Reference to internal conflict rules in Multi-unit States

Thirdly, Option B would necessarily require a *reference to internal conflict rules* in the clause on Multi-unit States (Prel. Doc. No 15 addresses this issue in Art. 11). This issue may be illustrated by a familiar example discussed at the Special Commission meeting in 2001: an intermediary is incorporated in Delaware, has offices in Ohio but has no physical presence in New York and does not conduct any business from there. The intermediary agrees with an account holder that the issues mentioned in Article 2(1) of the Convention should be governed by the law of New York. Such a result would not be achievable with the sole mechanism of Option B: in the US and likely in many other jurisdictions, parties to an account agreement may not be allowed to or may not be in a position to designate a place where the intermediary has no office and does not conduct any business as the place where the account is maintained. The only possibility to achieve the desired result is to have a provision in the Multi-unit State clause that would point the parties from Ohio – *i.e.* the place where according to their agreement the account is located – to New York. The mechanism to achieve this *internal renvoi* is to apply the internal conflict rules of Ohio. This mechanism, however, has been criticised as too complex by many experts; in addition, its design fails to achieve the desired result if there are no internal conflict rules available in the territorial unit designated as the place where the account is maintained.

Option A avoids the necessity of referring to internal conflict rules by allowing parties to designate the applicable law of any territorial unit within a Multi-unit State, without having to qualify this territorial unit as the place where the account is maintained. As a result, the approach taken under Option A might lead to the possibility of dropping the reference to the internal conflict rules in Article 11 altogether.

The problem of the "magic words"

In the course of discussions a further problem emerged in relation to *both* Option A and Option B. Under both these Options, the relevant intermediary and the account holder may be required to use *"magic words"* to comply with the requirement that the selected law be the law of the State where the account is maintained (Option B) or the law of State specifically governing the proprietary issues mentioned in Article 2(1) (Option A). If the parties fail to do so, the fallback rule would be triggered and again the certainty sought by the Convention would be lessened.

While in general clearly preferred over Option B, this issue of the "magic words" revealed that Option A might be further improved. Although parties to an account agreement are likely to insert in their account agreement a choice of law clause designating the law applicable to the *contractual* issues of their agreement, in practice it is rather unlikely that they would insert a choice of law clause which is specifically designed to apply to the *proprietary* issues mentioned in Article 2(1).

"Option A+": no need for magic words

"Option A+" emerged as an attempt to avoid the complication of the "magic words". Under this slightly revised approach, it is suggested that if a general choice of law clause is used in the account agreement, this should be enough to satisfy the choice of law approach under Article 4(1) of the Convention.

Two different laws for two different issues

However, parties to the custody agreement should still be entitled to specify *different* laws for proprietary and contractual issues. For example, a Spanish intermediary may want to agree with its account holder that the contractual aspects of their agreement are governed by English law, but the proprietary aspects by Spanish law. This freedom would allow the parties to enjoy the advantages of the law they want to govern their contractual obligations, while at the same time avoid any property law concept of that legal order which might be completely unfamiliar to them (such as the English "charge" in the example above).

No *à la carte* approach

Also, during the workshops, it was stressed that it was not desirable for the draft to allow an *à la carte* choice of law, whereby parties to custody agreements select different laws for the different proprietary issues listed in Article 2(1). This ought to be made explicit in the draft Convention.

Agreement in any relevant document

Furthermore, the final provision ought to take into account the situation where the parties do not insert their choice of law clause(s) in the main agreement, but in a side agreement (which is often easier to modify than the main agreement). This point has not been discussed at the Workshops, but it would appear to be too strict an approach to require the parties to insert their choice of law clause(s) into the main account agreement. Therefore, the provision should allow the parties to agree on the applicable law(s) in any relevant document.

The proviso: a simplified draft

Finally, it has also been suggested that the proviso be redrafted so as to ensure that the reference to the "office" only appears once in the introductory words to the proviso, but not in each of its sub-paragraphs. This is not intended to introduce any substantive change in the proviso, but merely to simplify the draft.[2] Also, the proviso has to be drafted in a way that it applies to both situations envisaged by the rule, *i.e.* where the parties have selected one law to govern the account agreement and where they have agreed that the contractual aspects should be governed by one law and the proprietary issues listed in Article 2(1) by another law.

New proposal

In light of these comments, the Permanent Bureau suggests drafting the Article 4(1) as follows:

> *The law applicable to all the issues in Article 2(1) is the law in force in the State agreed by the account holder and the relevant intermediary as governing the account agreement or, if they have agreed that another law is applicable to all such issues, that other law. The law designated under this provision applies only if the relevant intermediary has, at the time of the agreement, an office in that State, which –*

[2] One might point out, however, that under the revisited sub-paragraph c, it is the *office* which is being identified by means of identification, whereas in the original sub-paragraph c, it is the *securities accounts* which are identified by those means. We would be grateful for any comments as to whether this change introduces a substantive modification or not.

(a) effects or monitors entries to securities accounts;

(b) administers payments or corporate actions relating to securities held with the intermediary;

(c) is identified as maintaining securities accounts by an account number, bank code, or other specific means of identification; or

(d) is otherwise engaged in a business or other regular activity of maintaining securities accounts [, whether alone or together with other offices of the relevant intermediary or with other persons acting for the relevant intermediary in that or another State].

This suggested redraft would require a new term – *i.e.* account agreement – to be added to the definition section in Article 1. This definition could read as follows:[3]

"account agreement" means the agreement between the account holder and the relevant intermediary governing the securities account;

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It would be highly appreciated if this new proposal could be taken into consideration by the Member States and observers in their comments on the draft text contained in Preliminary Document No 15.

In order to provide sufficient time to consider this new proposal, please note that the ***deadline for these comments has been extended until the 15 October 2002.***

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[3] It should be noted that the Explanatory Report would explain that the "account agreement" need not be contained in one *single* main document, but may consist of more than one document, including side agreements, which also govern the securities account.