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PROPOSITION DE DISPOSITIONS-CLÉS POUR UNE FUTURE CONVENTION SUR LA LOI APPLICABLE AUX DROITS RÉELS PORTANT SUR DES TITRES INTERMÉDIÉS

Propositions de nouvel amendement au texte contenu dans le Document de travail No 16 de la réunion d'experts de janvier 2001

avec brefs commentaires explicatifs

soumis par le Bureau Permanent

(à désigner « projet annoté de juillet 2001 »)

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TENTATIVE TEXT ON KEY PROVISIONS FOR A FUTURE CONVENTION ON THE LAW APPLICABLE TO PROPRIETARY RIGHTS IN INDIRECTLY HELD SECURITIES

Suggestions for further amendment of the text contained in Working Document No 16 of the January 2001 experts meeting

with brief explanatory comments

submitted by the Permanent Bureau

(to be referred to as the "annotated July 2001 draft")

Document préliminaire No 3 de juillet 2001
à l'intention de la Commission spéciale de janvier 2002

Preliminary Document No 3 of July 2001
for the attention of the Special Commission of January 2002

Bureau Permanent de la Conférence ? Scheveningseweg 6 ? 2517 KT La Haye ? Pays-Bas
Permanent Bureau of the Conference ? Scheveningseweg 6 ? 2517 KT The Hague ? Netherlands

NOTE D'INFORMATION / INFORMATION NOTE

La proposition de texte suivante est un document consolidé reflétant l'état actuel des débats. Il est soumis à tous les Etats membres de la Conférence de la Haye et à tous les observateurs ayant participé au groupe de travail d'experts de janvier 2001. Les Etats membres et les observateurs, de même que toute personne intéressée, sont invités à ***soumettre des observations par écrit au Bureau Permanent (à l'attention de Christophe Bernasconi, Premier Secrétaire, cb@hcch.nl) avant le 1er octobre 2001***. Les notes explicatives relatives au texte proposé ont pour objet d'aider au processus de consultation. Sur le fondement des observations émises, un nouveau projet de texte sera préparé, qui servira alors de document de travail de base pour la réunion de la Commission Spéciale prévue pour janvier 2002.

Les deux rapports suivants servent de documents de référence essentiels :

- *La loi applicable aux actes de disposition de titres détenus dans le cadre d'un système de détention indirecte,* Rapport établi par Christophe Bernasconi, Document préliminaire No 1 de novembre 2000 à l'intention du Groupe de travail de janvier 2001 (désigné « Rapport de novembre 2000 ») ;

- *Rapport sur la réunion du Groupe de travail d'Experts (15 au 19 janvier 2001) et les travaux informels menés par le Bureau Permanent sur la loi applicable aux dispositions de titres détenus auprès d'un intermédiaire,* établi par le Bureau Permanent, Document préliminaire No 13 de juin 2001 à l'intention de la Dix-neuvième session (désigné « Rapport de juin 2001 »).

Ces deux documents sont disponibles sur le site Internet de la Conférence de la Haye (www.hcch.net) aux rubriques « travaux en cours », « titres intermédiés ».

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The following tentative text is a consolidated document reflecting the current status of discussion. It is submitted to all Member States of the Hague Conference and to all observers who participated in the experts Working Group meeting of January 2001. The Member States and observers, as well as any interested parties, are invited to ***submit written comments to the Permanent Bureau (for the attention of Christophe Bernasconi, First Secretary, cb@hcch.nl) before 1 October 2001***. The explanatory notes to the tentative text are designed to assist in the consultation process. On the basis of the comments received, a new draft text will be prepared which should then serve as the basic working document for the Special Commission meeting scheduled for January 2002.

The two following Reports serve as basic reference documents:

- *The Law Applicable to Dispositions of Securities Held Through Indirect Holding Systems*, Report prepared by Christophe Bernasconi, Preliminary Document No 1 of November 2000 for the attention of the Working Group of January 2001 (referred to as the "November 2000 Report");

- *Report on the Meeting of the Working Group of Experts (15 to 19 January 2001) and Related Informal Work Conducted by the Permanent Bureau on the Law Applicable to Dispositions of Securities Held with an Intermediary*, prepared by the Permanent Bureau, Preliminary Document No 13 of June 2001 for the attention of the Nineteenth Session (referred to as the "June 2001 Report").

  These two documents are available on the website of the Hague Conference (www.hcch.net) under the headings "work in progress", "indirectly held securities".

Article 1 Purpose of the Convention

(1) This Convention determines the law governing proprietary rights in respect of securities held with an intermediary.

This paragraph is intended to make clear that the proposed Convention (hereinafter the Convention) only deals with the identification of the appropriate law to govern *proprietary* aspects of dealings in securities held with an intermediary (see June 2001 Report, pp. 5-7, with further references). These dealings include in particular a pledge, a title transfer by way of security or an outright transfer (*e.g.* sale) of such securities (see below under Art. 2). If an investor's interest in the securities is merely of a contractual nature, the Convention will have no effect on this interest as such, but if for example the interest is provided as collateral or transferred to a purchaser, the proprietary rights arising from the transfer of purely contractual rights *are* covered by the Convention (additional note: the expression "purchaser" is used without specifying whether it is limited only to "buyers" or extends to other recipients of consensual transfers, *e.g.* a donee; additional clarification from experts on this issue would be welcome).

The Convention will not interfere with the nature of an investor's interest in securities held with an intermediary, nor impose any change on a State's substantive law in this regard (see also the comments under Art. 2, para. 1, "securities held with an intermediary"). Consequently, the interests which an investor holds in the securities under local law, prior to providing these interests as collateral or transferring them to a purchaser, will not be altered by the proposed regime. The conflict of laws rule adopted should apply rationally and consistently to an investor's interest irrespective of the form the interest takes.

In contrast with the January 2001 draft, the reference to "account rights" has been omitted. Concerns were raised during the subsequent informal working process about the use of the two terms "securities" and "account rights" for something that is essentially the same thing. Also, there were concerns that "account rights" could include purely contractual rights, with which the Convention is not concerned (unless such rights are provided as collateral or transferred to a purchaser, see above). Therefore, we suggest simplifying and harmonising the text by deleting references to account rights and using throughout the phrase "securities held with an intermediary", for which a definition has been included. The minor difference between the language used in the title ("indirectly held securities") and Article 1, paragraph 1 ("securities held with an intermediary"), is not intended to reflect any difference in substance. The sole purpose is to keep the title as short and as "catchy" as possible (the term "indirectly held securities" is indeed very widespread); the language in Article 1, on the other hand, is designed to describe as precisely as possible what is actually meant by indirectly held securities (*i.e.* securities that are held with an intermediary).

The Convention does *not* determine the law applicable to the *contractual or other non-proprietary aspects* of rights or duties with respect to securities held with an intermediary (unless such interests are provided as collateral or transferred to a purchaser, see above). During the informal working process, it has been suggested that this was appropriately reflected in paragraph 1 and is sufficiently clear. Nonetheless, it might be helpful to state this explicitly in a second paragraph; in addition, this would allow to make it clear that the Convention does not in any way apply to rights and duties of an *issuer* of securities or a *registrar or transfer agent*. Hence, it is proposed to keep, at least for the time being, the following paragraph in the suggested text of the Convention:

(2) This Convention does not determine the law applicable to the contractual or other non-proprietary aspects of rights or duties in respect of securities held with an intermediary, and in particular:

(a) the contractual rights and duties of parties to a transaction in securities;

(b) the contractual rights and duties arising from relations between an intermediary and an account holder;

(c) the rights and duties of an issuer of securities; or

(d) the rights and duties of a registrar or transfer agent.

Article 2 Definitions and interpretation

(1) In this Convention:

"securities" means any stocks, shares, bonds or other financial assets or instruments, or any interest therein;

The suggested language encompasses both *certificated* and *dematerialised* securities, whether such securities are *listed* on an exchange or not (see June 2001 Report, pp. 8-10, with further references). As regards *derivative instruments, subscription warrants* or *"covered" warrants* conferring the right to buy specified securities fall within the suggested definition. The same applies to *tradable or transferable options*. Other derivatives, such as *swaps* individually negotiated between particular counterparties, do not fall within the definition. *Swaps* themselves are not credited to an account; they are merely contracts for exchange of products or cash flows between the parties. *Physical commodities* and instruments representing physical commodities (such as *metal warrants* and *bills of lading*) are not securities and hence are not within the scope of the proposed Convention. As regards *cash*, see the comments made under "securities account".

"intermediary" means a person that in the course of business maintains accounts to which securities may be credited and is acting in that capacity either for others or for its own account;

This definition does not only include central banks and national central securities depositories (CSDs) and international central securities depositories (ICSDs), but includes any person who maintains accounts for others to which securities are credited. The term "person" should be given its ordinary meaning; it thus not only includes legal persons, but also natural persons, unincorporated firms and partnerships. The suggested definition is not tied to regulatory requirements (such as rules relating to supervision); regulatory requirements are a matter of substantive public law of the jurisdiction concerned (see June 2001 Report, pp. 10-12).

"relevant intermediary" means the intermediary with whom the account holder maintains the securities account;

Under the key substantive provision of the Convention (Art. 4), the law governing proprietary rights in securities held with an intermediary is the law of the place of the relevant intermediary (PRIMA). Under both approaches suggested in Article 5 (*i.e.* the "account approach" and the "branch/office approach"), that law is determined by the location of a particular office or branch of the relevant intermediary. Thus, in the case of a global intermediary with multiple offices or branches, the law governing particular accounts might be the law of different branches or offices of the intermediary. The definition of "relevant intermediary" above does not determine in that case which is the law to be applied. Rather this definition refers to the entire juridical entity of the intermediary. The definition of relevant intermediary is included only to make clear that references in the Convention to the relevant intermediary mean the customer's own intermediary rather than other upstream intermediaries, such as the CSD through which the securities are ultimately held.

Throughout the working process, various experts stressed that the Convention should specifically address the situation where several intermediaries are involved in a transaction, in particular where a collateral provider and collateral taker hold through different intermediaries and the collateral is provided by way of title transfer. Under such a holding pattern, the collateral provider's (transferor's/seller's) interest is not transferred directly to the collateral taker (transferee/purchaser), since the collateral provider never holds an interest with the same intermediary as the collateral taker. Instead, the collateral provider instructs its intermediary to transfer interests to the collateral taker's intermediary, with a request to the latter to credit the collateral taker's account. While the experts referred to above agree that PRIMA will simplify the choice of law issue and improve certainty at *each* level of the multi-tiered holding system by substituting a single law (*i.e.* the law of PRIMA) for the multiple possibilities that must now be considered at *each* level (*e.g.* law where certificates are located, law of issuer's incorporation, law of the forum, PRIMA, etc.), they also argue that PRIMA should go further. They urge that, in the interests of clarity and simplicity, the Convention should provide that a *single* law governs proprietary aspects of *all* stages of a transfer between parties who use different intermediaries.

Other experts, however, have expressed strong doubts about this proposal. They argue that while the simplicity of the proposal might be attractive at first sight, it also poses serious problems. They are not persuaded that it is necessary or desirable to have a sort of "Super-PRIMA" that trumps all the individual PRIMAs at each level of the multi-tiered holding system. They believe that PRIMA should provide as much simplicity and certainty in the world of book-entry holdings and transfers as the traditional *lex rei sitae* rule provides for physical possession and transfers of bearer securities. In other words, PRIMA should provide a single answer to what law governs the proprietary issues arising out of book-entry holdings and transfers of securities at each level of the multi-tiered holding system, *i.e.* the PRIMA at that level. But there is no need for a "Super-PRIMA" to trump these individual PRIMAs. An additional problem identified by these experts is that the parties involved in the early or middle stages of such a transfer may not be aware of the ultimate transferee or the location of its intermediary. Against this background, it would seem contrary to principle, and to the certainty and predictability which the Convention aims to produce, that parties in this position should be exposed to the effect of rules of property law of a jurisdiction of which they are unaware. Moreover, the suggestion would appear to have the result that the law governing the proprietary aspects of the earlier stages of the transfer is fixed only retrospectively; at the time that each stage occurs it will appear to be governed by one law, but this will be replaced by a different law when it

becomes clear that an ultimate transferee holding through an intermediary in a different jurisdiction is involved. A further difficulty mentioned by the opponents to the "single law" proposal arises from the fact that some intermediate transfers will be composite transfers of securities in the course of transmission to a number of different ultimate transferees who hold through intermediaries in different jurisdictions. In such a case it may not be possible to identify which securities are attributable to which ultimate transferee, leaving the position on governing law quite unclear.

In the November 2000 Report, it was suggested that under PRIMA the proprietary aspects of each of the different stages of this transfer process should be governed by a *different* law. Against this background, the decisive question as to whether the collateral taker (transferee/purchaser) acquired a valid interest would be subject to the *law of its own intermediary*.

Obviously, this issue needs to be discussed further.

"securities account" means an account with an intermediary to which securities may be credited;

What is the impact of the suggested language on *cash*? During the January 2001 experts meeting, several experts stressed that cash accounts should not fall within the scope of application of the Convention, as the central feature of indirect holding structures would normally not appear in relation to cash. Another group of experts, however, stressed that sometimes, in ICSDs, cash and securities are kept in the same account; they also referred to the fact that the proposed EU Collateral Directive does include cash in its conflict of laws provision. Against this background, excluding cash altogether from the Hague Convention might not be appropriate. The current draft takes an intermediate approach. The reference to "securities account" excludes from the scope of application cash credited to general "deposit accounts". However, where cash is credited as proceeds to a "securities account", the Convention should apply.

It should be noted, however, that the question as to what extent the Convention applies to cash has not yet been discussed in full details. In particular, one may question whether the Convention will have any significant impact even on cash credited as proceeds: in most legal systems, cash credited to an account does not give rise to a *proprietary* but merely to a *contractual* right. As already mentioned under Article 1, the Convention has no effect if an investor's interest is merely of a contractual nature.

"securities held with an intermediary" means the rights of an account holder derived from a credit of securities to a securities account;

As already mentioned under Article 1, the Convention deals only with choice of law, leaving it to each State's substantive law to determine the nature of an investor's interest in securities held with an intermediary. In some systems that interest is described as a form of direct property interest in the underlying securities, while in other systems it is treated as a special form of property interest in the property held by the intermediary. Indeed, in some systems the investor may have only a contractual claim against the intermediary. For drafting purposes some word or phrase is needed to designate whatever rights the relevant State's substantive law gives to an investor who holds securities through an account with an intermediary. The phrase "securities held with an intermediary" is used for that purpose because it is a common colloquial phrase. It is important to remember, however, that this phrase is used in the Convention as a specially defined term that refers to whatever the rights are under the substantive law of the relevant State.

"account holder" means a person to whose securities account securities are credited;

The "account holder" is a person, *i.e.* the investor, to whose securities account one or more securities are credited. Here again, the term "person" should be given its ordinary meaning; it not only includes legal persons, but also natural persons, unincorporated firms and partnerships.

"disposition" means pledge or outright transfer;

The use of the word "disposition" is intended to give the Convention a broad scope of application in the sense that the Convention extends to any act or dealing which, as a matter of applicable law, constitutes a proprietary disposition of indirectly held securities. In this broad sense, a disposition may be either a collateral transaction or a sale. The conflict of laws rule embodied in the Convention applies to both these categories. However, the broad meaning of the term "disposition" may not be construed as extending the Convention's scope beyond the proprietary aspects of a transaction over indirectly held securities; in particular, it may not be construed as applying the Convention to contractual aspects of such transactions.

"pledge" means any form of security interest whether possessory or non-possessory, including a title transfer by way of security;

The word "pledge" is used as a generic term and includes not only possessory security interests but also non-possessory forms of security interests (such as mortgages and charges). Under a pledge, the collateral provider retains ownership of the securities pledged. In today's economy, however, there are numerous ways of raising money and obtaining protection against credit exposure, and not all the ways of obtaining such protection utilise the pledge mechanism: some use a title transfer mechanism, under which ownership of the collateral is transferred to the collateral taker, who only has a contractual obligation to redeliver equivalent securities. These title transfer mechanisms fall under the expression "transfer by way of security". Examples of such title transfer arrangements include "repurchase agreements", "buy/sell-back" transactions, "securities loans", and swap transactions collateralised by means of a title transfer structure. Such title transfer arrangements are widely used to fulfil a security function, and where they do so, they are to be regarded as collateral transactions, even if – technically speaking – they do not create a pledge over collateral. Again, to be clear, in the Convention the term "pledge" is used to include transfer by way of security even though this is a broader definition than in some jurisdictions.

"perfection" means completion of the steps necessary to render a disposition effective against persons who are not parties to that disposition;

"proprietary effects" means effects that are capable of affecting third parties;

"insolvency administrator" means a person or body, including one appointed on an interim basis, authorised in an insolvency proceeding to administer the reorganization or liquidation of the debtor's assets or affairs;

"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.

The two last definitions are taken from Article 5, letters (e) and (f) of the *UNCITRAL Draft Convention on assignment of receivables in international trade*. Both these definitions include reorganisation procedures. They appear to be broad enough to cover different kinds of insolvency proceedings, irrespective of (i) the debtor, (ii) on which grounds the proceedings may be opened and (iii) whether the proceedings are voluntary or involuntary. There has not yet been discussion as to whether the definitions are indeed broad enough.

(2) References in this Convention to a disposition of securities held with an intermediary include a disposition[, as well as a transfer by way of operation of law,] in favour of the account holder's intermediary.

The reference to a "transfer by way of operation of law" is intended to ensure that the Convention also applies to situations where national law provides by statute an intermediary with a lien over indirectly held securities that are held by the intermediary for the account holder, for example to secure the purchase price where it has not yet been paid by the account holder. One has to emphasise, however, that during the informal working process, some experts questioned such a rule, stressing that the conflict of laws principles applicable to transfers by operation of law might be different from those applicable to dispositions *inter partes*. As this is an issue that clearly needs further discussion, it has been placed in brackets.

(3) References in this Convention to a disposition of securities held with an intermediary include a disposition of a securities account.

This provision merely intends to ensure that the Convention also applies if the investor provides the securities account rather than the securities or part of the securities credited to the account as collateral; similarly, the Convention also applies if the investor transfers the account rather than the securities or part of the securities credited to the account to another party.

(4) In this Convention, a person recorded on a securities account purely in an administrative capacity, for example as registrar for the issuer or as manager or agent for the account holder, shall not be considered an intermediary in relation to the holder of that account merely because that person also records in its own books details of the securities credited to that account.

This paragraph is intended to address a holding pattern which is particularly common in Nordic States. In these States, securities may be held either in an individual account in the name of the individual owner or under a conventional omnibus account structure. Where securities are held in an individual account at the CSD in the name of the account holder, the CSD also notes the identity of an "account manager" (typically a bank), which has been approved by the CSD, and which manages or administers the account on behalf of the account holder. Dispositions may only be made through the account manager. It seems clear that this structure should be treated as a direct holding pattern, since the account

holder's account at the CSD constitutes the record of his title; this is the case even if the account manager also maintains parallel records on its own books of the interests of customers for whom it acts as account manager. It needs to be made clear that such parallel records are not "securities accounts" and, by the same token, that such account managers are not "intermediaries" for purposes of the Convention. In other words, the Convention is designed to apply where the intermediary acts as "principal" but not merely as "agent" fulfilling an administrative function on behalf of the account holder.

Article 3 Internationality (territorial scope of the Convention)

This Convention applies in all cases involving a choice between the laws of different States. It applies in particular if, in relation to securities held with an intermediary, any two of the following are located in different States:

(a) the relevant intermediary;

(b) the issuer of the securities;

(c) the account holder;

(d) a party to a disposition of the securities; and

(e) an intermediary through whom the relevant intermediary holds, directly or indirectly, the securities.

The proposed language in Article 3 combines the advantages of two distinct approaches: the specific list of relevant cross-border factors (sub-paragraphs (a) to (e)) provides certainty, while the illustrative nature of the list and the general introductory wording (first sentence) continue to allow for the possibility that other cross-border elements may arise in particular situations which have not been identified (see June 2001 Report, p. 7).

Under the proposed language, the Convention applies if any of the account holder, the pledgee/outright transferee or the relevant intermediary are in different States. During the January 2001 experts meeting, there was consensus that the Convention should also apply in a case where the account holder, the pledgee/outright transferee and the relevant intermediary are all located in the same State, but the issuer of the securities is foreign (or, in the case of a diversified portfolio of securities issued in a number of different jurisdictions, at least one of the issuers is foreign); if the Convention were not applicable in such a case, there would be a risk of applying the "look-through" approach. The Convention should in any event also apply if any of the upstream intermediaries through whom the securities are held is located in another State. Finally, it should be noted that the expression "in different States" used in the present draft also covers situations where the pledgee/outright transferee and the relevant intermediary are in different Member States of a Regional Economic Integration Organisation. Obviously, the next question then is how to address a potential disharmony between the rules embodied in this Convention and

possible conflict of laws rules adopted by the Regional Economic Integration Organisation; this question, however, will need to be addressed in the final clauses of the Convention.

Article 4 Determination and scope of the applicable law

(1) The law governing rights in securities held with an intermediary (the "applicable law") is the law of the place of the relevant intermediary.

It has been suggested that the connecting factor should be reformulated as a direct reference to the place of the relevant securities account (see the comments relating to Art. 5), thereby removing the reference to the relevant intermediary. While this would be possible in principle, the current formulation does not seem to give rise to any ambiguity or lack of precision and, given that the reference to the "place of the relevant intermediary" is now widely used, there might be advantages in terms of familiarity in retaining the current structure.

It has also been suggested that there should be a specific provision identifying the *particular moment in time* that should be considered when determining the relevant intermediary. A large majority of experts, however, felt that the answer to this question was obvious and could only be "at the time of the pledge or outright sale transaction" (an example of an explicit rule on this issue is provided by Art. 100, para. 1 of the Swiss PIL Statute). Given the absence of any real difficulty, the Convention does not provide for an explicit rule on this issue. In addition, the insertion of a specific rule might trigger additional difficulties; in the case of a *priority* issue, for example, the Convention would have to describe the two (or more) conflicting moments to be considered in determining the issue of priority.

(2) The applicable law determines:

(a) the legal nature [characterisation] of the rights derived from the credit of securities to a securities account;

During the informal process, it was suggested that the word "characterisation" be used in the Convention to express the idea that the law applicable would determine the legal nature of the right at stake. The Permanent Bureau *counsels against using the word "characterisation"* in an international treaty. This expression is indeed used in many different ways in PIL doctrine and thus means different things to different people. In light of these difficulties, the word "characterisation" has been placed in brackets and replaced by the words "legal nature of the rights", which reflects accurately what is meant by the provision.

(b) the legal nature [characterisation] and proprietary effects of a disposition of securities held with an intermediary;

See the comments under sub-paragraph (a).

(c) the requirements for perfection of a disposition of securities held with an intermediary;

(d) whether a person's title to or interest in securities held with an intermediary is overridden by or subordinated to a competing title or interest;

Sub-paragraph (d) makes it clear that the applicable law governs all forms of dispute between or among claims of any property interest to securities held with an intermediary. This would include priority disputes among conflicting security interests. It would also include issues commonly described as adverse claim issues or issues of the rights of *bona fide* purchasers, such as whether the title or interest of a person who holds securities with an intermediary is subject to or may be defeated by an assertion that some other claimant is in fact the true owner of the securities or has some other form of claim to them.

(e) the duties of an intermediary to a person who asserts a competing claim to securities held with that intermediary; and

Sub-paragraph (e) provides that the applicable law also determines the duties of an intermediary to a person who asserts a competing claim. Because the indirect holding system is the mechanism for settlement of enormous volumes of securities trading, many systems of substantive law are designed to ensure that the settlement system cannot be disrupted by assertions of claims by persons other than the person recorded on the intermediary's records as the account holder. Sub-paragraph (e) is intended to make clear that an intermediary's obligations with respect to such issues are governed exclusively by the law of the intermediary's jurisdiction.

(f) the steps required for the realisation of a disposition of securities held with an intermediary.

Article 5 Determination of the place of the relevant intermediary

There is no doubt that the determination of the place of the relevant intermediary is the key issue of this Convention (see the comments in the November 2000 Report, pp. 40-41, and in the June 2001 Report, pp. 16-23). Similarly, it seems obvious that the success of the Convention will be measured against the degree of *ex ante* certainty it will provide: how easily and readily will the parties be in a position to establish the law applicable to the proprietary aspects of their transaction? This *ex ante* certainty is essential to meet the needs of market participants, who need to know which law applies to the proprietary aspects of the transaction and hence determines the perfection requirements to be fulfilled. As a result of the informal working process, *two principal approaches* are suggested to tackle this key issue; in addition, each of the two approaches has several options to be considered. Before turning to these approaches, it has to be stressed that one of the major issues that remains to be solved is the extent to which these rules would possibly be applicable to custody agreements already in place at the time the Convention comes into effect (see the "additional remarks" at the end of this Article).

I. "Account approach"

During the January 2001 experts meeting, there seemed to be a general consensus among the experts that the most promising approach to stating rules to determine the location of the relevant intermediary would be based on the place of the *account* to which the

securities are credited. It is on the *account* that the collateral taker's or transferee's interest will be recorded and where this interest may therefore eventually be enforced. Against this background, the "account approach" appeared to be a simple but legitimate form of modern extension of the *lex rei sitae* principle.

(1) The place of the relevant intermediary is the place where the securities account with that intermediary is maintained.

Since the January 2001 experts meeting, however, it has become increasingly clear that identifying a particular geographic location for an account is a difficult matter. In the most recent discussions, three different suggestions were made.

(i) **<u>Option A</u>**

(2) For the purposes of this Convention, the securities account is maintained at the place of the office or branch of the relevant intermediary agreed between the account holder and the intermediary, provided that the intermediary's maintenance of the securities account is subject to regulatory supervision in the place so agreed.

(ii) **<u>Option B</u>**

(2) For the purposes of this Convention, the securities account is maintained at the place of the office or branch of the relevant intermediary agreed between the account holder and the intermediary, provided that it is a place where the intermediary is subject to regulatory supervision.

Both Options A and B are based on the general idea of using the *consensual approach*, with a "nexus test" as a "reality check" (see June 2001 Report, pp. 17-21). Inasmuch as most commercially important intermediaries are regulated financial institutions, the most promising forms of nexus test appear to focus on regulation of the business of *maintaining securities accounts*. For this approach to succeed, it is important that the regulatory nexus test be drafted in a fashion that is consistent with general patterns of regulation in many different legal systems. In the informal working process since the January 2001 experts meeting, it has become clear that more information and analysis of the actual patterns of regulation is essential (in this regard, a set particular questions will be submitted by the Permanent Bureau to market participants at a later stage).

In order to stimulate research and discussion of this matter, the July draft includes two different approaches to the regulatory nexus test. Under Option A, the designation of an account location is effective only if the intermediary's maintenance of the *account* is subject to regulatory supervision in the place so agreed. It has been suggested that in at least some countries "custodial accounting rules" exist that would satisfy this requirement. Others, however, have suggested that regulatory structures may not focus on the manner in which the intermediary maintains securities accounts, but on the requirements that an intermediary must satisfy, such as capital requirements, in order to engage in the business of maintaining securities accounts. Accordingly, Option B states the regulatory nexus test in terms of regulation of the *intermediary*.

It should be noted that under either option, it is required that the intermediary actually has an office or branch in the agreed location. The purpose of the consensual approach is not to permit the parties to designate a wholly arbitrary location, but to determine which of the offices or branches of the intermediary should be treated as maintaining the account.

(iii) Option C

(2) A certificate issued by the relevant intermediary as to the place where the securities account is maintained is conclusive[, provided that the intermediary's maintenance of the securities account is subject to regulatory supervision in the place so designated (see *supra,* Option A)] [, provided that it is a place where the intermediary is subject to regulatory supervision (see *supra,* Option B)].

The general concept of Option C was briefly discussed at the January 2001 experts meeting, but the approach has not been the subject of much discussion since then. It is included in this draft to stimulate discussion of possible alternatives given the difficulty of drafting a completely satisfactory regulatory nexus test. Option C takes a different approach and allows the relevant intermediary to designate unilaterally the place of the account. This approach is based on the idea that the facts needed to make that determination may be knowable only to the intermediary that is maintaining the account. Third parties may have no way of independently determining whether the nexus test had been satisfied, even in cases in which the securities have been moved into a special pledge account that the intermediary maintains for the pledgee. Option C responds to this concern by giving complete protection to third parties who rely upon an intermediary's certification of the location of the account.

The words in brackets would limit the intermediary's freedom to designate the location of the account. Similarly to Options A and B, they would subject the intermediary's ability to designate a location to some "reality check" requirements.

II. "Branch/office approach"

Because an account is an intangible legal relationship, it cannot, literally, have a geographical location. Rather, in speaking of the location of an account, one typically has in mind particular activities that an intermediary carries out in connection with maintaining the legal relationship of a securities account. Although stating the rules on governing law in terms of location of an account may provide the easiest route of transition from traditional *lex rei sitae* rules for simple certificated securities held directly, it may be that retaining the concept of geographical location of an account causes more difficulties than it solves.

All proposed drafts since the January 2001 experts meeting have taken the approach of stating: first, that the governing law is the law of the place of the relevant intermediary; then, secondly, that the law of the place of the relevant intermediary means the location of the account, and then, finally, the operative rule on location of the account. At the Paris meeting of the enlarged Drafting Group in May 2001, the suggestion emerged of dropping the second step and stating that the governing law is the law of the place of the relevant intermediary as determined by the appropriate test. As the following provisions indicate, very little change in drafting would be required to implement this approach.

(1) The place of the relevant intermediary is the place of the office or branch of the relevant intermediary agreed between the account holder and the intermediary, provided that

(i) **<u>Option A</u>**

the intermediary's maintenance of the securities account is subject to regulatory supervision in the place so agreed.

Both the account approach and the branch/office approach do not exclude accounts maintained by *unregulated* entities from the Convention altogether (since this would leave an undesirable gap), but leave such accounts (which are relatively uncommon) to be governed by the balancing test in Article 5(3).

(ii) **<u>Option B</u>**

it is a place where the intermediary is subject to regulatory supervision.

(3) If the place of the relevant intermediary cannot be determined under paragraph 2 [paragraph 1 if the branch/office approach were adopted], the factors that may be considered in determining that place include the following:

It has to be mentioned that paragraph 3 [or 2, if the "branch/office approach" were adopted] is intended to deal with a *very small number of cases*, as the bulk of the cases will presumably fall within the scope of paragraph 2 [1].

(a) the location of the office or branch where the relevant intermediary treats the securities account as being maintained for regulatory, accounting or internal or external reporting purposes;

(b) the location of any office or branch of the relevant intermediary with which the account holder deals;

(c) the terms of the custody agreement, account agreement or any other agreement relating to the securities account between the relevant intermediary and the account holder;

(d) the terms of account statements or other reports prepared by the relevant intermediary that reflect the balance of the account holder's interest in the securities account; and

(e) the State whose law governs the agreement establishing the securities account.

It is worth mentioning that a number of experts who participated in the informal working process subsequent to the January 2001 meeting objected to the inclusion of sub-paragraph (e). Further discussion is needed.

(4) In applying the provisions of this Article, no account shall be taken of the following factors:

(a) the places where certificates representing or evidencing securities are located;

(b) the places where any register of holders of securities maintained by or on behalf of the issuer of the securities is located;

(c) the place where the issuer of the securities is organised or incorporated or has its statutory seat, central administration, principal place of business or its registered office;

(d) the place where any intermediary other than the relevant intermediary is located; or

(e) the places where the technology supporting the bookkeeping or data processing for the securities account is located.

It should be noted that paragraph 4 [or 3, if the "branch/office approach" were adopted] does not mean that the place of relevant intermediary cannot be a particular place just because the issuer is located in that place.

Additional remarks on the issue of pre-existing account or custody agreements

This tentative text does not specifically address the issue of *pre-existing* documentation (account or custody agreements), *i.e.* agreements concluded *before* the Convention's entering into force. As this is a very important question to a large segment of the industry, it seems important to promote discussion of this issue also, even if at this stage no draft provision is suggested. The following comments are merely designed to highlight the issue and to generate reactions.

The approach reflected in the above provisions of Article 5 should accomplish the objective of providing *ex ante* certainty for future transactions. However, during the informal working process, it has been suggested that, at least in some situations, it might be difficult to amend pre-existing agreements and to bring them in line with the provisions of the Convention. In other words, *the certainty provided by the Convention may not necessarily have a retroactive effect*.

It has therefore been suggested that consideration be given to adding provisions which would address this problem. One possibility could be to adopt – for *pre-existing* agreements – the "conclusive certificate" approach suggested above (see *supra,* Option C), even if that approach were not thought generally acceptable for *future* agreements (presumably, the "reality check" qualification presently appearing in brackets of Option C would also have to be addressed in the context of pre-existing agreements). Another possibility would be to provide that for the purposes of Article 5, paragraph 2, where a pre-existing agreement does not contain an *explicit* reference to the location of the account, certain *other* terms can be taken into account as determining or indicating the location agreed by the parties. By way of illustration, a statement that the intermediary is acting through a given branch could be treated as an agreement, or as an indication of an

agreement, that the account is located at that branch; another example of such an "interpretative clause" could be to say that a choice of law clause shall be treated as an agreement that the account is located in the jurisdiction whose law is selected.

Parties drafting agreements *after* the entering into force of the Convention can be expected to comply with the requirement of Article 5 and to expressly specify the location of the account – this is why the possibility of the "interpretative clause" might indeed be regarded as exclusively restricted to *pre-existing* agreements. During the informal working process, however, is has been suggested that such a provision could be beneficial for *new* agreements as well and that it should therefore apply generally. In such a case, this interpretative clause would presumably have to be inserted between the principal rule embodied in Article 5, paragraph 2, and the "fall-back" test contained in Article 5, paragraph 3. In all cases, it would need to be clear that the "fall-back" provisions of paragraph 3 would apply where the location of the account was not determined under paragraph 2 and any additional "interpretative clause". Finally, if the second example of an "interpretative clause" mentioned above (*i.e.* a choice of law clause contained in the agreement) were eventually adopted for *new* documentation as well, its relationship with the existing paragraph 3, sub-paragraph (e), would presumably have to be examined.

Article 6 Insolvency

(1) The opening of an insolvency proceeding shall not affect the validity of proprietary rights in respect of indirectly held securities that have been constituted and perfected in accordance with the law of the place of the relevant intermediary.

(2) Nothing in this Article affects the application of:

(a) any rules of insolvency law relating to the [ranking of categories of claim or to the] avoidance of a transaction as a preference or a transfer in fraud of creditors; or

(b) any rules of insolvency procedure relating to the enforcement of rights to property which is under the control or supervision of an insolvency administrator.

This important Article has not been discussed in the informal working process after the January 2001 experts meeting. Some delegations, however, have stressed that this provision should be expanded so as to bring it in line with the *EU Insolvency Regulation,* which entered into force on 31 May 2001 (for further comments, see the June 2001 Report, pp. 25-29).

Article 7 General applicability

This Convention applies whether or not the applicable law is that of a Contracting State.

See the June 2001 Report, p. 29.

Article 8 Exclusion of choice of law rules (*renvoi*)

In this Convention, the term "law" means the law in force in a State other than its choice of law rules.

See the June 2001 Report, pp. 29-30.

Article 9 Public policy and internationally mandatory rules

(1) The application of the law designated by the provisions of this Convention may be refused only if its application would be manifestly contrary to the public policy of the forum in relation to matters dealt with in this Convention.

This language is the result of the discussions at the January 2001 experts meeting and the subsequent informal working process. The Permanent Bureau suggests to modify this provision as follows: "The application of the law designated by the provisions of this Convention may be refused only if the effects of its application would be manifestly contrary to the public policy of the forum." First, the reference to the "effects" intends to make clear that the public policy exception does not contemplate the foreign disposition theoretically, but rather the actual result to which its application would lead in the concrete case (see *e.g.* Art. 17 of the Swiss PIL Statute of 1987, Art. 3081 of the Civil Code of Quebec of 1991, and Art. 16 of the Italian PIL Statute of 1995). Secondly, the expression "in relation to matters dealt with in this Convention" has been omitted, as it does not appear to be necessary. Indeed, it goes without saying that the Convention can only designate rules that are dealing with the topic covered by the Convention.

See also the June 2001 Report, pp. 30-32 (comments on Art. 9 and 10 of previous drafts).

(2) This Convention does not prevent the application of those provisions of the law of the forum which, irrespective of rules of conflict of laws, must be applied even to international situations, other than any provision imposing requirements with respect to perfection or relating to priorities.

See the June 2001 Report, pp. 30-32 (comments on Art. 9 and 10 of previous drafts).

Article 10 States with more than one legal system

I. Option A

(1) A State within which different territorial units have their own rules of law in respect of any matter dealt with in this Convention shall not be bound to apply this Convention to conflicts solely between the laws of such units.

(2) In relation to a State in which two or more sets of rules of law with regard to any matter dealt with in this Convention apply in different territorial units, any reference to the place of the relevant intermediary shall be construed as referring to the territorial unit of the relevant intermediary.

II. Option B

(1) A State within which the State and one or more of its territorial or other units have their own substantive rules of law or choice of law rules in respect of any matter dealt with in this Convention may make to the depositary a declaration that this Convention shall not apply to conflicts solely among the laws of such State and units.

(2) In applying this Convention, if a court in another State determines that the place of the relevant intermediary is in such a declaring State, the court shall apply the rules in force in the declaring State for determining which of the laws of the State and one or more of its territorial or other units is applicable.

(3) If a State has made no declaration under paragraph 1, or there are no rules referred to in paragraph 2, the rules of this Convention shall apply to determine which of the laws of the State and one or more of its territorial or other units is applicable.

Option A was submitted during the January 2001 experts meeting; Option B was suggested during the subsequent informal working process. The merits of each version have yet to be considered (see also the June 2001 Report, p. 33).

Article 11 Uniform interpretation

In the interpretation of the Convention, regard is to be had to its international character and to the need to promote uniformity in its application.

The issue of uniform interpretation has not yet been discussed. The provision is suggested by the Permanent Bureau with a view to promote discussion. One may also wish to add provisions referring to the fact that each Contracting State shall, when applying and interpreting the Convention, take due account of the case law of other Contracting States; a contracting State might also be invited to send to the Permanent Bureau at regular intervals copies of any significant decisions taken in applying the Convention and, as appropriate, other relevant information. Obviously, these questions need further discussion.

Article 12 Review of practical operation of the Convention

The Secretary General of the Hague Conference on Private International Law shall at regular intervals convene a Special Commission to review the practical operation of the Convention.

This issue has not yet been discussed. One may also wish to add provisions referring to the fact that the Special Commission may make *recommendations* on the application or interpretation of the Convention and may *propose modifications or revisions* of the Convention or the addition of protocols.

Article 13 Amendments to the Convention

To be completed (see also the comments under Art. 12).

Article 14 Signature, ratification, acceptance, approval or accession

(1) The Convention shall be open for signature by all States [and Regional Economic Integration Organisations].

(2) The Convention is subject to ratification, acceptance, approval or accession by the signatory States [and Regional Economic Integration Organisations].

(3) The instruments of ratification, acceptance, approval or accession shall be deposited with the Ministry of Foreign Affairs of the Kingdom of the Netherlands, depositary of the Convention.

These questions have not yet been discussed in the context of this project. In particular, the reference to Regional Economic Integration Organisations awaits full discussion. The provisions are merely suggested with a view to promote discussion.

[Article 15 Regional organisations

For the purpose of this Convention, Regional Economic Integration Organisation means any organisation constituted by Sovereign States to which their Member States have transferred competence in respect of matters governed by this Convention, including the competence to enter into international agreements in respect of these matters.]

If it is decided to include the reference to Regional Economic Integration Organisations in Article 14, a definition of these organisations may be required. The suggested definition has not yet been discussed. Similarly to the previous provision, it is merely suggested here to assist in the consultation process and to promote discussion.

Article 16 Territorial units

(1) If a State has two or more territorial units in which different systems of law are applicable in relation to matters dealt with in this Convention, it may at the time of signature, ratification, acceptance, approval or accession declare that the Convention shall extend to all its territorial units or only to one or more of them and may modify this declaration by submitting another declaration at any time.

(2) Any such declaration shall be notified to the depositary and shall state expressly the territorial units to which the Convention applies.

(3) If a State makes no declaration under this Article, the Convention is to extend to all territorial units of that State.

The language of Article 16 will have to be aligned with the final wording of Article 10.

Article 17 Entry into force

(1) The Convention shall enter into force on the first day of the month following the expiration of three months after the deposit of the third instrument of ratification, acceptance, approval or accession referred to in Article 14.

(2) Thereafter the Convention shall enter into force for each State subsequently ratifying, accepting, approving or acceding to it, on the first day of the month following the expiration of three months after the deposit of its instrument of ratification, acceptance, approval or accession.

Article 18 Denunciation

(1) A State [or Regional Economic Integration Organisation] Party to this Convention may denounce it by a notification in writing addressed to the depositary.

(2) The denunciation takes effect on the first day of the month following the expiration of three months after the notification is received by the depositary. Where a longer period for the denunciation to take effect is specified in the notification, the denunciation takes effect upon the expiration of such longer period after the notification is received by the depositary.

Article 19 Notifications by the Depositary

To be completed.

[Other final clauses]

To be completed.