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LE PROJET ACTUEL DE CONVENTION ASSURE-T-IL CONVENABLEMENT QUE L'INTERMÉDIAIRE PERTINENT (PRIMA) EST IDENTIQUE POUR TOUS LES TRANSFERTS DE TITRES DÉTENUS AUPRÈS D'UN INTERMÉDIAIRE DONNÉ, OU UNE DISPOSITION PARTICULIÈRE EST-ELLE NÉCESSAIRE POUR PARVENIR À CE RÉSULTAT ?

soumis par le Bureau Permanent

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DOES THE CURRENT DRAFT OF THE CONVENTION ADEQUATELY ENSURE THAT THE RELEVANT INTERMEDIARY (i.e. PRIMA) IS THE SAME FOR ALL DISPOSITIONS OF SECURITIES HELD WITH A PARTICULAR INTERMEDIARY, OR IS THERE A NEED FOR A SPECIFIC PROVISION TO ACHIEVE THIS?

submitted by the Permanent Bureau

Document préliminaire No 17 d'octobre 2002
à l'intention de la Session diplomatique sur les titres intermédiés

Preliminary Document No 17 of October 2002
for the attention of the Diplomatic Session on indirectly held securities

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Introduction

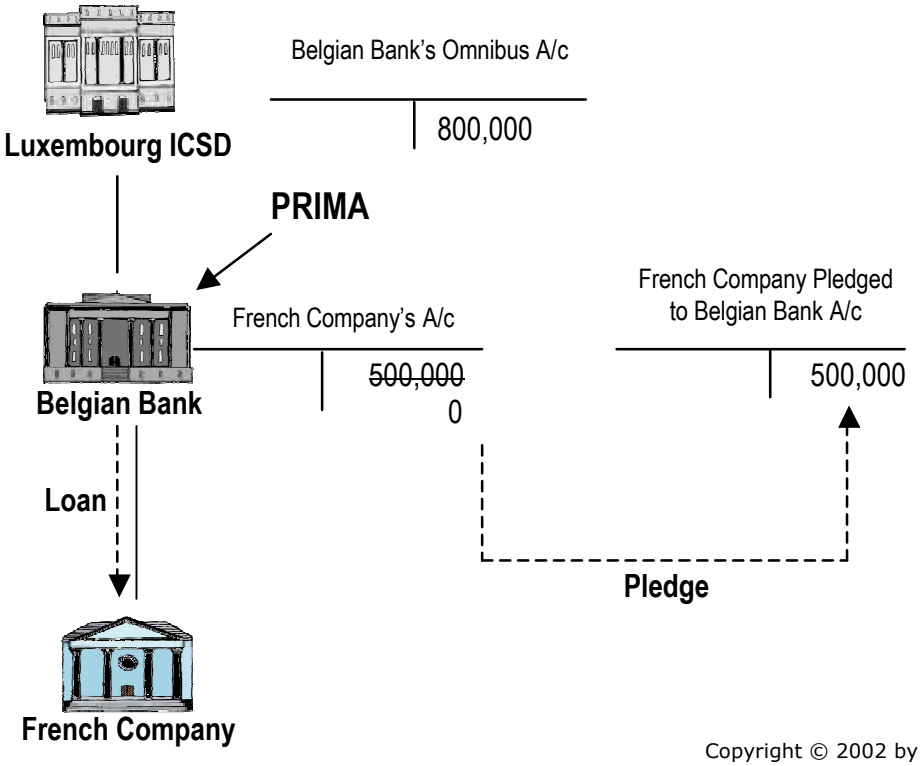
This Memo addresses the question of whether a specific provision (i.e. a new Art. 1(6)) needs to be inserted into the Convention with a view to ensure that the relevant intermediary, and hence PRIMA, are the same for all dispositions of securities held with a particular intermediary, whether the disposition is in the form of a security interest, transfer of title by way of security or outright transfer (see the definition of "disposition"). This result is necessary since all dispositions have an effect on the transferor's creditors and third parties who deal with the transferor or the securities after the disposition. Any other result would allow parties to manipulate the choice of the applicable law by changing the form of the disposition. This would undermine the certainty that the Convention seeks to provide.

This Memo concludes that under the current draft of the Convention (see Prel. Doc. No 15), PRIMA is indeed *the same* for all dispositions of securities held with a particular intermediary. The Permanent Bureau is not persuaded that an additional provision will increase the certainty of that result; on the contrary, we believe an additional provision is likely to add to the complexity of the text. Instead, we consider that, if additional clarification is needed, it would be more productive to achieve that by including in the Explanatory Report examples that illustrate how the Convention applies to various fact patterns. The following examples might be considered in this respect:

Example 1

French company holds 500,000 shares in a securities account with Belgian bank. Belgian bank holds a corresponding position of shares in a general omnibus account with Luxembourg ICSD, which together with the shares of other customers of Belgian Bank amounts to 800,000. Belgian bank makes a loan to French company. French company agrees to pledge the securities credited to its account with Belgian bank to Belgian bank as collateral for the loan. Pursuant to instructions from French company, Belgian bank perfects the pledge by marking French company's account with Belgian bank as a pledged account in favour of Belgian bank. No accounting entries are made at the level of Luxembourg ICSD or any other "upper-tier" intermediary. Figure A below illustrates this fact pattern:

Figure A

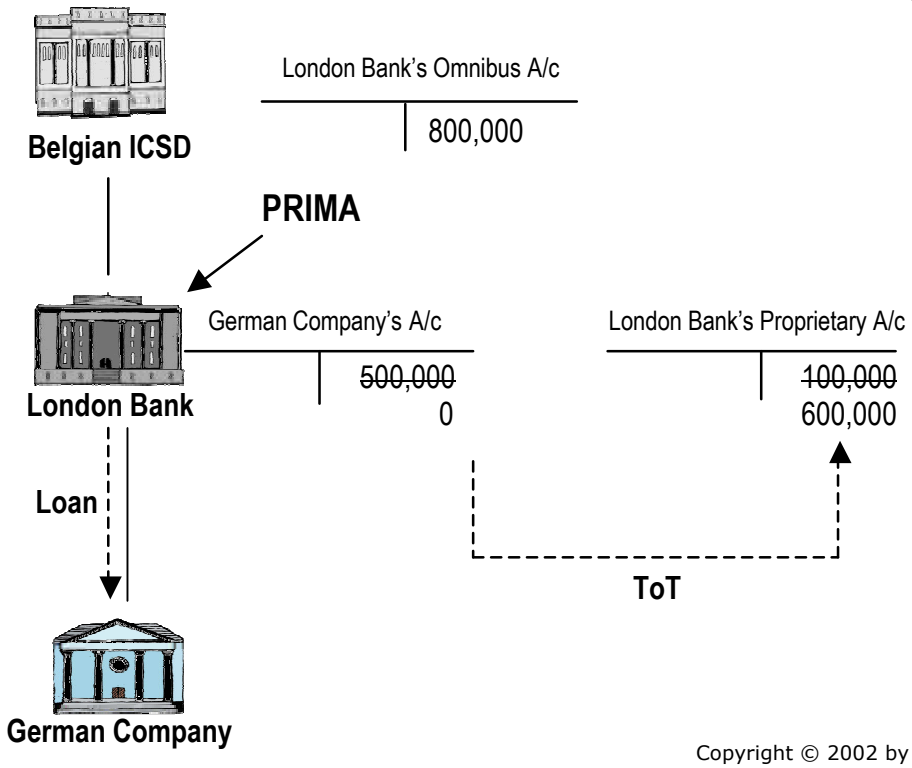


Belgian bank clearly falls within the definition of the term "relevant intermediary" in respect of the securities credited to French company's securities account with Belgian bank immediately before the disposition because it was the intermediary that maintained the account for French company. Luxembourg ICSD did not maintain any account for French company; it maintained an omnibus securities account for Belgian bank. Likewise, it is clear from the same definition that, for the same reason, Belgian bank is the "relevant intermediary" in respect of the securities credited to the account marked as a pledged account on its own books upon the completion of the disposition. Thus, Belgian bank would be the relevant intermediary for purposes of applying the PRIMA tests of Articles 4 and 5 to determine what law governs the issues listed in Article 2(1) in respect of the securities held by French company with Belgian bank, including the disposition (in the form of a pledge) of those securities in favour of Belgian bank.

Example 2

German company holds 500,000 shares in a securities account with London bank. London bank holds a corresponding position of shares in a general omnibus account with Belgian ICSD, which together with the shares of other customers of London Bank amounts to 800,000. London bank makes a loan to German company. German company agrees to transfer the securities credited to its account with London bank to London bank as security for the loan. Pursuant to instructions from German company, London bank effects the transfer by debiting the securities from German company's account with London bank and crediting them to London bank's proprietary account on its own books. No accounting entries are made at the level of Belgian ICSD or any other "upper-tier" intermediary. Figure B below illustrates this scenario:

Figure B



London bank clearly falls within the definition of the term "relevant intermediary" in respect of the securities credited to German company's securities account with London bank immediately before the disposition because it was the intermediary that maintained the account for German company. Belgian ICSD did not maintain any account for German company; it maintained an omnibus securities account for London bank. Likewise, it is clear from the same definition that, for the same reason, London bank is the "relevant intermediary" in respect of the securities credited to the proprietary account on its own books upon the completion of the disposition. The definition of "intermediary" includes persons who maintain securities accounts for themselves as long as they also maintain securities accounts for others and are acting in the capacity of maintaining accounts for themselves.

The conclusion that London bank is the relevant intermediary both before and upon the completion of the disposition of the securities is confirmed by Article 1(2)(b). That provision states that a disposition (by German company) of securities held with an intermediary (London bank) includes a disposition (by German company) in favour of the account holder's intermediary (London bank). Thus, London bank would be the relevant intermediary for purposes of applying the PRIMA tests of Articles 4 and 5 to determine which State's law governs the issues listed in Article 2(1) in respect of the securities held by German company with London bank, including the disposition of those securities in favour of London bank. Note that this point is equally applicable to Example 1.

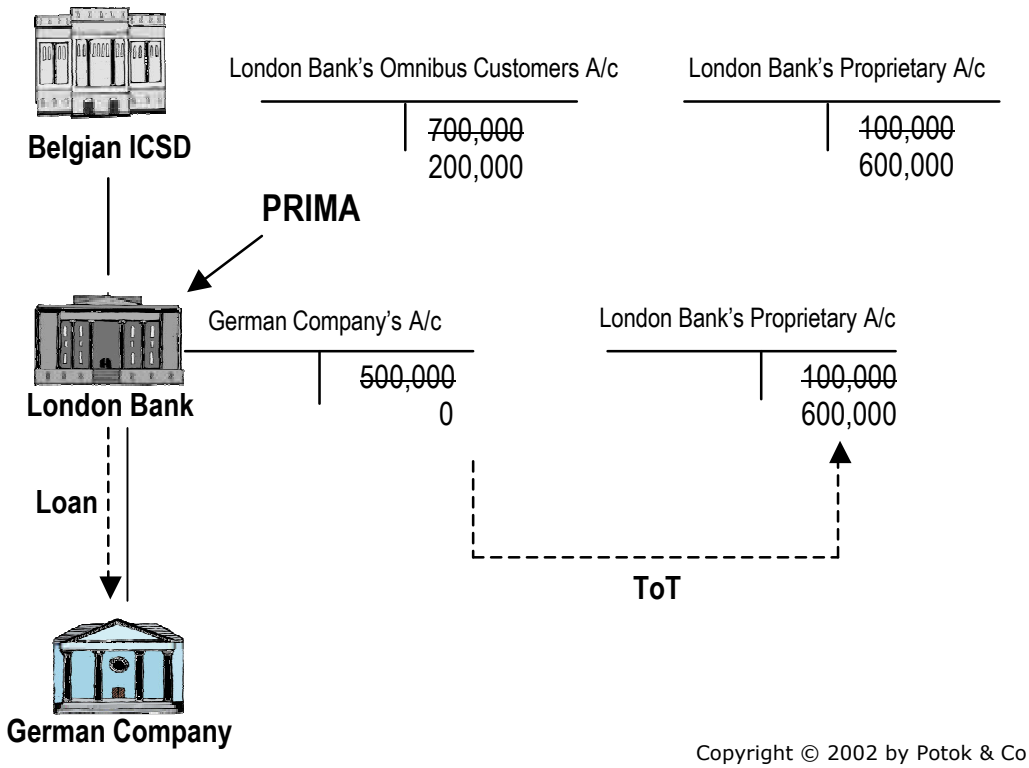
In the past, some experts have argued that Belgian ICSD would become the relevant intermediary upon the completion of the disposition. But relevant intermediary in respect to what? Not in respect of the disposition by German company of the securities held by German company with London bank, for the reasons stated above. Nothing in the current draft of the Convention provides any basis for the contrary conclusion, and there is no more reason to think that the contrary conclusion is true in Example 2 than in Example 1. Of course, Belgian ICSD was and continued to be the relevant intermediary in respect of any disposition by London bank of any securities held by London bank with Belgian ICSD. But that is a different disposition from the disposition by German company of the securities held by it with London bank.

This is not to minimise the practical importance to both German company and London bank of the quality of London bank's rights to the securities held with Belgian ICSD. If London bank has no enforceable interest in the securities credited to its account with Belgian ICSD, there may not be securities available to London bank to cover its obligation to German company. But that practical importance (which is equally true before German company's disposition) does not convert Belgian ICSD into the relevant intermediary for the purposes of applying the PRIMA tests of Articles 4 and 5 to the disposition of the securities credited to German company's account with London bank.

Nor is there anything in the current draft of the Convention that provides for a different result if the UK were a "look-through" jurisdiction. The Convention operates on the choice of applicable law issue independently of how securities held with an intermediary might be characterised for substantive law purposes. Note that this point is equally true with respect to all three examples mentioned in this Memo.

Some experts have also argued that Belgian ICSD would nevertheless become the relevant intermediary if, at the time of German company's disposition to London bank of the securities held with London bank, Belgian ICSD, acting upon instructions from London bank, moved London bank's corresponding position with Belgian ICSD from one account to another. Figure C below illustrates this fact pattern:

Figure C



In fact, UK banks and probably banks and brokers from other countries typically maintain at least two accounts with upper-tier intermediaries to comply with applicable regulations requiring them to keep customer assets segregated from their own assets. They typically have at least one account for securities held for customers and a separate account for their own securities. When they debit a person's account on their own books to effect a transfer of title in their favour, they also typically instruct their upper-tier intermediary to transfer a corresponding amount of securities from their account with the upper-tier intermediary labelled "customers account" into their account with such upper-tier intermediary labelled "proprietary account". But they do not do so to satisfy any commercial law requirements; they do so because segregation requirements under applicable regulatory law no longer apply with respect to the transferred securities.

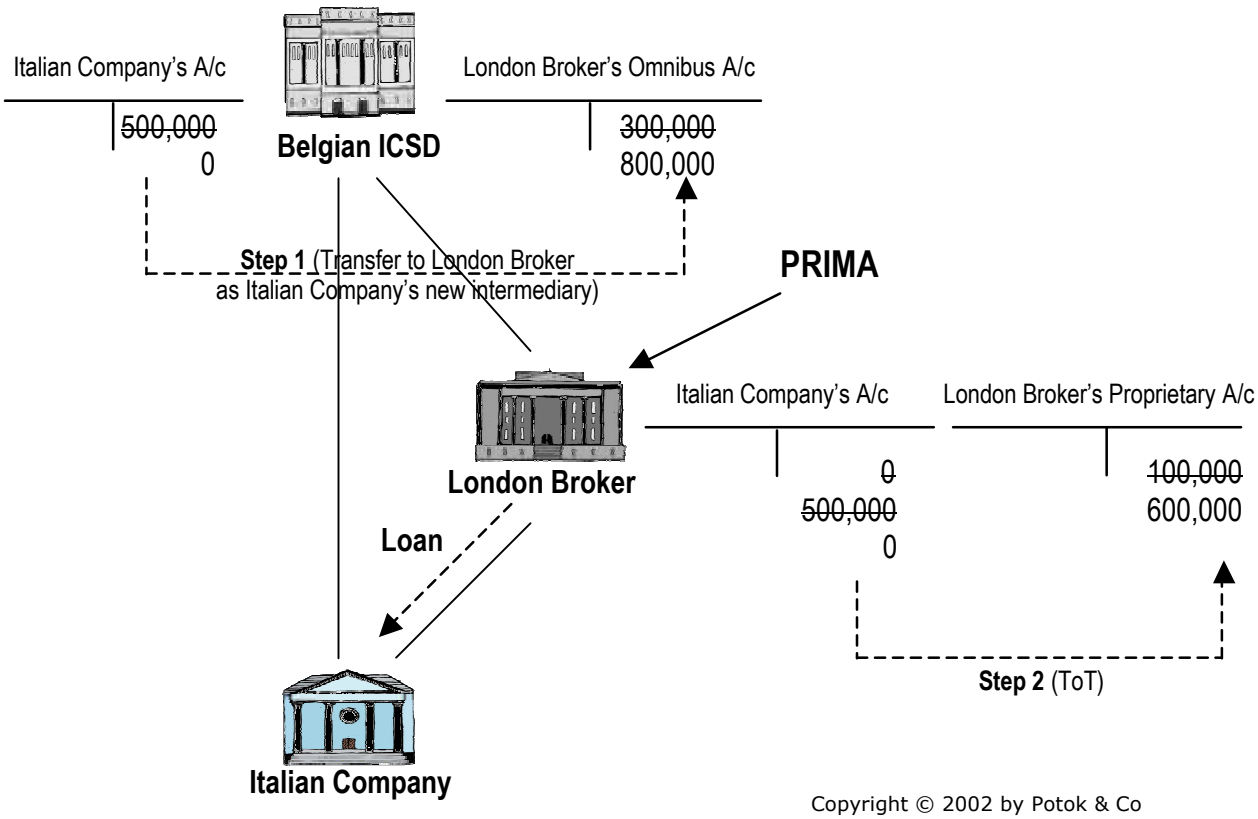
Moreover, any such transfer entered on Belgian ICSD's books results from instructions from London bank and not from instructions from German company. Even after the two dispositions (one on the books of London bank and one on the books of Belgian ICSD), there is no relationship between German bank and Belgian ICSD; the relevant intermediary is London bank, which continues to maintain both the securities account of German company and the securities account on its own behalf. The transaction on the books of Belgian ICSD has nothing to do with the pledge by German company. The point becomes even more apparent if one considers the situation where London bank conducts similar operations for 4 different account holders: on the books of Belgian ICSD, the result of London bank's instructions to Belgian ICSD is that an undifferentiated bundle of 2,000,000 shares held by London bank with Belgian ICSD are moved from one of its accounts to another.

London bank is the relevant intermediary in respect of the disposition of securities held and disposed by German company with and to London bank. There is nothing in the current draft of the Convention that provides any basis for concluding that Belgian ICSD becomes the relevant intermediary in respect of those securities merely because, upon the instructions of London bank, Belgian ICSD moves securities held by London bank with it from one account to another.

Example 3

Italian company holds 500,000 shares in a securities account with Belgian ICSD. London broker makes a loan to Italian company. Italian company agrees to transfer the securities to London broker as collateral for the loan. It does this in a two-step process. First, Italian company opens a securities account with London broker and instructs Belgian ICSD to move the securities from Italian company's account with Belgian ICSD to London broker's account with Belgian ICSD; Italian company then instructs London broker to credit the securities to Italian company's new account with London broker. Secondly, Italian company then instructs London broker to effect the transfer of the securities held with London broker by debiting the securities from Italian company's new account and crediting them to London broker's proprietary account on its own books. (The second step is identical to Example 2). Figure D below illustrates this fact pattern.

Figure D



Because London broker became Italian company's intermediary (by means of step 1, the establishment of the account), before the disposition of any securities as collateral for the loan, London broker was (at the time of step 2, the transfer of the securities) the relevant intermediary for the purposes of applying the PRIMA tests of Articles 4 and 5 to the disposition by Italian company of the securities held with London broker to London broker as collateral for the loan.

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